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OVERVIEW OF FEDERAL TRANSFER TAX SYSTEM

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I. INTRODUCTION TO FEDERAL TRANSFER TAX SYSTEM.

A. The federal transfer tax system is composed of three taxes:

1. Estate Tax;

2. Gift Tax; and

3. Generation-Skipping Transfer ("GST") tax.

B. These transfer taxes are imposed on the exercise of the privilege of transferring property.

II. FEDERAL ESTATE TAX.

A. *Gross Estate.* Under Code Sections 2031[1] and 2033, a decedent's "gross estate" includes the value of all property owned by the decedent at death and the value of all property in which the decedent had an interest at death, whether tangible or intangible and wherever situated.

1. Jointly-owned property.

a. The definition of gross estate includes interests held by a decedent as tenants in common because each tenant in common has a distinct, undivided interest in the property, which the tenant in common may transfer by will or trust.

b. Under Section 2040, the value of property owned by the decedent and another person in joint tenancy with rights of survivorship is

[1] References to "Code" refer to the Internal Revenue Code of 1986, 26 U.S.C. §1 et seq., and references to "Section" without further modification refer to Sections of the Code.

included in the decedent's estate except to the extent that it can be shown that the surviving co-tenant contributed to the acquisition or improvement of the property.

c. Where the decedent and the surviving joint tenant acquired the property by gift, bequest, devise or inheritance, the decedent's fractional interest in the property is included in the decedent's gross estate.

d. Under Section 2040(b), certain joint interests of husband and wife are treated differently and are referred to as "qualified joint interests." Specifically, only one-half of the value of a qualified joint interest is included in the estate of the first spouse to die, if the interests are held by the decedent and the decedent's spouse as tenants by the entirety or as joint tenants with rights of survivorship but only if they are the only joint tenants.

2. Life Insurance.

a. Under Section 2042, the value of the gross estate includes the value of all property receivable by the executor as insurance under policies held on the life of a decedent or receivable by other beneficiaries with respect to which the decedent possessed incidents of ownership with respect to the policy.

b. Examples of incidents of ownership with respect to a policy include the power of the insured to change the beneficiary, the power to pledge a policy for a loan, or the power to obtain a loan against the surrender value of a policy.

c. In addition, if an insured transfers ownership of a policy within three years of the insured's death, the proceeds will be brought back into the insured's gross estate under Section 2035(a).

3. Property with Retained Interests.

a. Under Sections 2036 to 2038, certain property may be treated as part of a decedent's gross estate if it is deemed that the grantor retained certain interests with respect to the property.

b. *Transfers with Retained Life Estate.* Under Section 2036, a decedent's gross estate includes the value of all property to the extent that the decedent has made a transfer (except for adequate and full consideration) by trust or otherwise, under which the decedent has retained:

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who will possess or enjoy the property or income.

c. An example of the application of Section 2036 is the reciprocal trust doctrine, where two parties make transfers to trusts such that each donor is in the same economic position before and after the transfer.

d. Under the reciprocal trust doctrine, these transfers are treated as interrelated, and each transfer is included in the donor's estate under Section 2036.

e. *Transfers Taking Effect at Death.* Under Section 2037, a decedent's gross estate also includes the value of all property to the extent of any interest therein of which the decedent has made a transfer (except for adequate and full consideration) by trust or otherwise if:

   (1) possession or ownership of the property can be obtained only by surviving the decedent; or

   (2) the decedent retained a reversionary interest in the property, and the value of the reversionary interest immediately before the death of the decedent exceeds 5% of the value of the property.

f. Under Section 2037(b), a "reversionary interest" includes a possibility that property transferred by the decedent may return to him or his estate, or may be subject to a power of disposition by him.

g. *Revocable Transfers.* Under Section 2038, the decedent's gross estate also includes transfers where the enjoyment of the property was subject at the date of the grantor's death to any

change through the exercise of a power by the decedent to alter, amend, revoke or terminate the transfer.

4. Property As to Which Decedent had a General Power of Appointment.

   a. Under Section 2041, a decedent's gross estate includes the value of all property as to which the decedent had a general power of appointment at the time of his or her death.

   b. Under Section 2041(b)(1), a general power of appointment is a power under which the holder of the power has the authority to appoint the property subject to the power in favor of anyone, including himself, his estate, his creditors, or the creditors of his estate, with the following exceptions:

      (1) A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to health, education, support or maintenance of the decedent;

      (2) A power exercisable only in conjunction with the creator of the power; or

      (3) A power exercisable only in conjunction with a person having a substantial and adverse interest in the property subject to the power.

5. Adjustments for Certain Gifts Made Within Three Years of Decedent's Death.

a. Section 2035(a) brings back into a decedent's gross estate certain interests transferred (or powers released) by the decedent within three years of the decedent's death that would have been included in the decedent's estate under Sections 2036, 2037, 2038 and 2042 had they not been transferred (or released).

b. In addition, the value of gift taxes on gifts made three years before the decedent's death is also included in the decedent's estate.

