



The Death (for the moment) of the Federal Estate Tax

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Overview

The Democratic majorities in the House and Senate have failed in their attempts to extend the federal estate tax for deaths in 2010.¹ That means that the estate tax (and the generation-skipping transfer tax²) does not exist for deaths in 2010.³ Federal gift tax stays in place, but at a flat 35 percent rate and a maximum exclusion of \$1 million. The expiration of the estate tax has significant implications for practitioners and their clients, and may provide some planning opportunities.

The Law Governing Deaths in 2010

For deaths in 2010, the basis of property that is acquired from a decedent will be the lesser of the decedent's adjusted basis in the property or the property's fair market value as of the time of the decedent's death. So, no basis step-up will be allowed (but basis could go down). Two significant exceptions may apply – (1) the executor can allocate up to \$3 million to increase the basis of assets that pass to the surviving spouse (or to a qualifying trust for the surviving spouse); and (2) the executor can allocate an additional \$1.3 million (increased by unused losses and loss carryovers) of aggregate

basis to other assets (on an asset-by-asset basis). So, the heirs would have to pay capital gain tax on excess amounts not covered by the basis increase rules. But, those rates are far less than the 45 percent estate tax rate the Democrats proposed in their estate tax extension bill.⁴ Indeed, it was the Senate Democratic leadership's insistence on a 45 percent rate that was a significant reason for the bill's failure in the Senate.⁵ Three Democrat Senators were resolute in their insistence on a rate no higher than 35 percent. The leadership wouldn't budge, so the proposal to extend existing (2009) law for another year failed.⁶

The Real Questions

While more estates would likely be impacted by the loss of stepped-up basis than would be impacted by the estate tax, the real question is whether the tax bill would be greater for the heirs if (and when) the inherited property is sold, and whether repeal reduces the impact on the functioning of business operations. Another key point is that with an estate tax, payment of any estate tax is due within nine months after death which may be at a time that is particularly inconvenient for an ongoing family business or farming operation after the decedent's

death.⁷ This can be a particular problem for a small business or family farming operation where it is impractical to sell a fraction of the business to pay estate tax due to a lack of a recognizable market for non-control interests that are not actively traded. However, the capital gains tax can be timed and managed by the heirs to minimize interference to existing business operations.

Note: There is general agreement that carryover basis is not good tax policy as applied to estates. The loss of complete-stepped up basis for deaths in 2010 will produce administrative and compliance issues. That will be particularly true for estates that lack good basis information.

Impact of the Estate Tax

Even though the federal estate tax impacts less than one percent of all estates (this is the projected impact for deaths in 2009), extending the estate tax became politicized in recent months.⁸ Proponents of extending the tax have typically claimed that it's just certain wealthy individuals that have been pushing for its elimination. While that may be true, such claims are typically not accompanied with a mention of data that indicates the estate tax's negative impact on businesses and the economy. For example, a couple of recent studies have shown that the tax is a drag on the economy, and is particularly harsh on small businesses. One study concluded that full and permanent repeal of the estate tax would create 1.5 million jobs, increase the probability of hiring by 8.6 percent, increase payrolls by 2.6 percent, expand investment by 3 percent and reduce the jobless rate (as of February 2009) by .9 percent.⁹ Another study found that the estate tax "impacts small firms disproportionately by encouraging well-

capitalized companies to gobble-up smaller ones at the owner's death" and promotes concentration of wealth by preventing small businesses from being passed on to heirs.¹⁰

Note: Proponents of extending the estate tax also typically fail to point out that not all countries have an estate tax. Those countries without an estate tax include Austria, Australia, New Zealand, Sweden, India, Virgin Islands, Gibraltar, Singapore and Russia. A reasonable question to ask is why these countries do not have an estate tax and the United States does.

Estate Tax Remnants Still Remain

In one sense, the estate tax is not completely gone for 2010. Even though the estate tax is repealed for deaths in 2010, those estates that have elected special use valuation, the qualified family-owned business deduction, or have elected to pay the estate tax in installments from pre-2010 deaths, the recapture rules will continue to apply in 2010 through the end of the applicable recapture period.

Planning Implications of Repeal

If the Congress does not enact legislation to deal with the estate tax in 2010, the estate tax will return for deaths in 2011 and thereafter. However, when it returns, the exemption will only be \$1 million (for generation skipping transfer tax (GSTT) purposes also) and the tax will have a top marginal rate of 55 percent (with a 5 percent surcharge applicable to adjusted taxable estates between \$10 million and \$17.184 million). Thus, for taxable estates exceeding \$17.184 million, the tax will be a flat 55 percent. The gift tax will return at a 45 percent rate.

