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THE SHAPE OF CHARITABLE GIFT PLANNING AFTER 'REPEAL' OF THE FEDERAL ESTATE TAX

A decade of change will alter some goals of charitable gift and estate planning, but most of the current techniques will survive.

WENDELL R. BIRD

Estate tax "repeal" will take place—for people who die in 2010, but not for the rest of us. Studies and opinions are mixed as to whether an actual repeal will reduce overall charitable donations. Present techniques for estate planning and gift tax planning are affected—but not generally rendered obsolete—by the increase in estate tax exclusion and by a possible repeal, though capital gain planning takes on a new life.

Estate tax 'repeal'

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, which could also mean the Estate and Gift Tax Ruse and Resuscitation Act of 2001) changed the landscape governing estate taxes more than any enactment since 1981. EGTRRA's changes included the following:

- An immediate reduction in the top estate tax rate from 55% to 50%, followed by a gradual reduction of rates from 50% to 45%.
- Repeal of the 5% surcharge (60% rate) on estates above $10 million.
- A gradual increase in the estate tax exclusion from $675,000 to $3.5 million.
- Repeal of the estate tax in 2010 (but not after), immediately followed by a return to the pre-EGTRRA rules in 2011.
- A gradual increase in the generation-skipping tax (GST) exemption from $1 million to $3.5 million, again followed by a return to the pre-EGTRRA rules in 2011.
- A less gradual elimination of the state death tax credit.
- Replacement of the basis step-up at death with carryover basis at death (unless value is less) after 2009.
- An increase in the gift tax exclusion to $1 million (without further increases).

As the Code stands now, total repeal of the estate tax and GST occurs only in the year 2010. Total revival of the estate tax and GST occurs in 2011. Gift taxes are not repealed, even for one year, and the gift tax exclusion does not rise above $1 million with the estate tax exclusion.

Changes in the estate tax. The estate tax exclusion is the amount that can be bequeathed free of federal estate tax to anyone except a

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EXHIBIT I Year-by-Year Effects of the Economic Growth and Tax Relief Reconciliation Act of 2001

(1) Year	(2) Estate Tax Exclusion	(3) Top Federal Estate Tax Rate	(4) Top State Estate Tax Rate	(5) GST Tax Exclusion	(6) Gift Tax Exclusion
2001	$675,000	55% + 5%	16% (part of 55%)	$1,060,000	$675,000
2002	$1,000,000	50%	12% (part of 50%)	$1,060,000	$1,000,000
2003	$1,000,000	49%	8% (part of 49%)	$1,060,000	$1,000,000
2004	$1,500,000	48%	4% (part of 48%)	$1,500,000	$1,000,000
2005	$1,500,000	47%	0% (?)	$1,500,000	$1,000,000
2006	$2,000,000	46%	0% (?)	$2,000,000	$1,000,000
2007	$2,000,000	45%	0% (?)	$2,000,000	$1,000,000
2008	$2,000,000	45%	0% (?)	$2,000,000	$1,000,000
2009	$3,500,000	45%	(?)	$3,500,000	$1,000,000
2010	0	0%	0% (?)	0	$1,000,000
2011	$1,000,000	55%		$1,060,000	$1,000,000

spouse (if a qualified transfer) or a charity. The Code refers to it variously as the "unified credit," the "applicable credit amount,"[1] and the "applicable exclusion amount." The estate tax exclusion increases during the ten-year period shown in Column 2 of Exhibit I, above.[2]

The estate tax top rate drops from 55% to 50% for decedents dying in 2002, then will drop gradually from 50% to 45%, as shown in Column 3 of Exhibit I.[3] The 50% rate in 2002 applies to estates of $2.5 million or more. The 49% rate in 2003 will apply to estates of $2 million or more, while the 45% rate in 2007 through 2009 will apply to estates of $1.5 million or more. The brackets are not inflation-indexed. Despite the downward progression, a real drop in rates depends on the states not modifying their state death taxes to make up for repeal of the state death tax credit. The estate tax is repealed during 2010, but then comes back into force in 2011.[4]

EGTRRA also repealed the 5% surcharge on estates above $10 million, which had the effect of imposing a flat 55% tax on such estates.[5]

State death tax credit and the effect on estate tax rates. The state death tax credit of Section 2011 currently is a carve-out from the federal estate tax (more colloquially called a sop or sponge) that does not increase the total tax on an estate. This credit will be eliminated over a four-year period, from a maximum of 16% in 2001 to 12% in 2002, 8% in 2003, and 4% in 2004. It will be zero in 2005-2010, after which—once again—the repeal sunsets for 2011 and after. The credit is shown in Column 4 of Exhibit I. Beginning in 2005, the state death tax credit will be replaced with a state death tax deduction.[6] This will have the effect of reducing the effective state rates, but will not eliminate them.