B. Federal Estate Tax Deductions.

1. *Estate Tax Marital Deduction.* Under Section 2056, a decedent's taxable estate is determined by deducting the value of any interest in property which is passing or has passed from the decedent to his surviving spouse.

a. To obtain the marital deduction with respect to any property interest, the following requirements must be met:

(1) the property must have been included in the decedent's gross estate;

(2) the property must actually pass to a surviving spouse; and

(3) the interest must be deductible (not a nondeductible terminable interest), as discussed below.

b. *Terminable Interest Rule.*

(1) Section 2056(b) provides that no marital deduction is allowed with respect to "terminable interests" passing from a decedent to his surviving spouse.

(2) A terminable interest in property is an interest which will terminate or fail on the lapse of time or on the occurrence or the failure to occur of some contingency. A property interest which constitutes a terminable interest is nondeductible if:

(a) another interest in the same property passed from the decedent to some other person for less than an adequate and full consideration in money or money's worth, and

(b) by reason of its passing, the other person or his heirs or assigns may possess or enjoy any part of the property after the termination or failure of the spouse's interest.

(3) *Exceptions to the Terminable Interest Rule.* A property interest passing to a decedent's surviving spouse is deductible even though it is a terminable interest and even though an interest therein passed from the decedent to another person, if it is a terminable interest only because:

(a) it is conditioned on the spouse's surviving for a limited period;

(b) it is a right to income for life with a general power of appointment;

(c) it consists of life insurance or annuity payments held by the insurer with a general power of appointment in the spouse;

(d) it is qualified terminable interest property; or

(e) it is an interest in a qualified charitable remainder trust in which the spouse is the only noncharitable beneficiary.

(4) *Survivorship Exception.* Section 2056(b)(3) provides an exception to the terminable interest rule so as to allow a deduction if

(a) the only condition under which it will terminate is the death of the surviving spouse within six months after the decedent's death, or her death as a result of a common disaster which also resulted in the decedent's death, and

(b) the condition does not in fact occur.

(5) *Exception for Life Estate with Power of Appointment in Surviving Spouse.* Under this exception, the marital deduction is allowed if an interest in property passes from the decedent to his surviving

spouse (whether or not in trust) and the spouse is entitled for life to all the income from the entire interest or all the income from a specific portion of the entire interest and the spouse holds a general power to appoint the entire interest or the specific portion. The following conditions must be satisfied:

(a) The surviving spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest.

(b) The income payable to the surviving spouse must be payable annually or at more frequent intervals.

(c) The surviving spouse must have the power to appoint the entire interest or the specific portion to either himself or herself or to his or her estate.

(d) The power must be exercisable by the surviving spouse alone and (whether by will or during life) must be exercisable in all events.

(e) The entire interest or specific portion must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse.

(6) *Qualified Terminable Interest Property ("QTIP") Trust Exception.* Under Section 2056(b)(7), a marital deduction is allowed for an interest that passes to a surviving spouse in trust if all of the following requirements are met:

(a) The surviving spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest.

(b) The income payable to the surviving spouse must be payable annually or at more frequent intervals.

(c) No person has a power to appoint any part of the property to any person other than the surviving spouse.

(d) A QTIP election must be made on the decedent's federal estate tax return with respect to a specific portion or all of the trust. Once made, the election is irrevocable.

2. Estate Tax Charitable Deduction.

a. Section 2055(a) allows an estate tax charitable deduction for transfers to the following types of recipients:

(1) Section 501(c)(3) corporations operated exclusively for religious, charitable,

scientific, literary or education purposes, which do not attempt to influence elections or legislation.

(2) Federal government, state government or subdivisions thereof for exclusively public purposes.

(3) Section 501(c)(3) fraternal or veterans' organizations.

(4) Certain employee stock ownership plans if the transfer qualifies as a qualified gratuitous transfer of qualified employer securities within the meaning of Section 664(g).

b. Under Section 2055(d), in order to receive the charitable deduction, the property must have been included in the decedent's gross estate.

3. Deduction for Expenses, Claims, Debts, Taxes and Losses.

a. Section 2053(a) allows an estate tax deduction for certain expenses and indebtedness, such as:

(1) *Reasonable Funeral Expenses.* In order to be deductible, funeral expenses must be actually expended and properly allowable out of property subject to claims under the laws of the local jurisdiction. Reg. § 20.2053-2.

(2) *Administration Expenses*. An administration expense must be actually and necessarily incurred in the administration of the estate in order to

be deductible. The administration expenses of an estate include the collection of assets, the payment of debts and the distribution of property to persons entitled to it. Administration expenses include executor's commissions, attorneys' fees and miscellaneous expenses. Reg. § 20.2053-3.

(3) *Claims Against the Estate*. An estate can deduct claims representing personal obligations of the decedent that existed and were enforceable against the decedent at the time of the decedent's death, whether or not then matured, and interest thereon which had accrued at the time of death. The allowance of a deduction for a claim founded upon a promise or agreement is limited to the extent that the liability was contracted bona fide and for an adequate and full consideration in money or money's worth.

