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George Steinbrenner's estate tax homerun

By Robert J. Kolasa

George Steinbrenner, the irascible owner of the New York Yankees, hit the ball far over the fence (for tax purposes anyways) when he passed away on July 13, 2010 with a purported $1.1 billion estate. If he had died last year, the executors of George's estate could have faced federal estate taxes of almost $500 million, depending on how the estate was structured. However, since Mr. Steinbrenner died in 2010 (a year in which there may be no federal estate taxes), his heirs pitched the proverbial perfect game and escaped with a *zero* estate tax bill.

The reason for this windfall dates back to June 7, 2001, when President George W. Bush made good his campaign pledge and signed the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").[1] Such legislation for tax years 2002-2009 slowly raised the federal estate tax exclusion amount from $675,000 to $3.5 million, culminating in the complete repeal of the federal estate tax in 2010 (jokingly referred to by tax lawyers as the 'Throw Grandma from the Train' year). To avoid an avalanche of wealth being transferred to low-income tax jurisdictions, the gift tax (affecting lifetime transfers) was retained with a $1 million exclusion amount and 35 percent top tax rate for 2010.

Due to budgetary constraints and the inability to gain 60 votes in the Senate, EGTRRA provided for a bizarre 'sunset' rule repealing such law in its entirety after December 31, 2010 as if such legislation had never been enacted.[2] This means that estate tax repeal (along with the other 2001 Bush tax cuts) magically expires in 2011, so that federal estate taxes are restored in that year with a $1 million exclusion amount. Correspondingly, Illinois changed its statutory scheme to parallel EGTRRA's sunset by providing no Illinois estate taxes for 2010, with a return in 2011 to the good old days of the $1 million estate tax exclusion and 2011 credit computations.[3]

Almost no estate planning attorney (including this author)[4] expected estate tax repeal to become reality in 2010. The most popular accepted belief was that the 2009 estate tax regimen ($3.5 million federal and $2 million Illinois estate tax exclusions) would be made permanent for 2010 and later years. In December 2009, there was a failed bid (H.R. 4154) to make the 2009 law permanent. Although both political parties accused the other of gridlock, in the end the Democrats did not have the votes and were unwilling to adopt Republican demands to increase the $3.5 million exclusion amount and downstroke the top 45 percent estate tax rate.

The Unlikely Possibility of 2010 Estate Tax Retroactivity

Incredibly, since no political compromise was forthcoming, at the stroke of midnight on December 31, 2009, the federal estate tax was repealed for 2010. Estate planners were shocked and in disbelief. The common mantra was that *surely* Congress would come to its senses and reinstate estate taxes retroactively in early 2010. Putting aside partisan politics about whether the estate tax is a good thing (its detractors portray it as double taxation on wealth previously subject to income taxes, while supporters decree it as good social policy crimping the institutionalized wealth of the rich), the reality is that most estate planners did not want to delve into the problematic 'carryover basis' tax regimen (discussed below) replacing estate taxes.

Accordingly, for the first half of 2010, we all waited for federal estate tax legislation to retroactively restore the estate tax effective January 1, 2010. Based on the *Carlton*[5] case, most tax scholars thought that retroactive estate tax legislation was constitutional and would be upheld by the Supreme Court. However, in the midst of legislative gridlock (mainly caused by the Obama administration's health care initiative), a

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curious thing began to happen—TAXPAYERS BEGAN DYING IN 2010! Lo and behold, estate tax repeal was no longer an issue to be theoretically discussed on a gentlemanly fashion in tax journals; it was a real issue affecting the estates of deceased taxpayers.

There's nothing like the death of billionaires to bring the estate tax back into the spotlight. Besides Mr. Steinbrenner, other billionaires who have died this year include real estate developer Walter Shorenstein and Houston energy magnate Dan Duncan. Mr. Duncan's fortune (estimated by Forbes magazine to be $9 billion) made him the 74th wealthiest person in the world. Had he died last year, Mr. Duncan's executors could have faced federal estate taxes of almost $4 billion, depending on how his estate was structured.

It goes without saying that the executors of the rich and famous (such as Messrs. Steinbrenner, Shorenstein and Duncan) would eagerly reserve millions of dollars to fund a legal battle challenging retroactive 2010 estate tax legislation, if such legislation ever became law. However, to the delight of this constituency, Congress *appears* (a hedge is always necessary when speaking about this legislative session) to have given up serious consideration of retroactive estate tax legislation. So, George Steinbrenner's heirs can probably retain his beloved New York Yankees in their portfolio without the liquidity drain of hundreds of millions of estate tax dollars.