Effect of states keeping a death tax. Thirty-seven states currently get as much as 16/55 of the federal estate taxes from the largest estates (16/60 when the 5% surcharge applies), and a significant portion of taxes from other taxable estates via the carve-out approach. In effect, the entire federal rate reduction comes from no longer carving out state death taxes and paying them to the states. Some state statutes provide for continuing independently if the federal estate tax is permanently repealed.

If the states amend and retain their death taxes, the aggregate federal and state rates could increase rather than decreasing, except in 2010. Thus, federal plus state rates on the largest estates could be 54% in 2002, 57% in 2003, 60% in 2004, 63% in 2005, 62% in 2006, and 61% in 2007-2009 (ignoring the effect of the fed-

[1] Section 2010(c).

[2] Sections 2010(c), 2001(c)(2). The estate tax exclusion does not increase for nonresident aliens.

[3] Section 2001(c)(2).

[4] Under Section 2210(b), if a qualified domestic trust (QDOT) is funded by a spouse dying before 2010, the estate tax is not repealed on distributions from the trust to a surviving spouse until 2021. The tax is repealed, however, on distributions from a QDOT funded by a spouse dying after 2009. A QDOT is a trust for a spouse who is not a United States citizen, and who consequently cannot benefit from the unlimited marital deduction. See Sections 2056(d), 2056A.

[5] Former Section 2001(c)(2). EGTRRA also repealed the deduction for qualified family-owned business interests (QFOBIs) for people dying after 2003. Section 2057.

[6] Section 2058(a). The deduction is reduced for nonresident aliens. Section 2106(a)(4).

eral deduction for state death taxes). The effective total tax would be less, but could be larger than before EGTRRA for estates above roughly $3 million after factoring in the deduction for state death taxes, a possible increase in state death taxes, and no increase of the state exclusion. Federal plus state rates on smaller taxable estates could also increase, though less dramatically than on the largest estates.

IN EFFECT, THE ENTIRE FEDERAL RATE REDUCTION COMES FROM NO LONGER CARVING OUT STATE DEATH TAXES AND PAYING THEM TO THE STATES.

The states differ greatly as to whether current death taxes will automatically recognize the increases in federal estate tax exclusion, and whether those taxes will automatically abate with federal elimination of the state death tax credit and carve-out.[7] The states can, however, be expected to amend their current laws to maintain at least much of their current revenue level.

Changes in the GST. The GST generally is a tax on bequests that skip one or more generations (such as a gift to grandchildren). It is imposed in addition to estate tax. The GST exemption is the amount that can be bequeathed tax free to a skip generation. EGTRRA gradually increases the GST exemption in line with increasing the estate tax exclusion, as shown in Column 5 of Exhibit I.[8]

Rules for automatic allocation. Before 2002, the GST exemption was allocated automatically for "direct skips" (so no gift tax return had to be filed to claim the GST exemption), but was not allocated automatically for "indirect skips." After 2001, the GST exemption is allocated automatically for both direct and indirect skips, unless a person elects out of it.[9] Generally, a direct skip is a direct transfer to a person two or more generations removed, or to certain trusts controlled by or solely for such people. An indirect skip is a transfer (other than a direct skip) to a "GST trust." A GST trust is a trust that could involve a generation-skipping transfer unless one of the following conditions is met:[10]

1. The trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons (a) before the date the individual reaches age 46, (b) on or before one or more specified dates that will occur before each individual reaches age 46, or (c) on the occurrence of an event that may reasonably be expected to occur before the individual attains age 46.
2. The trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument who is more than ten years older than such individuals.
3. The trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in 1 or 2, more than 25% of the trust corpus either must be distributed to one or more of their estates, or is subject to a general power of appointment exercisable by one or more of such individuals.
4. The trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if that person died immediately after the transferor.
5. The trust is a charitable lead annuity trust, a charitable remainder annuity trust, or a charitable remainder unitrust.[11]
6. The trust is a trust for which a gift tax charitable deduction was allowed for a right to receive annual payments of a fixed percentage of the net fair market value of the trust property, and which is required to pay principal to a non-skip person if alive when the yearly payments terminate.

The GST exemption now can be allocated retroactively, by a late election, if the order of deaths is unnatural, as provided in regulations. A trust now can be severed into two or more trusts, in a qualified severance, if various requirements are met.

Changes in the gift tax. The gift tax exclusion and estate tax exclusion were unified through 2001. Beginning in 2002, the gift tax exclusion remains level while the estate tax exclusion increases.[12] In 2010, the gift tax

[7] For planning purposes, this means that a federal formula clause for allocating the estate tax exclusion amount to the credit shelter trust (or more than the state exclusion amount), and the residue to the marital trust, which may eliminate federal estate tax on the first spouse's estate, may leave a significant state death tax.