(4) *Unpaid Mortgages or Other Indebtedness*. An estate may deduct the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided that the value of the property, undiminished by the mortgage of indebtedness, is included in the value of the gross estate. Reg. § 20.2053-7.

C. Federal Estate Tax Credits.

1. *Applicable Exclusion Amount.* Section 2010(a) allows an applicable credit amount against a decedent's federal estate tax. The applicable credit amount is the amount of estate tax that would be generated on a transfer of property in the amount of the "applicable exclusion amount," which is often referred to as a decedent's estate tax exemption.

2. *State Death Taxes*.

III. FEDERAL GIFT TAX.

A. *Introduction.*

1. *Generally.* Section 2511(a) provides that the gift tax is to apply "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible."

2. *Liability of Donor.* As described in Reg. § 25.2511-2(a), the gift tax is a primary and personal liability of the donor, and the liability attaches to the donor even if the identity of the donee is not known or ascertainable.

3. *Dominion and Control.* A gift is complete for gift tax purposes if the donor has parted with dominion and control in such a way that he has no power to change the disposition, whether for his own benefit or for the benefit of another individual. Reg. § 25.2511-2(b).

   a. *Example: Gift by Check.* For example, a gift by check relates back to the date of the delivery of the check by the donor if (1) there is an

unconditional delivery to the donee, (2) the check is deposited in the donee's bank account within a reasonable time, (3) the donor's account has a sufficient balance to permit payment when the check is delivered to the donee, and (4) the check is ultimately paid by the drawee bank. *Metzger v. Commissioner*, 100 T.C. 204 (1993), aff'd, 38 F. 3d 118 (4th Cir. 1994). A gift to charity is treated as relating back to the time the charity receives the check, even though the check may not be accepted and paid until after the donee's death.

b. *Example: Gift in Trust*. In determining whether a donor's transfer in trust is a completed gift, any power reserved by the donor must be analyzed, such as the following:

(1) *Donor's Power to Revoke Trust or Revest Trust Property in Self*. A transfer to a trust is an incomplete gift if the donor has the power revest the trust property in himself. Reg. § 25.2511-2(c).

(2) *Donor's Power to Name New Beneficiaries or Change Interests*. A transfer to a trust is an incomplete gift if the donor has the power to name new beneficiaries or to change the interests of the beneficiaries unless the power is a fiduciary power limited by an ascertainable standard. Reg. § 25.2511-2(c).

(3) *Donor's Power to Change Manner and Timing of Enjoyment*. A transfer to a trust is a completed gift if the donor only has the power to determine the manner or

timing of the enjoyment of a gift. Reg. § 25.2511-2(d).

4. Donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. Reg. § 25.2511-1(g)(1).

5. As stated in Reg. § 25.2512-8, transfers subject to gift tax include sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given.

    a. For example, an interest-free demand loan results in a taxable gift of the use of the transferred funds. *Dickman v. Commissioner*, 465 U.S. 330 (1984). Section 7872 codifies the gift tax treatment of interest-free and low-interest loans.

    b. A sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) is deemed to be made for an adequate and full consideration in money or money's worth. Reg. § 25.2512-8.

6. *Disclaimers***.** A disclaimer occurs when a donee refuses to accept property or a property interest transferred to the donee. By disclaiming a property interest, a person may be deemed to have made a gift of the interest to the person then receiving the interest. However, qualified disclaimers, as defined in Section 2518, are not subject to gift tax.

a. *Irrevocable and Unconditional*. A qualified disclaimer is irrevocable and unconditional.

b. *Refusal in Writing*. The disclaimer must be in writing.

c. *Timing*. The disclaimer must be received by the transferor or the holder of the legal title of the interest within 9 months of the date on which the transfer creating the interest in the disclaimant is made or the day on which the person attains age 21.

d. *No Acceptance.* The disclaimant must not have accepted the property interest or any of its benefits.

e. *Interest Passes Without Direction by Disclaimant*. The interest must in fact pass to another person without any direction or control by the disclaimant.

B. Federal Gift Tax Exclusions.

1. *Gift Tax Annual Exclusion.* Under Section 2503(b), the gift tax annual exclusion permits an individual to give present interests in property in an amount equal to the annual exclusion (currently $12,000 in 2007) per donee without incurring gift tax liability.

a. Married donors can annually give up to $24,000 per donee if they agree to gift-splitting, as discussed below.

b. Additionally, under Section 2642(c), the GST tax does not apply to direct skips which are nontaxable gifts.

(1) *Present Interests***.** Only gifts of present interests qualify for the annual exclusion. A present interest is defined as an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property. Reg. § 25.2503-3(b).

(a) Outright gifts of property or cash generally qualify for the annual exclusion.

(b) Gifts in trust be structured as present interests in order to qualify for the annual exclusion. Section 2503(c) provides an exception for certain trusts created for minors.

(2) *Future Interests.* Future interests include reversions, remainders, and other interests or estates which are to be enjoyed or used at some future date.

2. *Unlimited Exclusion for Certain Qualified Transfers to Tuition or Medical Expenses.* Section 2503(e)(1) provides an exclusion for certain amounts paid by a donor directly to a qualifying education institution or a medical provider on behalf of an individual for tuition expenses or medical care.

