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Estate Planning for 2010 and Beyond

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By

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I. THE TURBULENCE CREATED BY THE 2001 TAX ACT

A. The Phase-In of EGTRRA

1. The estate tax reductions enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16 ("EGTRRA") are completed in 2009 with a $3.5 million exemption equivalent and a flat rate of 45%.
2. The repeal of the federal credit for state death taxes has produced different results from state-to-state, depending on the existence and structure of the state estate tax. In a strictly "coupled" state, where the state tax is tied to the federal credit from time to time, there is no state tax. In a "decoupled" state, where the state tax typically is tied to the federal credit in effect at some point before 2002, there is a state tax. Section 2058 allows a deduction for the state tax in calculating the taxable estate, which generally results in an iterative (or algebraic) calculation.
3. In some of those states, however, the state law does not allow a deduction for the state tax in calculating the state tax itself. This avoids the iterative calculation, but it changes the effective federal and state tax rates. Federal Form 706 has been redesigned to accommodate the calculation of tax in such a state by providing a separate line 3a on page 1 for calculating a "tentative taxable estate" net of all deductions except state death taxes, a line 3b for separately deducting state death taxes, and a line 3c for the federal taxable estate (old line 3). The "tentative taxable estate" in effect *is* the taxable estate for calculating the state tax (but not the federal tax) in such a state.
4. The following table shows the resulting marginal rates on the largest estates:

Top Marginal Tax Rates			
	Federal	State	Total
"Coupled" State	45%	0	45%
Ordinary "Decoupled" State	38.8%	13.8%	52.6%
"Decoupled" State/No Deduction	37.8%	16%	53.8%
In 2011 (Under Current Law)	39%	16%	55%

5. The landscape is further complicated by other departures from the federal model in various jurisdictions, such as jurisdictions which have decoupled their tax systems not only from the federal credit for state death taxes but also from the phased increases in the federal unified credit, so that the state exemption is less than the federal exemption. See the compilation of state laws, available on-line at http://www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf.
6. In some states, the tide is flowing in the other direction. Virginia's decoupled estate tax was repealed in 2007. In February 2009, an effort to reinstate it was

defeated, or at least deferred until 2010 (when fiscal challenges will be great).

B. Watching a Byrd at Sunset

1. It is well known that the "repeal" of the federal estate tax takes effect in 2010, for only one year. In 2011, EGTRRA "sunsets" and the estate tax law returns to where it would be without the enactment of EGTRRA – namely the former 55% rate (with a 60% "bubble"), a credit for state death taxes, and the $1 million exemption that would have been reached in 2006 under the phased in changes made by the Taxpayer Relief Act of 1997.
2. Section 901(a) of EGTRRA states that "[a]ll provisions of, and amendments made by, this Act shall not apply ... to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010." Section 901(b) goes on to state that "[t]he Internal Revenue Code of 1986 ... shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted."
3. Section 901 is the only section in the ninth and last title of the Act, entitled "Compliance with Congressional Budget Act."
4. The Congressional Budget Act of 1974 (2 U.S.C. § 621 *et seq.*) prescribes the procedures by which Congress adopts spending and tax priorities in a budget resolution and implements those priorities in a streamlined process of budget reconciliation. In a 1985 amendment sponsored by Senator Robert Byrd (D-WV) (and hence known as "the Byrd rule"), section 313(f)(2) of the Budget Act (2 U.S.C. § 633(f)(2)) was added to make it out of order in the Senate to include in budget reconciliation "new budget authority or outlays" (which includes the reduction of tax receipts, *see* 2 U.S.C. § 622(2)(A)(iv)) beyond that provided for in the budget resolution. Since the 2001 budget resolution generally covered ten years, it would have been out of order to reduce taxes beyond the tenth year.
5. The Byrd rule can be waived by a vote of 60 Senators (just as a Senate filibuster against general legislation can be broken by a vote of 60 Senators). H.R. 1836, which became EGTRRA, originally passed the Senate, on May 23, 2001, by a vote of 62-38. That Act, however, garnered 62 votes only with a "sunset" provision in it. The Senate was not asked to vote on a non-sunsetting repeal, and presumably the votes were just not there. In the Senate consideration of H.R. 1836, amendments to eliminate the estate tax repeal were defeated by votes of 43-56 and 42-57. Even an amendment to preserve the estate tax only for estates greater than $100 million was defeated by a vote of 48-51.

C. The Cost of Repeal

1. The structure of EGTRRA significantly affects the "cost" of the "repeal" it nominally enacted.
2. In 2001, Congress anticipated large budget surpluses. There was debate over how

large the surpluses might be, there was debate over how much of the projected surpluses should be "given back to taxpayers" in the form of tax cuts, and there was debate over what form those tax cuts should take. Congress decided on tax cuts, over a ten-year period, of one and one-third trillion dollars. Even that would not fund every tax cut Congress wanted to confer, however, and it was necessary to set priorities and make trade-offs, even in 2001.

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

4. Congress obviously also mitigated the federal revenue loss from the 2001 Act by repealing the state death tax credit and thereby shifting a significant part of the burden to states whose estate taxes were tied to the federal credit and have therefore been phased out. Since the state death tax credit is now fully repealed, that is a technique that Congress cannot use again.

II. PAST REMINISCENCES

A. The World War I Era

1. In the Revenue Act of September 8, 1916, as the United States entered World War I, Congress enacted the current estate tax, imposed at rates of 1% to 10% on taxable estates over $50,000. In the Act of March 3, 1917, the rates were generally increased by half, to levels of 1½% to 15%. In explaining the Senate bill, which would have doubled rates to 2%-20%, the Finance Committee said:

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

S. REP. NO. 103, 65TH CONG., 1ST SESS. 14 (1917) (emphasis added).

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

support of doubling the tax and in support of repealing the tax! The 1926 House-Senate conference, of course, accepted the House approach.

B. The Kennedy-Johnson Studies and the Nixon Administration

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

1. Taxation of appreciation at death or at the time of gifts (carryover basis enacted in 1976, repealed in 1980, and enacted again in 2001, effective 2010).
2. Unification of the gift and estate taxes.
    a. Same rates (1976).
    b. Same base – tax-inclusive (1976, for gifts within three years of death).
    c. Single exemption (1976 – until 2003).
    d. Abolition of the "gifts in contemplation of death" rule (1976).
3. Unlimited marital deduction, including income interests (1981).
4. Repeal of the exclusion of interests in qualified retirement plans (1984).
5. More explicit rules governing disclaimers (1976).
6. An "orphan exclusion" equal to the amount of the gift tax annual exclusion multiplied by the number of years by which the orphan is under 21 (roughly in 1976 – repealed in 1981).
7. Tightening of the deduction rules for transfers to charity (1969).
8. More rational allocation of deductions between estate tax and income tax returns (in part by the "*Hubert* regulations" in 1999).
9. Tax on generation-skipping transfers (1976 and 1986).
10. Liberalized extended payment of estate taxes (section 6166) (1976).
11. Discontinuance of "flower bonds" redeemable at par to pay estate tax (last issued 1971, last matured 1998).