[8] Section 2631(a)

[9] Section 2632(c).

[10] Section 2632(c)(3)(B).

[11] While the allocation is automatic for charitable lead unitrusts, it is not automatic for charitable lead annuity trusts

will remain in place for lifetime taxable gifts of over $1 million, while the estate tax is repealed for the year. Changes in the gift tax exclusion are shown in Column 6 of Exhibit I.

From 2002 through 2009, the gift tax rates will be the same as the estate tax rates. Beginning in 2010, the year of estate tax repeal, the maximum gift tax rate will be 35%—the maximum income tax rate.

Before 2002, a number of techniques could be used to prevent a gift from being completed, thereby delaying gift tax. After 2009, most transfers to trusts will be treated as completed gifts, and thus potentially taxable gifts, unless the trust is a grantor trust wholly owned by the donor or the donor's spouse.[13]

Changes in basis step-up and carryover. Until 2010, the tax basis of assets owned at death is stepped-up to their fair market value under Section 1014. After 2009, the tax basis will be carried over to the beneficiaries, at the lower of the decedent's adjusted basis or the fair market value under new Section 1022. Any decedent will, however, be allowed a $1.3 million basis increase ($60,000 for nonresident aliens) and a surviving spouse will be allowed an additional basis increase of $3 million. The $1.3 million increase will be increased by unused built-in losses and loss carryovers. All three figures will be indexed for inflation. There will be three requirements for obtaining these increases in basis:

1. The property will have to be "owned by the decedent at the time of death." This will include half of property jointly owned with the surviving spouse, the proportionate share of other joint property, half of community property generally, and property transferred during life to a qualified revocable trust, but not property over which the decedent holds a power of appointment.
2. The property will have to be "acquired from the decedent." This will include property transferred by the decedent during life to a qualified revocable trust, and property transferred during life to a trust taxable in the estate because of a power to alter, amend, or terminate.
3. In the case of the $3 million increases for spouses, the property will have to be "qualified spousal property," a term that generally covers the same property that qualifies for the marital deduction—either outright transfer property or qualified terminal interest property (QTIP). This term excludes property subject to a power of appointment. The surviving spouse will not then be able to allocate his or her $1.3 million to a QTIP trust.

Property constituting the right to receive income in respect of a decedent (IRD) will not be eligible for a basis increase. Other property not eligible for such an increase will include:[14]

- Property acquired by the decedent by gift or inter vivos transfer for less than fair market value during the three years before death.
- Securities of a foreign personal holding company.
- Stock of a domestic international sales corporation (DISC) or former DISC.
- Stock of a foreign investment company or of a passive foreign investment company (unless a qualified electing fund election has been made).

Under the post-2009 rules, the $1.3 million step-up generally should be fully used before the $3 million step-up is used by estates that cannot fully use both. The reason is there are fewer restrictions on the $1.3 million step-up, whereas assets given to a spouse for the $3 million will be subject to estate tax in the spouse's estate if total assets exceed the estate tax exclusion and an estate tax remains in effect.

Section 121 currently allows the exclusion of gain from the sale of a living person's principal residence to the extent of $250,000 for a single individual or $500,000 for joint owners. EGTRRA extends this rule to the decedent's estate and to the beneficiaries of a qualified revocable trust, effective for people dying after 2009. The same requirements will apply. The residence will have to have been used as the decedent's principal residence for two or more of the five years immediately preceding the date of sale, but an heir occupying the residence may add his or her period of occupancy.

BEGINNING 2002, THE GIFT TAX EXCLUSION REMAINS LEVEL WHILE THE ESTATE TAX EXCLUSION INCREASES.

Effect of 'repeal' on charitable giving levels

Countless speeches by estate planners have been built on the estimate from 1990 by Avery and

[12] Section 2505(a)(1). The gift tax exclusion is not available to nonresident aliens.

[13] Section 2511(c).

[14] Sections 1022(d)(1)(C), (D).

Rendall that $10.4 trillion would change hands in the 55 years from 1990 to 2044—$189 billion per year.[15] A more recent study by Havens and Schervish gave a "low-range best estimate" of $41 trillion in the 55 years from 1998 to 2052—$745 billion a year.[16] This led them to conclude, even before the 1999-2000 Internet bubble and its bursting in 2000-2001, that "a golden age of philanthropy is dawning, especially among wealth holders and the upper affluent."[17]

Effects before 2009. Estate tax rates do not drop very significantly before 2010. The estate tax exclusion does not go above $2 million until 2009. Right now, most estates of $2 million per spouse can avoid estate tax by planning, without needing to make charitable contributions to achieve that result. Thus, one lawyer writes,

> There really should be very little, if any, effect on charitable planning through 2009. As stated above, the prospective decedent will need to plan as if death could occur at any time, and the rates will remain high until the one-year repeal in 2010. Thus, the effect of the Act on charitable planning should be de minimis.[18]

THE $1.3 MILLION STEPUP GENERALLY SHOULD BE FULLY USED BEFORE THE $3 MILLION STEPUP IS USED BY ESTATES THAT CANNOT FULLY USE BOTH.