For married couples, a common estate planning technique that has been utilized for many years with respect to potentially taxable estates is to utilize drafting language in will and trusts that eliminates federal estate tax upon the first spouse's death and minimizes estate tax upon the surviving spouse's death by dividing the first spouse's estate into two packages – (1) formula clause language that leaves the maximum amount of property to the surviving spouse in a form that does not qualify for the marital deduction so as to fully utilize the deceased spouse's applicable exclusion against the estate tax (in other words, the clause language leaves the maximum amount of property to the surviving spouse in life estate form that eliminates estate tax in the first spouse's estate – typically referred to as the “bypass trust”)¹¹; and (2) an outright gift to the surviving spouse (or a trust for the surviving spouse's benefit – known as the “marital trust”) of the balance of the estate (which passes tax free via the unlimited marital deduction).

Note: Some estate planners, especially when handling very large estates, utilize formula drafting language which has each spouse gift the spouse's GSTT exemption to a trust for the children (and, perhaps, grandchildren), with the balance of the estate passing either to the surviving spouse or the children.

Because of the use of formula clause language that is tied to the level of the exemption at the time of death to minimize tax over both spouse's estates (for example, typical drafting language may specify that the credit shelter amount (the “bypass trust” amount) is pegged as “the largest amount that can pass free of federal estate tax”), for deaths occurring while no estate tax exists a question will be raised as to the effect of any

formula-derived gift. Will it fail because the formula clause language utilized refers to a non-existent tax (and/or exemption)? If so, the entire estate might pass to the surviving spouse.¹² That could create a problem on the surviving spouse's estate if the Congress re-enacts the estate tax. The surviving spouse's estate would be inadvertently “over-stuffed” resulting in a higher tax than would have been the case had the formula clause language worked as anticipated in the first estate. Another concern is that while all of the property may go to the surviving spouse, it may pass to the spouse in life estate form rather than outright. That will give the surviving spouse an income interest in the property for life, but not outright control. Will the income stream from the life estate property be enough for the surviving spouse? The answer to that question depends on the age and lifestyle of the surviving spouse, among other things.

Note: For deaths after 2009, only those assets that pass outright to the surviving spouse or pass to the surviving spouse via a marital trust qualify for a basis increase. So, if the formula clause results in the assets of the first spouse passing entirely to the surviving spouse in life estate form, none of the assets would be eligible for a basis increase.¹³

So, are there ways around the problem of the impact of repeal on present formula drafting language in wills and trusts? Maybe all that is necessary is that a codicil to an existing will be executed or that trust language be amended. But, clients must take action to update their plans – or practitioners should review existing client plans and take the initiative to get clients to make the necessary changes. However, some clients will want to delay doing anything, preferring instead to wait and see what, if anything, the

Congress chooses to do. That could be a real client counseling issue. For clients that really need to have some estate planning done (for various reasons), here are some suggestions: (1) revise existing estate planning clause language to specify that if death occurs at a time when the federal estate tax is not in effect, a specified pecuniary amount will pass either outright or in trust for the children so as to reduce the amount passing to the surviving spouse; (2) alternatively, revise existing clause language to specify that if death occurs when there is no estate tax, all property passing to the surviving spouse is in trust with the spouse as beneficiary with the trust having language designed to minimize (or avoid) the impact of any estate tax that may be in effect at the surviving spouse's death; or (3) for GSTT planning purposes, revise existing clause language to specify that property that would have passed outright to children now passes in trust for their benefit – again to minimize or avoid the impact of a reinstated GSTT.¹⁴

But, in any event, estate planners should not lose sight of common planning techniques that are still in play. Such techniques include the use of annual exclusion gifts (presently \$13,000 per donee per year) – they should still be made (as well as other techniques that shift future asset value to later family generations) to keep the estate size manageable in the event the estate tax again becomes law.

From a gift tax planning standpoint the basic idea is to consider techniques that either take advantage of the repeal of the GSTT or the 35 percent gift tax rate. Such strategies might include using the \$1 million gift tax exemption to fund a “Crummey”-type trust for children and grandchildren.¹⁵ If one believes that a higher gift tax rate will apply in the future, an aggressive gifting strategy could be utilized with the result that taxable

gifts would be taxed at 35 percent rather than 45 percent. This strategy also dovetails with an estate tax minimization strategy if it is believed that the estate tax will return. Also, practitioners may want to consider the use of qualified terminable interest trusts (QTIP) to benefit a surviving spouse and allow the surviving spouse to adopt a “wait and see” approach as to whether a QTIP election should be made based on whether the estate tax is in existence.¹⁶

Future Legislative Attempts?

