

ESTATE TAX RELIEF

STATUS

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), the estate and generation skipping transfer taxes are repealed for decedents dying and generation skipping transfers made during 2010. The gift tax remains in effect during 2010, with a \$1 million exemption amount (not to be confused however with the \$13,000 annual exclusion per donee (as explained below)) and a gift tax rate of 35 percent.

The estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions (including repeal of the estate and generation skipping transfer taxes) do not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, in general, the estate, gift, and generation skipping transfer tax rates and exemption amounts that would have been in effect had EGTRRA not been enacted apply for estates of decedents dying, gifts made, or generation skipping transfers made in 2011 and later years.

A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of \$1 million applies for purposes of determining the tax on cumulative taxable transfers made by a taxpayer through lifetime gift or bequest. (There will also be a 5 percent surtax on taxable transfers between \$10 million and \$17.184 million. The surtax is designed to recapture the benefits of the graduated rate structure of the estate tax and results in an effective marginal tax rate of 60 percent on wealth transfers in that range.)

HISTORY

Some form of the estate tax has been used as a revenue-raiser over the past two centuries. Each of the four times the estate tax was enacted was to raise money to help with our nation's defense. In three of the instances, the Quasi-War with France at the end of the 18th Century, the Civil War, and the Spanish American War at the end of the 19th Century, the tax was repealed after it was no longer needed. However, after the fourth time it was created, under the Revenue Act of 1916, a year before the U.S. entered World War I, it was not repealed, as the federal government realized that there are numerous ways to spend our money even after the original need passes. This law set the top rate at 10 percent for estates valued over \$5 million and provided a \$50,000 exemption. A year later, under the Revenue Act of 1917, the top rate increased to 25 percent on estates worth more than \$10 million.

In response to this tax, individuals began to give their money away before they died to avoid any tax. The federal government responded by passing the Revenue Act of 1924, which established a gift tax. The gift tax included a lifetime exclusion of \$50,000 and \$500 annually per recipient. This bill also increased the top rate on estates over \$10 million to 40 percent. However, the gift tax was repealed a couple of years later and the estate tax rate was reduced to 20 percent on estates worth more than \$10 million. The exemption was also increased from \$50,000 to \$100,000.

The estate tax became particularly burdensome during the Presidency of Franklin Roosevelt. Under the Revenue Act of 1932, the estate tax exemption went back to \$50,000, with the remaining estates were taxed at a graduated rate ranging from 1 percent on estates worth up to \$100,000 to 45 percent on estates above \$10 million. This bill also reestablished the gift tax at a rate of 75 percent of the estate tax. The lifetime exclusion was again set at \$50,000 with an annual exclusion of \$5,000 per recipient.

The top rate was increased again in 1934 to 60 percent and then to 70 percent on estates over \$50 million a year later. The 1935 tax measure also reduced the exemption for both estates and gifts to \$40,000. During World War II, President Roosevelt signed into law the Revenue Act of 1940, which added a 10 percent surtax to the income, estate, and gift taxes. The following year, he signed into law the Revenue Act of 1941, which produced a graduated estate tax rate from 3 percent on estates worth less than \$5,000 to 77 percent on estates over \$50,000,000. The gift tax experienced similar increases, as it remained at 75 percent of the estate tax rate.

The estate tax and the gift tax were officially unified under the Tax Reform Act of 1976. This legislation created a single, graduated tax rate imposed on both lifetime gifts and testamentary dispositions. The estate and gift tax rates were graduated to a maximum tax rate of 70 percent on cumulative gifts or taxable estates of more than \$5,000,000. Furthermore, it set the exemption at \$161,000 before 1980 and \$175,625 thereafter.

In 1981, President Reagan signed into law the Economic Recovery Tax Act, which increased the exemption from \$175,625 to \$600,000 over a six-year period. The law also reduced the top rate from 70 percent to 50 percent over a three-year period on estates worth more than \$2.5 million. However, this reduction was halted by the Deficit Reduction Act of 1984, which froze the top rate at 55 percent.

The Taxpayer Relief Act of 1997

In 1997, President Clinton signed into law the Taxpayer Relief Act, which would increase the exemption from \$600,000 to \$1 million by the year 2006. This bill created the Qualified Family-Owned Business Interest (QFOBI) provision, which protected from the estate tax \$1.3 million in assets for farms and closely-held businesses. This provision expired in 2003. (However, it will be automatically revived in 2011, as explained below.)