Few speakers and writers give odds in favor of the estate tax actually being repealed for any year other than 2010. It appears that clients are being counseled that permanent repeal is a chimera rather than a reality. Thus, it is unlikely that clients will alter their charitable behavior until 2009 or 2010 arrives and until repeal is actually extended.

> Given that the repeal of the estate tax is only to last for one year and that the gift tax is to remain, the Act is unlikely to have any effect on charitable testamentary planning.
>
> Should future legislation make the 2010 regime permanent, the effect would be far more pronounced.[19]

Arguments for a dramatic fall in bequests. Independent Sector commissioned a study by what is now PricewaterhouseCoopers, and described it as concluding that "repeal of the estate tax would likely reduce charitable bequests by one-tenth to one-third—or $1.5 to $5 billion a year."[20] The study estimated that repeal of estate tax would have reduced a one year's $8.5 billion in charitable bequests to $5.5 billion—a $3 billion difference in that year's total charitable giving of $190 billion.[21] Independent Sector took the position of "oppos[ing] repeal of the estate tax" for several reasons, including the likelihood that it "would eliminate a strong incentive to give through an individual's estate." While noting that "repeal would leave more wealth in private hands and this positive wealth effect could stimulate increased giving," at the same time "repeal would eliminate the tax incentive to give and this could likely reduce giving."[22]

The Council on Foundations, while not taking a formal position, did cite this and other studies as showing a negative impact of repeal on charitable giving.[23] A Treasury Department economist, David Joulfaian, in a study of estate tax returns for 1992, concluded that repeal of the estate tax would reduce charitable bequests by about 12%.[24] Professor Leslie Lenkowsky, head of the Corporation for National Community Service, appeared to rely on these studies in saying that "[e]liminating [estate tax] will reduce bequests by 12% to 31%.... This would translate into a loss of $2 billion to $5 billion in gifts to charity."[25]

A study by William Gale of the Brookings Institute and Joel Slemrod of the University of Michigan Business School argued that repeal of the estate tax would have a negative effect on charitable bequests, principally because the most taxed estates are the most donative estates. "In 1997, of the 329 taxable estates with

[15] Avery and Rendall, "Estimating the Size and Distribution of the Baby Boomers' Prospective Inheritances," Study from Department of Consumer Economics & Housing (Cornell University, 1990).

[16] Havens and Schervish, "Millionaires and the Millennium: New Estimates of the Forthcoming Wealth Transfer and the Prospects for a Golden Age of Philanthropy," Study from Social Welfare Research Institute (Boston College, 1999).

[17] *Id.* at 23.

[18] Duronio, "Charitable Gift Planning After the 2001 Tax Act," 13 Exempts 146 (Nov/Dec 2001).

[19] *Id.* at 148.

[20] "Statement by Peter Shiras, Senior Vice President, Independent Sector," www.independentsector.org/media/taxstatement.html.

[21] Price Waterhouse, "Impact of Tax Restructuring on Tax-Exempt Organizations" (1997); see PriceWaterhouseCoopers, "Incentives for Nonitemizers To Give More: An Analysis Prepared for Independent Sector" (Jan. 2001).

[22] "Independent Sector Policy Position on the Estate Tax and Charitable Tax Bequests," www.independentsector.org/programs'gr'estateposition.html (Mar. 2001).

[23] "Estate Tax Repeal," Council on Foundations, www.cof.org/government/GovRelations/issuepapers/gift.htm (8/16/01).

[24] Joulfaian, "Estate Taxes and Charitable Bequests by the Wealthy," National Bureau of Economic Research Working Paper 7663 (Apr. 2000).

[25] "Estate Tax," Wall St. J. (1/5/01). Lenkowsky was earlier the professor of Philanthropic Studies and Public Policy at Indiana University.

gross estates in excess of $20 million, 182 made charitable contributions and those that did contributed an average of over $41 million!"[26] The next year, 1998, the 595 estates with $10-20 million in assets produced nearly 50% of the deductions for charitable bequests, and only a third as many estates with more than $20 million in assets produced about 40% of the deductions for charitable bequests.[27] Of course, those were the estates paying a large portion of estate tax.

