PRESENTATION TO THE ESTATE PLANNING SECTION OF THE UTAH STATE BAR

THE CURRENT STATE OF THE ESTATE TAX

(May 13, 2008)

I. Introduction.

As every estate planner knows, the current estate tax laws were enacted in June, 2001, and went into effect in 2002. The first seven years have been relatively uneventful, as the estate tax exemption has periodically increased and the maximum tax rates have come down. (Slide 1) However, beginning next year, the budgetary constraints under which the 2001 Act was enacted begin to produce some very strange results. (Slides 2 and 3) For almost seven years now, all of us have anticipated that Congress would do something to fix the problems with the estate tax, yet so far we are still waiting. Although on the surface it may seem like nothing is happening, deep down in the depths of the legislative branch (e.g., the Senate Finance Committee), "a surprising amount of attention" is being given to the federal estate tax. (Ronald D. Aucutt, Capital Letter No. 3, May 7, 2007).

II. Overview of Recent History for the Federal Estate Tax.

A. Recent Current Events. For such an arcane and little understood area of tax law (at least not well understood by the general public), it is surprising how closely tied the estate tax is to current events and political dynamics. Although the 2001 Act was passed less than seven years ago, in some ways it seems like we live in a very different world now. Some of the main events that have changed the political landscape and the federal budget include: (1) the attacks on September 11, 2001; (2) the five-year war in Iraq beginning in 2003; (3) Hurricane Katrina hitting New Orleans on August 29, 2005; (4) the Democrats gaining control of both houses of Congress in January, 2007 after essentially twelve years of Republican control; and (5) the current presidential campaign. (Slide 4)

B. Recent Legislative Efforts: The Shift From Repeal to Reform. Not only did Hurricane Katrina cause major damage to the Gulf Coast of the United States, it may also have changed the legislative tide with respect to the repeal of the federal estate tax. In fact, after the House of Representatives voted in April, 2005 to permanently repeal the estate tax (see H.R. 8), the Senate was scheduled to vote on the bill in early September of that year, but postponed the vote after Katrina hit. Since that time, the effort for repeal seems to have lost steam. According to one

recent commentator, ". . . anything the repeal effort may have had going for it in recent years has now dwindled sharply. Those who have been looking for repeal should look no more." Ronald D. Aucutt, *Insights*, Willamette Management Associates (Autumn 2007), p. 35, 38. (Slide 5) The focus has now shifted from estate tax repeal to estate tax reform. Aucutt refers to this as "the death of the death of the death tax." Id., p. 37.

The shift from repeal to reform can be seen in the two most recent bills passed by the House of Representatives, both of which would have been effective on January 1, 2010. (Slide 6) First, in June 2006, the House passed H.R. 5638, titled the "Permanent Estate Tax Relief Act of 2006" ("PETRA"). Then, in July 2006, the House passed H.R. 5970, titled the "Estate Tax and Extension of Tax Relief Act of 2006" ("ETETRA"). Neither of these bills has received the requisite 60 votes in the Senate.

Under H.R. 5638, or PETRA, there would be a $5,000,000 exemption, indexed for inflation, and a base rate tied to the capital gains rate, effective January 1, 2010. For estates over $25,000,000, the rate would be doubled. The gift tax exemption and rate would be unified with the estate tax exemption and rate. Finally, the deduction for state inheritance taxes would be repealed. ETETRA, passed by the House a month later, was similar to PETRA, with some important differences. ETETRA would phase in an exemption of $5,000,000 in $250,000 increments between 2010 and 2015, and would phase in a top estate tax rate of 30% by reducing the rate in 2% increments over the same time period. The base rate would still be linked to the capital gains rate. Both bills contained a portability feature with respect to the estate tax exemption, as discussed in greater detail below.

In terms of counting votes in the Senate on possible reform, Aucutt notes that on March 23, 2007, when the Senate considered the budget resolution for fiscal year 2008, two different amendments were proposed--one by Republicans and the other by Democrats. Although both amendments were rejected, and the voting was relatively partisan, essentially 70 out of 100 Senators voted for a $5,000,000 exemption and a 35% rate, which is far more than the 60 votes needed to approve new legislation on the estate tax.

