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ESTATE TAX LEGISLATION

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Ronald D. Aucutt

I. THE TURBULENCE CREATED BY THE 2001 TAX ACT

The following timeline summarizes the state of the law year-by-year, under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), if no changes are made:

TABLE 1
Year-by-Year Summary of the Changes Made by EGTRRA

	2001	2002	2003	2004	2005	**2006**	2007	2008	2009	2010	2011 on
Estate Tax											
Exclusion	$675,000	$1 million		$1.5 million		**$2 million**			$3.5m		$1 million
Lowest rate	37%	41%		45%		**46%**	45%				41%
Top rate	55%	50%	49%	48%	47%	**46%**	45%				55%
5% bubble	Yes	**No**									Yes
QFOBI	Yes			**No**							Yes
State tax credit	100%	75%	50%	25%	**None. State taxes are deductible.**						100%
GST Tax											
Exemption	$1 million indexed (from 1998)			$1.5 million		**$2 million**			$3.5 million		$1m, indexed
Rate	55%	50%	49%	48%	47%	**46%**	45%				55%
Gift Tax											
Exclusion	$675,000	**$1 million**									
Lowest rate	37%	**41%**								35%	41%
Top rate	55%	50%	49%	48%	47%	**46%**	45%			35%	55%
5% bubble	Yes	**No**									Yes

II. THE STATE DEATH TAX CREDIT

A. Under EGTRRA, the credit for state death taxes was reduced to 75% of its former level in 2002, 50% of its former level in 2003, and 25% of its former level in 2004. In 2005 the credit was repealed and replaced with a deduction for state death taxes paid. The result was a dramatic shift of revenue from states to the federal government in states that employ a “pick-up” estate tax in the amount of the federal credit (“coupled” states). For example, for a taxable estate of $10 million in a coupled state, the state revenue, of course, declined by 25% each year until it disappeared in 2005. Meanwhile, the percentage loss in *federal* estate tax revenue from an estate of this size does not even reach double figures until 2009.

In 2005, the federal tax on such an estate was actually 3% *larger* than the net federal tax in 2001. These results are shown in Table 2:

TABLE 2 Tax on a Taxable Estate of $10 Million (assuming no adjusted taxable gifts and a pick-up state tax only)						
Year	State Pick-Up Estate Tax		Net Federal Estate Tax		Gross Estate Tax	
	Tax	Change from 2001	Tax	Change from 2001	Gross Tax	Change from 2001
2001	$1,067,600	—	$3,852,650	—	$4,920,250	—
2002	$800,700	-25%	$3,629,300	-6%	$4,430,000	-10%
2003	$533,800	-50%	$3,821,200	-1%	$4,355,000	-11%
2004	$266,900	-75%	$3,798,100	-1%	$4,065,000	-17%
2005	0	-100%	$3,985,000	+3%	$3,985,000	-19%
2006	0	-100%	$3,680,000	-4%	$3,680,000	-25%
2007	0	-100%	$3,600,000	-7%	$3,600,000	-27%
2008	0	-100%	$3,600,000	-7%	$3,600,000	-27%
2009	0	-100%	$2,925,000	-24%	$2,925,000	-41%
2010	0	-100%	0	-100%	0	-100%
2011	$1,067,600	0	$3,727,400	-3%	$4,795,000	-3%

B. A few states have a death tax in excess of the federal credit. Other states have a death tax that is tied inflexibly to the federal credit in effect in 2001, either historically or because they have "decoupled" from the federal tax since 2001. In such states (and in any other state that re-enacts an estate tax at 2001 levels), the tax "relief" from the Act has been minimal in the early years, particularly before 2005 when the deduction for non-creditable state taxes takes effect. Table 3 recapitulates the real top rates in a state with only a "pick-up" tax (a "coupled state") and in a state with a tax tied to the pre-2002 credit (a "decoupled state" or "uncoupled state"). (The state tax in 2010 is hard to predict.)

TABLE 3 Real Effective Top Tax Rates						
Year	"Coupled" State			"Decoupled" State		
	Federal	State	**Total**	Federal	State	**Total**
2001	39%	16%	**55%**	39%	16%	**55%**
2002	38%	12%	**50%**	38%	16%	**54%**
2003	41%	8%	**49%**	41%	16%	**57%**
2004	44%	4%	**48%**	44%	16%	**60%**
2005	47%	0	**47%**	40.52%	13.79%	**54.31%**
2006	46%	0	**46%**	39.66%	13.79%	**53.45%**
2007	45%	0	**45%**	38.79%	13.79%	**52.59%**
2008	45%	0	**45%**	38.79%	13.79%	**52.59%**
2009	45%	0	**45%**	38.79%	13.79%	**52.59%**
2010	0	0	**0**	0	?	**?**
2011	39%	16%	**55%**	39%	16%	**55%**

C. The odd state tax rates after 2004 in Table 3 result from the fact that the state tax itself is deducted in calculating the taxable estate, which is the base for the state tax in most states. The statutes of some states, such as Maryland, explicitly exclude the deduction of the state tax from this calculation. As a result, in Maryland, the top rate is 16% for all years through 2009. But because the larger Maryland tax is still deducted in calculating the federal taxable estate, the effective net federal rate is reduced further, but not enough to completely offset the higher state tax. Table 4 is a remake of Table 3 to show these differences:

TABLE 4
Real Effective Top Tax Rates

Year	"Coupled" State			State Like Maryland		
	Federal	State	**Total**	Federal	State	**Total**
2001	39%	16%	**55%**	39%	16%	**55%**
2002	38%	12%	**50%**	38%	16%	**54%**
2003	41%	8%	**49%**	41%	16%	**57%**
2004	44%	4%	**48%**	44%	16%	**60%**
2005	47%	0	**47%**	39.48%	16%	**55.48%**
2006	46%	0	**46%**	38.64%	16%	**54.64%**
2007	45%	0	**45%**	37.80%	16%	**53.80%**
2008	45%	0	**45%**	37.80%	16%	**53.80%**
2009	45%	0	**45%**	37.80%	16%	**53.80%**
2010	0	0	**0**	0	?	**?**
2011	39%	16%	**55%**	39%	16%	**55%**

D. Form 706 has been redesigned to accommodate the calculation of tax in a state like Maryland, by providing a separate line 3a on page 1 for calculating a "tentative taxable estate" net of all deductions except state death taxes, a line 3b for separately deducting state death taxes, and a line 3c for the federal taxable estate (old line 3). The "tentative taxable estate" in effect *is* the taxable estate for calculating the state tax (but not the federal tax) in a state like Maryland.

E. States have historically depended on the IRS to do most of their auditing for them, and the IRS has obliged by requiring proof of payment of any *creditable* state death tax before allowing an increased state death tax credit in the event of any adjustment of the taxable estate. Presumably, the IRS will continue to require such proof of payment of any *deductible* state death tax before allowing an increased deduction in similar circumstances, and states will still be able to rely on IRS audit activity for the most part.

F. The landscape is further complicated by other departures from the federal model in various jurisdictions, such as jurisdictions which have decoupled their tax systems not only from the declining federal credit for state death taxes but also from the phased increases in the federal unified credit. Using Maryland as an example again, the exemption under Maryland law for decedents dying in 2006 is \$1,000,000, not \$2,000,000. It is unclear how Maryland will enforce the filing of returns and the collection of tax in the case of estates greater than \$1,000,000 and under \$2,000,000 (which do not have to file a federal return).

G. In some states, however, the tide is flowing the other direction. Virginia's decoupled estate tax, for example, has been repealed, effective July 1, 2007.

III. WATCHING A BYRD AT SUNSET

A. With reference to transfer taxes, section 901(a) of EGTRRA states that "[a]ll provisions of, and amendments made by, this Act shall not apply … to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010." Section 901(b) goes on to state that "[t]he Internal Revenue Code of 1986 … 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."

B. Section 901 is the only section in the ninth and last title of the Act, entitled "Compliance with Congressional Budget Act." The Congressional Budget Act of 1974 (2 U.S.C. § 621 *et seq.*) prescribes the procedures by which Congress adopts spending and tax priorities in a budget resolution and implements those priorities in a streamlined process of budget reconciliation. In a 1990 amendment sponsored by Senator Robert Byrd (D-WV) (and hence known as "the Byrd rule"), section 313 of the Budget Act (2 U.S.C. § 633(f)(2)) was amended to make it out of order in the Senate to include matters in budget reconciliation that are nongermane or "extraneous," including increases in deficits beyond the fiscal years covered by the reconciliation and decreases in revenue beyond the scope of the budget resolution. Since the budget resolution generally covers ten years, then it would be extraneous, and out of order, to reduce taxes beyond the ten-year budget window.

C. The Byrd rule can be waived by a vote of 60 Senators (just as a Senate filibuster against general legislation can be broken by a vote of 60 Senators). H.R. 1836 originally passed the Senate, on May 23, 2001, by a vote of 62-38. That Act, however, garnered 62 votes only with a "sunset" provision in it. The Senate was not asked to vote on a non-sunsetting repeal, and presumably the votes were just not there. In the Senate consideration of H.R. 1836, amendments to eliminate the estate tax repeal were defeated by votes of 43-56 and 42-57. Even an amendment to preserve the estate tax only for estates greater than $100 million was defeated by a vote of 48-51.

D. Thus, as written, the estate and GST tax repeal and carryover basis will be in effect for just one year! After 2010, the 2001 changes will "sunset" and the law will revert to the law that would have been in effect in 2006 under the Taxpayer Relief Act of 1997. The last year for which TRA '97 made changes was 2006, for which it prescribed a unified estate and gift tax credit resulting in an exemption equivalent of $1 million, a top rate of 55% with a 60% "bubble," a QFOBI deduction, an indexed GST exemption, a full state death tax credit, and a full fair market value basis at death.

IV. PAST REMINISCENCES

A. In the Revenue Act of September 8, 1916, as the United States entered World War I, Congress enacted the current estate tax, imposed at rates of 1% to 10% on taxable estates over $50,000. In the Act of March 3, 1917, the rates were generally increased by half, to levels of 1½% to 15%. In explaining the Senate bill, which would have doubled rates to 2%-20%, the Finance Committee said (S. REP. NO. 103, 65TH CONG., 1ST SESS. 14 (1917) (emphasis added)):

> *Such a tax, when used as an emergency measure, is necessarily unequal in operation.* Only if continued at the same rate for many years—the period of a generation—does it become equal for all persons in like situation. *If levied as a war tax, that is, as a temporary emergency measure, it falls only upon the estates of those who happen to die during the period of the emergency.* Particularly is it to be remembered that perhaps a majority of those dying during the war and leaving estates to be taxed will be soldiers and sailors dying in defense of our country. *On the other hand, as a permanent measure, such a tax, even at the rates already fixed by existing law, trenches in considerable degree on a sphere which should be reserved to the States.*

In its version of the Revenue Act of 1926, when the gross rates ranged from 1% to 20%, the House of Representatives raised the state death tax credit to 80% of the basic tax, while the Senate version would have repealed the estate tax. In support of repeal, the Finance Committee quoted the excerpts from its 1917 report that are italicized above. S. REP. NO. 52, 69TH CONG., 1ST SESS. 8 (1926). In short, the Finance Committee of 1917 and 1926 seems to have cited the same arguments in support of doubling the tax and in support of repealing the tax! The 1926 House-Senate conference, of course, accepted the House approach.

B. On **February 5, 1969**, less than two weeks after the inauguration of President Nixon, Congress published a multi-volume Treasury Department work entitled "Tax Reform Studies and Proposals," reflecting work that had been overseen by Assistant Secretary of the Treasury for Tax Policy Stanley Surrey during the Kennedy and Johnson Administrations. It included a number of estate and gift tax proposals. The following list of the estate and gift tax proposals gives the date each proposal was eventually enacted in some form:

1. Taxation of appreciation at death or at the time of gifts (carryover basis enacted in 1976, repealed in 1980, and enacted again in 2001, effective 2010).