One of the more visible statements opposing estate tax repeal was the "petition signed by hundreds of wealthy Americans" led by Bill Gates' father, which was published in the *New York Times* and other newspapers:

> Only the richest 2 percent of our nation's families currently pay any estate tax at all. Repealing the estate tax would enrich the heirs of America's millionaires and billionaires while hurting families who struggle to make ends meet.
>
> ***
>
> The estate tax exerts a powerful and positive effect on charitable giving. Repeal would have a devastating impact on public charities ranging from institutions of higher education and land conservancies to organizations that assist the poor and disadvantaged.[28]

While the signers indeed include a few names from the Forbes 400 list (Gates Sr. is not one, but David Rockefeller, Jr., Steven C. Rockefeller, George Soros, Susan Packard Orr, and Ted Turner are), most of the signers are university professors (only a few of whom, such as John Kenneth Galbraith, would likely face any estate tax under the old law), attorneys, foundation officers, and the like.

Many others have opposed repeal of estate taxes. The administration's first director of faith-based and community initiatives, John DiIulio, opposed repeal.[29] The head of a National Council of Nonprofit Associates, Sheri Brady, was typical of the majority of positions taken by those charities that announced positions, in saying that repealing the estate tax "will result in a loss of revenue for programs that benefit the most needy ... while reducing donations to these same [nonprofit] organizations."[30]

Arguments against a dramatic fall in bequests. The Heritage Foundation conducted a survey and reached the opposite conclusion. Because there are fewer studies taking the pro-repeal position, it is quoted at greater length than the anti-repeal studies. The ultimate conclusion was that:

> The critical economic factor in the level of donations is income, not tax breaks. When the economy is strong, donations rise. Thus, with reductions in marginal tax rates stimulating the economy and personal income, the most likely result (mirroring the historical pattern) would be an increase—not a reduction—in donations....
>
> ***
>
> Although changes in the tax may alter the manner and timing of charitable contributions, it is unlikely that they would have any significant effect on total giving—except possibly to increase it.[31]

Moreover, the study noted, total charitable donations in 1999 were $190.16 billion, and estate bequests were $15.61 billion, so that even a reduction of $3 billion would amount to only 1.5%, which could easily be compensated for by a small increase in economic growth.

The study reasoned as follows:

1. The economy is "the critical factor" in the level of donations; and to the extent that tax policy spurs economic growth, donations will increase. Moreover, the level of charitable giving as a percentage of income and economic output has remained relatively constant for decades. "This pattern suggests that steps to stimulate economic growth (and thus personal income growth) ... are very likely to be associated with increased giving.
2. There is no significant long-term effect from changes in income tax rates. The Foundation pointed out that over the past two decades there have been "quite dramatic" changes in marginal tax rates, the number of tax brackets, and other changes that influence the after-tax "price" of charitable donations. "During most of these changes," it said, "concerns very similar to the worries expressed

IT APPEARS THAT CLIENTS ARE BEING COUNSELED THAT PERMANENT REPEAL IS A CHIMERA RATHER THAN A REALITY.

[26] Gale and Slemrod, "We Tax Dead People," www.brook.edu/views/papers/gale/20000612.htm, p. 18 (6/12/00).

[27] Chronicle of Philanthropy, 7/27/00.

[28] "Wealthy Campaign Against Estate Tax Repeal," www.taxplanet.com/prez/pestate-petition-text/pestate-petition-text.html (Feb. 2001). See "Plan to Repeal Tax Draws New Critics," Chronicle of Philanthropy, p. 42, 2/22/01.

[29] "Defending the Estate Tax," N.Y. Times, 2/16/01.

[30] "Elimination of the Estate Tax Won't Do Charities Any Good," Chronicle of Philanthropy, 2/8/01. See also "Phase-out of Estate Tax Will Make It Tougher to Raise Funds Over Long Term, Experts Say," Chronicle of Philanthropy 27, 6/14/01.

[31] Butler, "Why the Bush Tax Cuts Are No Threat to Philanthropy," Heritage Foundation Backgrounder No. 1417, p. 2, 3/8/01.

today were raised about the impact of the tax proposals on philanthropy.... [T]here is no indication of any significant relationship between these tax changes and charitable giving over the long term."

3. Thus, "[r]eduction or repeal of the estate tax is unlikely to have a major impact on giving." Specifically:

> The professional economic research in recent years has tended to support the view that the permanent income/overlapping generations motive has dominated household savings and bequest behavior in the United States. This implies that any public policy that increases the amount of savings available to households—such as eliminating estate taxes or other taxes on savings—will increase the "residual" left to charitable organizations as well.[32]

Professor Paul Schervish, director of the Social Welfare Research Institute at Boston University, formerly opposed repeal of the estate tax, but changed his position after concluding that repeal would generate more direct charitable gifts.[33] A Harris Interactive survey concluded that "[e]liminating the federal estate tax would not cause most people, including the wealthiest Americans, to change their charitable giving habits."[34] Fully three-quarters of women and 71% of men said "repeal in estate laws would not affect giving," and the remainder were likely not unified about which direction repeal would affect their giving.