C. Senate Committee on Finance Hearings. In the last six months, the Senate Committee on Finance has held at least three different public hearings on the fate of the estate tax. (Slide 7) The first hearing was held on November 14, 2007, and focused on the current design of the estate tax. It also discussed basic issues such as rates, exemption amounts, and the impact of the tax on family farms and businesses. In connection with this hearing, the Joint Committee on Taxation prepared a 48-page document entitled "History, Present Law,

and Analysis of the Federal Wealth Transfer Tax System" (JCX-108-07), dated November 13, 2007, which was "clearly written from an economist's perspective" (see Aucutt, Capital Letter 7, December 14, 2007).

The second hearing was held on March 12, 2008, and considered a number of alternatives to the present estate tax system, including an inheritance tax, income inclusion, and a deemed realization system. For this hearing, the Joint Committee on Taxation prepared a study entitled "Description and Analysis of Alternative Wealth Transfer Tax Systems" (JCX-22-08), dated March 10, 2008. This study compared differences between a number of systems for taxing gratuitous transfers during life and at death, including estate tax, inheritance tax, income inclusion, deemed realization, and hybrid. In essence, an estate tax system imposes a tax on a decedent's estate before it is distributed, while an inheritance tax system imposes a tax on the beneficiaries of a decedent's estate. In contrast, under the income inclusion approach, a gift or bequest is included in the taxable income of the recipient (making it similar to an inheritance tax). Finally, under a deemed realization system, the transfer is typically treated as a realization event triggering taxable gain in excess of basis to the decedent or the donor, frequently taxed at capital gains rates. According to the report from the Joint Committee on Taxation, out of the thirty countries belonging to the Organisation for Economic Co-Operation and Development (the "OECD"), only the United States and the United Kingdom have an estate tax, while the majority have inheritance taxes. Notwithstanding the study by the Joint Committee, it seems very unlikely that the U. S. would switch to a system other than the estate tax.

The most recent (and perhaps the most relevant) hearing was held on April 3, 2008, and focused on possible reforms to the existing estate and gift tax system. In this case, the Joint Committee produced a 49-page document entitled "Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform" (JCX-23-08), dated April 2, 2008. This report, which will be discussed further below, focused on portability, full reunification of estate and gift taxes, liquidity to pay the estate tax (especially in the case of family farms and businesses), and other possible areas of reform.

D. Election of a New President. It is also important to consider the effect that the election of a new president will have on reforming the estate tax. For example, consider the fact that in June 2001, when the current estate tax law was passed, President Bush had just taken office for the first time, a scenario that will be repeated in early 2009. The impact of a change in the Presidency can be illustrated by comparing the opening lines of the following two Statements from the Office of Management and Budget. (Slides 8 and 9) First, on June 8, 2000, at the tail-end of the Clinton administration, the OMB stated: "The Administration

strongly opposes H.R. 8, which would repeal the estate and gift taxes. Repeal of these taxes would be fiscally unwise, would reduce the overall fairness and progressivity of the tax system, and would harm charitable giving. The President would veto this legislation repealing the estate and gift taxes if it were presented to him" (emphasis added). In contrast, on June 18, 2003, a few years into the Bush administration, the same federal office stated: "The Administration strongly supports H.R. 8. . . . Eliminating the death tax is a matter of basic fairness. The death tax results in the double taxation of many family assets while hurting the source of most new jobs in this country—America's small businesses and farms" (emphasis added). Notice the subtle change in terminology, as "estate and gift taxes" become the "death tax."

However, as noted above, the movement for estate tax repeal has lost its strength, and none of the leading candidates in the current presidential campaign favors repeal. Comparing the different positions of the three main candidates at the present time, Senator McCain would apparently raise the exemption to $10 million per person (or is that per couple?) and reduce the rate to 15%, while Senators Clinton and Obama would both freeze the 2009 exemption of $3.5 million and have a top tax rate of 45%. (Slide 10) However, although I'm sure that the identity of our next President will have some impact on the legislation that is ultimately enacted, given the consensus that appears to be forming in Congress, my own opinion is that the new law will be much more a creature of the legislative branch than of the executive branch.