C. The Ford Administration

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

D. The Reagan Administration

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

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

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

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

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

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

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

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

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

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

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

2. "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" was published by the White House on **May 29, 1985**. It was

popularly called "Treasury II" or "White House I" or sometimes "Regan II" in reference to the fact that Donald T. Regan was the Secretary of the Treasury who signed the transmittal letter for "Treasury I" and had become the White House chief of staff by May 1985. Based generally on Treasury I, it was the rough model for the Tax Reform Act of 1986. It contained no proposals affecting transfer taxes.

a. Ultimately, the Tax Reform Act of 1986 (Public Law 99-514) did enact a supposedly simpler GST tax (but at a rate equal to 100%, not 80%, of the top estate tax rate).

b. In the Omnibus Budget Reconciliation Act of 1987 ("OBRA") (Public Law 100-203), the House of Representatives added a repeal of the state death tax credit, a rule valuing interests in family-owned entities at their pro rata share of the total value of all interests in the entity of the same class, and rules regarding "disproportionate" transfers of appreciation in estate freeze transactions. H. REP. NO. 100-391, 100TH CONG., 1ST SESS. 1041-44. The House-Senate conference retained only the estate freeze rules, as section 2036(c) (which in turn was repealed in 1990 and replaced with the supposedly more workable rules of chapter 14).

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

E. The Clinton Administration

1. The Clinton Administration's budget proposals for fiscal 1999 included a proposal to "eliminate non-business valuation discounts," described as follows:

> The proposal would eliminate valuation discounts except as they apply to active businesses. Interests in entities would be required to be valued for transfer tax purposes at a proportional share of the net asset value of the entity to the extent that the entity holds readily marketable assets (including cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, non-income producing property such as art or collectibles, commodities, options and swaps) at the time of the gift or death. To the extent the entity conducts an active business, the reasonable working capital needs of the business would be treated as part of the active business (i.e., not subject to the limits on valuation discounts). No inference is intended as to the propriety of these discounts under present law.

a. The Clinton Administration's budget proposals for fiscal 2000 and fiscal 2001 repeated this proposal, except that "readily marketable assets" was changed to "non-business assets" and "the propriety of these discounts under present law" was changed to "whether these discounts are allowable under current law."

b. This proposal was reduced to legislative language in section 276 of H.R. 3874, 106th Cong., 2d Sess., introduced on March 9, 2000, by the Ranking Democrat on the House Ways and Means Committee, Rep. Charles Rangel of New York. This bill would have added a new section 2031(d) to the Code, the general rule of which read as follows:

> (d) VALUATION RULES FOR CERTAIN TRANSFERS OF NONBUSINESS ASSETS—For purposes of this chapter and chapter 12—
>
> > (1) IN GENERAL—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092), the value of such interest shall be determined by taking into account
> >
> > > (A) the value of such interest's proportionate share of the nonbusiness assets of such entity (and no valuation discount shall be allowed with respect to such nonbusiness assets), plus
> > >
> > > (B) the value of such entity determined without regard to the value taken into account under subparagraph (A).

c. A slightly different articulation of this rule appeared in section 303 of H.R. 1264, 107th Cong., 1st Sess., which Rep. Rangel introduced on March 26, 2001, partly as an alternative to the Republican proposals that became EGTRRA:

> (d) VALUATION RULES FOR CERTAIN TRANSFERS OF NONBUSINESS ASSETS—For purposes of this chapter and chapter 12—
>
> > (1) IN GENERAL—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092)—
> >
> > > (A) the value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and
> > >
> > > (B) the nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.

Rep. Rangel's 2001 bill would also have added a new section 2031(e) to the Code, to read as follows:

> (e) LIMITATION ON MINORITY DISCOUNTS—For purposes of this chapter and chapter 12, in the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092), no discount shall be allowed by reason of the fact that the transferee does not have control of such entity if the transferee and members of the family (as defined in section 2032A(e)(2)) of the transferee have control of such entity.

Identical statutory language for new sections 2031(d) and (e) appeared in H.R. 5008, 107th Cong., 2d Sess. § 3 (introduced June 24, 2002, by Rep. Earl Pomeroy (D-ND)), H.R. 1577, 109th Cong., 1st Sess. § 4 (introduced April 12, 2005, by Rep. Pomeroy), and H.R. 4242, 110th Cong., 1st Sess. § 4 (introduced November 15, 2007, by Rep. Pomeroy).

d. Clinton Administration proposals have inevitably experienced a bit of a revival now that Democrats control the Congress and White House. Democratic staff members have publicly referred to them as a possible model for legislative drafting. This is perhaps reflected in H.R. 436, the current version of Rep. Pomeroy's bill, discussed in Part VII.A on page 25.

e. The same Clinton Administration's proposed budgets also recommended the repeal of the personal residence exception from section 2702.

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

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

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

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

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

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

III. REPUBLICAN-LED EFFORTS TO REPEAL OR REFORM

A. Early Efforts After 2001 To Make Repeal Permanent

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

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

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

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

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

d. Before voting on permanent repeal, the Senate took up alternatives offered by Democratic Senators, including accelerated increases in the unified credit (which failed by a vote of 38-60) and expansion of qualified family-owned business interest (QFOBI) relief (which failed by a vote of 44-54).

B. Reports of Compromise Efforts

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

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

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

C. The 2004 Election

1. On the day after his reelection in 2004, President Bush referred to the "political capital" that he had earned and intended to "spend." He also made it clear that one of the centerpieces of his domestic agenda was to make permanent the tax cuts enacted in 2001 and 2003, including the repeal of the estate and GST taxes.

2. Also in the 2004 election, the Republicans maintained control of the House and gained four seats in the Senate. Fifty-five was more Republicans than there had

been in the Senate since Herbert Hoover was President. This gain in the Senate immediately triggered a lot of speculation about the new votes that might be available for permanent repeal of the estate tax.

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

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

5. It is harder still to evaluate the intangible factor of weighing votes rather than counting them. A vote in 2000 for a measure everyone knew President Clinton would veto, a vote in 2001 for a repeal for only one year nine years in the future, and a vote in 2002 where the counting had already been done were not necessarily indicative of how lawmakers would vote on a measure with a realistic chance of success, when it is actually necessary for them to take responsibility for their actions (as the 2006 votes were to show).

D. The Final Push for Repeal or Compromise

1. The permanent repeal of the federal estate tax was placed before the Senate when, by a more or less bipartisan vote of 272-162 on April 13, 2005, the House passed the 109th Congress's version of H.R. 8 (the "Death Tax Repeal Permanency Act of 2005") to eliminate the 2011 "sunset" that limits repeal to just the year 2010. [Of the 272 Members of the House who voted for H.R. 8 in April 2005, 216 (almost a majority) returned to the Democratically-controlled 110th Congress, and 179 (a sizable minority, consisting of 142 Republicans and 37 Democrats) have returned to the new 111th Congress.]