LIFETIME CHARITABLE GIFTS WILL CONTINUE TO GENERATE AN INCOME TAX DEDUCTION, WHICH WILL BE COMPARATIVELY MORE VALUABLE.

There are other factors that would exert a mollifying effect on charitable donations:

- Taxable estates are only 2% of total estates, and charitable bequests are less than 8% of giving.[35]
- Some giving, such as religious tithing, is relatively unaffected in amount by tax consequences
- Most charitable giving is for charitable rather than tax purposes; no donor is better off by making a charitable donation than not; and any tax-oriented bequests to avoid estate tax would be replaced by tax-oriented gifts to avoid the replacement carryover basis.[36]

Many other opinions, including President Bush's,[37] have supported repeal of the estate tax. A counter-petition to the Gates petition, also appearing in full-page advertisements in the *New York Times* and *Washington Post,* said that "African-American Business Leaders Call for End to Estate Tax," and was signed by many notable entrepreneurs.

Effect of 'repeal' on charitable gift planning

Regardless of the effect these changes have on charitable bequests overall, individuals planning their giving and their estates will face choices based on how the law stands now and how it may stand in the future.[38]

Impact on charitable gift planning techniques. Whether or not repeal of the estate tax becomes more than a one-year wonder, the shifting rules that will govern the next few years will affect the well-known vehicles of gift and estate planning.

Lifetime gifts. Lifetime charitable gifts will continue to generate an income tax deduction, which will be comparatively more valuable if there is no estate tax and no estate tax deduction. In other words, it will be better to make charitable gifts during life than at death. Lifetime gifts of highly appreciated assets will become more attractive when the estate step-up in basis ends after 2009 and heirs would otherwise pay capital gains tax.

Testamentary charitable gifts will remain attractive, particularly for IRD assets—401(k) plans, IRAs, and other qualified retirement plans—because they will be subject to income tax at ordinary income rates. Testamentary gifts will also be attractive for the most appreciated capital gains assets because those assets would

[32] *Id.* at 8.

[33] "Philanthropy Can Thrive Without an Estate Tax," Chronicle of Philanthropy 47 (1/11/01).

[34] "New Poll Shows How Wealthy View Estate Tax," Chronicle of Philanthropy 23, 1/25/01). The full poll can be obtained for a mere $1,950 from HNW Digital, jkerwin@hnwdigital.com; see www.hnwdigital.com.

[35] In 2001, according to the American Association of Fundraising Counsel Trust for Philanthropy, charitable contributions were $203 billion. Bequests made up $16 billion of this, or 7.8%. "Gifts to Charity in U.S. Topped $203 Billion in 2000, Study Says," N.Y. Times (5/24/01).

[36] To the extent higher estate taxes produce higher charitable giving, three factors may maintain the present estate tax levels and so maintain charitable giving. First, estate taxes have not been repealed except in 2010, and to the extent donors do not believe the repeal will be extended, charitable contributions will be unaffected. Second, estate taxes are only reduced at the highest rates and not at the lower rates until 2010, and the estate tax credit does not rise above $2 million until 2009-2010. Third, states may raise the effective rates between 2002 and 2010, by imposing state inheritance taxes in place of the carve-outs that were repealed by EGTRRA. While the top federal rates drop from 55% to 45%, states may increase their additional inheritance taxes by as much as the 16% carve-out.

[37] "Governor George W. Bush: 'A Tax Cut with a Purpose,'" page 10 (1999).

[38] Note that special rules apply to charitable contributions of nonresident aliens. Section 873.

be subject to capital gains tax after 2009 when they were sold (if the $1.3 million step-up and, when a surviving spouse was involved, the $3 million step-up to a surviving spouse were used). Allocating these assets to charitable bequests will be an important part of post-mortem planning.

Testamentary charitable gifts do not provide an income tax deduction, but testamentary marital gifts followed by the surviving spouse's charitable gift do.

CRTs. Lifetime charitable remainder trusts (CRTs) will remain and will be more frequently used as a way to sell assets with deferral or elimination of capital gains tax—when those assets need to be sold before the stepped-up basis rule ends in 2010—and to get an income tax charitable deduction.[39] Lifetime CRTs benefiting the donor should be unaffected by estate tax repeal, while lifetime CRTs benefiting another person should become limited to the donor's life, since any post-death support will be free of estate tax after repeal if added by will. A lifetime CRT for another person that extended beyond the donor's life would be an unnecessarily large gift that could instead be extended tax-free by a bequest.