C. Federal Gift Tax Deductions.

1. *Unlimited Gift Tax Marital Deduction.* Section 2523 allows an unlimited gift tax marital deduction for qualified interests that a donor gives to the donor's spouse.

a. *Requirements*. Section 2523 includes the following requirements for the gift tax marital deduction:

(1) *U.S. Citizens*. The spouses must be U.S. citizens on the date of the gift.

(2) *Deductible Interest*. The interest must not be a nondeductible terminable interest, as discussed above.

2. *Unlimited Gift Tax Charitable Deduction.* Section 2522(a) allows an unlimited gift tax charitable deduction for transfers to the same recipients discussed above with respect to the federal estate tax charitable deduction.

D. Gift Splitting.

1. *Generally.* Section 2513 allows one spouse to treat his or her gifts to any person other than his or her spouse as made one-half by each spouse.

2. *Requirements.* In order to split gifts, all of the following requirements must be met:

a. *U.S. Citizen or Resident Spouses***.** Both spouses must be U.S. citizens or residents at the time of the gift.

b. *Married and No Subsequent Remarriage in Same Calendar Year***.** The donor must have been married at the date of gift, and each donor cannot remarry during the calendar year in which the gift occurred.

c. *Consent of Both Spouses on Gift Tax Return***.** Both spouses must signify their consent to split their gifts on their gift tax returns.

3. *Joint and Several Liability.* Both spouses are jointly and severally liable for the entire gift tax liability.

IV. FEDERAL GENERATION-SKIPPING TRANSFER TAX.

A. *Generally.* The GST tax is imposed on transfers to individuals who are two or more generations below the transferor and to certain trusts.

B. *Key Definitions.*

1. *Transferor.* The transferor for GST tax purposes is the decedent (for transfers subject to estate tax) or the donor (for transfers subject to gift tax).

2. *Skip person.* A skip person is:

a. An individual assigned to a generation more than one generation below that of the

transferor (determined under the rules of section 2651); or

b. A trust if:

(1) All interests in the trust are held by skip persons; or

(2) No person holds an interest in the trust and no distributions, other than a distribution the probability of which occurring is so remote as to be negligible (including distributions at the termination of the trust), may be made after the transfer to a person other than a skip person.

C. *Generation-Skipping Transfer.* A generation-skipping transfer is an event that is either a direct skip, a taxable distribution, or a taxable termination.

a. *Direct skip*.

(1) A direct skip is a transfer to a skip person that is subject to federal estate or gift tax.

(2) If property is transferred to a trust, the transfer is a direct skip only if the trust is a skip person.

(3) Only one direct skip occurs when a single transfer of property skips two or more generations.

b. *Taxable termination.*

(1) A taxable termination is a termination (occurring for any reason) of an interest in trust unless:

(a) A transfer subject to Federal estate or gift tax occurs with respect to the property held in the trust at the time of the termination;

(b) Immediately after the termination, a person who is not a skip person has an interest in the trust; or

(c) At no time after the termination may a distribution, other than a distribution the probability of which occurring is so remote as to be negligible (including a distribution at the termination of the trust) be made from the trust to a skip person.

(2) *Partial termination.* If a distribution of a portion of trust property is made to a skip person by reason of a termination occurring on the death of a lineal descendant of the transferor, the termination is a taxable termination with respect to the distributed property.

(3) *Simultaneous terminations.* A simultaneous termination of two or more interests creates only one taxable termination.

c. *Taxable distribution.*

(1) A taxable distribution is a distribution of income or principal from a trust to a skip person unless the distribution is a taxable termination or a direct skip.

(2) If any portion of GST tax (including penalties and interest) imposed on a distributee is paid from the distributing trust, the payment is an additional taxable distribution to the distributee.

(3) If federal estate or gift tax is imposed on any individual with respect to an interest in property held by a trust, the interest in property is treated as having been distributed to the individual to the extent that the value of the interest is subject to federal estate or gift tax.

D. GST Tax Exemption and Exclusions.

1. GST Tax Exemption. The GST tax exemption for decedents dying 2007 is $2 Million.

2. GST Tax Exclusion for Annual Exclusion Gifts.

a. *Generally***.** As discussed above, the gift tax annual exclusion under Section 2503(b) permits an individual to give an amount equal to the annual exclusion) per donee without incurring any gift tax liability, if the gift is of a present interest.

b. *Outright Gifts***.** An outright gift to a skip person qualifies for the annual exclusion for both gift tax and GST tax purposes because it is a direct

skip (a transfer to a skip person subject to gift tax) and because it qualifies as a present interest under Section 2503(b).

c. *Gifts in Trust***.**

(1) For a transfer in trust to qualify for the annual exclusion for GST tax purposes, the following requirements must be met:

(a) the transfer must be a direct skip,

(b) the trust must meet the requirements of the gift tax annual exclusion under Section 2503(b), and

(c) the trust must meet the additional requirements imposed by Section 2642(c).