The practical problem is that the fiduciary of a decedent who dies in 2010 should probably retain a reserve for 2010 estate taxes as a hedge against retroactive estate tax legislation, however unlikely. This may greatly annoy estate and trust beneficiaries, but the executor/trustee really has no choice but to hold such funds (or face personal liability) until the situation becomes clear. The worst case scenario is that retroactive 2010 estate tax legislation triggers a lengthy court battle challenging the law's constitutionality. This process could take years and ensure the earmarking of billions in estate tax reserves (held by the IRS?) until the litigation is resolved.

Risky Business—Predicting the 2011 Estate Tax Law

The latest bipartisan effort (introduced July 14, 2010) to deal with the federal estate tax was by Senators Jon Kyl (R-AZ) and Blanche Lincoln (D-AR).[6] Their proposal would require the Senate Finance Committee to amend H.R. 5297, the Small Business Lending Fund Act of 2010, to permanently set the estate tax rate at 35 percent, with a $5 million exemption amount phased in over 10 years and indexed for inflation. It would also provide an election for deceased taxpayers to either retain this year's estate tax repeal (with carryover basis) or pay estate taxes under the provisions of the new bill. This measure resembles prior (mostly Republican) efforts to reach a compromise.

It appears that at least for now, the Democratic leadership has rejected the Kyl-Lincoln proposal. The following statement by Democratic Senator Robert P. Casey Jr. (D-PA) appears to be a good indication of the tenor of the Democratic position (which generally adopts a $3.5 million exclusion, with a top rate of 45 percent):

> For the life of me I can't understand why those who claim to be fiscally responsible want to have a much more generous tax break for the wealthiest of the wealthy...Or I should say, the wealthiest of the extremely wealthy.[7]

Political reality seems to be that we will have to wait until after the November elections to see if Congress will address the estate tax situation. Most probably, the possibility of retroactive 2010 estate tax legislation is dead and the fight will be between one of rates (35 percent to 45 percent) and estate tax exclusions ($3.5 million to $5 million). It is also likely that once the federal estate tax exclusion is reinstated to at least $3.5 million, that Illinois in its current budgetary throes will reenact the $2 million Illinois estate tax exclusion that was in existence under 2009 law (creating differences between the federal and Illinois exclusion amounts, along with the Illinois QTIP election to deal with this mismatch).[8]

The 600-pound gorilla in the room is what if Congress once again (ala December 2009) becomes mired in gridlock and no legislation is passed. The result would be unbelievably ugly—the return of the pre-EGTTRA estate tax exclusion of $1 million and top rates of 55 percent. If this happens, the amount of estate-tax-driven legal work would exponentially explode, with clients suddenly pulling their heads out of the sand to cope with confiscatory estate taxes. While good for business, reenactment of the draconian pre-EGTTRA estate tax laws is one scenario this estate planner hopes will never happen.

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Dealing with the 2010 'Carryover Basis' Law

For better of worst, all estate planning professionals should have a rudimentary understanding of the current 2010 federal estate tax law. There has been a natural inclination of many not to study this matter given the possibility of the retroactive restoration of the estate tax. As discussed above, since the possibility of retroactive legislation is remote, a technical knowledge of the 2010 rules is advisable to properly administer 2010 estates.

The most prominent feature of the 2010 law is the implementation of "carryover basis" (in lieu of the long standing 'stepped up' basis rules). By way of explanation, when a taxpayer sells an asset, there is generally an income tax on the difference between the sales proceeds and 'cost basis' (what was paid for the asset). Under the pre-2010 rules (Code Section 1014(a)), when a person died the cost basis was generally increased ('stepped up') to its value on date of death. When the asset is later sold, only the difference between the sales proceeds and date of death value would generally be taxed. Although estate taxes could be generated by the inclusion of the asset in the estate tax base, the forgiveness of pre-death appreciation for income tax purposes constituted a major countervailing tax benefit.