Testamentary CRTs will be popular for people who expect to die after 2009, because they will defer or avoid future capital gains tax on all appreciation. If estate tax repeal is made permanent, an unlimited amount could be given via CRTs, and a 10% minimum interest for charity would avoid a 20% federal capital gains tax as well as state capital gains tax. The charitable interest would be deferred, while the capital gains tax would be fairly immediate after death.

People with spouses, however, will find it better to use a QTIP trust, with or without a charitable remainder. The $1.3 million and $3 million step-ups in basis cannot be allocated to CRTs, while they can be allocated to a QTIP trust.

Remainder interests in residences and pooled income funds. The impact of estate tax repeal on these gifts will parallel the impact on CRTs. A charitable gift of a remainder interest in a personal residence or farm enjoys an exception from the usual rule denying charitable deductions for contributions of partial interests.[40] A gift to a pooled income fund is an irrevocable transfer of assets in return for a lifetime income interest, followed by a charitable remainder.[41]

Effect on CLTs. Lifetime charitable lead trusts (CLTs—the non-grantor type) will gain a little appeal by the reduction in income tax rates, because they will generate a charitable deduction at the higher current rates and will cause future grantor taxation at the slightly lower future rates. In addition, they will remain the most effective way to leverage the $1 million gift tax exclusion into a larger amount to be delivered at a later date (such as when a child or children reach a certain age) that will arrive before the expected date of any estate tax repeal. (If permanent repeal occurs, there would be no tax need to make lifetime gifts for delivery after that date, because a testamentary gift could do the job.)

CLTs with generation skipping will continue to require careful choices—between grantor and non-grantor types, and between annuity and unitrusts—to ensure that gifts do not exceed the GST exemption so long as the GST remains in existence.

Testamentary CLTs will lose their uses once there is no estate tax to minimize. It will be better simply to bequeath the assets outright or in trust to heirs and to charity. There is no advantage from CLTs in selling appreciated property.

MOST CURRENT TECHNIQUES FOR MINIMIZING ESTATE TAXES WILL REMAIN USEFUL UNTIL REPEAL ACTUALLY OCCURS.

Effect on charitable gift annuities. There should be no negative impact of estate tax repeal on these gifts. Charitable gift annuities are only set up during life and are not subject to estate tax. The taxes affecting them are income taxes, because the donation establishing the charitable gift annuity provides a charitable deduction, and appreciated assets avoid capital gains tax. Like CRTs, however, charitable gift annuities may become more popular because of estate tax repeal, as a way to sell assets with elimination of capital gains tax.

IRA, 401(k), and qualified plans. Lifetime gifts of an employee's interest in an IRA, Section 401(k) plan, or qualified plan (all of which would be IRD assets) will be beneficial only if proposals are enacted to allow charitable gifts without penalty before the retirement date.

Testamentary gifts of IRAs, 401(k)s, and other qualified plans will remain attractive, since the income tax on them will continue even if the estate tax is repealed, leaving them the least

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[39] Sections 664, 170(f)(2)(A).

[40] Section 170(f)(3)(B)(i).

[41] See Section 642.

attractive assets for noncharitable heirs to receive. IRD assets are less attractive to noncharitable heirs because they are subject to income tax, are taxed at ordinary income rates, and cannot receive any allocation of the $1.3 million or $3 million step-up in basis after 2009.

Impact on general estate planning techniques. Besides effects tied to specific types of planned giving vehicles, estate tax repeal, if made permanent, would also affect noncharitable planning techniques.

Credit shelter trusts and marital bequests. The moving target of varying estate tax exclusions will cause mischief with existing formulas, and make any formulas difficult to apply. A common pre-2002 formula allocated to the credit shelter trust (one funded with the portion of the estate exempted from tax by the decedent's estate tax exclusion) the maximum amount that can be bequeathed tax free, and allocated to the marital trust the remainder of the estate. This can have the effect in 2009 of allocating $3.5 million to the credit shelter trust and—for an estate of less than $3.5 million—nothing to the marital trust. In 2010, the same formula can allocate the entire estate to the credit shelter trust. The smaller the estate, the bigger the problem of underallocating to the surviving spouse.

IF REPEAL IS CONTINUED BEYOND 2010, MINIMIZING CAPITAL GAINS TAX (AND STATE INHERITANCE TAXES) WILL REPLACE MINIMIZING FEDERAL ESTATE TAX AS THE FOCUS OF PLANNING.

Possible solutions include (1) a pecuniary limit on the amount going to the credit shelter trust, (2) a pecuniary limit on the amount going to the marital trust with the remainder to the credit shelter trust, (3) fractional shares to each, (4) an income interest or limited withdrawal power for the spouse in the credit shelter trust, or (5) an independent executor's power to grant an income interest to the surviving spouse. Other suggestions have been advocated as well.