2. Unification of the gift and estate taxes.

    a. Same rates (1976).

    b. Same base—tax-inclusive (1976, for gifts within 3 years of death).

    c. Single exemption (1976—until 2003).

d. Abolition of the "gifts in contemplation of death" rule (1976).

3. Unlimited marital deduction, including income interests (1981).

4. Repeal of the exclusion of interests in qualified retirement plans (1984).

5. More explicit rules governing disclaimers (1976).

6. An "orphan exclusion" equal to the amount of the gift tax annual exclusion multiplied by the number of years by which the orphan is under 21 (roughly in 1976—repealed in 1981).

7. Tightening of the deduction rules for transfers to charity (1969).

8. More rational allocation of deductions between estate tax and income tax returns (in part by the "*Hubert* regulations" in 1999).

9. Tax on generation-skipping transfers (1976 and 1986).

10. Liberalized extended payment of estate taxes (section 6166) (1976).

11. Discontinuance of "flower bonds" redeemable at par to pay estate tax (last issued 1971, last matured 1998).

C. "Blueprints for Basic Tax Reform" was published by the Treasury Department **January 17, 1977**, during the last week of the Ford Administration, in response to Secretary of the Treasury William Simon's lament that the United States should "have a tax system which looks like someone designed it on purpose." In the context of proposing a comprehensive model of income taxation that depended on a dramatically broader tax base, "Blueprints" assumed that transfers by gift or at death would be recognition events. Such capital gains, whether by gift, at death, or otherwise, would be fully taxed at ordinary income rates, with adjustments to the basis of corporate stock for retained earnings and to the basis of all assets for general price inflation. Pre-enactment gain would be excluded, following the precedent of the "carryover basis at death" rules that were enacted in 1976. "Blueprints" was not embraced by the incoming Carter Administration.

D. "Tax Reform for Fairness, Simplicity, and Economic Growth" (popularly called "Treasury I") was published by Treasury on **November 27, 1984**, just weeks after President Reagan's landslide reelection. It included the following:

1. Imposition of gift tax, like the estate tax, on a "tax-inclusive" basis.

2. Imposition of tax only once, when beneficial enjoyment ceases, ignoring retained powers (a proposal that kindled an "easy to complete"/"hard to complete" debate).

3. Treatment of all powers of appointment as general powers of appointment if the holder could benefit from them, without regard to complicating concepts such as “ascertainable standards” and “adverse interests.”

4. Valuation of fractional interests in an asset at their pro rata share of the value of the asset owned or previously transferred by the transferor or the transferor’s spouse.

5. A simplified GST tax (compared to the GST tax enacted in 1976) with a $1 million exemption and a flat rate (in this proposal equal to 80% of the top estate tax rate).

6. Elimination of the phase-out of the credit for tax on prior transfers from a member of the same or a younger generation.

7. Expansion of section 6166 deferral of the payment of estate tax to all cases where the estate lacks sufficient cash or marketable assets, without regard to whether it holds an interest in a business. Liquidity would be reevaluated annually on an “if you have it send it in” basis (or at least send in 75% of it).

8. Conversion of the IRD deduction under section 691(c) to a basis adjustment.

9. Replacement of the separate rate schedule for calculating the maximum state death tax credit with a maximum credit equal to a flat 5% of the taxable estate. This would have resulted in a substantially smaller state death tax credit in most cases.

10. Repeal of section 303, which provides for exchange treatment of stock redemptions to pay certain taxes and funeral and administration expenses.

E. “The President’s Tax Proposals to the Congress for Fairness, Growth, and Simplicity” was published by the White House on **May 29, 1985**. It was popularly called “Treasury II” or “White House I” or sometimes “Regan II” in reference to the fact that Donald T. Regan was the Secretary of the Treasury who signed the transmittal letter for “Treasury I” and had become the White House chief of staff by May 1985. Based generally on Treasury I, it was the rough model for the Tax Reform Act of 1986. It contained no proposals affecting transfer taxes.

1. Ultimately, the Tax Reform Act of 1986 did enact a supposedly simpler GST tax (but at a rate equal to 100%, not 80%, of the top estate tax rate).

2. In the Omnibus Budget Reconciliation Act of 1987 (“OBRA”), the House of Representatives added a repeal of the state death tax credit, a rule valuing interests in family-owned entities at their pro rata share of the total

value of all interests in the entity of the same class, and rules regarding "disproportionate" transfers of appreciation in estate freeze transactions. H. REP. NO. 100-391, 100TH CONG., 1ST SESS. 1041-44. The House-Senate conference retained only the estate freeze rules, as section 2036(c) (which in turn was repealed in 1990 and replaced with the supposedly more workable rules of chapter 14).

3. The other transfer tax suggestions of Treasury I have not been enacted.

F. The "Death Tax Elimination Act of 2000" (H.R. 8) was passed in 2000 by large majorities in Congress, including 59 Senators, but it was vetoed by President Clinton. H.R. 8 would have –

1. reduced the top rate from 55% to 40.5% in annual steps from 2001 through 2009,

2. converted the "unified credit" to an exemption, thereby allowing the exemption to be applied to the top marginal rate rather than to the lower rates as the credit is,

3. eliminated the 5% surtax that results in the 60% "bubble" for taxable estates larger than $10 million,

4. repealed the estate tax, gift tax, and generation-skipping transfer tax (GST tax), beginning in 2010, and

5. replaced the estate, gift, and GST taxes with a carryover basis regime, beginning in 2010.

G. A substitute to H.R. 8 offered in the House Ways and Means Committee by the ranking Democratic member, Rep. Charles Rangel, would have –

1. lowered all rates by 20% (*e.g.*, lowering the top rate from 55% to 44%), beginning in 2001,

2. increased the "exemption equivalent" sheltered from tax by the unified credit to $750,000 in 2001 and to $1.2 million by 2006,

3. increased the $1.3 million deduction for qualified family-owned business interests ("QFOBIs") to $2 million, and

4. replaced the credit for state death taxes with a deduction.

H. The "Death Tax Relief Now Act of 2000" (H.R. 5315), introduced by Rep. John Tanner (D-Tenn.) after President Clinton had vetoed H.R. 8, would have –

1. lowered all rates by 20%, beginning in 2001,

2. increased the "exemption equivalent" to $1.3 million in 2001,

3. repealed the QFOBI deduction,

4. replaced the credit for state death taxes with a deduction,

5. reduced the top estate tax rate to 39.6% (to match the top income tax rate!) in 2010, and

6. indexed all rate brackets for inflation after 2010.

President Clinton reportedly was willing to sign H.R. 5315.

I. In the consideration of H.R. 2646, the Farm Security and Rural Investment Act of 2002, which President Bush signed on May 13, 2002, the Senate added an expression of the "sense of the Senate" that the estate tax repeal should be made permanent. Even though such an expression had no statutory or other binding effect whatsoever, it garnered only 56 votes, with 42 votes opposed, although the two Senators not voting (Senators Bennett of Utah and Domenici of New Mexico) were Republicans who had supported the repeal of the estate tax in the past.

J. As part of an agreement reached to facilitate consideration of certain tax provisions of the energy bill (H.R. 4), the leadership of the Senate agreed to allow consideration of a proposal to remove the "sunset" feature of the estate and GST tax repeal, so that the repeal scheduled under EGTRRA to take effect in 2010 would no longer be scheduled to sunset on January 1, 2011—making the repeal, in effect, permanent. The vote was promised by the end of June 2002.

1. The repeal measure the Republican leadership agreed to consider would only make the repeal of the estate and GST taxes in 2010 permanent for the years 2011 and beyond. Until 2010, the rates would fall and the unified credit would rise, on the schedule enacted in 2001. The gift tax unified credit would continue to be limited, so as to shelter gifts only up to $1 million, and after 2009 the gift tax would continue in effect, with a 35% rate. The state death tax credit would be phased out by 2005, and carryover basis would be enacted as a permanent replacement for the estate tax, beginning in 2010.

2. This permanent repeal measure involved a suspension of the budget reconciliation rules under which EGTRRA was crafted, and therefore it required the vote of 60 Senators—the same 60-vote requirement that contributed prominently to the odd results in EGTRRA in the first place.

3. The vote was held on June 12, 2002. The vote was 54-44, and the measure therefore failed. (The two Senators not voting supported repeal.)

4. Before voting on permanent repeal, the Senate took up alternatives offered by Democratic Senators, including accelerated increases in the unified

credit (which failed by a vote of 38-60) and expansion of qualified family-owned business interest (QFOBI) relief (which failed by a vote of 44-54).

K. The October 22, 2003, *Washington Post* reported that Senator Jon Kyl (R-AZ), an important member of the Senate Committee on Finance who has been a major player in actively advocating permanent repeal of the estate tax, was at that time considering abandoning that position in exchange for an increase in the estate tax exemption to $15 million per person and a decrease in the estate tax rate, above that exemption, to 15%, the current income tax rate on capital gains.

1. The *Post* report was silent as to what, if anything, Senator Kyl would do about the gift and GST taxes, about adjustment of basis at death, and about state death taxes. The *Post* also reported that Senator Kyl's proposal had gained the interest of several Democratic Senators and the support of several important lobbyists. The article implied that the impetus for Senator Kyl's proposal was the growth of the deficit and the risk that if a Democrat were elected President in 2004 permanent repeal or substantial reduction of the estate tax would be a dead letter.

2. Then, on October 23, 2003, one day after the *Post* report, Senator Kyl repudiated the article. As if to leave no doubt, on the same day Senator Kyl introduced S.J. Res. 20, to express "the sense of the Congress that the number of years during which the death tax … is repealed [that is, 2010] should be extended, pending the permanent repeal of the death tax."

V. THE COST OF REPEAL

A. In 2001, when the estate tax was "repealed" (albeit only for the year 2010), Congress anticipated large budget surpluses. There was debate over how large the surpluses might be, there was debate over how much of the projected surpluses should be "given back to taxpayers" in the form of tax cuts, and there was debate over what form those tax cuts should take. Congress decided on tax cuts, over a ten-year period, of one and one-third trillion dollars. Even that would not fund every tax cut Congress wanted to confer, however, and it was necessary to set priorities and make trade-offs—the equivalent of "spending political capital"—even in 2001.

1. Obviously Congress was able to "repeal" the estate tax in 2001, within its $1.35 trillion tax cut budget, in large part by postponing the complete repeal to the year 2010. See Table 1. In fact, since the estate tax is due nine months after death, the revenue effect of complete repeal will not be significantly felt until October 1, 2010, the first day of fiscal 2011. Thus, the 2001 estate, gift, and GST tax changes were projected to decrease revenue by a total of $84 billion for the ten fiscal years 2001 through 2010, but to reduce revenue by $54 billion in fiscal 2011 alone.

2. In contrast, the Joint Committee on Taxation estimated that making repeal permanent in 2005 by repealing the 2011 "sunset" provision of the 2001 Act would cost $290 billion over the next ten years, even though it would not change the law until 2011. As time has passed since the enactment of the 2001 Act, more revenue loss is projected as more fiscal years (2012, 2013, 2014, and 2015) fall within the ten-year budget window. By the measure of the ten-year budget window, making estate tax repeal permanent in 2010 is simply more expensive today than it would have been in 2001.

B. It is also well known that Congress mitigated the federal revenue loss from the 2001 Act by repealing the state death tax credit and thereby shifting a significant part of the burden to states whose estate taxes were tied to the federal credit and have therefore been phased out. See Table 2. Since the state death tax credit is now fully repealed, that is a technique that Congress cannot use again. Again, that means that permanent estate tax repeal is more expensive today than in 2001.