III. Possible Substantive Features of a New Estate Tax Law.

Some of the best indicators of the potential provisions of the new estate tax law may be the two bills passed in the House of Representatives in 2006, especially H.R. 5970 or ETETRA, which is the later of the two bills. Additional clues can be found in the most recent hearing by the Senate Finance Committee, held on April 3, 2008, and the accompanying report from the Joint Committee on Taxation, dated April 2, 2008. A number of these provisions are discussed below.

A. Portability.

As noted, both of the estate tax bills passed by the House of Representatives in 2006 contained an exemption portability feature. This feature was discussed extensively in the April 2, 2008 report. The basic idea behind portability is that a surviving spouse can take advantage of the total unused estate tax exemption amounts of all predeceased spouses, but not to exceed the exemption in effect at the surviving spouse's death. This amount is referred to as the "aggregate deceased spousal unused exclusion amount." Some of the reasons given in favor of portability are fairness to taxpayers and the elimination of costly estate planning. In order to qualify for this treatment, an election would

need to be made on the estate tax return of each deceased spouse. (Slides 11 and 12)

> Example One: Husband and Wife have a total of $10,000,000, all of which is owned in joint tenancy or passes to the surviving spouse pursuant to beneficiary designations. Husband dies in January with a $5,000,000 exemption, leaving all of his assets to Wife. Wife dies in December with a $10,000,000 estate when the basic exemption amount is still $5,000,000. Because Husband did not use his exemption amount, under portability, Wife's exemption amount becomes $10,000,000, which is sufficient to cover her entire estate without the payment of any estate taxes. In contrast, without portability and assuming a 40% tax rate, Wife's estate would pay $2,000,000 in estate taxes.

> Example Two: The facts are the same as in Example One, except that Wife remarries, lives for two years, and then dies survived by New Husband. At the time of her death, Wife has a total exemption amount of $10,000,000 (the combination of her exemption and Old Husband's exemption), but only $8,000,000 in assets. New Husband then marries Wife 2, who dies with an estate of $1,000,000 and uses that much exemption at her death. An election to give New Husband the unused exemption amount is made on the estate tax return of both Wife 1 and Wife 2. New Husband then dies two years later with an estate of $11,000,000. The regular exemption at the time of death for each of the three decedents is $5,000,000. Although the total unused exemption of Wife 1 and Wife 2 is $6,000,000 ($2,000,000 plus $4,000,000), and New Husband has his own $5,000,000 exemption, the "aggregate deceased spousal unused exclusion amount" is limited to $5,000,000 (the regular exemption at the time), and New Husband has a taxable estate of $1,000,000. In theory, New Husband received portable exemption in the successive transfer from Old Husband to Wife 1, and in the aggregate, from Wife 1 and Wife 2.

B. Full Reunification of the Gift Tax and the Estate Tax. Prior to 2002, the gift tax and the estate tax were fully unified in both rate and exemption amount. This complete unification continued during 2002 and

2003, but beginning in 2004, the estate tax exemption jumped to $1,500,000 while the gift tax exemption remained at $1,000,000, making the two taxes unified in rate only. Following the sunset in 2011, this partial unification returns to full unification. At the present time, Congress is clearly considering a full reunification of the gift and the estate tax under any new law that is passed. However, one factor that will weigh into this decision is the use of the gift tax to discourage gifts to lower bracket taxpayers for income tax purposes, which would be compromised by enacting a much higher gift tax exemption. The greater incentive to make gifts that would result from increasing the gift tax exemption would also be amplified by the tax exclusive nature of the gift tax (i.e., no tax is paid on the tax) in comparison to the tax inclusive nature of the estate tax (i.e., a tax is paid on the tax).