(2) *Direct Skip***.** A transfer in trust must be a direct skip to qualify for the annual exclusion for GST tax purposes.

(a) A trust is a skip person if: (a) all interests in the trust are held by skip persons, or (b) if no person holds an interest in the trust and at no time after the transfer may a distribution be made to a non-skip person.

(b) Under Section 2642(c), a transfer in trust will qualify for the annual exclusion for GST tax purposes if no part of the trust

income or principal may be distributed to or for any person other than the skip person-beneficiary, and the trust assets must be included in the skip person-beneficiary's gross estate if the skip person-beneficiary dies before the trust terminates.

(c) As discussed above, the transfer in trust must be a transfer of a present interest in property in order to qualify for the annual exclusion for both gift and GST tax purposes (examples: Section 2503(c) Minor's Trust, Crummey Trust).

3. GST Tax Exclusion for Education Expenses and Medical Expenses. As discussed above, Section 2503(e)(1) excludes from gift tax certain qualified transfers for amounts paid by a donor to a qualifying educational institution or a medical provider on behalf of an individual for tuition expenses or medical care. Under Section 2542, a transfer that qualifies for this gift tax exclusion is also excluded from GST tax.

V. PROSPECTS OF ESTATE TAX REFORM.

A. *Current Estate Tax Exemption and Rate Schedule.*

YEAR	ESTATE TAX EXEMPTION	MAXIMUM ESTATE TAX RATE
2007	$ 2,000,000	45%
2008	$ 2,000,000	45%
2009	$ 3,500,000	45%
2010	NOT APPLICABLE	NO ESTATE TAX
2011-on	$ 1,000,000	55% (w/ "bubble tax")

B. *History.* Congress came extremely close to passing comprehensive estate tax reform last July, falling on two separate occasions just a few votes short of the 60 vote margin required in the Senate. Although estate tax reform is not likely to be seriously reconsidered until after the November 2008 elections, many estate planning practitioners believe that estate tax legislation will be enacted before the estate tax sunset in 2011.

1. The House of Representatives passed two estate tax bills last summer:

    a. The Permanent Estate Tax Relief Act of 2006 ("PETRA"); and

    b. The Estate Tax and Extension of Tax Relief Act of 2006 ("ETETRA").

2. It is beneficial to examine the evolution of estate tax reform leading up to PETRA and ETETRA to predict our future estate tax law.

    a. Commentators have declared that the Democratic Party has morphed into the "party

of larger exemptions," while the Republican Party may be characterized as the "party of lower rates."

b. There is a significant likelihood that, at some point in time, the estate tax exemption will be increased and the estate tax rate reduced.

c. Once again, whether this ultimately comes to fruition remains to be seen. In any event, it is clear that some form of substantial estate tax reform is coming down the pike – if not through new legislation soon, then through the scheduled changes in 2009 and 2010, and the 2011 sunset provisions. Democrats and Republicans in Congress have less than 3 years remaining to resolve its differences and craft productive estate tax reform before the one-year repeal of the estate tax.

3. All of our clients should enter into estate planning in contemplation of the anticipated increase in the estate tax exemption.

a. Particular focus should be given to "affluent" clients with an approximate net worth equal to the increased estate tax exemption (as much as $5,000,000 for a single client; $10,000,000 for husband and wife).

b. The usual arsenal of sophisticated estate planning techniques should continue to be deployed for our "wealthier" clients.

c. However, several of these techniques may no longer be appropriate for many of our "affluent" clients. Likewise, maximum generation-skipping exemption plans may no

longer be favored by the merely "affluent" clients.

4. Of one thing we can be certain: the estate tax laws are never "cast in stone." A cursory review of the history of the estate tax provides the necessary context to examine our current situation.

C. *Historical Overview*. The description of "Permanent Estate Tax Relief" contained in the acronym of PETRA is laughable on its face. There will be three Congressional elections and a new President before the estate tax law is sunseted in 2011. The only tax law that matters is the estate tax regime in effect at the time of a client's death. After all, it has been noted that "death is a once-in-a-lifetime event." A brief survey of the evolution of our estate tax law is helpful in providing perspective for future planning purposes.

1. *Prior Estate Tax Laws.* The estate tax was initially used to finance wars. The reason generally expressed for the estate tax was that the largest estates had the most to lose due to war. The estate tax has been repealed twice before.

a. The estate tax was first passed during the War of 1812. It was repealed two years later.

b. The estate tax was reinstated briefly during the Civil War.

(a) Enacted in the form of an inheritance tax.

(b) Initial rates ranged from 0.75% to 5%.

(c) Repealed in 1870.

c. The current estate tax was enacted in 1916 during World War I in order to, in the words of

Congress, "break up the swollen fortunes of the rich."

(a) Rates ranged from 1% to a maximum of 10% (for estates in excess of $5,000,000).

(b) Gift tax was enacted 8 years later in the Revenue Act of 1924.

2. *Changes in Estate and Gift Tax Rules and Rates.* Although the estate tax survived the close of the 20th century, there have been substantial changes in the tax rate over the last 90 years.

a. The gift tax was repealed in 1926 but was reinstated during the Depression.

b. The estate tax rates in the Revenue Act of 1935 ranged from 2% to 70%.

c. The maximum estate tax rate from 1948 through 1976 was a draconian 77%!