VI. OTHER POLITICAL REALITIES

A. On the day after his reelection, President Bush referred to the "political capital" that he had earned and intended to "spend." He also made it clear that one of the centerpieces of his domestic agenda was to make permanent the tax cuts enacted in 2001 and 2003, including the repeal of the estate and GST taxes.

B. The following is from page 3 of the "General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals" (emphasis added):

> **<u>Current Law</u>**
>
> The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created a new 10-percent individual income tax rate bracket, reduced marginal income tax rates for individuals, doubled the child credit and extended its refundability, reduced marriage penalties, eliminated the phase-out of personal exemptions and the limitation on certain itemized deductions for higher-income taxpayers, provided additional incentives for education, increased IRA and pension incentives, provided relief from the alternative minimum tax (AMT), ***eliminated the estate and generation-skipping transfer taxes, and modified the gift tax***. These and several other provisions of EGTRRA sunset on December 31, 2010.
>
> The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) increased the amount of qualifying property that can be expensed in the year of purchase rather than being depreciated and lowered the tax rates on qualifying dividends and on capital gains. The liberalized expensing provision, as extended, sunsets on December 31, 2007. The dividend and capital gains provisions sunset on December 31, 2008.

Reasons for Change

The tax relief and incentives to work, save, and invest provided by EGTRRA and JGTRRA are essential to the long-run performance of the economy. All taxpayers should have the certainty of knowing that the provisions of EGTRRA will extend beyond 2010. Taxpayers plan for periods far beyond the scheduled sunset dates of the EGTRRA and JGTRRA provisions when saving for their children's education, undertaking new business ventures, planning for retirement, and ***planning future contributions to charity and bequests for their children***. Taxpayers require the certainty that can be provided today by permanently extending the provisions of EGTRRA and JGTRRA. Permanent extension of the provisions is essential for promoting growth and higher levels of income in the future.

Proposal

The provisions of EGTRRA that sunset on December 31, 2010 would be ***permanently extended***. The provisions of JGTRRA that sunset on December 31, 2007 and December 31, 2008 would be permanently extended.

As the budget proposal worked its way through Congress, it did not *provide* for permanent estate tax repeal, but it was said that it would "*accommodate* … a permanent extension of the death tax repeal." "CHAIRMAN'S MARK 2006 BUDGET PREPARED BY THE U.S. SENATE BUDGET COMMITTEE," March 9, 2005, at 22.

C. The President's proposed fiscal 2007 budget, released February 6, 2006, renewed the call for making permanent the tax cuts of the past five years, including the repeal of the federal estate and GST taxes.

D. This has also been a frequent theme of President Bush's Saturday morning radio addresses and other speeches.

E. Also in the 2004 election, the Republicans maintained control of the House and gained four seats in the Senate. Fifty-five is more Republicans than there have been in the Senate since Herbert Hoover was President. This gain in the Senate immediately triggered a lot of speculation about the new votes that might be available for permanent repeal of the estate tax.

1. Extrapolating from the 59 Senate votes for H.R. 8 (which President Clinton vetoed) in 2000, the 58 votes for EGTRRA in 2001, and especially the 54 votes for the up-or-down repeal vote in June 2002 (with two absent Senators expressing support for repeal), many observers have attempted to predict the likely votes for repeal in light of the intervening personnel changes. *See*, *e.g.*, Sullivan, "60-Vote Majority at Hand for Estate Tax Repeal," Tax Notes, Nov. 29, 2004, at 1174.

2. Some have also cited the intangible effect of the "Daschle factor"—the likelihood that Democrats in "red states" carried by President Bush, especially those up for reelection in 2006, will have second thoughts about opposing the supposedly popular repeal of the estate tax. *Id.*

3. It is harder still to evaluate the intangible factor of weighing votes rather than counting them. A vote in 2000 for a measure everyone knew President Clinton would veto, a vote in 2001 for a repeal for only one year nine years in the future, and a vote in 2002 where the counting had already been done are not necessarily indicative of how lawmakers will vote on a measure with a realistic chance of success, when it is actually necessary for them to take responsibility for their actions.

4. The outcome of any vote on estate tax repeal, including the determination of whether a 60-vote majority in the Senate is even needed, may well depend on how the measure is packaged.

F. Ultimately, estate tax repeal or reform, like most other legislative possibilities, depends on congressional and Administration priorities, which in turn are affected by the competition from a host of other priorities:

1. Iraq.

2. Iran.

3. Lebanon and the rest of the Middle East.

4. Afghanistan.

5. North Korea.

6. Sudan.

7. Relations with Russia.

8. War on terror, homeland security, and domestic surveillance.

9. Disaster preparedness and responsiveness.

10. Immigration.

11. Energy policy, alternative energy technology, and gas prices.

12. Investigations and indictments.

13. Coal mine safety.

14. Confirmation of judicial and other appointments.

15. Social Security, Medicare, and Medicaid reform.

16. Making general income tax relief permanent, including –

    a. across-the-board income tax cuts,

    b. individual AMT relief,

    c. marriage penalty relief,

    d. expanded child tax credit, and

    e. expensing and other small business relief.

17. Other extensions of expiring provisions, including –

    a. the increased AMT exemption,

    b. personal tax credits allowed against regular tax and AMT,

    c. the deduction for sales taxes,

    d. 15-year straight-line cost recovery for leasehold improvements,

    e. above-the-line deduction for tuition and related expenses,

    f. Archer medical savings accounts, and

    g. The 15% tax rate on capital gains and qualified dividends.

Many of these priorities affect a lot more voters, a lot more often, than does estate tax repeal. And all of these factors are affected by federal budget deficits!

VII. DEVELOPMENTS IN THE 109TH CONGRESS

A. The issue was squarely placed before the Senate when, by a more or less bipartisan vote of 272-162 on April 13, 2005, the House passed the 109th Congress's version of H.R. 8 (the "Death Tax Repeal Permanency Act of 2005"), which would eliminate the 2011 "sunset" that limits repeal to just the year 2010.

   1. At the end of July 2005, just before the August recess, Senate Majority Leader Bill Frist of Tennessee filed a motion of "cloture" on H.R. 8, basically the Senate form of "calling the question," which requires approval of 60 Senators. When the Senate was scheduled to reconvene on September 6, the day after Labor Day, there was only one matter that might have been ahead of that cloture motion, a cloture motion on S. 147, the "Native Hawaiian Government Reorganization Act of 2005."

2. Meanwhile, with full repeal lacking 60 votes, compromise efforts continued. The idea of a 15% rate, mentioned in the October 22, 2003, *Washington Post*, although quite a departure from the top 55% rate of just a few years ago and even the 45% top rate projected to arrive in 2007 under present law, has proved remarkably durable, and it remained the target rate openly discussed by Senator Kyl and others as the compromise discussions reached a public crescendo. In contrast, the $15 million exemption level reported in October 2003 has been elusive. Following the 2004 elections, the most often mentioned aspiration was an exemption of $10 million. In mid-July, $8 million was mentioned in the press, and by the end of July it was $3.5 million.

3. By Labor Day, the pressures of dealing with Hurricane Katrina had become too much for the Senate, and the estate tax vote was postponed.

    a. Opponents of repeal of the estate tax asked how Congress could possibly consider huge tax cuts for the nation's wealthiest families when multitudes on the Gulf Coast had been left with nothing.

    b. Supporters of repeal asserted that now more than ever the economy needs the reassurance of stability in tax policy, especially regarding the taxation of saving and investment, which is so important in the Gulf Coast rebuilding effort.

B. By mid-February 2006, Senator Frist had publicly stated his intention to reschedule the estate tax vote for May 2006, which had been discussed at a retreat of Republican Senators in January 2006.

C. In an April 21, 2006 letter, Senator Frist reminded all Republican Senators of the May agenda. The letter had the following headings:

1. Winning the War on Terror.

2. Securing Our Border.

3. Improving the Quality of Life: Health Care.

4. Energy.

5. Governing Effectively: Judges, Who Interpret the Law, Not Make Law.

6. Keep Jobs and Growth.

7. Kill the Death Tax Forever. Under this heading, Senator Frist wrote:

> America is a nation taxed from the moment it awakes until the moment it sleeps. From the first cup of coffee you drink to the last water you sip

> when you brush your teeth, you pay a tax. We are an overtaxed nation, and hardworking Americans deserve a break.
>
> There's a lot of senseless taxes out there. But no tax seems to make less sense to me than taxing you after you're dead.
>
> Death tax is bad policy: it drives people to spend billions of dollars and create complicated tax structures for the sole purpose of avoiding payment. And it is immoral: the amounts subject to the death tax have already been taxed once. More to the point, death should not be a taxable event.
>
> Because of Katrina, we could not act on repealing the death tax last fall. Now is our time. Here is our moment. Let's end the death tax forever.

D. In April 2006, Public Citizen and United for a Fair Economy published "Spending Millions to Save Billions: The Campaign of the Super Wealthy to Kill the Estate Tax." This exposé names those said to be involved in a long-term campaign to repeal the estate tax and critiques what it calls "myths" about the tax. The report may be viewed at http://www.citizen.org/documents/EstateTaxFinal.pdf.

E. In May 2006, the Joint Economic Committee of Congress published "Costs and Consequences of the Federal Estate Tax." This study, similar to previous JEC studies on the same subject, discusses arguments for and against the estate tax and concludes generally that the estate tax is wasteful and hurts the economy. This report may be viewed at http://www.house.gov/jec/press/2006/05-01-06.htm.

F. On May 2, 2006, a "Summit for Permanent Death Tax Repeal" convened at the National Press Club in Washington. It was sponsored by the Family Business Estate Tax Coalition, and participants included Senator Kyl, Ways and Means Committee Member Congressman Kenny Hulshof (R-MO), and Al Hubbard, Assistant to the President for Economic Policy and Director of the National Economic Council. The consensus at the Summit was to support a compromise of a 15% rate, a $5 million exemption (indexed for inflation), and continued stepped-up basis for appreciated assets, all effective January 1, 2010.

G. On June 8, 2006, the Senate considered a cloture motion to take up H.R. 8, which the House had passed in April 2005, thus returning the debate to the posture that had been expected before the hurricanes of late August 2005. The motion was only to take up H.R. 8, not necessarily to approve it but possibly to amend it with something like Senator Kyl's 15%/$5 million proposal.

    1. Prior to the vote, however, Senator Kyl had circulated the suggestion that he would agree to a second rate of, say, 30%, imposed on taxable estates over, say, $30 million. That made it unlikely that the last few necessary Democratic votes would support a 15% rate that did not include a 30% super-rate.

2. The vote was 57-41 in favor of cloture, three votes short of the necessary 60. (The two Senators who did not vote would have voted no.)

H. On June 22, 2006, by a vote of 269-156, the House of Representatives passed a new bill, H.R. 5638, called the “Permanent Estate Tax Relief Act of 2006” (“PETRA”).

1. PETRA, effective January 1, 2010, would have provided a $5 million exemption equivalent (indexed for inflation after 2010), an initial rate tied to the top income tax rate on general capital gains (currently 15%), a rate equal to double that rate on taxable estates over $25 million (not indexed), gift tax exemptions and rates conformed to the estate tax, repeal of the deduction for state death taxes, retention of a stepped-up basis at death for appreciated assets, and repeal of the 2011 “sunset” for the other transfer tax provisions of EGTRRA.

2. PETRA would also have provided a mechanism for surviving spouses to use the unused exemptions of predeceased spouses.

3. In addition, PETRA included a relief provision for the timber industry, widely viewed as an effort to attract the votes of Senators Maria Cantwell and Patty Murray of the State of Washington.

4. The Bush Administration, despite its official commitment to full and permanent repeal of the estate tax, announced on June 22 that it supported H.R. 5638 “as a constructive step toward full repeal of the death tax.”