C. Liquidity. The Joint Committee Report also focuses on the following three code sections which help provide liquidity to estates owning family farms and other closely held businesses: special use valuation under § 2032A; installment payments under § 6166; and the deduction for family-owned businesses under § 2057. Although the report acknowledges that these three code sections have been criticized for their complexity, it goes on to state that "it is not clear that Congress could achieve its stated objective of ameliorating burdens on family-owned businesses without creating complexity" (p. 22). The report also concludes that many estates owning such businesses have enough liquidity to pay the estate tax, but that the tax may nonetheless "impair a business's ability to function and grow" (p. 15).

D. Additional Areas of Possible Reform. As an Appendix, the April 2, 2008 Joint Committee on Taxation Report included a section from another Joint Committee Report dated January 27, 2005, entitled "Options to Improve Tax Compliance and Reform Tax Expenditures." The 2005 Report consisted of about 435 pages, and covered a wide range of taxes, the last of which were estate and gift taxes (pages 392 through 424). The section on estate and gift taxes (Section XI) contained five parts, the first three of which became the Appendix to the April 2008 report. These three areas of possible reform are: "A. Limit Perpetual Dynasty Trusts (secs. 2631 and 2632)"; "B. Determine Certain Valuation Discounts More Accurately for Federal Estate and Gift Tax Purposes (secs. 2031, 2512, and 2624)"; and "C. Curtail the Use of Lapsing Trust Powers to Inflate the Gift Tax Annual Exclusion Amount (sec. 2503)." (Slide 13)

(1) Dynasty Trusts. With respect to dynasty trusts, the report states that "perpetual dynasty trusts are inconsistent with the uniform structure of the estate and gift taxes to impose a transfer tax once every generation." (JCX-23-08, p. 34) It also proposes that the allocation of

generation skipping exemption to such a trust be prohibited, except to the extent it involves transfers to children and grandchildren.

(2) Valuation Discounts. The report notes that "minority and marketability discounts in particular often create substantial reductions in value," which sometimes "do not accurately reflect value." (JCX-23-08; p. 40) To correct this problem, the report proposes that a "basic aggregation rule" be applied to the transferor and that a "transferee aggregation rule" be applied to the transferee. If under the basic aggregation rule, the transferor has control, the transferred interest is valued accordingly. If under the basic aggregation rule, the transferor does not have control, but under the transferee aggregation rule, the transferee does have control, the value of the transferred interest is determined according to its value in the hands of the transferee. Also, if after the application of these aggregation rules, the transferor or the transferee is treated as controlling an entity, and if at least one-third of the entity's assets are marketable, there is a look-through rule that requires taking into account the market values of those assets for purposes of valuing the transferor's interest in the entity.

(3) Crummey Powers. According to the report, "recent arrangements involving Crummey powers 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." (JCX-23-08, p. 47) The report proposes the following three options for restricting Crummey powers: (i) only direct, noncontingent beneficiaries of a trust will be treated as donees; (ii) "powers to demand the distribution of trust property are taken into account only if they cannot lapse during the holder's lifetime" (the report continues: "This option effectively eliminates Crummey powers as a tax planning tool."); and (iii) a "facts-and-circumstances" analysis that disregards powers subject to an arrangement or understanding that they will not be exercised, or for which there is not a meaningful possibility that they will be exercised.

IV. Budgetary Issues and Constraints.

When both the House and the Senate approved the 2008 budget resolution on May 17, 2007 (almost exactly one year ago), both Houses of

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Congress essentially put in requirements that any estate tax relief be “paid for” by adjustments to other taxes or budget items, so that deficits are not increased and surpluses are not reduced. In reviewing these numbers for the 2008 budget, Congress looked at both a five-year and a ten-year budget window. (Slide 14) Although hopefully this does not happen, it’s possible that Congress will stay within a five-year budget window by simply extending the 2009 law through 2011 or 2012 (see Aucutt, Capital Letter 3, May 7, 2007), thereby solving the biggest problems (repeal and then sunset) but postponing important decisions that need to be made in order to provide clarity for taxpayers.