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

3. Meanwhile, with full repeal lacking 60 votes, compromise efforts continued. The idea of a 15% rate, mentioned in the October 22, 2003, *Washington Post*, although quite a departure from the top 55% rate of just a few years ago and even the 45% top rate achieved in 2007 under present law, had proved remarkably durable, and it remained the target rate openly discussed by Senator Kyl and others as the compromise discussions reached a public crescendo. In contrast, the

$15 million exemption level reported in October 2003 was elusive. Following the 2004 elections, the most often mentioned aspiration was an exemption of $10 million. In mid-July, $8 million was mentioned in the press, and by the end of July it was $3.5 million.

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

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

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

5. On May 2, 2006, a "Summit for Permanent Death Tax Repeal" convened at the National Press Club in Washington. It was sponsored by the Family Business Estate Tax Coalition, and participants included Senator Kyl, Ways and Means Committee Member Congressman Kenny Hulshof (R-MO) (who retired from Congress and ran, unsuccessfully, for Governor of Missouri in 2008), and Al Hubbard, Assistant to the President for Economic Policy and Director of the National Economic Council. The consensus at the Summit was to support a compromise of a 15% rate, a $5 million exemption (indexed for inflation), and continued stepped-up basis for appreciated assets, all effective January 1, 2010.

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

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

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

E. PETRA

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

1. PETRA, effective January 1, 2010, would have provided

   a. a $5 million exemption equivalent (indexed for inflation after 2010),

   b. an initial rate tied to the top income tax rate on general capital gains under section 1(h)(1)(C) (currently 15%, but returning to 20% in 2011 if Congress does not act),

c. a rate equal to double that rate on taxable estates over $25 million (not indexed),

d. gift tax exemptions and rates re-conformed to the estate tax (rather than a special exemption of $1 million and a special rate of 35% as in 2010 under current law),

e. repeal of the deduction for state death taxes (which itself replaced the phased-out credit for state death taxes in 2005),

f. retention of a stepped-up basis at death for appreciated assets, and

g. repeal of the 2011 "sunset" for the other transfer tax provisions of EGTRRA.

2. PETRA would also have provided a mechanism for a surviving spouse's estate and gift (but not GST) exemptions to be increased (but no more than doubled) by the amount of the exemption that was not used by that spouse's predeceased spouse.

   a. This in effect would have allowed a surviving spouse an exemption of up to $10 million (in 2010 and thereafter), indexed for inflation, if the first spouse to die did not use any exemption – if, for example, the estate of the first spouse to die were left entirely to the surviving spouse.

   b. This treatment would have to be elected on a timely estate tax return of the first spouse to die, and the Internal Revenue Service would have been authorized to reexamine that return at the time the surviving spouse died, no matter how much time had passed, for the purpose of determining the exemption available to the surviving spouse (but not for the purpose of changing the tax with respect to the first return).

   c. The $25 million level for the higher rate would not have been transferable between spouses.

3. In addition, PETRA included a relief provision for the timber industry, widely viewed as an effort to attract the votes of Senators from timber-growing states.

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

5. On June 27, Senator Frist announced that PETRA would not be brought to the Senate floor before the Fourth of July recess.

F. ETETRA

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

1. ETETRA modified PETRA by

    a. phasing in the $5 million exemption equivalent in $250,000 annual increments from $3.75 million in 2010 (up from $3.5 million in 2009) to $5 million in 2015,

    b. delinking the top estate tax rate (but not the initial 15% rate) from the capital gains tax rate,

    c. phasing in the top 30% rate in 2% annual increments from 40% in 2010 (down from 45% in 2009) to 30% in 2015,

    d. extending the indexing for inflation (after 2015) to the $25 million bracket amount, and

    e. removing the "miscellaneous" provisions of EGTRRA from the repeal of the EGTRRA sunset, meaning that they again would be scheduled to expire in 2011.

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

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

G. Adjournment

1. After recessing for the November 7 elections and returning for a "lame duck" session, the 109th Congress adjourned without enacting ETETRA-like changes or any other significant changes to the estate, gift, and GST taxes.

2. Congress did, however, enact a number of the extenders that had been in ETETRA, but without estate tax changes, without an increase in the minimum wage (which was postponed to 2007), and without even the relief provisions for the timber industry that had originated in PETRA.

IV. REASSESSING THE LIKELIHOOD OF REPEAL

A. Milestones in the History of the Repeal Movement

1. President Reagan's low-key interest in repeal, which produced only a reduction of the top rate from 70% to 50%, in a phased reduction that ultimately leveled off at 55%,

2. President Reagan's legacy of populist support for tax cuts of all kinds, coupled with increasing unrest among some economists and some leaders of public opinion with the economic and personal burden of the tax increasingly referred to as the "death tax,"

3. the Republican takeover of the House of Representatives in 1994, spurred by a "Contract with America" in which tax relief was prominent,

4. President Bush's presidential campaign of 2000, drawing on two decades of growing anti-tax sentiment in promising to return huge projected budget surpluses to the American people in "Tax Cuts with a Purpose," including repeal of the death tax,

5. the "repeal" itself in EGTRRA, albeit only after nine years and then only for one year,

6. the immediate commitment from the 2001 Republican leadership to "make the tax cuts permanent," even as projected budget surpluses dwindled,

7. history-defying Republican mid-term election gains in 2002, followed by still more Republican gains in the presidential year of 2004,

8. an October 2003 Washington Post report – immediately denied but publicly affirmed after the 2004 election – that Senate Finance Committee member and repeal supporter Jon Kyl was working with other Senators to craft a bipartisan compromise proposal that would increase the exemption to $15 million and decrease the rate, above that exemption, to 15%, the current income tax rate on capital gains,

9. the perennial endorsement of full repeal by the House of Representatives, culminating in a 272-162 vote in April 2005 for the current version of H.R. 8, the "Death Tax Repeal Permanency Act of 2005,"

10. the scheduling for just after Labor Day in 2005 of a Senate vote to take up H.R. 8, to either approve it or, more likely, to amend it along the lines of Senator Kyl's compromise,

11. the abrupt postponement of that vote after Hurricane Katrina,

12. the recommitment of the Senate Republican leadership to an estate tax vote in 2006, affirmed at a retreat of Republican Senators in January, announced by Senate Majority Leader Bill Frist (R-TN) in February, and reaffirmed in Senator Frist's call in an April 21 letter to Republican Senators to "end the death tax forever,"

13. a resolve by representatives of most pro-repeal constituencies at a May 2 "Summit for Permanent Death Tax Repeal" to get behind Senator Kyl's 15% compromise, with a $5 million exemption, as the most practical way to achieve at least a substantial measure of estate tax relief,

14. a 57-41 Senate vote on June 8 on a "cloture" motion to take up H.R. 8, which thereby failed for lack of the required 60 votes,

15. passage by the House of two new estate tax compromise bills customized to attract the support of 60 Senators – H.R. 5638, the "Permanent Estate Tax Relief Act of 2006" ("PETRA") by a vote of 269-156 on June 22, and H.R. 5970, the "Estate Tax and Extension of Tax Relief Act of 2006" ("ETETRA") by a vote of 230-180 on July 29, and
16. a 56-42 Senate vote on August 3 on a cloture motion to take up consideration of H.R. 5970, which thereby also failed for lack of the required 60 votes.