5. On June 27, Senator Frist announced that H.R. 5638 would not be brought to the Senate floor before the Fourth of July recess. His press release said:

> The House of Representatives made tremendous progress last week toward achieving a permanent solution to the death tax. Now it’s up to the Senate to decide whether it can improve upon the House bill or whether this is the bill that should be sent to the President for his signature. Everyone should be clear: The Senate will vote on a permanent reduction to this tax. The vast majority of my Democratic colleagues have so far refused to address this issue; it’s my hope that their constituents will use the upcoming recess to explain the importance of supporting a reasonable and permanent solution to this unfair tax.

I. On July 29, 2006, by a somewhat less enthusiastic and less bipartisan vote of 230-180, the House of Representatives passed still another bill, H.R. 5970, called the “Estate Tax and Extension of Tax Relief Act of 2006” (“ETETRA”).

1. ETETRA modified PETRA by phasing in the $5 million exemption equivalent from 2010 to 2015, delinking the top estate tax rate (but not the 15% rate) from the capital gains tax rate, phasing in the top 30% rate from

2010 to 2015, and extending the indexing for inflation (after 2015) to the $25 million bracket amount. ETETRA also removed the "miscellaneous" provisions of EGTRRA, dealing with conservation easements, section 6166, and the well-known GST exemption changes, from the repeal of the EGTRRA sunset, meaning that they again would be scheduled to expire in 2011.

2. In addition to the estate tax provisions and the timber relief provision, ETETRA included two-year "extenders" of the research credit and other expiring provisions, an increase in the minimum wage to $7.25 per hour by June 1, 2009, and a number of other tax changes not related to the estate tax. The estate tax provisions, extenders, and minimum wage increase were popularly referred to as the "trifecta."

3. On August 3, the Senate cloture vote to take up consideration of H.R. 5970 failed by a vote of 56-42. Senator Frist, who of course favored cloture, changed his vote to no to preserve his right to request reconsideration later this year, and Senator Baucus (D-MT), who was expected to vote yes, was absent because of the recent death of his nephew in Iraq, thus suggesting that the total support for cloture might have been 58 votes. The only Senator to change from his vote on June 8 was Senator Byrd (D-WV).

VIII. PETRA AND ETETRA

A. PETRA and ETETRA were passed by the House of Representatives when it became clear that there would not be enough votes (60 under the Senate's procedural rules) for full repeal or even for such significant reductions without the "sweeteners" first of the timber provision and then of the extenders and the minimum wage increase. Because the last several years seem to have presented the best opportunity for the repeal of the estate tax, the apparent failure of repeal this year could mean that the estate tax will be with us for the foreseeable future.

B. Nevertheless, bills like PETRA and ETETRA might suggest the type of framework Congress would consider if and when it does decide to resolve the volatility and uncertainty in the law that has existed since 2001. The following are the essential elements of H.R. 5970 (ETETRA), all effective January 1, 2010:

1. The **estate tax exemption** (technically the amount sheltered from tax by the "unified credit," $2 million currently and $3.5 million in 2009) would have been increased in $250,000 annual increments after 2009, until it reached $5 million in 2015. The exemption would have been indexed for inflation after 2015.

2. The **estate tax rate** above that exemption would have been equal to the top income tax rate on general capital gains under section 1(h)(1)(C) (currently 15%) up to a taxable estate of $25 million. Above $25 million,

the rate would have been 40% in 2010 and would have been reduced in 2% annual increments until it reached 30% (not tied to the capital gains tax rate) in 2015 and thereafter. The $25 million amount would also have been indexed for inflation after 2015.

3. Table 5 summarizes the federal estate tax exemptions and rates that would have been enacted by ETETRA:

TABLE 5
Estate Tax Exemptions and Rates under H.R. 5970

Year	Exemption (applied as a "unified credit")	Initial Rate	Rate Over $25,000,000*
Under Current Law			
2006	$2,000,000	46%	
2007	$2,000,000	45%	
2008	$2,000,000	45%	
2009	$3,500,000	45%	
Under ETETRA (H.R. 5970)			
2010	$3,750,000	15%**	40%
2011	$4,000,000	20%**	38%
2012	$4,250,000	20%**	36%
2013	$4,500,000	20%**	34%
2014	$4,750,000	20%**	32%
2015	$5,000,000*	20%**	30%

* The $5,000,000 and $25,000,000 numbers would be indexed for inflation after 2015.
** This rate would be equal to the highest income tax rate on general capital gains in section 1(h)(1)(C), permanently 20%, but 15% through 2010. It is expected that some lawmakers will attempt to extend the 15% capital gains tax rate beyond 2010.

4. The **gift tax exemption** (currently only $1 million) and **gift tax rates** would have been the same as the estate tax exemption and rates.

5. The **GST exemption**, as under current law, would have been equal to the estate tax exemption ($5 million in 2015 and thereafter, indexed for inflation), and the **GST tax rate** would have been equal to the top estate tax rate (30% in 2015 and thereafter).

6. The deduction for **state death taxes**, which replaced the credit for state death taxes in 2005, would have been repealed.

7. For estate and gift (but not GST) tax purposes, **a surviving spouse's exemption** would have been increased (but no more than doubled) by the amount of the exemption that was not used by that spouse's predeceased spouse. This in effect would have allowed a surviving spouse an exemption of up to $10 million (in 2015 and thereafter), indexed for

inflation, if the first spouse to die did not use any exemption – if, for example, the estate of the first spouse to die were left entirely to the surviving spouse. This treatment would have to be elected on a timely estate tax return of the first spouse to die, and the Internal Revenue Service would have been authorized to reexamine that return at the time the surviving spouse died, no matter how much time had passed, for the purpose of determining the exemption available to the surviving spouse (but not for the purpose of changing the tax with respect to the first return). The $25 million level for the higher rate would not have been transferable between spouses.

8. ETETRA **would have repealed the carryover basis rules** that were to replace the federal estate tax in 2010; assets would continue to get a new basis equal to their estate tax, or date-of-death, value.

C. If legislation such as PETRA or ETETRA ever became law –

1. Once again the review of estate plans would be needed.

a. Clients will need to review their estate planning documents to make sure their documents are appropriate in light of their financial situation and the new legislation. Some clients may no longer be subject to estate tax, and the burden may be less for those clients who are still subject to the tax.

b. In reviewing their situations, clients should remember that Congress (as it has in the past) can always change the law – for example, to defer or decrease the post-2009 estate tax exemptions and increase the post-2009 tax rates. Those clients with assets in excess of the ultimate estate tax exemption (say, $5 million) will still need tax-influenced estate planning documents.

c. Clients with assets greater than the present estate tax exemption of $2 million but less than the ultimate exemption should have tax-influenced estate planning documents because of the possibilities of death before their estates are wholly exempt, increases in asset values, or future congressional action.

d. If any new legislation does not begin to take effect until 2010 or some other future time, currently effective estate plans should not be dismantled or abandoned on the assumption that the provisions in the new legislation are guaranteed.

e. If the estate tax rate is tied in any way to the income tax rate on capital gains, the apparent relief provided by the new legislation may prove to still be unreliable and volatile. For example, in 2011, the capital gains tax rate is scheduled under current law to increase from 15% to 20%, which would, under ETETRA, for 2011, make the federal estate tax rate 20% for estates up to $25 million (and 38% over $25 million).

2. The ownership of assets between spouses should also be reviewed.

   a. With an increased estate tax exemption, the ways and proportions in which a husband and wife own property between them will continue to be important for many clients.

   b. Although transferability of a predeceased spouse's exemption to the surviving spouse, along the lines of ETETRA, will simplify estate planning for some married couples, it will involve both the forfeiture of the opportunity to shelter intervening growth in value from estate tax and the potential for reconsidering previous valuations. This and other complexities will still make the affirmative use of the first spouse's exemption, probably through the use of a trust, more advantageous in some cases. This will be especially likely in cases involving illiquid assets that the family does not expect to sell, such as an interest in a family business.

   c. On the other hand, for many assets, income tax basis will become a much more important factor. For example, with an estate tax rate equal to the federal capital gains tax rate for most taxable estates (under ETETRA, those under $25 million), there will be more incentive to include appreciating assets in the surviving spouse's estate to obtain the stepped up basis and reduce the income tax burden on sale. This will be especially likely in states with an income tax of their own but no estate tax of their own.

   d. In addition, although the federal estate tax rate above the exemption amount has been relatively flat for the past few years and will be completely flat from 2006 through 2009 (at a rate of 46% in 2006 and 45% in 2007-2009), a jump from 15% to 40% (as under ETETRA in 2010) at a level of $25 million would, for married persons with estates at or near that level, revive interest in so-called "estate equalization" techniques to subject some of the combined estates to a lower tax at the death of the first spouse to die.

   e. Techniques that once were viewed with skepticism for estate planning purposes, such as owning property jointly with right of survivorship, may become more important, while less settled techniques such as using joint trusts in non-community property states may warrant more attention.

3. The use of the gift and estate tax exemptions will still be challenging.

   a. Even PETRA and ETETRA would not have changed the gift tax exemption of $1 million until 2010, even though the estate tax exemption will be $2 million through 2008 and $3.5 million in 2009. Thus, under this kind of legislation, the challenges in passing wealth to children and other beneficiaries through 2009 would remain. While large gifts that remove wealth from the donor's estate will continue to be an important estate planning tool, careful planning will demand that the gift tax exemption be used wisely.

   b. Both before and after any such legislation takes effect, there will continue to be a premium on early planning and the use of leveraged gift strategies (for example, GRATs, sales to grantor trusts, and charitable lead trusts).

   c. Because what are popularly called the gift and estate tax "exemptions" are really the effect of a cumulative "unified credit," calculations will not always be what they seem. For example, it is natural to assume that a person who has used $800,000 of the $1,000,000 gift tax "exemption" can now make another $200,000 of gifts tax-free, or that, under ETETRA, beginning in 2015, a person who has made $2,000,000 of gifts could leave an additional $3,000,000 free of estate tax. Those types of generalizations have never been universally true and can create unpleasant surprises.

4. Attention to state death taxes will continue to be important.

   a. The state death tax credit, phased out from 2002 through 2005, is not likely to be reinstated. As a result, state estate taxes in the over 20 states that have an estate tax will be a greater proportion of the overall tax burden, and the differences from state to state and mismatches between state and federal taxes will become more dramatic and frustrating. For example, under ETETRA, the federal tax rate over $25 million would have been 40% in 2010 and the state tax (typically at a top rate of 16%) would not have been deductible, making the overall top estate tax rate in those states 56%. (Before the "tax cuts" of 2001, the top rate was 55%.)

   b. Therefore, well-informed planning for mobility among states and ownership of property in several states will probably be as important as ever, or more important than ever.

5. Lifetime generation-skipping planning will still be challenging, at least until 2010.

   a. With the gap between the gift tax exemption of $1 million and the GST exemption of $2 million through 2008 and $3.5 million in 2009, it can be expensive to implement effective lifetime GST tax planning techniques. It will still be important to be alert for opportunities to create, update, merge, divide, or extend generation-skipping trusts.

   b. Under ETETRA, beginning in 2010, with a GST tax rate of 40% and an estate tax rate of 15%, it would have been more important than ever to find ways to avoid the GST tax by subjecting assets in generation-skipping trusts to the estate tax in estates below $25 million. But the effect of state taxes must again be considered, because above $25 million a combined estate tax rate of 56% (in states with a 16% tax) would be considerably greater than the 40% GST tax rate.

   c. The traditional assumption that a trust should distribute all its income to beneficiaries, as well as traditional notions of "income" and "principal" themselves, will continue to serve some families well, but in many cases will have to be reexamined and refined to accommodate the large tax exemption amounts and the passage of more significant wealth that will be a part of the estate planning landscape.