(a) Maximum rate applied to estates in excess of $10,000,000.

(b) Inflation-adjusted (at an assumed 3.6% annual rate) equates to an estate valued at approximately $75,000,000 today.

(c) The failure to adjust for the effect of inflation is one of the primary reasons estate tax reform is sought.

(d) Although the maximum gift tax rate was approximately 58% during this period, it was roughly

25% lower than the maximum estate tax rate.

d. The Tax Reform Act of 1976 established a unified estate and gift tax rate schedule.

(a) Rates ranged from 18% to 90%.

(b) Maximum 90% rate applied to transfers in excess of $5,000,000.

(c) Generation-skipping tax was enacted.

e. The Economic Recovery Tax Act of 1981 made the following changes:

(a) Maximum rate decreased to 55%.

(b) Exemption increased to $175,000 in 1982, gradually phased in to $600,000 by 1987.

(c) Gift tax annual exclusion increased from $3,000 to $10,000 per donee.

(d) Allowed marital deduction for "QTIP" trusts.

f. *Tax Reform Act of 1986.* The Tax Reform Act of 1986 created a new Internal Revenue Code of 1986, repealing the Internal Revenue Code of 1954.

(a) Very little effect on estate and gift tax rules.

(b) Repealed prior generation-skipping tax law and added

chapter 13 to the Internal Revenue Code exclusively to cover generation-skipping transfers.

(1) Adopted a $1,000,000 per transferor exemption.

(2) Prior GST focus was on the transferee (who each received an exemption of $250,000 per transferor).

g. The Revenue Act of 1987 created the "5% bubble" for estates between $10,000,000 and $21,040,000.

(a) Phased out benefit of unified credit and progressive tax rates.

(b) Resulted in a marginal 60% estate tax bracket.

h. The Taxpayer Relief Act of 1997 made substantial changes to the estate and gift tax law.

(a) Increased estate and gift tax exemption gradually over 9 years to $1,000,000 by 2006.

(b) Indexing of generation-skipping exemption and annual exclusion for effect of inflation.

(c) Adopted the family-owned business exemption.

i. *The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")* reduced

the maximum estate tax rate from 55% to 50% in 2002 and reduced the marginal estate tax rate by 1% per year through 2007. In addition, the estate tax exemption was increased in stages under the schedule set forth below. The estate tax is completely eliminated for taxpayers who die in 2010, with a new cost basis regime. As you know, the tax changes "sunset" in 2011, reverting to the 2001 exemptions and rates.

YEAR	ESTATE TAX EXEMPTION	MAXIMUM ESTATE TAX RATE
2002	$ 1,000,000	50%
2003	$ 1,000,000	49%
2004	$ 1,500,000	48%
2005	$ 1,500,000	47%
2006	$ 2,000,000	46%
2007	$ 2,000,000	45%
2008	$ 2,000,000	45%
2009	$ 3,500,000	45%
2010	NOT APPLICABLE	NO ESTATE TAX
2011-on	$ 1,000,000	55% (w/ "bubble tax")

D. Recent Estate Tax Reform Legislation.

1. *2005 Reform Legislation.* Congress was close to crafting a compromise estate tax reform package in 2005. Senator Jon Kyl (R-Arizona) and Senator Max Baucus (D-Montana) entered into negotiations on the terms of an estate tax compromise bill.

a. *Republican Proposal.* Senator Kyl initially proposed a $10,000,000 estate tax exemption

($20,000,000 for married couples) and a 15% estate tax rate, and later modified his position:

(a) Increase in the individual estate tax exemption to $8,000,000 (and would consider a permanent increase to $3,500,000); and

(b) Estate tax rate tied to the capital gain rate (currently 15%).

b. *Democratic Response.* Although Senator Baucus did not respond with a public formal offer, Finance Committee Chair Chuck Grassley (R-Iowa) supported his efforts in recruiting the support of Democrats for estate tax reform and cautioned Republicans that seeking "complete repeal might blow the whole thing up."

c. Senator William Frist (R-Tennessee) planned to force a Senate vote on estate tax repeal before the 2005 summer break.

(a) The House of Representatives passed the Death Tax Repeal Permanency Act (H. R. 8) by almost a two-thirds vote (272-162) on April 13, 2005.

(b) Senator Frist did not have the necessary 60 votes to prevail.

(c) The vote was postponed until September to allow time for a compromise to be reached.

d. It is safe to say the Hurricane Katrina changed everything. It would have been politically insensitive to work on estate tax relief during the aftermath of the Gulf Coast devastation.

e. Large estates benefit more from a sharp reduction in estate tax rates than by the increase in the amount of the estate tax exemption.

(a) *Effect of 15% Rate.* A flat 15% estate tax rate constitutes a two-thirds cut from the 2007 scheduled rate of 45%.

(1) Saves $30,000,000 on a $100,000,000 taxable estate.