B. What Might Have Been

1. We will probably never know how the Senate would have voted just after Labor Day in 2005, if Katrina had not intervened. But it is clear that **even before Republicans lost control of Congress to the Democrats in the 2006 election**, the effort for total repeal had simply lost too much traction to have a meaningful chance of recovery. Consider the following:
2. In October 2003, Senator Kyl was publicly insisting on full and permanent repeal and denying rumors of compromise, but by the end of 2004 his push for a 15% rate instead of full repeal was a matter of general knowledge. Even before the June 8 cloture vote, it was understood in the Senate that Senator Kyl would accept a 30% rate for the largest estates – an understanding that later was reflected in PETRA and ETETRA. Once willingness to compromise in this way is conceded, it is very hard to credibly reassert a "purist" position.
3. As late as April 21, 2005, a letter from Majority Leader Frist called on his Republican colleagues to "end the death tax forever," but by summer he was leading the effort to bring ETETRA to a vote, with its 15% and 30% rates.
4. The Bush Administration's official position had been to favor full and permanent repeal, but the White House called PETRA "a constructive step toward full repeal of the death tax." Again, once a compromise effort is dignified in that way, it can become, in effect, the new agenda.
5. The opposition to repeal – indeed even the opposition to substantial reduction – has been resolute and deep, as indicated by the failure of the ETETRA "sweeteners" to change more than one Senator's vote.
6. Meanwhile, the support for total repeal has been diluted both by years of frustrations and by the realization that carryover basis would be a very unwelcome substitute.
7. Unlike 2001, when large budget surpluses were forecast, the current fiscal climate of large budget deficits fuels the unease of politicians and voters with "tax cuts for the rich."
8. As a practical matter, estate tax repeal will usually require 60 votes in the Senate.

V. "OPTIONS" PRESENTED BY THE JOINT COMMITTEE STAFF

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

A. Perpetual Dynasty Trusts

1. The first proposal is labeled "Limit Perpetual Dynasty Trusts (secs. 2631 and 2632)." The purpose of this proposal is described as follows:

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

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

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

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

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

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

B. Valuation Discounts

1. The second proposal is labeled "Determine Certain Valuation Discounts More Accurately for Federal Estate and Gift Tax Purposes (secs. 2031, 2512, and 2624)." The purpose of this proposal is described as follows:

> The proposal responds to the frequent use of family limited partnerships ("FLPs") and LLCs to create minority and marketability discounts. ... The proposal seeks to curb the use of this strategy frequently employed to

manufacture discounts that do not reflect the economics of the transfers during life and after death.

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

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

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

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

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

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

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

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

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

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

C. Lapsing Crummey Powers

1. The third proposal is labeled "Curtail the Use of Lapsing Trust Powers to Inflate the Gift Tax Annual Exclusion Amount (sec. 2503)." The purpose of this proposal is described as follows:

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

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

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

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

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

3. Again curiously, the proposal does not explore the possibility of making "tax-vesting" (includibility in the powerholder's gross estate), rather than actual non-lapsing, the test, even though a tax-vesting test is already used for trusts for minors under section 2503(c) and for all GST tax purposes under section 2642(c)(2).

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

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

D. Consistent Basis

1. The fourth proposal is labeled "Provide Reporting for a Consistent Basis Between the Estate Tax Valuation and the Basis in the Hands of the Heir (sec. 1014)." The

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

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

E. 529 Plans

1. The fifth and final proposal is labeled "Modify Transfer Tax Provisions Applicable to Section 529 Qualified Tuition Accounts (sec. 529)." This proposal would essentially subject 529 plans to the transfer tax rules that are generally applicable.
2. An exception is the special rule allowing the use of five annual gift tax exclusions for a single transfer, which apparently would not be changed.

VI. "MIDDLE CLASS" FOCUS UNDER DEMOCRATIC LEADERSHIP

A. The Fiscal 2008 Congressional Budget Resolution (March 2007)

1. On March 21, 2007, in the context of finalizing the fiscal 2008 budget resolution (S. Con. Res. 21), the Senate, by a vote of 97-1 (with only Senator Fiengold (D-WI) opposed), approved an amendment offered by Senator Baucus (joined by Senators Mary Landrieu (D-LA), Mark Pryor (D-AR), Evan Bayh (D-IN), and Bill Nelson (D-FL)) that in effect would make the $132 billion surplus projected for 2012 available to offset tax cuts in both 2011 and 2012, including selective extension of the tax cuts enacted in 2001 and 2003.
2. Senator Baucus stated that under this amendment "the Senate's highest priority for any surplus should be American families." 153 CONG. REC. S3469 (daily ed. March 21, 2007). Accordingly, the first priority Senator Baucus cited was improving children's health care coverage under the State Children's Health Insurance Program (SCHIP). Senator Baucus continued:

> Then our amendment takes the rest of the surplus and returns it to the hard-working American families who created it. Our amendment devotes the rest of the surplus to the extension and enhancement of tax relief for hard-working American families.
>
> Here are the types of tax relief about which we are talking. We are talking about making the 10-percent [income] tax bracket permanent....
>
> We are talking about extending the child tax credit....
>
> We are also talking about continuing the marriage penalty relief....
>
> We are also talking about enhancing the dependent care credit....
>
> We are talking about improving the adoption credit....

> We are talking about [taking] combat pay [into account] under the earned-income tax credit, otherwise known as the EITC....
>
> **We are talking about reforming the estate tax. We want to try to give American families certainty. We want to support America's small farmers and ranchers, and in this amendment, we have allowed room for estate tax reform that will do that.**
>
> And we talk about returning surplus revenues to hard-working American families.

3. Senator Kent Conrad (D-ND), the Chairman of the Senate Budget Committee (and a former North Dakota Tax Commissioner), responded:

> Madam President, I thank very much Senator Baucus for his leadership on this very important amendment. This amendment is to reassure all those who have benefited from the middle-class tax cuts that those tax cuts will go forward, that those children who are not now currently covered under the SCHIP legislation will have the opportunity to be covered.
>
> The Senator has also provided for small business because we have a number of provisions that are critically important to small business and, of course, to prevent the estate tax from having this bizarre outcome, which is now in the law, where the exemption would go down to $1 million from $3.5 million just two years before. That makes no sense. So the Senator provides for room in this amendment to deal with estate tax reform.
>
> The precise contours of that will be up to, obviously, the Finance Committee.

4. In response to the ensuing discussion of several of the points he had made, Senator Baucus subsequently said (*id.* at S3470):

> There is an underlying answer to all these questions; namely, these are questions the Finance Committee is going to address and find the appropriate offsets and deal with the pay-go when it comes up at that time.