The requirements for businesses to qualify for this exemption included: the family business must comprise at least half of the estate; the business must be passed to qualified heirs defined as family members or people employed by the business for at least 10 years prior to death; the business must be 50 percent owned by one family, 70 percent owned by two families or 90 percent owned by three families, as long as the decedent's family owns 30 percent of the business; (Family is defined as the spouse, ancestors, and lineal descendants of the individual, the individual's spouse, parents, and the spouses of the lineal descendants.) the decedent or a member of his family must have owned and materially participated in the business for a least five of the last eight years preceding death; and, each qualified heir, or a member of their family, must materially participate in the business for at least five of eight years after the decedent's death. Publicly-traded companies did not qualify.

Although QFOBI may look reasonable on paper, in practice it was a failure. Because it is so complex and vague, less than 3 percent of family-owned businesses were able to take advantage of QFOBI. In 1998, only 173 of 97,856 estate tax returns used QFOBI. In 1999, only 889 of 103,979 estate tax returns used QFOBI. In 2000, only 1,470 of 108,322 estate tax returns used QFOBI.

Economic Growth and Tax Relief Reconciliation Act of 2001

One of the top priorities for President Bush, dating back to his initial campaign in 2000, had been to ease the tax burden on American citizens. He immediately followed through on this pledge when he signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Among other things, this law began the process of phasing out the estate tax until its full repeal in 2010. However, the estate tax would return to its pre-EGTRRA levels of a 55 percent tax rate and a \$1 million exemption in the year after full repeal. (In 2001, the exemption was \$675,000 but under the then existing law it was scheduled to rise to \$1 million in 2006.)

CURRENT AND FUTURE LAW

Basis In Property Received

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property, with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and is decreased by depreciation deductions taken with respect to the property.

Basis in property received by lifetime gift

Under present law, property received from a donor of a lifetime gift takes a carryover basis, with modifications in certain circumstances. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift is increased, but not above fair market value, by any gift tax paid by the donor. The basis of property transferred by a lifetime gift cannot exceed the property's fair market value on the date of the gift. If the basis of the property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss from a subsequent sale of the property, the basis is the property's fair market value on the date of the gift.

Basis in property received from a decedent who dies before 2010

Under law in effect through 2009, property passing from a decedent's estate generally took a "stepped-up" basis. In other words, the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This increase or "step up" in basis eliminates the recognition of income on any appreciation of the property that occurred while the decedent held the property.

If the value of property on the date of the decedent's death (or the alternate valuation date) is less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent's estate. This stepped-down basis eliminates any potential tax benefit from any unrealized loss.

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse generally was treated as having passed from the decedent and, thus, was eligible for stepped-up basis. Under law in effect through 2009, this rule applied if at least one-half of the whole of the community interest was includible in the decedent's gross estate.

Basis in property received from a decedent who dies during 2010

In 2010, upon repeal of the estate tax, the rules providing for date-of-death fair market value ("stepped-up") basis in property acquired from a decedent are repealed, and a modified carryover basis regime under section 1022 of the Code have taken effect. Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply, other than property that is income in respect of a decedent. Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real property that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

An executor generally may step up the basis in assets owned by the decedent and acquired by the beneficiaries at death, subject to certain special rules and exceptions. Under these rules, each decedent's estate generally is permitted to increase the basis of assets transferred by \$1.3 million. The \$1.3 million amount is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. In addition, the basis of property transferred to a surviving spouse may be increased by an additional \$3 million. Thus, the basis of property transferred to a surviving spouse may be increased by at least \$4.3 million.

Repeal Of Modified Carryover Basis Regime For Determining Basis In Property Received From A Decedent Who Dies After December 31, 2010

As a result of the sunset of EGTRRA, the modified carryover basis regime in effect for determining basis in property passing from a decedent who dies during 2010 does not apply for purposes of determining basis in property received from a decedent who dies after December 31, 2010. After that time, the law in effect before 2010, which generally provides for stepped-up basis in property passing from a decedent, applies.

State Death Tax Credit; Deduction For State Death Taxes Paid

State death tax credit under prior law

Before 2005, a credit was allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate ("State death taxes"). The maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent's adjusted taxable estate. Most States imposed a "pick-up" or "soak-up" estate tax equal to the maximum Federal credit allowed.

Phase-out of State death tax credit; deduction for State death taxes paid

Under EGTRRA, the amount of allowable State death tax credit was reduced each year from 2002 through 2004. For decedents dying after 2004, the State death tax credit was repealed and replaced with a deduction for death taxes actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent.

Reinstatement of State death tax credit for decedents dying after December 31, 2010

Neither the EGTRRA modifications to the State death tax credit nor the replacement of the credit with a deduction applies for decedents dying after December 31, 2010. Instead, the State death tax credit as in effect before the above-described EGTRRA phase-out and modifications applies.