(2) Saves $600,000,000 on a $2,000,000,000 taxable estate.

(b) *Tax Basis.* The "step up" in cost basis of assets at death could recoup a significant portion of estate tax payable.

2. 2006 Estate Tax Reform Legislation.

a. *Majority Leader's Position.* Senator William H. Frist (R-Tennessee) promised a May 2006 vote on full estate tax repeal.

(a) *Frist Letter.* In an April 24, 2006 letter addressed to Republican congressmen, Senator Frist called "death tax" repeal a top priority on the Senate agenda over the next five weeks.

(b) *Sample of Estate Tax Rhetoric.* Senator Frist wrote: "The 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."

b. *Summit at National Press Club.* Estate tax reform proponents, led by the publisher of the Seattle Times, held a summit meeting at the Washington Press Club to rally behind the 15% estate tax rate compromise.

c. *Full Estate Tax Repeal.* Senators on both sides of the issue were skeptical that 60 votes could be raised to repeal the estate tax.

d. *Free Enterprise Fund.* The Free Enterprise Fund financed a multimillion dollar advertising campaign targeting vulnerable senators.

(a) Television commercials ran in Rhode Island, Arkansas, North Dakota and Montana.

(b) Advertisements were also financed by the Club for Growth and Freedom Works.

e. *Compromise Legislation.* It was clear from the outset that estate tax repeal could not garner the necessary 60 votes for passage. However, the consideration of the estate tax repeal provided a forum for the Senate to vote on a

reform alternative. Discussion took to the form of discerning the level of reform which could garner the necessary 60 votes for passage in the Senate.

(a) Senator Max Baucus, ranking member of the Senate Finance Committee, was the chief negotiator on this issue on behalf of Senate Democrats. He engaged in discussions with his fellow Democrats, specifically those Democrats who are members of the Senate Finance Committee. Senator Baucus sought to find consensus on a reform proposal that could get the necessary 60 votes for passage in 2006. Compromise legislation was borne after the anticipated failure of estate tax repeal.

(b) Senator Kyl was the chief negotiator on behalf of Senate Republicans. Senator Kyl continued to publicly support a reform deal with a 15% rate, and an exemption in the $5 million range. Senator Kyl suggested in both public and private discussions his belief that such a proposal could garner the necessary 60 votes for passage.

(c) The Senate voted not to proceed with full estate tax repeal legislations in June.

(d) Eleven months after the House passed its bill.

(e) Four Democrats voted in favor of estate tax repeal.

f. *First Attempt: Permanent Estate Tax Relief Act ("PETRA") of 2006 (H. R. 5638)*.

(a) *Senate Specifications.* The Senate took up H. R. 8 a second time in June to add additional provisions designed to attract the vote of a few "fence-sitting" Senators.

(b) Estate tax reform was tied to timber tax breaks to win the votes of senators in Washington and other timber states.

(c) The House of Representatives was requested to resubmit a bill to these specifications.

(d) The House passed PETRA (H. R. 5638) by a 269-156 vote.

(e) *Reunification of Gift, Estate and Generation-Skipping Exemptions.* Beginning in 2010, the estate, gift and generation-skipping tax exemptions would be reunified.

(1) *Increase in Estate, Gift and Generation-Skipping Tax Exemptions*. The estate, gift and generation-skipping tax exemptions would be increased to $5,000,000 in 2010. The tax exemptions

would be inflation-adjusted thereafter.

(2) 2010 would be used as the index year.

(3) The increases would be made in $100,000 increments.

(f) *Reduction in Estate Tax Rates*. The estate tax rate would be dramatically reduced to the long-term capital gain rate (currently 15%) for estates valued between $5,000,000 and $25,000,000.

(1) The estate tax rate would be equal to twice the long-term capital gain rate (currently 30%) for estates in excess of $25,000,000.

(2) The long-term capital gain rate under IRC Section 1(h)(1)(C) is currently 15%.

(3) The long-term capital gain rate under IRC Section 1(h)(1)(C) is scheduled to increase to 20% in 2011, unless extended.

(g) *Portability Feature (Carryover of Unused Exemption)*. Married couples could take full advantage of the $5,000,000 estate tax exemption (indexed for inflation) by carrying over any unused

exemption to the surviving spouse.

(1) Would be exercised through an election on a timely-filed estate tax return of the first deceased spouse.

(2) Statute of limitations pertaining to the amount of estate tax exclusion amount would remain open until after the death of the surviving spouse. The "super-extended" statute of limitations is not subject to an adequate disclosure exception.

(h) *Step Up In Basis.* The current "step up in basis" regime would remain in effect.

(i) *State Death Tax Credit.* There would be no state death tax credit allowable on the estate tax return.