5. After being asked specifically about the estate tax, Senator Baucus stated that the amendment "contemplates extending the estate tax provisions that are in effect in 2009 permanently."
   a. In the context of this budget resolution, of course, "permanently" means only through 2012 (or perhaps only through 2011, since the tax from 2011 estates would generally be payable in *fiscal* 2012, which begins October 1, 2012).
   b. The prospect of extending 2009 law through 2011 or 2012 is intriguing. It reflects some thoughtful attention to the concerns about the instability of the current estate tax law, especially as 2010 approaches.
   c. Moreover, by eliminating the repeal year of 2010, an extension actually picks up some revenue to offset the revenue lost in 2011 and 2012. The revenue loss in 2011 and 2012, when the exemption would increase from $1 million (under current law) to $3.5 million, would be complicated by the fact that the top federal rate would go from 39% (net of the state death tax credit) under

current law to something like 37.8%, 38.8%, or 45% (as in the table on page 1).

d. Since the revenue gain from 2010 is a one-time gain, it will not be available again to mitigate revenue losses, meaning that permanent estate tax reduction will become even more expensive if this extension were enacted.

6. On March 23, 2007, the Senate rejected a variation of Senator Kyl's proposal to direct the tax-writing committees to report an estate tax exemption of $5 million (indexed for inflation) and a top rate no higher than 35%. The vote was 48-51. The vote was severely partisan; no Democrat voted for it, and only one Republican (Senator Voinovich) voted against it. The four Senators who voted for cloture on H.R. 8 in June 2006 but not for Senator Kyl's March 2007 amendment were Senators Baucus, Lincoln (D-AR), Bill Nelson (D-FL), and Ben Nelson (D-NE).

7. On the same day, by a vote of 25-74, the Senate rejected an amendment offered by Senator Ben Nelson that he described as follows (*id.* at S3667 (March 23, 2007)):

> Like the Kyl amendment, our amendment will allow us to accommodate the Landrieu proposal of a $5 million [exemption] and 35 percent [rate] with a surcharge for the largest estates. Unlike the Kyl amendment, this amendment is fiscally responsible and deficit neutral [that is, it will be paid for].

Only four Republicans (Senators Susan Collins and Olympia Snowe of Maine, Richard Lugar of Indiana, and George Voinovich of Ohio) voted for Senator Nelson's amendment.

8. Thus, with only Senators Collins, Lugar, and Snowe voting for both the Kyl amendment and the Nelson amendment, it might be said that 70 Senators voted on March 23 for an exemption of $5 million and a top rate no greater than 35% (at least if it can be "paid for" and depending on what Senators Nelson and Landrieu meant by "a surcharge for the largest estates").

9. The Senate approved the overall budget resolution on March 23 by a largely partisan vote of 52-47.

10. On May 9, 2007, when the Senate was considering the appointment of Senators to the House-Senate conference on the budget resolution, Senator Kyl offered the following motion (*id.* at S5838 (May 9, 2007)):

> That the conferees on the part of the Senate on the disagreeing votes of the two Houses on the concurrent resolution S. Con. Res. 21 (the concurrent resolution on the budget for fiscal year 2008) be instructed to insist that the final conference report include the Senate position to provide for a reduction in revenues, sufficient to accommodate legislation to provide for permanent death tax relief, with a top marginal rate of no higher than 35%, a lower rate for smaller estates, and with a meaningful exemption that shields smaller estates from having to file estate tax returns, and to permanently extend other family tax relief, so that American families, including farmers and small business owners, can continue to

enjoy higher after-tax levels of income, increasing standards of living, and a growing economy, as contained in the recommended levels and amounts of Title I of S. Con. Res. 21, as passed by the Senate.

a. In explaining the motion, Senator Kyl said: "While the motion does not specify that amount, an exemption of $5 million per estate indexed for inflation is what is contemplated." *Id.* at S5839.

b. Senator Conrad opposed the motion, on the grounds that it was not paid for and that the subject was already covered by the Baucus amendment in the Senate resolution, which he as a Senate conferee would be committed to support. *Id.*

c. Nevertheless, Senator Kyl's motion passed by a vote of 54-41, with eight Democrats in favor and no Republicans opposed.

d. The binding effect of such a motion to "instruct" conferees was unclear. Even provisions "sufficient to accommodate" the desired legislation would still leave the implementation up to the tax-writing committees.

11. On May 17, 2007, the House and Senate approved the budget resolution with intriguing references to the estate tax.

a. The provisions of the budget resolution applicable to the House of Representatives (section 303(b)(2)) permit

> one or more bills, joint resolutions, amendments, motions, or conference reports that provide for tax relief for middle-income families and taxpayers and enhanced economic equity, such as extension of the child tax credit, extension of marriage penalty relief, extension of the 10 percent individual income tax bracket, modification of the Alternative Minimum Tax, *elimination of estate taxes on all but a minute fraction of estates by reforming and substantially increasing the unified credit,* extension of the research and experimentation tax credit, extension of the deduction for State and local sales taxes, and a tax credit for school construction bonds ... provided that such legislation would not increase the deficit or decrease the surplus for the total over the period of fiscal years 2007 through 2012 or the period of fiscal years 2007 through 2017.

H.R. REP. NO. 110-153, 110TH CONG., 1ST SESS. 27 (2007).

b. With respect to the corresponding language of the budget resolution applicable to the Senate (section 303(a)), an overview prepared by the staff of the Senate Budget Committee stated:

> The Conference Agreement supports middle-class tax relief, including extending marriage penalty relief, the child tax credit, and the 10 percent bracket subject to the pay-as-you-go rule. It also supports reform of the estate tax to protect small businesses and family farms. House provisions include additional procedural protections to help ensure fiscal responsibility.

c. The proviso that the contemplated tax relief "not increase the deficit or decrease the surplus for the total over the period of fiscal years 2007 through

2012 or the period of fiscal years 2007 through 2017" – what the Senate Budget Committee's overview refers to as "procedural protections to help ensure fiscal responsibility" – can fairly be interpreted to mean that under the budget resolution the Ways and Means Committee will not include any tax relief provisions that are not "paid for" through increases of other taxes or projected budget surpluses. This will be an especially hard standard to meet in view of the current deficit that the budget needs to overcome and the commitment of Ways and Means Committee Chairman Charlie Rangel (D-NY) and other Members of Congress to give priority to the very expensive task of fixing the individual alternative minimum tax.

B. The Fiscal 2009 Congressional Budget Resolution (March 2008)

1. In the consideration of the fiscal 2009 budget resolution (S. Con. Res. 70) on March 11, 2008, Senator Baucus again proposed an amendment that would make projected surpluses available for middle-class tax relief. He said, at 154 CONG. REC. S1840 (daily ed. March 11, 2008):

> This amendment would take the surplus in the budget resolution and give it back to the hard-working American families who earned it. It would make permanent the 10-percent tax bracket. It would make permanent the child tax credit. It would make permanent the marriage penalty relief. And it would make permanent the changes to the dependent care credit. Further, it would make changes to the tax law to honor the sacrifices our men and women in uniform make for us every day. **We lower the estate tax to 2009 levels.** And it would allow middle-income taxpayers who do not itemize their deductions to nonetheless take a deduction for property taxes.