Gift Tax

Under present law, a donor of a lifetime gift is allowed an annual exclusion of \$13,000 for 2010 on a transfer of a present interest in property to any one donee during the taxable year. If a non-donor spouse consents to split the gift with the donor spouse, the annual exclusion is \$26,000 for 2010. A donor pays tax on gifts above that amount during his or her life only when the cumulative amount of annual gifts above the \$13,000 limit exceeds the \$1 million gift tax exemption. The gift tax rate in 2010 is 35 percent.

The Congressional Budget Office has observed that EGTRRA complicated the strategic use of gifts to transfer wealth to heirs before a benefactor's death—a significant element of estate planning for many taxpayers. The law gave taxpayers an incentive to defer taxable gifts until 2010, when the gift tax rate would be lower than in earlier years. It also gives people an incentive to make gifts in 2010 at the 35 percent gift tax rate rather than wait until 2011 or thereafter, when most gifts would be taxed at a rate of 55 percent and bequests to heirs would be taxed at rates between 41 percent and 55 percent.

Transfers To A Surviving Spouse

A 100-percent marital deduction generally is permitted for the value of property transferred between spouses.

Special-Use Valuation

An executor may elect to value for estate tax purposes certain “qualified real property” used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is \$1 million for 2010. Real property generally can qualify for this “special-use” valuation if at least 50 percent of the adjusted value of the decedent’s gross estate consists of farm or closely-held business assets (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business real property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent’s family for five of the eight years immediately preceding the decedent’s death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent’s death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-Owned Business Deduction

Before 2004, an estate was permitted to deduct the adjusted value of a “qualified family owned business interest” (QFOBI) of the decedent, up to \$675,000. The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of \$675,000 is elected, then the unified credit effective exemption amount is \$625,000, for a total of \$1.3 million. If the qualified family-owned business deduction is less than \$675,000, then the unified credit effective exemption amount of \$625,000 is increased by the difference between \$675,000 and the amount of the qualified family-owned business deduction. However, the unified credit effective exemption amount cannot be increased above \$675,000. Because of the coordination between the qualified family owned business deduction and the unified credit effective exemption amount, the qualified family-owned business deduction would not provide a benefit in any year in which the applicable exclusion amount exceeds \$1.3 million.

A qualified family-owned business interest generally is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent’s family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent’s family owns, in the case of the 70-percent and 90-percent rules, at least 30 percent of the trade or business.

To qualify for the exclusion, the decedent (or a member of the decedent’s family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent’s date of death. In addition, at least one qualified heir (or member of the qualified heir’s family) is required to materially participate in the trade or business for at least 10 years following the decedent’s death. The qualified family-owned business rules provide for a graduated recapture based on the number of years after the decedent’s death within which a disqualifying event occurred. In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent’s death. However, the 10-year recapture period can be extended for a

period of up to two years if the qualified heir does not materially participate in the trade or business for a period of up to two years after the decedent's death.

EGTRRA repealed the qualified family-owned business deduction for estates of decedents dying after December 31, 2003. *As a result of the sunset of EGTRRA, the qualified family-owned business deduction is available to estates of decedents dying after December 31, 2010.*

Installment Payment Of Estate Tax For Closely Held Businesses

Under prior law, the estate tax generally was due within nine months of a decedent's death. However, an executor generally could elect to pay estate tax attributable to an interest in a closely held business in two or more (but no more than 10) installments. An estate was eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeded 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions).

If the election was made, the estate could defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This election effectively extended the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applied to the amount of deferred estate tax attributable to the first \$1.33 million (in 2009) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of \$1.33 million (in 2009) was equal to 45 percent of the rate applicable to underpayments. Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Under pre-EGTRRA law, for purposes of these rules an interest in a closely held business was: (1) an interest as a proprietor in a sole proprietorship; (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership was included in the decedent's gross estate or the partnership had 15 or fewer partners; and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation was included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

Under post-and pre-EGTRRA law, the decedent could own the interest directly or, in certain cases, indirectly through a holding company. If ownership was through a holding company, the stock must be non-readily tradable. If stock in a holding company was treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the two-percent interest rate did not apply. The value of any interest in a closely held business did not include the value of that portion of such interest attributable to passive assets held by such business.

Effective for estates of decedents dying after December 31, 2001, EGTRRA expanded the definition of a closely held business for purposes of installment payment of estate tax. EGTRRA increased from 15 to 45 the maximum number of partners in a partnership and shareholders in a corporation that may be treated as a closely held business in which a decedent held an interest,

and thus would qualify the estate for installment payment of estate tax. This amount was adjusted annually for inflation after 1998. The original amount for 1998 was \$1 million. The 2010 amount is \$1.34 million.