Although it may be easy to criticize Congress for not having resolved the estate tax problem five or six years ago, at least their concern for fiscal responsibility in this case is commendable. In this regard, Paul A. Volcker, Former Chairman of the Federal Reserve, makes the following interesting observation (Slide 15):

> What we can’t escape is a simple piece of logic. Once we agree on total expenditures and revenues, if we lose one existing source of revenue—say from the federal estate tax—we will have to find a replacement . . . It’s hard for me—hard in terms of economic analysis—to think of practical alternatives with fewer adverse effects than a (reformed) estate tax.

This is the reality that Congress is dealing with—even though many members of Congress would like to repeal the estate tax or have much higher exemptions, decedents’ estates are a relatively easy source of funding, and the price tag for switching to a different source may be simply too great.

In terms of budgeting, there are a number of things that Congress might do when it enacts a new estate tax law. First, in addition to the level of the exemption, another factor that becomes very important is determining the tax rates that will be imposed. Although this is only a generalization, “Republicans are thought to traditionally favor lower rates while Democrats favor higher exemptions or credits.” (Aucutt, Washington Report, ACTEC Journal, Summer 2005). Assuming a Congress controlled by the Democrats, it will be interesting to see where these different levels are set. As estate planners, we are often more interested in the exemption amount than in the rate. However, in terms of dollar amounts, the rate differential will potentially have a much greater impact than changes in the exemption amount. For example, looking at a very large estate of $100,000,000, increasing the exemption from $3.5 million to $5 million would save the estate $450,000 at a 30% estate tax rate. However, for the same estate, dropping the rate from 30% to 15% would save the estate $14,250,000. Of course, the bigger the estate, the greater the impact that the rate differential will have, while the savings from a change in the exemption amount essentially remains constant.

Second, regardless of the level of the exemptions and rates established by Congress, it is very likely that those levels will be phased in over time, as would be the case under ETETRA. This will allow Congress to start in the right direction without having to do everything all at once.

Third, something that really helped Congress in passing the 2001 law was having what might be called a hidden source of funding. At that time, the law provided for a federal credit for state estate taxes paid. By phasing the credit out over four years, Congress obtained a valuable source of funds, as the rising exemptions and one-year repeal were partially funded by revenue that would otherwise have gone to the states (at least in the case of states with a pick up tax equal to the federal credit). Although this one-time source of funding is not available to assist with changes in the potential 2009 estate tax law, there are at least two other potential hidden sources. One is the deduction for state estate taxes paid that replaced the credit provided under former law. Although the deduction is not nearly as valuable as the credit, it would provide for a positive federal cash flow if repealed. A more important source is the repeal of the one-year repeal in 2010. By replacing estate tax repeal with an exemption of perhaps $3,750,000 in 2010, a significant source of funding becomes available for raising the exemption in other years.

V. Predictions.

According to one commentator on the estate tax, “nothing is harder to predict than the output from a mixture of politics, economics, and rhetoric.” Beth Shapiro Kaufman, “Gazing Into the Crystal Ball: A Prediction of Post-Election Action,” Estate Planning (December 2007), pp. 39, 42. Notwithstanding the risk, I’m going to make a prediction anyway. In June 2009, Congress finally passes a new estate tax law that has the following general attributes (Slide 16): (1) a phased-in $5,000,000 exemption; (2) a phased-in top tax rate of 30%; (3) indexing for inflation; (4) portability; (5) a $1,000,000 gift tax exemption (i.e., partial unification only); (6) a deduction but no credit for state estate taxes; (7) a generation-skipping exemption unified with the estate tax exemption; (8) tougher rules on valuation discounts; (9) modified special valuation rules and exemptions for family businesses and farms; and (10) the continuation of a step-up in basis for appreciated assets. However, there is a good chance that (8) and (9) will take more time to resolve and will therefore be postponed for subsequent legislation.

Perhaps an even bigger question is: Who is going to sign the new Act into law? However, on that point, I’m not going to venture any predictions.

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