PETRA ESTATE TAX EXEMPTION & RATES

YEAR	ESTATE TAX EXEMPTION	ESTATE TAX RATE
2006	$ 2,000,000	46%
2007	$ 2,000,000	45%
2008	$ 2,000,000	45%
2009	$ 3,500,000	45%
2010	$ 5,000,000	15% (30% above $25,000,000)[2]
2011	$ 5,000,000 (inflation adjusted)[3]	15% (30% above $25,000,000)
2012	$ 5,000,000 (inflation adjusted)	15% (30% above $25,000,000)
2013	$ 5,000,000 (inflation adjusted)	15% (30% above $25,000,000)
2014	$ 5,000,000 (inflation adjusted)	15% (30% above $25,000,000)
2015	$ 5,000,000 (inflation adjusted)	15% (30% above $25,000,000)
2016-on	$ 5,000,000 (inflation adjusted)	15% (30% above $25,000,000)

g. *Senate Vote.* The Senate failed to raise the 60 votes necessary to cut off debate on PETRA.

(a) The vote was 57-41 in favor of bringing PETRA to a vote on the Senate floor. (Three votes short of the 60 vote threshold.)

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[2] The current long-term capital gain rate under IRC Section 1(h)(1)(C) is 15%. It is scheduled to increase to 20% in 2011, unless the 15% long-term capital gain rate is extended. The estate tax rate for taxable estates between $5,000,000 and $25,000,000 would be set at the long-term capital gain rate. The estate tax rate for taxable estates in excess of $25,000,000 would be set at twice the long-term capital gain rate.

[3] Beginning in 2011, the estate tax exemption would be inflation-adjusted and would increase in $100,000 increments.

(b) If brought to the Senate floor, only 51 votes would have been required to pass PETRA.

(c) Senators Rockefeller (D-West Virginia) and Schumer (D-New York) abstained from voting.

h. *Second Attempt: Estate Tax and Extension of Tax Relief Act ("ETETRA") of 2006 (H. R. 5970)*. In one last effort to pass estate tax reform before the November elections, Senator Frist decided to combine the minimum wage bill and pension legislation to the estate tax bill,

(a) Referred to on Capitol Hill as the "Trifecta Bill."

(b) Designed to attract the vote of Senate Democrats.

i. The House of Representatives passed ETETRA (H. R. 5970) by a 230-180 vote, a narrower margin than PETRA (H.R. 5638).

(a) *Reunification of Gift, Estate and Generation-Skipping Exemptions.* Beginning in 2010, the estate, gift and generation-skipping tax exemptions would be reunified.

(b) *Increase in Estate, Gift and Generation-Skipping Exemptions*. The estate, gift and generation-skipping tax exemptions would be increased to $3,750,000 in 2010 (as opposed to $5,000,000 under PETRA).

(1) The exemptions would increase in five annual increments of $250,000, reaching $5,000,000 in 2015.

(2) The exemptions would be inflation-adjusted after 2015 (the index year), with increases made in $100,000 increments.

(c) *Reduction in Estate Tax Rates*. The estate tax rate would be dramatically reduced to the long-term capital gain rate for estates valued between $5,000,000 and $25,000,000.

(1) The long-term capital gain rate under IRC Section 1(h)(1)(C) is currently 15%.

(2) The long-term capital gain rate under IRC Section 1(h)(1)(C) is scheduled to increase to 20% in 2011, unless extended.

(d) Unlike PETRA, the estate tax rate would not be pegged to the long-term capital gain rate for estates in excess of $25,000,000.

(1) 40% in 2010.
(2) 38% in 2011.
(3) 36% in 2012.
(4) 34% in 2013.
(5) 32% in 2014.

(6) 30% in 2015-on.

(e) *Portability Feature*. Beginning in 2010, married couples could take full advantage of the increased estate tax exemption by carrying over any unused exemption to the surviving spouse.

(1) Would be exercised through an election on a timely-filed estate tax return of the first deceased spouse.

(2) Estate tax exclusion amount statute of limitations would remain open until after the death of the surviving spouse.

(f) *Step-Up In Basis.* The current "step-up in basis" rules would continue.

(g) *State Death Tax Credit*. There would be no state death tax credit allowable on the federal estate tax return.

j. *ETETRA Exemption and Rate Schedules*. The estate, gift and generation-skipping tax exemption and rate schedules proposed by ETETRA are set forth below:

ETETRA ESTATE TAX EXEMPTION AND RATES

YEAR	ESTATE TAX EXEMPTION	ESTATE TAX RATE
2007	$ 2,000,000	45%
2008	$ 2,000,000	45%
2009	$ 3,500,000	45%
2010	$ 3,750,000	15%[4] (40% above $25,000,000)
2011	$ 4,000,000	15%* (38% above $25,000,000)
2012	$ 4,250,000	15%* (36% above $25,000,000)
2013	$ 4,500,000	15%* (34% above $25,000,000)
2014	$ 4,750,000	15%* (32% above $25,000,000)
2015	$ 5,000,000	15%* (30% above $25,000,000)
2016-on	$ 5,000,000 (inflation adjusted)	15%* (30% above $25,000,000)

[4] Equal to the long-term capital gain rate under IRC Section 1(h)(1)(C). The current long-term capital gain rate is 15%. It is scheduled to increase to 20% in 2011, unless the 15% long-term capital gain rate is extended. The estate tax rate applicable to estates in excess of $25,000,000 is not pegged to the long-term capital gain rate.