EGTRRA also expanded availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business was eligible for installment payment of the estate tax. EGTRRA provided that an estate with an interest in a qualifying lending and financing business that claimed installment payment of estate tax must make installment payments of estate tax (which would include both principal and interest) relating to the interest in a qualifying lending and financing business over five years. EGTRRA clarified that the installment payment provisions require that only the stock of holding companies, not the stock of operating subsidiaries, must be non-readily tradable to qualify for installment payment of the estate tax.

EGTRRA provided that an estate with a qualifying property interest held through holding companies that claimed installment payment of estate tax must make all installment payments of estate tax (which would include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

As a result of the sunset of EGTRRA, the EGTRRA modifications to the estate tax installment payment rules described above do not apply for estates of decedents dying after December 31, 2010; instead, the installment payment rules generally in effect prior to the EGTRRA modifications will apply.

Generation-Skipping Transfer Tax Rules

A generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a skip person (as defined above). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption generally equal to the estate tax effective exemption amount is provided for each person making generation skipping transfers. EGTRRA made a number of modifications.

As a result of the sunset of EGTRRA, the EGTRRA modifications to the generation skipping transfer tax rules described above do not apply for generation skipping transfers made after December 31, 2010. Instead, in general, the rules as in effect prior to the EGTRRA modifications apply.

TAX AND ECONOMIC BACKGROUND

Since 1977, generally about 1 percent to 2 percent of adults who died each year have left estates large enough to be taxable. In 2000, before EGTRRA was enacted, 51,200 estates were taxable, representing 2.2 percent of adult deaths in that year. EGTRRA reduced the percentage of estates that were taxable. For example, 17,400 taxable estate tax returns were filed in 2007; most were for deaths in 2006, when the effective exemption amount was \$2 million, representing about 0.7 percent of adult deaths in that year.

Larger estates pay a significant portion of the estate tax. In 2007, taxes on gross estates valued at more than \$20 million were 36 percent of total estate taxes for that year, and taxes on gross estates valued at more than \$10 million accounted for 55 percent of total estate taxes.

About 2.1 percent of farmers (1,137) and 2.4 percent of small-business owners (8,291) who died in 2005 had to file estate tax returns.

Since 1945, estate and gift tax receipts have consistently remained near or below 2 percent of federal revenues. In recent years, they have been less than 1.5 percent of federal tax revenues. Under current law, revenues from estate and gift taxes will total \$420 billion, or 1.2 percent of revenues, over the 2010–2019 period, CBO forecasts. About \$364 billion (87 percent) of that total is from estate tax receipts, and \$56 billion (13 percent) is from gift tax receipts.

Congress' Joint Committee on Taxation surveyed what other countries do and found that inheritance tax is more common than an estate tax, as is imposed in the United States. An inheritance tax generally is imposed on the heir who receives a bequest the tax generally depends upon the size of the bequest received. The United States also imposes a generation-skipping tax in addition to any estate or gift tax liability on certain transfers to heirs two or more generations younger. This effectively raises the marginal tax rates on affected transfers. Countries that impose an inheritance tax do not have such a separate tax but may impose higher rates of inheritance tax on bequests that skip generations.

The committee compared total revenue collected by selected countries from estate, inheritance, and gift taxes to total tax revenue and to gross domestic product (“GDP”) to attempt to compare the economic significance of wealth transfer taxes in different countries. Among these selected countries, in 2005, Belgium, Finland, France, Japan, the Netherlands, Spain, and the United Kingdom collected more such tax revenue as a percentage of the GDP than did the United States. Denmark, Germany, Ireland, Korea, Luxembourg, and Switzerland collected modestly less revenue from such taxes as a percentage of the GDP than did the United States. The remaining 16 countries collected less than half as much revenue as a percentage of GDP from such taxes as did the United States. As a percentage of tax revenue, Belgium, France, and Japan relied more heavily on their estate, inheritance, and gift taxes as a revenue source, although the Netherlands, Spain, and the United Kingdom each collected at least seven-tenths of one percent of total tax revenue from estate, inheritance, and gift taxes.

OUTLOOK

There is some talk on the majority side of a retroactive freeze of the 2009 estate tax top marginal rate level of 45 percent and individual exemption of \$3.5 million. It is hard to imagine that proponents could get 60 votes for that initiative in the Senate.

There is one school of thought that the majority would never let the rate go up and the exemption go down to their pre-2001 levels. However, it happens automatically and with the increasing pressures from the growing deficit, it is not clear that majority will go see that as a priority.