The Congress may try to pass an extension bill in 2010 and make it retroactive to January 1.¹⁷ But, that will surely trigger lawsuits. A retroactive reinstatement of the estate tax could be challenged as an unconstitutional violation of the Ex Post Facto Clause – i.e., it's unconstitutional to retroactively collect tax on the estates of people that died during the timeframe that the tax was repealed, or upon trust terminations or distributions in that same timeframe.¹⁸ However, the U.S. Supreme Court previously stated in *Carlton v. United States*¹⁹, that a retroactive tax law is valid under the Constitution if (1) the government shows that the statute has a rational legislative purpose and is not arbitrary and irrational; and (2) the period of retroactivity is "modest."²⁰ However, there is caselaw indicating that the result might be different if the Supreme Court were to view the passage of a retroactive estate tax bill as a "wholly new" tax rather than as simply fixing something in an existing tax.²¹ But, because the Congress allowed the estate tax to die, a retroactive "fix" would be a new tax - there is no estate tax law on the books at the present time. That is what could make a reinstatement of the estate tax retroactive to January 1, 2010, unconstitutional.²²

In early February 2010, an estate tax prepayment idea was floated by Senator Cantwell (D-WA) as a compromise between those Senators that don't want the estate tax rate to exceed 35 percent and the push by the Administration (and Senate Democratic leadership) for a 45 percent rate. Under the proposal, individuals with relatively large estates that might be subjected to estate tax if it is reenacted could essentially "prepay" estate taxes by placing assets in a "prepayment trust" during life with the trust assets taxed at a 35 percent rate. The tax could be paid over a five year period.²³

Also, in 2009, there were some attempts to provide permanent estate tax relief for small businesses and farms. Perhaps those efforts will become reality in 2010. One approach may be to exclude closely held business interests from estate tax with recapture if sale occurs within a specified period of time from the transferor's death. Such excluded transfers could also be tagged with a carryover basis if that is deemed necessary as a political compromise.

Conclusion

Perhaps the Congress will consider some type of compromise legislation in the next few weeks. Clearly, any debate concerning reenactment of the estate tax should involve discussions concerning the estate tax rate, the structure of the tax rate (graduated, flat or stair-stepped), the amount of the estate tax exemption, whether the estate and gift tax are to be unified, whether the estate tax exemption should be portable among spouses, and any applicable phase-ins (with respect to either the rate of tax, or the exemption amount).

In any event, practitioners should carefully counsel clients that the utilization of techniques designed to provide maximum

benefit without an estate tax in place may not actually provide any benefit if the Congress passes retroactive estate and gift tax legislation that is ultimately upheld by the courts. That's one of the scenarios that makes estate planning at the present time so difficult, and makes the review of present estate planning documents critical to make sure that they still carry out the client's intent for disposition of the assets at death, and contain language that is as flexible as possible to deal with future changes in the law.

¹ In early 2009, the Administration had proposed making existing law (\$3.5 million estate tax exemption and 45% rate) applicable to transfer taxes (estate tax, gift tax and generation skipping transfer tax (GSTT)) permanent beginning in 2010. As the year progressed, the estate tax issue seemed to filter to the background behind spending legislation and, later, proposed health care legislation.

² The GSTT is separate from and in addition to the estate tax, and applies to transfers (outright or in trust) that skip generations (as defined by statute).

³ Provisions contained in the Economic Growth Tax Relief Reconciliation Act (EGTRRA) of 2001 specified that the federal estate tax exemption would gradually rise through 2009 combined with a gradual reduction in the estate tax rate. At the same time, the GSST and gift tax rates would fall at the same pace. In 2010, the estate tax and GSST would be repealed, but the gift tax would remain at a 35 percent rate on taxable gifts. Beginning with deaths after 2010, the estate tax and GSST would return, but only with a \$1 million exemption and a 55 percent top rate. The Congress, since 2001, made numerous attempts to address the looming one-year repeal, but could not reach agreement.

⁴ On December 3, 2009, the U.S. House passed H.R. 4154, the "Permanent Estate Tax Relief for Families, Farmers and Small Businesses Act of 2009." The bill passed the U.S. House by a 225-200 margin with no Republicans supporting the bill.

⁵ There were also other reasons for the bill's failure in the Senate. One was that the bill was projected to reduce federal revenues by \$234 billion over 10 years without any offset. To address this concern, House leaders had inserted into the bill a "pay-as-you-go" budget requirement that would offset future tax cuts

or spending. However, that provision received some opposition in the Senate because it would not have applied to the estate tax provisions of the bill and some other tax provisions presently slated for expiration after 2010.