D. Non-tax estate planning will become more and more important. See Part XIII, beginning at page 46, *infra*.

E. ETETRA contains surprises and traps to watch.

1. While the initial estate tax rate would be the capital gains income tax on the date of the decedent's death, the initial gift tax rate would be the capital gains income tax rate *at the end of the calendar year in which the gift is made*. This means that it might be impossible to determine the tax consequences of a gift when it is made.

2. The rule of section 2511(c) is retained, treating a transfer in trust as a taxable gift unless the trust is treated as wholly owned by the grantor for income tax purposes, meaning that all future income of the trust is taxed to the grantor. In context, it is clear that this provision was originally intended to reinforce the effectiveness of the gift tax as a backstop to the income tax after the repeal of the estate and GST taxes, and that its justification would be questionable once the estate tax is restored.

3. Various miscellaneous changes made by EGTRRA would continue to be "sunsetted" on January 1, 2011.

   a. A number of these changes involve the rules governing allocations of the GST exemption and the consequences of such allocations – expanding the deemed allocation rules with respect to gifts (section 2632(c)), permitting retroactive allocation in certain cases (section 2632(d)), permitting severance of trusts that are partly but not wholly protected by allocations (section 2642(a)(3)), clarifying valuation rules applicable to allocations (section 2642(b)), authorizing relief from late allocations when appropriate (section 2642(g)(1), and recognizing substantial compliance in making allocations (section 2642(g)(2)).

   b. Other changes expanded the estate tax rules relating to conservation easements (section 2031(c)(2) & (8)), increased from 15 to 45 the number of shareholders in a corporation or partners in a partnership that is considered closely-held and therefore eligible for installment payment of estate tax (section 6166(b)(1) & (9)), and clarified the installment payment of estate taxes in the case of certain holding companies and certain lending and finance businesses (section 6166(b)(8) & (10)).

4. The proposed portability of the unified credit between spouses –

   a. would apply to the estate and gift taxes, but not the GST tax,

   b. would apply to the unused credit of more than one deceased spouse, but not so as to provide any surviving spouse with more than double the regular exemption,

   c. would apparently apply even to the spouses of spouses (for example, Husband 2, who survives Wife, who survived Husband 1), with the same double-the-regular-exemption limit, and

   d. would require an affirmative election, despite the bad experience with such elections, for example in the context of the QTIP election from 1981, when the QTIP rule was enacted, until the estate tax return was finally revised in October 1991 to deem the election to have been made to the full extent consistent with the numbers shown on the return.

F. At this writing (September 13, 2006), the prospects for ETETRA-like changes remain murky.

1. Congress is in session for most of September and will return for a "lame duck" session after the November election. Senate Republican leaders

have suggested that they might try to bring ETETRA to a vote again, either in September or after the election. Senator Kyl, the chairman of the Senate Republican Policy Committee, has said that marriage penalty and child tax credit provisions might be added to the bill, and Senator Trent Lott (R-MS) has suggested adding an extension of the Medicare Part D prescription drug program, but neither of these ideas has gained clear traction.

2. Meanwhile, Senate Democrats have indicated they might object to a motion to adjourn if the "extenders" included in H.R. 5970 have not been enacted. As a practical matter, the Internal Revenue Service may need guidance regarding the extenders before November in order to prepare for the 2006 income tax filing season, although it is not clear that Senators see that as a concern.

IX. THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

A. Even though the President's victory speech on the day after the 2004 election was relatively brief, it included an affirmation that it is his goal to "transform the tax system." To that end, he appointed a bipartisan advisory panel on tax reform, charged with developing recommendations to make the tax law simpler, fairer, and supportive of economic growth and job creation, while taking account of the historically favorable tax treatment of home ownership and charitable giving.

B. On November 1, 2005, after ten months of study, twelve public meetings in five states and Washington, D.C., and the input of nearly a hundred witnesses and thousands of written comments, the Panel published its Report. The Report is available at http://www.taxreformpanel.gov/final-report.

C. The Report's letter of transmittal to the Secretary of the Treasury complains that "[o]ur tax code is rewritten so often that it should be drafted in pencil." It calls the environment in which most taxpayers contend with the tax law a "fog of ignorance." Eight of the Report's nine chapters and its technical appendix begin with a cartoon ridiculing the tax code for its obscurity, instability, and intrusiveness. On one page it pictures 35 tax forms and worksheets (none more than an inch high) that contribute to completion of the second page of Form 1040. Complementing its illustrations, the Report is written in a simple and reader-friendly style, pausing often to define such terms as "gross income" and "marginal rate" and posing examples such as "Let's say you are just offered a great job…" (page 6) and "Imagine that the government imposed a special tax on ice cream…" (page 29).

D. In its nearly 300 pages, the Report criticizes the current tax law, especially for its complexity, explores a number of alternative approaches, and recommends two of those approaches as alternative solutions. An alternative labeled the "Simplified Income Tax Plan" seems to be offered with the most enthusiasm, and it has been viewed by many commentators as the only alternative with serious prospects of acceptance. It would compress nearly all features of the current income tax, including the income tax return itself, into fewer, simpler, and more comprehensible features. The other alternative is the "Growth and Investment Tax Plan," which, while avoiding adoption of a true consumption tax model, would move the income tax law closer to such a model than the current admittedly "hybrid" system.

1. The two alternatives differ mainly in their taxation of businesses. Many of the purely individual aspects of the tax law would be the same or similar under the two approaches. Where individual and business tax regimes most commonly intersect—in the treatment of stock ownership—the Simplified Income Tax Plan would exclude from individual taxation the dividends paid from domestic earnings of U.S. corporations and 75% of the capital gain on the sale of corporate stock held longer than a year, while interest (other than interest from municipal bonds) would be taxed at regular income tax rates. Under the Growth and Investment Tax Plan, all those forms of income—dividends, interest, and capital gains—would be taxed at a rate of 15%.

2. Under both the Simplified Income Tax Plan and the Growth and Investment Tax Plan, the individual and corporate alternative minimum tax (AMT) would be repealed. As to individuals, however, the regular income tax would then be transformed to more closely resemble the AMT, by repealing or limiting deductions that are disallowed tax preferences under the current AMT, and by lowering and simplifying rates.

3. For example, both the Simplified Income Tax Plan and the Growth and Investment Tax Plan would repeal the deduction for state and local taxes, which may be the single most common reason that otherwise simple returns get thrown into the AMT regime.

4. The Report also recommends the repeal of the deduction for home mortgage interest. In the executive order creating the Panel, however, President Bush had encouraged recommendations that recognize "the importance of home ownership and charity in American society." As a substitute for the mortgage interest deduction that the Panel viewed as available to more homeowners, the Report recommends a Home Credit against the tax, equal to 15% of the interest paid on home mortgages up to a limit equal to 125% of the median home sale price in the county, based on data used by the Federal Housing Administration (FHA).

5. With respect to charity, the Report recommends a deduction available to all taxpayers for charitable contributions in excess of 1% of income, tax-free rollovers from IRAs to charity, and tax-free sales of property if the sale proceeds are donated to charity within 60 days (which is intended to reduce uncertainty and controversy over valuation).

6. The Panel's recommendations would both broaden and narrow the exclusion for health insurance, extending it to individual policies but limiting it to the national average projected to be spent on health insurance.

7. Other tax-free fringe benefits would be eliminated, except for certain benefits provided in-kind at the workplace, such as an on-site company cafeteria.

8. The tax treatment of Social Security benefits would be simplified.

9. Fifteen forms of tax-preferred saving (other than defined benefit plans) would be consolidated into just three vehicles—Save at Work Plans, Save for Retirement Accounts, and Save for Family Accounts.

10. The personal exemption, standard deduction, and child tax credit would be consolidated into a simple Family Credit.

11. The "marriage penalty" would be reduced by making every tax benefit for a married couple exactly twice the corresponding benefit for a single taxpayer.

E. The benefits of the Panel's recommendations for individuals are largely in the form of simplification. The major substantive changes that are recommended are largely aimed at businesses, including small businesses and entrepreneurs. For the largest businesses, the most important recommendations are likely to be those abandoning U.S. taxation of the worldwide income of multinational corporations.

F. The President's executive order of January 7, 2005, creating the Panel expressed its mandate in terms of the "Internal Revenue Code," the "Federal tax laws," and the "Federal tax structure." It did not single out the income tax, except in its directive that "[a]t least one option submitted by the Advisory Panel should use the Federal income tax as the base for its recommended reforms" (which the Report does in its Simplified Income Tax Plan). Nevertheless, the Panel interpreted its mandate as limited exclusively to the federal income tax, at one point (on page 192) explicitly declaring even payroll taxes to be "beyond the scope of the panel's mandate, which focused only on income taxes." As a result, while some of the Panel's public meetings included testimony about the estate tax, the Report offers no analysis or recommendations regarding the estate, gift, and GST taxes.

G. Perhaps the closest the Report comes to touching estate planning professionals directly is the recommendation under the Simplified Income Tax Plan (at pages 123-24) that the "inside buildup" in life insurance policies be subject to income tax annually, unless the policy cannot be cashed out. The currently tax-free growth on deferred compensation would also be taxed. The Report states that "[a]nnuities, life insurance arrangements, and deferred compensation plans that are currently in existence would continue to be taxed under current-law rules." (This highlights one of the principal difficulties with this kind of simplification. In effect it requires the long-term maintenance of dual systems of rules – the new simplified rules and the old rules for grandfathered arrangements.)

H. There are other passing references in the Report of which estate planners might take special notice.

1. The Report singles out valuation as a problem in administering the income tax charitable deduction and in response proposes clearer standards for appraisals, new information reporting by appraisers, expanded information reporting by charities, and new penalties for appraisers (as well as the provision for tax-free sales and rollover of sale proceeds). Consistently with its bypassing of the estate tax, the Report does not mention the arguably greater problem valuation is in administering the estate tax and falls short of recommendations, such as improved procedures for avoiding or settling valuation disputes, that could be most useful in the estate and gift tax context.

2. The Report also strikes a chord familiar to estate planners by pointing out the difference between a "tax-exclusive" sales tax rate and a "tax-inclusive" income tax rate (page 208), a distinction between the gift tax and the estate tax that has influenced our planning since the beginning.

I. The Panel's recommendations adhere strictly to a goal of revenue-neutrality, using conventional revenue estimating (although the Report reveals some support on the Panel for more "dynamic" estimates) and the conventional ten-year "budget window."

1. The Panel's recommendations might be characterized as more favorable to savings, investment, and capital than is current law. In the view of many economists, that is the way to encourage economic growth. These economists would agree with the Panel's Report that "[o]nly people can bear the burden of taxation" (page 34), and that a tax nominally on capital or the income from capital can be borne by investors, workers, customers, or a combination of the three (page 29). (Ironically, in illustrating the current distribution of tax burdens, the Report notes that in the statistics compiled by Treasury "[t]he estate and gift tax is assumed to be borne by decedents" (page 32). That is obviously just a working convention; it can't be true. But whether the ultimate burden of the estate tax in fact falls on the decedent's heirs, or elsewhere in the economy, is one of the great debates the estate tax fosters in some circles.)

2. Some politicians, supported by other economists, view favoring capital the same as favoring the rich, because wealthier people, almost by definition, control more capital. It is plausible if not inevitable that "tax cuts for the rich" in a regime of enforced revenue-neutrality produce real or perceived

tax increases for the middle class. The Panel's recommendations have therefore been criticized for their unfriendliness to working people. Whether fair or not, such perceptions make it hard to marshal the necessary bipartisan support in an already bitterly partisan Washington.