Under the new 2010 rules (Code Section 1022), the basis of the decedent's property is first calculated as the *lesser* of its cost basis, or fair market value at date of death. The decedent's executor may then allocate up to $1.3 million, to increase the bases of assets up to their fair market value. For example, assume a decedent owns a piece of real estate worth $3 million on death for which the basis is $500,000. Under Code Section 1022, the decedent's $500,000 basis would initially remain the same upon death (i.e., the 'carryover' to heirs). The executor may then increase the basis of the real estate to $1.8 million by allocating the entire $1.3 million basis increase to that asset. In addition to the $1.3 million basis increase, the decedent's fiduciary could also allocate an additional $3 million to increase the bases of assets (not exceeding fair market value) that the surviving spouse receives outright or through a QTIP trust (called "qualified spousal property"). Both basis adjustments are indexed for inflation for years after 2010.

The provisions of Section 1022 are complex and contain many special provisions requiring careful reading and implementation, some of which may greatly complicate estate and trust administration.[9] By far, the biggest condemnation is that the new rules are fundamentally impractical as requiring detailed inter-generational keeping of cost basis records which will not be accurately maintained by clients. Other major criticisms of these rules are that (1) in the absence of express guidance in the will or trust, beneficiaries will disagree upon the method of basis allocation selected by the executor, thereby imposing possible liability on the fiduciary for breach of fiduciary duty; (2) when assets are held in various ways by the decedent (i.e., trust, will, joint tenancy or via beneficiary designation), multiple persons will be deemed executors for tax purposes, resulting in the compilation of inconsistent basis allocations and returns; (3) many existing trusts and wills are not optimized to fully utilize the allowable basis increases, in particular the $3 million spousal adjustment, resulting in the 'wasting' of such basis increases; and (4) for some estates with substantial appreciation, more taxes will be incurred under the Section 1022 rules than under pre-2010 law.[10]

Tax return preparers can take solace in that for 2010, the new rules may actually *increase* the number of returns required to be filed for decedents. In lieu of estate tax returns, Code Section 6018 requires the filing of informational returns (detailing the Section 1022 basis adjustments) if the fair market value of the decedent's property (other than 'cash')[11] exceeds $1.3 million. Presumably, the IRS will develop some type of automatic basis adjustment rule for estates having less than $1.3 million in non-cash assets. The IRS must have been waiting in line with practitioners for repeal of the carryover basis tax regimen, as the Section 1022 forms have not yet been released as of early August 2010.

The biggest technical headaches generated by the new law relate to the Generation Skipping Transfer Tax ("GST"). While a detailed explanation of the GST is well outside the scope of this paper, suffice it to say that the GST closed a loophole in the estate and gift tax system where property could be transferred to successive generations without intervening estate or gift tax consequences. For 2009, the GST generally imposed an *additional* 45 percent tax for transfers to 'skip persons' (i.e., grandchildren, or lower generation beneficiaries, or trusts benefitting such persons) in excess of a $3.5 million exemption amount. EGTTRA repealed the GST in the same fashion as the estate tax, meaning that the GST is gone for 2010, but resurrects in 2011. Major problems of GST repeal and expected reenactment relate to: (1) the inability to allocate GST exemption to 2010 transfers; (2) whether distributions from trusts created or funded in 2010 will be subject to GST in later years; (3) the post-2010 effect of pre-2010 GST exemption allocations (including automatic and retroactive allocations); and (4) invalid 2010 GST formula allocations. The GST issues should keep the IRS and practitioners dealing with multi-generational trusts busy for years.[12]

While not exhaustive, the following pointers may aid practitioners in dealing with the 2010 tax regimen (presuming the carryover basis rules are not repealed):

- **Review Formula Allocations.** Review all marital/nonmarital and GST formula clauses during estate tax repeal. Beware formula clauses which are predicated on the existence of the federal estate tax or GST which may spawn unintended results. For example, a $10 million estate leaving a nonmarital trust to children of the largest amount that can pass without federal estate taxes, with remainder to my spouse, in 2010 would leave zero to the spouse (versus the spouse receiving $6.5 million in 2009). Sometimes minimum allocations such as 50 percent of the residuary estate to the surviving spouse are appropriate, or alternative dispositive scenarios can be drafted dependent on whether the estate tax is then in existence.
- **Consider 2010 Gifts.** The top 2010 gift tax rate of 35 percent encourages taxable gifts to be made this year, since it is historically lower than the top pre-EGTRRA (55 percent) or 2009 (45 percent) gift tax rates. Since the Democrats seem to support reinstating a top 45 percent gift tax rate for post-2010 years, making a gift this year may save the 10 percent rate differential. Additional savings may result (versus having such gifts subject to estate taxes), since the gift tax is computed on a tax-exclusive basis—there is no tax on the assets paying the gift tax—if the donor survives the gift by three years. Additionally, lifetime gifts are generally not taken into account in the Illinois estate tax base thereby reducing Illinois estate taxes.[13]
- **Revise Trusts to Give Direction Regarding the Executor's Authority to Allocate Basis Increases.** Since unhappy benefi-