⁶ Some commentators have tried to blame Republican Senators (none of which supported the bill) for failure of the estate tax to be extended for deaths in 2010. The fact remains, however, that as of December 2009, the Democrats still had the necessary 60 votes in the Senate to pass the bill. Thus, no Republican votes were needed to pass the bill. The Democratic leadership's insistence upon a 45 percent estate tax rate was objectionable to three Democrat Senators - (Blanche Lincoln (D-AR), Mary Landrieu (D-LA) and Claire McCaskill (D-Mo). Indeed, Senator Lincoln had earlier proposed a bill specifying a 35 percent top rate and a \$5 million exemption.

⁷ While the nine-month timeframe may not be sufficient time to raise the cash necessary to pay the estate tax liability, and insurance may not be practical for various reasons, it has been possible to make an election on the decedent's estate tax return to pay the tax in installments over (essentially) a fifteen-year period at a favorable interest rate. See I.R.C. §6166. However, numerous requirements must be satisfied to make the election and not all estates will qualify to make the election.

⁸ The estate tax issue has been highly politically for a number of years. Numerous unsuccessful attempts had been made from 2002 through 2006 to fully repeal the federal estate tax.

⁹ Eakin and Smith, "*Changing Views of the Estate Tax: Implications for Legislative Options*," American Family Business Institute, February 2009.

¹⁰ Yakevlov, P. and A. Davies, 2009. "The Effect of Estate, Inheritance, and Gift Taxes on the Survival of Small Businesses: A Panel Data Analysis," *National Tax Journal*, under review. One of the basic conclusions of the study is that the estate tax results in smaller businesses being acquired by larger businesses. After a series of multiple acquisitions, a very large company can result.

¹¹ Also, the "bypass trust" property could pass outright to the decedent's children.

¹² Even more troublesome, perhaps, is that the property could pass to the decedent's children from a prior marriage. In addition, such formula clause language could inadvertently result in the complete defunding of charitable bequests.

¹³ Another potential problem with of formula clause language can occur if the language results in the

funding of the "bypass trust" with an amount that is in excess of any state level exemption. Some states still have an estate tax that would subject those excess amounts to tax. Those states presently with an estate tax are Connecticut, Delaware, Maine, Maryland, Minnesota, New York, Ohio, Oregon, Vermont and Washington. Also, the District of Columbia has an estate tax.

¹⁴ Because the GSTT is also repealed for deaths after 2009, one consideration may be to make transfers to "skip" generations (e.g., grandchildren) in an amount that is less than the transferor's \$1 million gift tax exemption. As a hedge against reenactment of the estate tax and the GSTT, property could instead be placed in trust for the surviving spouse with the grandchildren designated as beneficiaries under formula clause language that leaves the maximum amount to the grandchildren free of GSTT. Under this approach, however, the donor would need to make a qualified terminable interest property (QTIP) election on a timely filed gift tax return. Also, grandchildren could be named as remainder beneficiaries on various types of charitable trusts.

¹⁵ See *Crummey v. Comr.*, 397 F.2d 82 (9th Cir. 1968).

¹⁶ See the text of footnote 13, *supra*.

¹⁷ Indeed, the Chairman of the Senate Finance Committee and the Chairman of the House Ways and Means Committee (the tax-writing committees in the Congress) have expressed their intent to extend the 2009 law for deaths after 2009, perhaps on a permanent basis and, perhaps, retroactive to January 1, 2010.

¹⁸ Article I, Section 9 of the United States Constitution contains the Ex Post Facto Clause.

¹⁹ 512 U.S. 24 (1994).

²⁰ The Court's opinion was unanimous, and the period of retroactivity was 14 months.

²¹ The *Carlton* case involved closing a loophole on a retroactive basis to an *existing* estate tax.

²² Also, 2010 is an election year and the more time that passes with the estate tax expired, not only does that bolster the argument that a retroactive reinstatement of the tax is unconstitutional, but it makes reinstatement of the tax much more politically difficult.

²³ As Joe Kristan has correctly noted on his blog (www.taxupdateblog.com), the current gift tax structure essentially accomplishes the same thing as the "prepayment trust." As Joe points out, "[T]he tax cost of gifting assets is lower than that of passing them on at death because the gift tax rate is imposed

only on assets that reach the next generation; the estate tax is imposed on the whole estate, including the amount that has to go to the government to pay the tax.”