3. If the Panel's recommendations go nowhere, that could be the reason.

4. On the other hand, the current unavoidable attention to the pervasiveness of the AMT and anxiety about tax cuts to be rolled back in 2009 and 2011 may create a climate in which these fundamental reform proposals have the best chance in decades.

5. In any event, to the extent the political reaction to the Report reaches the plane of debating the incidence of taxes on capital, it might provide some clues about the viability of significant estate tax reform as a continuing item on the post-Katrina national agenda.

J. In a speech on May 19, 2006, Secretary of the Treasury (now former Secretary of the Treasury) John Snow affirmed that fundamental tax reform was needed, but said that its time has not yet come. Meanwhile, the development of Treasury's recommendations to the President is not helped by the fact that there has not been a confirmed Assistant Secretary of the Treasury for Tax Policy since 2003. President Bush nominated Acting Assistant Secretary Eric Solomon on May 8, 2006, but his confirmation by the Senate is now being delayed over a concern for the strategy of Treasury and the Service in attacking the so-called "tax gap" – the difference between taxes owed and taxes paid.

X. ELEMENTS OF A THOUGHTFUL STABILIZATION OF THE FEDERAL ESTATE TAX, SHORT OF REPEAL

A. Attention to Rates.

1. Although roles were reversed in 2000 and 2001, Republicans are thought to generally favor lower rates, while Democrats are thought to generally favor higher exemptions or credits.

2. It is hard to see how the timid rate reductions enacted in 2001, especially in "decoupled" or "anchored sponge" states (see Tables 3 and 4), or even the reductions proposed in H.R. 5638 and H.R. 5970, could justify a declaration of victory by estate tax opponents.

3. Economists often opine that higher rates cause the greatest risk of distortion and inefficiency.

4. Significant tax rate reduction is historically accompanied by attempts at "base-broadening." With regard to the estate tax, this could include various reforms of the sort that have been considered but not implemented

in the past. See Part IV *supra* **and** Part X *infra*. Such reforms inevitably create work for estate planners.

5. Significant estate tax rate reduction will discourage techniques the IRS might frown upon, even without specific substantive reform, simply by lowering the stakes.

6. For example, if the estate tax rate approximated the income tax rate on capital gains, a valuation discount would be nothing more than an elective deferral of the tax until the property is sold.

   a. Indeed, if those two rates were comparable, there would be no conceptual reason not to generally allow taxpayers to elect out of the estate tax and accept a zero basis for hard-to-value assets. If the estate and capital gains rates were not comparable, comparability could be simulated by treating such assets as ordinary income assets, or by taxing the disposition of such assets at estate tax rates. (This would in effect be an adaptation of the section 6166 model, with the Government's interest in the form of an equity interest rather than a debt interest.) Administrability might be the only issue that would impede such a reform.

   b. On the other hand, when the estate tax rates in H.R. 5638 and the initial estate tax rate in H.R. 5970 were hard-wired to the capital gain tax rate in effect from time to time, estate planners were anxious about the inherent instability and unpredictability.

7. Rate reduction might be an occasion for Congress to consider pro-taxpayer simplifications, such as the "portability" of the unified credit (or exemption) reflected in H.R. 5638 and H.R. 5970, and to examine the issues identified in the 2004 report of the Task Force on Federal Transfer Taxes, comprised of representatives from the American Bankers Association, the American Bar Association Section of Real Property, Probate and Trust Law and Section of Taxation, the American College of Tax Counsel, the American College of Trust and Estate Counsel, and the American Institute of Certified Public Accountants. The Task Force Report discusses issues arising under present law (long phase-out, one-year repeal, and sunset), carryover basis, the retention of the gift tax system, the existing federal estate, gift and GST tax system, and alternatives to a transfer tax system. Both the 39-page Executive Summary and the 191-page Report may be viewed on-line at http://www.abanet.org/rppt/section_info/tttf/home.html. The Report is also reprinted at 58 TAX LAWYER 93 (Fall 2004).

8. Experience with the current 15% income tax rate on capital gains and dividends teaches that rates cannot drop so low that clients will not be interested in minimizing their application.

B. Attention to Exemptions, Exclusions, and Unified Credits.

1. A higher estate tax unified credit might have to be traded for lower rates.

2. A higher estate tax unified credit means that fewer taxpayers pay estate tax in exchange for a stepped-up basis, which could make it harder in the long term to justify a stepped-up basis, although history teaches that Americans are reluctant to accept either carryover basis or taxation of capital at death.

3. But an estate tax paid by fewer people might look more confiscatory and might foster unrest over the need for and fairness of such a tax.

4. The increasing estate tax unified credit has resulted in the decoupling of the gift tax unified credit and in many states has provoked the use of a lower unified credit for purposes of calculating the state tax.

C. Attention to the Currently Decoupled Gift Tax.

1. There may be less reason for the gift tax unified credit to be lower than the estate tax unified credit if the latter does not increase as much.

2. Likewise, there might be less reason for the gift tax as a backup to the income tax if the estate tax is not permanently repealed, especially if gift and estate tax rates and income tax rates are more comparable.

D. Attention to the State Death Tax Credit.

1. It is obvious that the state death tax credit—unchanged from 1926 until 2001—served more than a revenue-sharing role. It discouraged disorderly competition among states, made it less likely that changes in domicile were driven by estate tax considerations, and simplified estate planning for clients with property in more than one state.

2. Although it is normally awkward to reinstate a tax provision after it has been completely phased out (as of January 1, 2005), the fact that some states have kept decoupled estate tax regimes in place would minimize the disruption in those states, and other states would not be likely to squawk about the reinstatement of a painless revenue source.

3. Although some decoupled states have “frozen” the hypothetical federal unified credit used in calculating the state tax—in some cases at exclusion levels of $1 million or less—those states are a small minority and might be persuaded to reconsider, if they were marginalized by the reinstatement of largely identical tax regimes in most other states.

E. Awareness of the Political Realities.

1. The need to package tax initiatives to secure enactment, especially in the Senate, and to do so within fiscal constraints, can result in a resort to "targeted" provisions designed to gain support of particular constituencies or to properly "spread" the revenue impact. But targeted provisions also create work for estate planners.

2. Furthermore, remembering the lessons of recent legislation, especially EGTRRA, we dare not underestimate the ability and disposition of Congress to surprise us—perhaps dramatically.

XI. "OPTIONS" PRESENTED BY THE JOINT COMMITTEE STAFF

On January 27, 2005, the Staff of the Joint Committee on Taxation published a 430-page Report entitled OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, as requested in February 2004 by Chairman Grassley and Ranking Member Baucus of the Senate Finance Committee. The Report may be viewed at http://www.house.gov/jct/s-2-05.pdf. Under the heading of Estate and Gift Taxation, it presents five proposals, estimated to raise revenue by $4.2-4.7 billion over ten years.

A. "Limit Perpetual Dynasty Trusts (secs. 2631 and 2632)."

1. The purpose of this proposal is described as follows:

> Perpetual dynasty trusts are inconsistent with the uniform structure of the estate and gift taxes to impose a transfer tax once every generation. In addition, perpetual dynasty trusts deny equal treatment of all taxpayers because such trusts can only be established in the States that have repealed the mandatory rule against perpetuities.

2. The proposal would prohibit the allocation of GST exemption to a "perpetual dynasty trust" that is subject either to no rule against perpetuities or a significantly relaxed rule against perpetuities. If an exempt trust were moved to a state that had repealed the rule against perpetuities, the inclusion ratio of the trust would be changed to one. (Presumably this latter rule would apply only if the relocation of the trust produced a change in the governing law, and a similar rule would also apply if the situs state changed its governing law.)

3. The details, not disclosed in the Report, will be important.

a. For example, the proposal states that it would apply in a state that relaxes its rule against perpetuities to permit the creation of interests for individuals more than three generations younger than the transferor. Presumably, the statutory language would be drafted so as not to be harsher than present law under a classical rule against perpetuities, which easily allows transfers to great-great-grandchildren.

b. Likewise, rather than an outright prohibition on allocation of GST exemption, as the proposal says, it seems more appropriate to simply limit allocation of the transferor's GST exemption to a one-time use (permitting a tax-free transfer to grandchildren) and then allow the allocation of GST exemption, again for one-time use, by members of each successive generation also.

c. An overall objective of tax-neutrality among jurisdictions would be salutary, but elusive.

B. "Determine Certain Valuation Discounts More Accurately for Federal Estate and Gift Tax Purposes (secs. 2031, 2512, and 2624)."

1. The purpose of this proposal is described as follows:

> The proposal responds to the frequent use of family limited partnerships ("FLPs") and LLCs to create minority and marketability discounts. … The proposal seeks to curb the use of this strategy frequently employed to manufacture discounts that do not reflect the economics of the transfers during life and after death. More broadly, the proposal attempts to reduce the inefficiency caused by the creation of complicated structures that serve only to shelter value from taxation.

2. The proposal would determine valuation discounts for transfers of interests in entities by applying aggregation rules and a look-through rule. The aggregation rules are what the Report calls a "basic aggregation rule" and a "transferee aggregation rule."

a. The basic aggregation rule would value a transferred interest at its pro rata share of the value of the entire interest owned by the transferor before the transfer. For example, a transferred 20% interest would be valued at one-fourth the value of an 80% interest if the transferor owned an 80% interest and at one-half the value of a 40% interest if the transferor owned a 40% interest.

b. The transferee aggregation rule would take into account the interest already owned by the transferee before the transfer, if the transferor does not own a controlling interest. For example, if a person who owns an 80% interest transfers a 40% interest by gift and the other 40% interest at death to the same transferee, the gifted 40% interest would be valued at one-half the value of the 80% interest originally owned by the donor and the bequeathed 40% interest would be valued at one-half of the value of the 80% interest ultimately owned by the donee/legatee.

c. Interests of spouses would be aggregated with the interests of transferors and transferees. The proposal explicitly (and wisely) rejects any broader family attribution rule "because it is not correct to assume that individuals always will cooperate with one another merely because they are related."

3. The look-through rule would require the portion of an interest in an entity represented by marketable assets to be valued at its pro rata share of the value of the marketable assets, if those marketable assets represent at least one-third of the value of the assets of the entity.

4. The Report states: "The proposal seeks to curb the use of this strategy frequently employed to manufacture discounts that do not reflect the economics of the transfers during life and after death. More broadly, the proposal attempts to reduce the inefficiency caused by the creation of complicated structures that serve only to shelter value from taxation."

5. The proposal takes a measured approach which appears designed to avoid the uncertain and overbroad reach of previous legislative proposals. Nevertheless, the successive focus on what the transferor originally owned and on what the transferee ends up with—in contrast, for example, to the simple aggregation with the *transferor's* previous transfers—could produce some curious results.

   a. Transferors with multiple transferees—*e.g.*, parents with two or more children—will apparently have more opportunities to use valuation discounts than transferors with only one transferee.

   b. Transfers over time can apparently be treated more leniently than transfers at one time.

   c. The results illustrated in the examples, based on the assumption that a majority (*i.e.*, more than 50%) represents control, will apparently be easier to avoid in an entity like a limited partnership or LLC, where a 99% interest is often a noncontrolling interest.

   d. Testing valuation discounts ultimately against what the transferee ends up with will encourage successive transfers (retransfers) or transfers split, for example, between a child and a trust for that child's descendants.

   e. In "fixing" these anomalies, it is crucial not to expand family attribution rules beyond spouses and thereby undo one of the most commendable examples of restraint in the proposal and jeopardize the public acceptance of the proposal.