The spousal step-up in basis after 2009 also introduces complications. A formula that underallocates to the marital trust (or to a marital trust that is not "qualified spousal property," such as a QTIP trust) can waste the $3 million of step-up in basis for qualified spousal property. It can also leave the surviving spouse without sufficient assets to use his or her own $1.3 million step-up in basis.

Techniques for minimizing estate tax. Most current techniques will remain useful until estate tax repeal actually occurs, except that lifetime taxable gifts will generally be inadvisable because the gift tax exclusion will be less than the estate tax exclusion in 2003-2010. Likely to remain among the leading techniques are:

- Living to 2010 or at least to a year with a high estate tax exclusion (though the step-up in basis will be lost in 2010 and after).
- Lifetime nontaxable gifts to reduce taxable estates and shift appreciation.
- Charitable contributions to reduce taxable estates and to support worthy charities.
- Using insurance purchases or transfers through irrevocable life insurance trusts to remove life insurance from taxable estates.[42]
- Marital deduction bequests to defer estate tax to a spouse's taxable estate, to use the $3 million step-up, and to fund a spouse's $1.3 million of basis step-up.
- Discounted bequests via grantor retained annuity trusts (GRATs), family limited partnerships (FLPs),[43] charitable trusts (discussed above), and other devices. Because they typically involve a term of ten years or more, qualified personal residence trusts (QPRTs)[44] remain useful only to the extent it is unlikely that estate tax repeal will be extended beyond 2010.
- Estate "freezes" via freeze FLPs and installment sales.

If estate tax repeal takes place, dynasty trusts will become more popular as a mechanism for transferring assets and income streams to children, grandchildren, and future generations (subject to the limits imposed by the GST tax).

When the step-up in basis is lost after 2009, the planning focus will shift to minimizing capital gain tax.

Techniques for minimizing gift tax. Lifetime gifts will continue to be used to reduce taxable estates, because there is an estate tax every year until 2010 and possibly thereafter. Some of the most useful techniques will continue to be:

- Annual exclusion gifts.
- Insurance through an irrevocable life insurance trust, since premiums can avoid gift tax by use of the annual exclusion or the gift tax exclusion.

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[42] Irrevocable transfers of life insurance escape estate and gift tax after a three-year look-back.

[43] See generally Bird, "Family Limited Partnerships and Marketable Securities," 27 Tax Management Estates, Gifts & Trusts J. 131 (May 2002).

[44] Bird, "Qualified Personal Residence Trusts (QPRTs) and Estate Planning," Estate Planner's Alert (CCH) 3, Nov. 2000

- Lifetime gifts, particularly when leveraged through discounting techniques such as GRATs,[45] FLPs, QPRTs (if estate tax repeal is unlikely to occur), defective grantor trusts (DGTs), charitable trusts, and other devices.
- Lifetime gifts to freeze values through freeze FLPs, sales to DGTs, and installment sales.
- Lifetime loans that will be forgiven by will when there is no estate tax. If the interest is only accrued and not paid, however, the original issue discount (OID) rules may apply.

Techniques for minimizing generation-skipping tax. The GST exemption drop after 2010 makes it advantageous for large estates to fund a generation-skipping trust in 2009, when the GST exemption is $3.5 million, or in 2006-2008, when it is $2 million.[46]

Techniques for minimizing capital gains tax. If the estate tax repeal is continued beyond 2010, minimizing capital gains tax (and state inheritance taxes) will replace minimizing federal estate tax as the focus of planning. Many assets will be preserved from capital gains tax by the $1.3 million and $3 million basis stepups, and by the $250,000 primary residence exclusion. After that, some of the leading techniques will be:

- Charitable gifts and bequests of highly appreciated assets, since families will pay capital gains tax but charities will not.
- Lifetime loans to be forgiven at death (at least if the OID rules do not apply), until Congress realizes that this is an obvious route around a high gift tax and a zero estate tax.
- Insurance, either to pay the capital gains tax or to replace appreciated assets donated to charity.

Conclusion

Estate and deferred contribution planners cannot afford to assume that estate tax repeal will actually occur, or that it will become permanent, or that their clients will live until that doubtful time. Thus, most pre-EGTRRA techniques remain viable at least until repeal becomes effective, and most (but not all) remain viable thereafter, in many cases to reduce capital gain that results from loss of basis stepup at death. ■

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[45] Zero GRATs are possible. Walton, 115 TC 589 (2000).

[46] This assumes that when the GST exemption drops back to $1,060,000 in 2011 and after (as adjusted for inflation), it will not penalize generation-skipping trusts created when the GST exemption was higher. Whether that will be so is not knowable until Congress tinkers with the estate tax, or the IRS promulgates regulations.