ciaries may sue the executor for perceived unfair basis allocations, the decedent's governing instrument should arguably direct how such basis allocation should be made. In general, there are three approaches: (1) allocations which reduce income taxes the most; (2) allocations which are proportionate to the value of the interests passing to the different beneficiaries; and (3) allocations which are proportionate to the appreciation in the interests of the different beneficiaries.

- **Asset Consolidation.** Consolidate all a client's properties under the same person or persons, at least during 2010, to eliminate some of the disputes that can arise among competing fiduciaries over the proper allocation of a decedent's $1.3 million and $3 million basis adjustments.
- **Review Marital Trusts to Optimize the $3 Million Qualified Spousal Basis Adjustment.** Some well known marital trust techniques (i.e., estate trusts; Clayton QTIPs; selected general power of appointment trusts), while generating marital deduction under pre-2010 law, do not constitute QTIP trusts for purposes of Code Section 1022(c). In addition, even if a marital trust meets such definition, such trust may be underfunded with trust property. In both cases, the $3 million qualified spousal property basis increase may be wasted. For estates with substantial appreciation, it behooves practitioners to analyze the trust language to optimize the applicable basis adjustments. Generally, single QTIP trusts work well to fully utilize the $1.3 million and $3 million basis adjustments, although other techniques may also be satisfactory. Furthermore, in the case of a dying spouse, consider transferring appreciated property (from the well spouse to the terminal spouse) to optimally utilize the respective basis adjustments.[14]
- **Consider 'Outright' GST Gifts in 2010.** In light of the uncertainty whether 2010 gifts in trust to 'skip' persons (i.e., grandchildren), will be subject to future GST, consider making outright transfers to grandchildren in 2010. Such transfers are clearly not subject to GST in 2010 or later years (presuming the GST is not retroactively re-enacted in 2010). Unfortunately, for minor grandchildren, gifts to UTMA accounts do not work (such accounts are viewed as trusts under the GST regulations). Consider gifting skip persons limited partnership interests or LLC equity in manager-managed LLCs in order to enable the older generation to retain control of such interests, without GST implications. Another option for 2010 GST transfers is to gift property to a skip person (or trust for a skip person) and rely on the skip person to disclaim the gift within nine months (to non-skip persons) if it is determined that a GST would otherwise be imposed. ■

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1. Public Law No. 107-16.
2. EGTRRA Section 901.
3. 35 ILCS 405/2(c).
4. See Robert J. Kolasa, *Federal and Illinois Estate Tax Laws Under the Obama Administration*, The Docket (February 2009).
5. The United States Supreme Court has repeatedly upheld retroactive tax legislation against a due process challenge. See *Carlton v. United States*, 512 US 24 (1994) and cases cited therein.
6. LISI Estate Planning Newsletter #1678 (July 23, 2010) at <http://www.leimbergservices.com>.
7. Id.
8. See Robert J. Kolasa, *The Illinois QTIP Election to the Rescue*, 97 Ill Bar J 612 (December 2009).
9. For example, Code Section 1022 contains special rules for noncitizen residents, negative basis property, income in respect of a decedent, jointly held properties, foreign companies and revocable trusts.
10. See Howard M. Zaritsky, *Practical Estate Planning in 2010* (Warren, Gorham & Lamont 2010), for a thorough discussion with forms of the Code Section 1022 rules. Many of the ideas mentioned in the remainder of this article were obtained from this source.
11. It should be interesting to see whether the IRS will define 'cash' to include money market instruments (which dipped below $1 per share for some institutions during the 2008-2009 financial crisis).
12. See Howard M. Zaritsky, *Practical Estate Planning in 2010*, supra footnote 11 above, Chapter 4.
13. See Robert J. Kolasa, *How to Use Gifts to Reduce Illinois Estate Taxes*, 96 Ill Bar J 580 (November 2008), *Erratum,* 97 Ill Bar J 115 (March 2009).
14. Code Section 1022(d)(1)(C)(ii).

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