2. Once again, Senator Conrad chimed in:

> Mr. President, I thank the chairman of the Finance Committee, Senator Baucus, for this excellent amendment. This will extend the middle-class tax cuts, the 10-percent bracket, the childcare credit, and the marriage penalty relief provisions. All those tax cuts will be extended.
>
> In addition, as I understand it, the chairman of the Finance Committee has crafted an amendment that will include significant estate tax reform because we are now in this unusual situation of where, under current law, the estate tax will go from a $3.5-million exemption per person in 2009 to no estate tax in 2010, and then in 2011, the estate tax comes back with only $1 million exemption per person. The amendment of the Senator from Montana would make certain it stays at $3.5 million and is allowed to rise with inflation.

3. And again, Senator Baucus's amendment was approved with only Senator Feingold opposed. The vote was 99-1.

4. On the following day, as he had in 2007, Senator Kyl offered an amendment that would provide a $5 million estate tax exemption (indexed for inflation) and a top rate of 35%. *Id.* at S1922 (daily ed. March 12, 2008). An alternative, "paid for," amendment offered by Senator Salazar (D-CO) was defeated by a vote of 38-62. *Id.* at S2044. Senator Kyl's amendment was then defeated by a vote of 50-50. *Id.*

a. Vice President Cheney had been in the presiding officer's chair and recognized Senators Salazar and Kyl just before the vote on Senator Salazar's amendment (*id.*), but he was no longer in the Senate chamber to break the tie after the vote on Senator Kyl's amendment

b. During the debate, Senator Kyl complained (*id.* at S1923-24):

> The American people need to understand what is really going on. Each year we pass a budget that, theoretically, allows for a reform of the estate tax, but then we don't do anything about it. And the budget itself isn't law. The budget is merely a goal, a blueprint of where we want to go for the year. If you don't follow it up with a bill, you haven't done anything. But Members here pat themselves on the back and go back home and tell their constituents that they voted to cut the estate tax. Oh, that is wonderful, people say. But it is never followed up with an actual bill.
>
> So the chairman of the Finance Committee said: Well, he would have the goal of marking up a bill this spring. He has since advised me he has no plans whatsoever for a real bill on estate tax, and said: It won't happen.

5. Democratic Senators Landrieu and Lincoln voted for Senator Kyl's amendment, while Republican Senator Voinovich voted against it. Republican Senators Collins, Snowe, and Voinovich joined 35 Democrats, including Senators Landrieu and Lincoln, to vote for Senator Salazar's amendment. Thus, only four Senators (Collins, Landrieu, Lincoln, and Snowe) voted for both amendments, meaning that 84 Senators voted for substantial estate tax relief, albeit in what were essentially "free" votes. [Nine of the 50 Senators who voted for the Kyl amendment are not back in the 111th Congress, although in one case (Mike Johanns replacing Chuck Hagel of Nebraska) that should not change the vote. Four of the 38 Senators who voted for the Democratic alternative are not back in the 111th Congress; they happen to be Senators Obama, Biden, Clinton, and Salazar. But even after those subtractions, there are currently 71 Senators who voted in for some form of a $5 million exemption and 35% rate.]

C. Finance Committee Hearings

On October 4, 2007, while the Senate Finance Committee was considering the tax features of an energy, conservation, and agriculture tax package entitled the Heartland, Habitat, Harvest, and Horticulture Act of 2007, Senator Kyl proposed an amendment that would set the estate tax exemption at $5 million indexed for inflation, tie the estate tax rate above $5 million to the capital gains tax income tax rate (currently 15%), and add a 30% bracket beginning at $25 million. (This is essentially the same as ETETRA.) Senator Kyl withdrew the amendment after Chairman Baucus promised to hold a hearing on estate tax reform "later in the year," with the goal of marking up a bill in the spring of 2008.

1. The Finance Committee held that hearing on November 14, 2007. A manufacturer from Iowa and a rancher from Nevada advocated repeal of the estate tax or at least a substantial increase in the exemption. Warren Buffett of Berkshire Hathaway supported a progressive estate tax (with an exemption of

perhaps $4 million) as necessary to prevent "plutocracy." Practitioner Conrad Teitell of Stamford, Connecticut, pointed out the caprice of current law and the complexities and uncertainties faced in estate planning. Both Chairman Baucus and Ranking Member Grassley complained about the estate tax, expressed their preference for repeal, but offered a commitment to serious reform as an achievable alternative. Chairman Baucus promised more extensive hearings in 2008 with a goal of major changes in the 111th Congress (2009-2010).

2. A second hearing was held on March 12, 2008. Three professors discussed alternatives to the estate tax system, largely donee-based taxes such as inheritance taxes and inclusion of inheritances in income, as well as income taxes on gains imposed at the donor level. It was clear that the Senators in attendance (three Democrats and three Republicans at various times) were not inclined to replace the estate tax with another regime, although they obviously were aware of the coming anomaly in 2010 and 2011 and seemed interested in finding some way to avoid it. Both Democrats and Republicans expressed concern for the liquidity problems of family-owned farms and businesses.

3. A third hearing was held on April 3, 2008. Witnesses were invited to discuss

   a. the need to clarify, modernize, simplify, and otherwise improve the rules for deferred payment of estate tax under section 6166,

   b. the "portability" of transfer tax exemptions (and exemption equivalents represented by the unified credit) from deceased spouses to surviving spouses,

   c. reunifying the estate and gift tax unified credits, and

   d. the effect of the estate tax on charitable giving.

   The topics provide clues about the "targeted" relief to look for in any legislation (tied to family farms and other family businesses which have been a vocal concern of Senators, especially Democrats like Senator Lincoln). The witnesses' statements are available at http://finance.senate.gov/sitepages/hearing040308.htm. With respect to the "portability" of transfer tax exemptions, see Gerzog, "Portability of Exemptions," TAX NOTES, May 5, 2008, at 509.

VII. RUNNING OUT OF TIME IN THE ONE-HUNDRED-ELEVENTH CONGRESS

A. The Pomeroy Bill (H.R. 436)

1. On January 9, 2009, Rep. Earl Pomeroy (D-ND) introduced H.R. 436, called the "Certain Estate Tax Relief Act of 2009." It received a great deal of attention, but the attention was probably overdone (not surprising in today's atmosphere of anticipation). Rep. Pomeroy is the tenth most senior Democrat on the Ways and Means Committee, and there is no indication that this bill reflected much input or participation, if any, from the Ways and Means Committee staff. It was not even featured on Rep. Pomeroy's own website.

2. H.R. 436 would freeze 2009 estate tax law – a $3.5 million exemption equivalent

(with no indexing) and a 45 percent rate.