6. An appropriate legislative structure built around a comprehensive *transferor* aggregation rule would permit a number of helpful collateral results.

   a. There would be no aggregation (except from a spouse) beyond what the transferor once controlled. As a result, the measure would be limited to its intended purpose of curbing the application of valuation discounts resulting from entities, structures, or fractionalization *created* by the transferor.

   b. There would be no need for a look-through rule, which otherwise might unfairly catch interests in holding companies which the transferor never controlled and deny appropriate discounts which the transferor never created.

   c. The aggregation rule should apply to the calculation of gift and estate tax *deductions* as well as the value included in the gift or the gross estate, thereby reversing the harsh (but apparently appropriate under current law) result seen in Technical Advice Memoranda 9050004 (Aug. 31, 1990) and 9403005 (Oct. 14, 1993) (all stock owned by decedent valued as a control block for purposes of the gross estate, but marital bequest valued separately for purposes of the marital deduction), relying on *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987) (estate of a decedent who owned all the stock of a corporation entitled to prove a control premium for a 51-percent block of stock bequeathed to spouse), and *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

   d. A clear statutory rule of this sort should put an end to the haphazard development of case law on an ad hoc basis in cases with extreme facts.

7. The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2005, released on August 15, 2006, listed eight projects under the heading "Gifts, Estates and Trusts." Item number 8 is "Guidance under section 2704 regarding restrictions on the liquidation of an interest in a corporation or partnership."

   a. This project, carried over from the 2003-04, 2004-05, and 2005-06 plans, might be intended to address section 2704(b)(4), which states:

      > The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has

> the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

Arguably, this is what estate planners *do*! But the legislative proposal would presumably supersede this guidance project.

b. The proposal does not indicate that it would be would be the exclusive legal basis for evaluating and challenging the use of the valuation discounts it addresses. For example, if such rules were enacted, it would clearly be appropriate for Congress to repudiate an aggressive use by the Service of section 2036(a)(2) to try to achieve indirectly what these rules would accomplish directly. "Reform" proposals, in their raw form, are rarely so even-handed.

C. "Curtail the Use of Lapsing Trust Powers to Inflate the Gift Tax Annual Exclusion Amount (sec. 2503)."

1. The purpose of this proposal is described as follows:

> Recent arrangements involving Crummey powers [i.e., lapsing powers of withdrawal from a trust] have extended the "present interest" concept far beyond what the Congress likely contemplated in enacting the gift tax annual exclusion, resulting in significant erosion of the transfer-tax base.

2. The proposal offers three options for curbing the use of lapsing Crummey powers.

a. Limit Crummey powers to "direct, noncontingent beneficiar[ies] of the trust." This would repudiate the broad use of Crummey powers sustained in *Cristofani v. Commissioner*, 97 T.C. 74 (1991).

b. Limit Crummey powers to powers that never lapse. As the proposal acknowledges, "[t]his option effectively eliminates Crummey powers as a tax planning tool."

c. Limit Crummey powers to cases where "(1) there is no arrangement or understanding to the effect that the powers will not be exercised; and (2) there exists at the time of the creation of such powers a meaningful possibility that they will be exercised. This option requires a facts-and-circumstances analysis of every Crummey power."

3. Again curiously, the proposal does not explore the possibility of making "tax-vesting" (includibility in the powerholder's gross estate), rather than actual non-lapsing, the test, even though a tax-vesting test is already used

for trusts for minors under section 2503(c) and for all GST tax purposes under section 2642(c)(2).

4. Indeed, if lapsing Crummey powers were ever eliminated, Congress might at the same time recognize the desirability of allowing section 2503(c) trusts to extend beyond age 21, even for life, subject to a tax-vesting requirement patterned after section 2642(c)(2).

5. The proposal is silent about its possible application to lapsing rights of withdrawal at age 21 to qualify a trust under section 2503(c), although the principles seem to be the same.

D. "Provide Reporting for a Consistent Basis Between the Estate Tax Valuation and the Basis in the Hands of the Heir (sec. 1014)."

1. The idea here is that an heir will be required to use as the income tax basis the same value that is used for estate tax purposes, with the rather noncontroversial objective of consistency. To implement this rule, the executor would be required to report the basis to each recipient of property and to the IRS.

2. In addition, consideration might be given to a vehicle analogous to Form 8082 (by which beneficiaries of an estate can report an income tax position that is inconsistent with the Form K-1 received from the executor) to permit the use of a different basis by the heir if the inconsistency is disclosed and explained to the IRS.

E. "Modify Transfer Tax Provisions Applicable to Section 529 Qualified Tuition Accounts (sec. 529)."

1. This proposal would essentially subject 529 plans to the transfer tax rules that are generally applicable.

2. An exception is the special rule allowing the use of five annual gift tax exclusions for a single transfer, which apparently would not be changed.

XII. SHORT-TERM LEGAL AND DRAFTING CONSIDERATIONS THIS DECADE

A. Increases in the Estate Tax Unified Credit/Exemption Equivalent

1. It is the increase over time in the estate tax unified credit/exemption equivalent that may cause the most distortion in estate plans, especially those of married couples.

2. In general, however, it should not be assumed that estate plans before 2002 were perfect reflections of the clients' wishes and that any change from those plans is a "distortion." The pre-2002 plans themselves may

have been distortions of the clients' true preferences, distortions suffered solely for tax reasons.

3. It has often been said that EGTRRA provides a reason to seriously ask clients "what they really want."

4. Formula clauses have inevitably become more complicated. Floors and caps on tax-motivated formula results are more common, sometimes expressed as percentages, sometimes as monetary amounts (perhaps with indexing for inflation), and sometimes both. There is nothing wrong with this.

5. The different relative sizes of marital and non-marital dispositions might warrant reexamination of former choices between pre-residuary and residuary dispositions, pecuniary and fractional dispositions, and "minimum worth," "true worth," and "fairly representative" funding.

6. The increases in the estate tax unified credit/exemption equivalent (added to those set in motion in 1997) will cause attention to the *titling* of assets between a husband and wife (or jointly) to be even more important. No longer is it sufficient to make sure each spouse owns at least $600,000. Similarly, the proper attention to "non-probate" assets such as employee retirement benefits, IRAs, and life insurance will be more important.

7. Reliance on disclaimers seems to be increasing somewhat, including disclaimers of jointly owned assets under Reg. § 25.2518-2(c)(4).

8. Any new regime of portability of exemptions between spouses, as in PETRA and ETETRA, would change this analysis, but would not necessarily be without issues. See Part VIII.C.2 on page 21 *supra*.

9. In any event, the increased unified credit will dramatically reduce the number of taxable estates and contribute further to the differentiation of our practices by class of client served.

B. Increases in the GST Tax Exemption

1. In general, the increases in the GST exemption may have a distortive effect similar to that of the increases in the estate tax unified credit/exemption equivalent.

2. The conformity of the GST exemption to the estate tax exemption equivalent (after 2003) means that measures to properly manage the *titling* of property between spouses for the purposes of either tax will probably work for purposes of the other tax also.

3. The conformity of the GST exemption to the estate tax exemption equivalent will theoretically reduce the need for "reverse QTIP" elections

and reduce the number of trusts required to optimize the use of the unified credit and the GST exemption. In many sophisticated cases, however, clients will already have used their unified credit and GST exemption unevenly, and two marital bequests, one with a reverse QTIP election, might still be needed.

4. The failure of the gift tax exemption equivalent to conform to the estate tax exemption equivalent (and thereby to the GST exemption) after 2003 has made it harder to maximize the leverage of the GST exemption by allocating it to inter vivos gifts of property that might increase in value. One technique might be the more frequent allocation of GST exemption to gifts sheltered from the gift tax (but not the GST tax) by "Crummey powers."

5. For further discussion of drafting involving the GST tax and its interrelationship with state death taxes, see Part G.3 on page 45.

C. Changes in GST Exemption Allocation Rules

1. Although EGTRRA cures or relieves a number of GST tax problems, it also creates an unintended pitfall that appears to make it necessary to review all irrevocable trusts—particularly life insurance trusts and other trusts depending on the use of Crummey withdrawal powers—to make sure that those trusts are not "GST trusts," which automatically (and perhaps unnecessarily) consume a part of the donor's GST exemption. This is especially undesirable in estate plans designed to use the GST exemption during lifetime or at death in another, more effective, manner.

a. **Example 1.** Father created Trust 1 some years ago and has been making annual cash gifts to Trust 1, subject to Crummey withdrawal powers designed to qualify the gifts for the gift tax annual exclusion. Trust 1 owns a life insurance policy on Father's life and uses the annual gifts to pay the premiums to keep the policy in existence. At Father's death, Trust 1 will continue for the benefit of Mother for her life. At Mother's death, the assets of Trust 1 will pass to Father's and Mother's then-living descendants, subject to contingent trusts for any beneficiaries under age 23.

b. **Example 2.** Trust 2 owns a second-to-die insurance policy on the lives of Father and Mother funded with annual Crummey right-of-withdrawal gifts. Trust 2 provides that, at the death of the surviving spouse, the trustee can use the insurance proceeds to make loans to the survivor's estate to provide funds to pay estate taxes and, after 15 months, the assets of Trust 2 are to be divided into shares for the then-living descendants.

2. It appears that neither of these trusts is designed or expected to provide benefits to any generation below that of the grantor's children, and thus neither trust would ordinarily be subject to GST tax. Nevertheless, under the new rules enacted by EGTRRA, it appears possible that both these trusts would be viewed as "GST trusts," meaning that each gift made to either trust by Father during 2001 and subsequent years will automatically consume part of Father's GST exemption, unless he elects out of the automatic allocation.

3. In other cases, donors may *want* the automatic allocation rule to apply—for example, in a true generation-skipping situation in which the trust agreement directs that the child's share of a trust be held for the child's life with remainder to the child's descendants. But even then, EGTRRA adds complicating wrinkles, especially if the trust is funded with Crummey right-of-withdrawal gifts, and the result might depend on the particular level of those gifts from year to year.

4. Regulations to govern the elections in and out of the automatic allocation of GST exemption were published in proposed form on July 12, 2004, and in final form on June 21, 2005.

    a. The proposed regulations, while generally welcomed, were critiqued for possible shortcomings, including the rigid and sometimes impractical requirement to "identify" the trust or trusts to which the contemplated elections would apply. The definition of a "GST trust" in section 2632(c)(3)(B) is not simple, and it is sometimes hard to tell when a trust is a "GST trust," especially when a trust has multiple beneficiaries in multiple generations and maybe in multiple branches of the family. Similarly, it is sometimes not clear when a transfer is made to a trust or who the transferor is, or the deemed transferor might not even realize that a transfer has been made. This problem most commonly arises in trusts with complex arrays of Crummey withdrawal powers or in trusts holding, for example, interests in group life insurance policies, as to which the premium payments are made by a third party such as an employer.

    b. The final regulations permit elections to be made in a much more generic and flexible manner. The final regulations permit an election out of automatic allocation in very broad terms with respect to "(1) one or more prior-year transfers subject to section 2642(f) (regarding ETIPs) made by the transferor to a specified trust or trusts; (2) one or more (or all) current-year transfers made by the transferor to a specified trust or trusts; (3) one or more (or all) future transfers made by the transferor to a specified trust or trusts; (4) all future transfers made by the transferor to all trusts (whether or not in existence at the time of the election out); or (5) any combination of [the foregoing].”

c. In addition, the final regulations treat an affirmative partial allocation of GST exemption as an effective election out of any automatic allocation. Thus, if a person transfers $100,000 to a GST trust and affirmatively allocates $40,000 of GST exemption to that trust, the transferor will be treated, without more, as having elected out of automatic allocation rules for the remaining $60,000. Although such an allocation seems to be an unusual and inefficient use of the GST exemption, it always reduces the chances for errors and ambiguities when taxpayers and return preparers are relieved of the obligation to say the same thing more than once in different ways on the same return.

5. Some estate planners prefer to elect out of automatic allocations and spell out the allocation they desire on the gift tax return. Others simply make sure they either elect in or out properly and let the automatic allocation rules operate; in this way the return preparer is relieved of the burden of devising an effective formula or otherwise getting the details right. In any event, the 2001 changes do not diminish the importance of using great care in both preparing and reviewing gift tax returns involving generation-skipping transfers.