3. H.R. 436 would also revive, effective January 1, 2010, the "phaseout of graduated rates and unified credit" of pre-2002 law, expressed as a 5 percent surtax.

   a. The pre-2002 surtax applied only to taxable estates between $10,000,000 and $17,184,000. Because of the increase in the unified credit to match a $3.5 million exemption, the surtax under H.R. 436 would apply to taxable estates from $10 million **all the way up to $41.5 million**.

   b. In other words, the marginal rate between $10 million and $41.5 million would be 50 percent (45 percent plus 5 percent), and the ultimate tax on a taxable estate of $41.5 million, calculated with the current unified credit of $1,455,800, plus the 5 percent surtax on $31.5 million (the excess over $10 million), would be $18,675,000 – exactly 45 percent of $41.5 million.

   c. At least the old 5 percent surtax **used** to work that way when there was a federal credit and no deduction for state death taxes. Today, it would still work that way in "coupled" states where in effect there is no state death tax. Once again, the repeal of the state death tax credit makes the math more complicated in "decoupled" states that impose their own tax. In those states, the actual numbers will depend on the structure of the state tax, but in general the combined federal and state **marginal** rates for taxable estates between $10.1 million and $41.5 million will be 56.9 percent in states that conform to the federal deduction for their own state taxes and 58.0 percent in states that have decoupled even from that federal deduction.

   d. Regardless of the stature or future of H.R. 436 in general, the revival of the surtax idea might gain traction in a revenue-minded and middle-class-focused congressional environment. No idea ever fades away completely.

   e. If a surtax like this were enacted, it would be one more reason to be careful in providing blanket general powers of appointment in trusts subject to the GST tax, because at least the GST tax is imposed at a flat 45 percent rate.

4. H.R. 436 would add a new section 2031(d), generally valuing transfers of nontradeable interests in entities holding nonbusiness assets as if the transferor had transferred a proportionate share of the assets themselves. If the entity holds both business and nonbusiness assets, the nonbusiness assets would be valued under this special rule and would not be taken into account in valuing the transferred interest in the entity. Meanwhile, new section 2031(e) would deny a minority discount (or discount for lack of control) in the case of any nontradeable entity controlled by the transferor and the transferor's ancestors, spouse, descendants, descendants of a spouse or parent, and spouses of any such descendants. The statutory language is identical to the bills introduced by Rep. Rangel in 2001 and Rep. Pomeroy in 2002, 2005, and 2007, discussed in Part II.E.1.c on page 7. These rules would apply for both gift and estate tax purposes and would be effective on the date of enactment.

B. The Mitchell-Kirk-Nye Bill (H.R. 498)

1. On January 14, 2009, Rep. Harry Mitchell (D-AZ), joined by Reps. Mark Kirk (R-IL) and Glenn Nye (D-VA), introduced the "Capital Gains and Estate Tax Relief Act of 2009" (H.R. 498). None of these three Congressmen is a member of the Way and Means Committee.
2. Like PETRA, H.R. 498 would tie the estate tax rate to the top income tax rate on general capital gains under section 1(h)(1)(C), with a rate equal to double that rate on taxable estates over $25 million. Unlike PETRA, however, H.R. 498 would make the 15% income tax rate of section 1(h)(1)(C) permanent and would not allow it to return to 20% in 2011 as it would under current law.
3. Like ETETRA, H.R. 498 would phase in an exemption equivalent of $5 million by 2015 and would index it for inflation after that.
4. Like both PETRA and ETETRA, H.R. 498 would repeal the deduction for state death taxes and provide for "portability" of the unused unified credit of a predeceased spouse.
5. Inexplicably, like ETETRA (but unlike PETRA), H.R. 498 would not repeal the 2011 sunset of the "miscellaneous" provisions of EGTRRA dealing with conservation easements, allocation of GST exemption, and deferral of estate tax under section 6166.

C. President Obama and the Arithmetic of the Estate Tax

1. Although the estate tax was not prominent in the 2008 presidential campaign, President Obama's campaign embraced making permanent the 2009 estate tax law, with a $3.5 million exemption and 45% rate.
2. Freezing the federal estate tax at its 2009 level would increase federal revenues for fiscal 2011 – the 12 months that begin October 1, 2010 – because that is when the tax will be collected with respect to decedents dying in 2010, the current repeal year.
3. After 2010, reversing the EGTRRA "sunset" and "reducing" the federal estate tax to its 2009 level will of course reduce federal revenues (relative to what the pre-2002 law would produce in 2011). But that reduction of federal revenue would be of less magnitude and different composition than might sometimes be assumed, because, if the EGTRRA sunset were allowed to run its course and pre-2002 law, **including the credit for state death taxes**, returned in 2011, the net federal rate on the largest estates would not increase very much.
4. If pre-2002 law returned, at the level of a taxable estate of $3.5 million (the 2009 exemption), the net federal marginal rate would be **45.4%**, as it was before 2002. At a taxable estate of $3.6 million, it would drop to **44.6%**, and never again would be above 45%, the current federal rate in states with no deductible state death tax. At a taxable estate just under $10 million, the net federal marginal rate would be **39.8%**. Because of the 5% surtax under old section 2001(c)(2), the net

marginal rate would become **44.8%** at $10 million and then **44%** over $10.1 million. At a little over $17 million, the net marginal rate would fall to **39%**, the net rate on all taxable estates above that level. These rates compare to the 2009 net federal marginal rate on the largest estates of **45%** in "coupled" states, **38.8%** in ordinary "decoupled" states, and **37.8%** in "decoupled" states where the state tax itself is not allowed as a deduction in computing the state tax.

5. The upshot of all this is that a return to pre-2001 law in 2011 would, compared to 2009 law, collect more federal revenue, but mostly from estates at the low end of the range of taxable estates. The very largest estates would actually get a federal tax cut in many states. It is a bit of an oversimplification to ignore state taxes and other factors, but the prima facie effect of raising substantial revenue from the smallest taxable estates and reducing the net federal marginal rates on the estates of the richest decedents would not fit well with President Obama's priorities.

D. The Obama Administration's Budget Proposals

1. The ambitious document announcing the Administration's proposed budget, "A New Era of Responsibility: Renewing America's Promise," was published February 26, 2009. The document has few tax details. But in a summary of the adjustments to baseline projections to reflect selective (targeted) continuation of the 2001 and 2003 tax cuts, a footnote (footnote 1 to Table S-5) states that "the estate tax is maintained at its 2009 parameters." Apparently the gift tax exemption is assumed to remain $1 million, and the exemptions are not indexed for inflation or portable between spouses.