6. While in the past it has been customary to direct the severance of a trust exempt from the GST tax *prior to* the receipt of an addition to the trust, that may no longer be necessary under the relaxed severance rules, but it might still be a good practice. Even so, instruments governing generation-skipping trusts should now include a general authorization for the trustee to sever the trust at any time.

7. The removal of the repeal of the “sunset” for these GST tax provisions between H.R. 5638 and H.R. 5970 has aggravated concern about the permanence of these provisions.

D. Decreases in the Estate, Gift, and GST Tax Rates

1. In general, the gradual reduction of tax rates will not have a significant effect on estate planning.

2. With the difference between the beginning effective rate and the top rate eliminated, “estate equalization” will ordinarily have less effect and will be used less (although such techniques as making only a partial QTIP election in order to maximize a credit for tax on prior transfers under section 2013 will continue to be useful). With the enactment of a two-rate structure such as those in H.R. 5638 and H.R. 5970, “estate equalization” would come back into fashion.

3. While the increases in the estate tax unified credit/exemption equivalent may take many previously taxable estates off the tax rolls, both the beginning rates and the top rates will still be high enough to make planning to reduce the taxable estate worthwhile.

E. "Repeal" of the Estate and GST Taxes

1. Planning for "repeal" is often difficult, because some clients (those who do not think repeal has already occurred) are generally skeptical that repeal will ever occur. Other clients, of course, have already taken repeal to the bank (not unreasonably, in the case of smaller estates), and it is hard to get them interested in estate planning of any sort, even for non-tax objectives.

2. EGTRRA has prompted a lot of angels-on-the-head-of-a-pin speculation about, for example, whether in 2010 a pecuniary marital bequest of "the smallest amount necessary to reduce the federal estate tax to zero" would produce a bequest of zero (because no bequest is needed to reduce the tax to zero) or 100% (because in the total absence of a tax the tax can never be "reduced" to zero no matter how large the bequest is). (Alumni of the "new math" [now old] might identify the underlying issue as the difference between zero and the null or empty set.) In any event, the use of the word "federal" is significant, in view of the decoupling of federal and state estate taxes. See Part G on page 44.

3. Similarly, a non-marital formula bequest might be written in terms of "the largest value of [the residuary estate] that can pass free of federal estate tax by reason of the unified credit…." If there is no estate tax, then the entire residuary estate can pass "free of federal estate tax," but no amount is free of tax "by reason of the unified credit." So what does this formula provide for—all or nothing?

4. At a minimum, estate planning documents should make it clear what happens in the event the estate tax or GST tax is not applicable.

   a. "Not applicable" or "does not apply," with reference to the estate tax, will probably be a better formulation than "has been repealed" or "is repealed."

      i. For example, arguably, if the law does not change, in 2011 it will be true that the estate tax "has been repealed," because it will have been repealed for the year 2010. Yet it will apply in full force in 2011.

      ii. Even "is repealed" can be troublesome. Technically, EGTRRA did not "repeal" the estate tax; it merely added section 2210(a), providing that the estate tax "shall not apply to the estates of decedents dying after December 31, 2009."

iii. The capacity of Congress to surprise us should not be underestimated in any event. If, for example, a certain result under an estate planning document is conditioned on "the top estate tax rate falling below 35 percent," what would be the result if Congress kept the rate at 50% but made the estate tax calculation tax-exclusive like the gift tax, producing an effective comparable rate of 33⅓%? Even apart from such fantastic scenarios, what account should be taken of the incremental burden of *state* tax rates in the wake of the repeal (that is, inapplicability!—see section 2011(f)) of the state death tax credit?

b. One must be careful, though, to make sure that an expression like "not applicable" or "does not apply" cannot be construed to mean merely that there is no tax by reason of a charitable or marital deduction, or by reason of the unified credit.

c. It is important to make a proper distinction between federal and state taxes. See Part G on page 44. If the federal estate tax is repealed, but not state taxes, the tax planning may, or may not, be the same.

d. It is also important to take care that a clearly expressed intent not be frustrated by traditional boilerplate provisions such as—

i. a direction that assets the value of which is not included in the gross estate be added directly to the marital trust (when there is no gross estate);

ii. a direction that no asset be used to fund a marital bequest for which a marital deduction is not allowed (since if there is no estate tax there is no marital deduction); or

iii. a direction that a charitable legatee must be an organization "contributions to which are deductible under section 2055" (for the same reason).

e. As to the GST tax, it has been widely observed that in 2010 there could be a vast difference between "the amount of the GST exemption" (arguably none) and "the amount that is exempt from GST tax" (arguably the entire fund). In addition, unlike the estate tax, the GST tax might not apply until a generation later. Therefore, a formulation like "if the GST tax does not apply to this trust at the time of my death" should probably be reworded as something like "if under the law in effect at the time of my death this trust is not subject to GST tax and neither this trust nor distributions from it will be subject to GST tax in the future."

5. In any event, references to dates (*i.e.*, "if my death occurs after December 31, 2009") should never be used.

6. On top of everything else, care must be taken to avoid a violation of any policy against conditions subsequent, in the manner of *Commissioner v. Procter*, 142 F.2d 824 (4th Cir.), *cert. denied*, 323 U.S. 756 (1944).

7. If repeal ever becomes "permanent" (how will we know?), there will be a premium on collapsible or amendable techniques, such as (in general) limited partnerships and LLCs (which usually can be amended by the parties, in contrast to trusts).

8. Meanwhile, providing a power in an independent trustee (or sometimes someone such as a "trust protector") to *amend* a *revocable* trust can be seen as a backstop in the event of significant changes in the law after the client has become incompetent.

F. Decoupling and Freezing of the Gift Tax Exemption

1. The obvious effect of the "reduced" gift tax exemption (relative to the estate tax exemption) is to place a premium on gifts in a form that leverages the use of the unified credit.

2. Examples are family limited partnerships (FLPs) or limited liability companies (LLCs), charitable lead trusts, grantor retained annuity trusts (GRATs), grantor retained income trusts (GRITs) (where available), installment sales to grantor trusts, other intra-family sales, other intra-family loans at the applicable federal rate (AFR), qualified personal residence trusts (QPRTs), split-dollar life insurance (at least of the non-equity kind), Crummey trusts, and any other annual exclusion gifts.

3. The payment of gift tax, which has never been popular, will be even harder to sell now (especially with the *possibility* of repeal of the estate tax in clients' minds).

4. Even legislation such as that in H.R. 5638 and H.R. 5970 would keep the gift tax mismatch in effect through 2009.

G. Decoupling of Federal and State Death Taxes

1. The repeal of the federal credit for state death taxes means it will be much more important to watch what state legislatures do, and it might be necessary to understand the operation of the tax regimes of several states. Perhaps most troubling are those states that are decoupling their tax

systems not only from the declining federal credit for state death taxes but also from the phased increases in the federal unified credit.

2. In the long term, it is easy to imagine that state death tax regimes will be an important factor in the choice of domicile by wealthy people.

3. Since the combined federal and state estate tax rate might now exceed the nominal statutory estate tax rate (see Tables 3 and 4), it might therefore exceed the top GST tax rate. Thus, the popular technique of granting a beneficiary a general power of appointment to the extent trust property is subject to the GST tax might actually result in more tax, not less.

    a. This technique might still be a good idea, because the additional flexibility of a general power of appointment (which can be used for leveraged gifts, charitable planning, and other affirmative estate planning) might outweigh the increase in rates.

    b. An appropriate response might be to add language providing that the general power shall apply only to the extent it produces a decrease in the overall level of federal, state, and local estate, inheritance, GST, and similar taxes.

    c. As always, it is important to avoid giving a beneficiary a general power of appointment in all cases simply by giving a beneficiary the power to allocate GST exemption, or even to rearrange his or her own estate outside of the generation-skipping trust, so as to manipulate a formula general power. Meanwhile, a general power *conferred* by an independent trustee might be analyzed as a general power *held jointly* with the independent trustee, with similarly undesirable results. There are no easy answers to such questions.

4. The state tax has always been the dominant component of the total tax at the low end where estates first begin to be taxable. As a result, in states that are decoupled from the federal state death tax credit but conformed to the federal unified credit there will now be a disproportionate "penalty" for *slightly* exceeding the estate tax exclusion amount. For example, in 2006, when the estate tax exclusion amount is $2,000,000, if the taxable estate is $2,200,000 ($200,000 over the exclusion amount), the total federal and state taxes, assuming no adjusted taxable gifts, will be $126,027. That represents a 63% rate on the "excess" $200,000.

5. While the payment of gift tax as such is unpopular, the making of substantial gifts even on one's deathbed might now be an advantage in large estates, because it could save non-creditable state taxes. Most state taxes are computed with reference to the federal taxable estate (as is the maximum credit under section 2011), without regard to "adjusted taxable gifts." Since most states piggyback on federal definitions, the gift tax

payable that is added to the gross estate under section 2035(b) will itself become subject to state tax, but the underlying gift will not be. Such gifts might be made pursuant to a clear authorization in a durable power of attorney, but that might require the revision of powers of attorney that are now limited to annual exclusion gifts, unified credit gifts, gifts in accordance with the principal's past giving patterns, or some other limitation that would impede the achievement of this purpose.

XIII. LONG-TERM IMPACT OF REPEAL OR SUBSTANTIAL REDUCTION OF THE ESTATE TAX

A. Areas of practice that will be affected include:

1. Planning to pay federal estate and GST taxes.

2. Planning to qualify for the marital deduction for estate tax purposes.

3. Planning to qualify for the charitable deduction for estate tax purposes.

4. Planning to make gifts and dispositions at death to avoid the federal estate and GST taxes, including using the annual gift tax exclusion and applicable exclusion, as well as other techniques, such as GRATs, QPRTs, FLPs, and dynasty trusts designed to minimize transfer taxes.

B. Areas of practice that should not be affected include:

1. Planning for the disposition of the client's assets at his or her death.

2. Asset protection planning.

3. Planning for marital and other dissolutions.

4. Planning for disability.

5. Planning for incompetence.

6. Business succession planning (without the estate tax to blame for failure of a business).

7. Using business entities to accomplish non-tax objectives.

8. Charitable giving (income tax considerations will still be relevant, and techniques such as lifetime charitable remainder trusts to facilitate diversification will not be affected at all).

9. Retirement planning.

10. Planning for life insurance protection.

11. Fiduciary litigation (perhaps more so if there is more to fight over).

12. Coping with carryover basis (or whatever income tax regime replaces the estate tax). This could include investing assets in arrangements where high-basis and low-basis assets can effectively offset each other (as in some family limited partnerships) or inside build-up of value can escape income taxation altogether (as in most life insurance contracts).

13. Planning to pay state death taxes (in many states).

14. Planning for clients with property in more than one state.

15. Planning to minimize gift taxes (especially if the applicable exclusion amount for gift tax purposes remains less than it is for estate tax purposes, and the client wants to give a larger amount).

16. Planning for children with disabilities.

17. Planning for spendthrift children.

18. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.

19. Planning for nonresident aliens with assets in the United States or who plan to move to the United States.

20. Planning for citizens who are planning to change their citizenship (although not to avoid transfer taxes, unless they think repeal will be short-lived).

21. Planning to live with non-tax regulatory regimes, including Sarbanes Oxley, the Patriot Act, HIPAA, and charitable governance reform.

22. Planning for possible reinstatement or increase of the estate, gift, and GST taxes.

C. See also the discussion of specific actions to consider if legislation like PETRA or ETETRA ever became law, in Parts VIII.C through VIII.C.5, beginning on page 20 *supra*.