2. Table S-4 sets forth the Administration's projections of estate and gift tax revenues, as follows [with a column added to show the calendar year of gift or death that corresponds to the revenue in each fiscal year]:

Fiscal Year	Corresponding Calendar Year	Projected Revenue
2008	2007	$29 billion
2009	2008	$26 billion
2010	2009	$20 billion
2011	2010	$23 billion
2012	2011	$25 billion
2013	2012	$27 billion
2014	2013	$27 billion
2015	2014	$29 billion
2016	2015	$31 billion
2017	2016	$33 billion
2018	2017	$36 billion
2019	2018	$38 billion
Fiscal 2010-2014		$121 billion
Fiscal 2010-2019		$288 billion

a. The receipts for any <u>fiscal</u> year (which begins October 1) correspond generally to gifts made, and the estates of decedents dying, in the preceding calendar year. The dip for fiscal 2009 presumably reflects depressed values in calendar 2008, and the larger dip for fiscal 2010 (although many would have expected it to be even larger) presumably reflects the increased exemption in effect in calendar 2009. The plateau from fiscal 2013 to fiscal 2014 is a mystery.

b. The ten-year estate and gift tax revenue under current law is estimated to be about $544 billion, which means that under Table S-4 the Administration proposal would cost about $256 billion of revenue, or about 47% of current-law estimates, over ten years.

c. But on June 11, 2009, revenue estimates from the Joint Committee on Taxation scored the ten-year cost of the Administration proposal at about $234 billion, or about 43% of current-law estimates.

E. The Fiscal 2010 Congressional Budget Resolution

1. The House and Senate versions of the budget resolution, H. Con. Res. 85 and S. Con. Res. 13, both as proposed by the respective Budget Committees and as passed by the House and Senate respectively, allow for 2009 estate tax law to be made permanent.

2. Reviving a technique often used in the 1990s under congressional Pay-As-You-Go (or "PayGo") rules, several Senate amendments to the budget resolution provided for "deficit-neutral reserve funds" to acknowledge various Senate's aspirations within the constraints of the overall revenue and spending targets. These amendments do not literally create "funds"; they simply permit the appropriate committees to consider changes to the allocations in the budget resolution down the road, but only if the budget deficit would not be aggravated by those reallocations. As a practical matter, a "deficit-neutral reserve fund" represents a commitment to consider certain actions agreed to be desirable if other mandated actions are scaled down or turn out to be less expensive than expected, revenue estimates are adjusted upward, or the appropriate committees discover that they can "afford" or "pay for" those actions in some other way.

3. On April 2, 2009, the Senate, by a vote of 51-48, approved a "deficit-neutral reserve fund" provided for in an amendment offered by Senator Blanche Lincoln (D-AR) and cosponsored by Senators Jon Kyl (R-AZ), Ben Nelson (D-NE), Chuck Grassley (R-IA), Mark Pryor (D-AR), Pat Roberts (R-KS), Mary Landrieu (D-LA), Michael Enzi (R-WY), Susan Collins (R-ME), and John Thune (R-SD). The precise wording of Senator Lincoln's amendment is:

> The Chairman of the Senate Committee on the Budget may revise the allocations of a committee or committees, aggregates, and other appropriate levels and limits in this resolution for one or more bills, joint resolutions, amendments, motions, or conference reports that would provide for estate tax reform legislation establishing–
>
> (1) an estate tax exemption level of $5,000,000, indexed for inflation,

(2) a maximum estate tax rate of 35 percent,

(3) a reunification of the estate and gift credits, and

(4) portability of exemption between spouses, and

provided that such legislation would not increase the deficit over either the period of the total of fiscal years 2009 through 2014 or the period of the total of fiscal years 2009 through 2019.

4. In short, Senator Lincoln's 2009 amendment had about the same effect as would have the amendment proposed by her cosponsor Senator Nelson in 2007 (see Part VI.A.7 on page 21) and by Senator Salazar in 2008 (see Part VI.B.4 on page 23) – that is, in Senator Nelson's words, "[l]ike the Kyl amendment, [but] fiscally responsible and deficit neutral." In an environment of extreme fiscal challenges, that effect could be very small.

5. Senator Lincoln's amendment was supported in the debate by Minority Leader Mitch McConnell (R-KY) and Senator Chuck Grassley (R-IA) and opposed by Majority Leader Harry Reid (D-NV) and Senator Kent Conrad (D-ND).

   a. Reprising themes of past Congresses, Minority Leader McConnell reminded his colleagues the "[n]o one should have to be taxed on their assets twice, and no one should have to visit the tax man and the undertaker on the same day. It is the Government's final outrage. But if we can't repeal this tax, then we should at least lower it at a time when Americans are already burdened by shrinking retirement savings."

   b. In reply, the Majority Leader scolded that it was "so stunning, so outrageous, that some would choose this hour of national crisis to push an amendment to slash the estate tax for the superwealthy.... I can think of no way to describe this amendment other than stunning hypocrisy."

6. As if to leave no doubt about the aspirational nature of this amendment, the Senate then immediately approved, by a vote of 56-43, a amendment offered by Assistant Majority Leader Richard Durbin (D-IL), providing that "[i]n the Senate, it shall not be in order to consider any bill, joint resolution, amendment, motion, or conference report that would provide estate tax relief beyond $3,500,000 per person ($7,000,000 per married couple) and a graduated rate ending at less that 45 percent unless an equal amount of tax relief is provided to Americans earning less than $100,000 per year and that such relief is in addition to the amounts assumed in this budget resolution." Senator Kyl mildly opposed the Durbin amendment, but Senators Lincoln, Nelson, and Pryor themselves voted for it.

7. On April 29, 2009, the conference report on the budget resolution was passed by votes of 233-193 in the House and 53-43 in the Senate.

   a. In general, the commitment to making 2009 estate tax law permanent was retained. (The lowest 10 percent income tax rate was also made permanent, while the top individual income tax rates were allowed to return to pre-2001 levels and individual AMT relief was extended for only three years.)

b. But in the generic context of "tax relief that supports working families ... [and] businesses," section 325 of the budget resolution apparently places any additional estate tax relief in the Senate under a "pay for" discipline of the sort reflected in the Lincoln amendment. Section 317 contains similar language with respect to the House in the context of "savings incentives."

F. The Baucus Bill (S. 722)

1. Meanwhile, on March 26, 2009, Chairman Max Baucus (D-MT) of the Senate Finance Committee had introduced the "Taxpayer Certainty and Relief Act of 2009" (S. 722), including Title III captioned "Permanent Estate Tax Relief."

2. Consistent with the Obama Administration's budget proposals, S. 722 would make permanent the current $3.5 million estate tax applicable exclusion amount and 45% rate. It would again fully unify the gift tax with the estate tax by providing a single exclusion amount of $3.5 million, and it would also make the cap on the reduction of value under the special use valuation provisions of section 2032A equal to the applicable exclusion amount. Beginning in 2011, it would index the applicable exclusion amount for inflation.

3. S. 722 would also make permanent the other transfer tax changes made by EGTRRA, including the rules affecting the allocation of GST exemption. And it would provide for the "portability" of the unused gift and estate tax unified credit of a deceased spouse to the surviving spouse and the surviving spouse's estate.

4. Compared to ETETRA, there are five important differences in S. 722.

   a. The exemption is $3.5 million.

   b. The rate is 45%.

   c. The section 2058 deduction for state death taxes is retained.

   d. The cap on the special use valuation reduction is tied to the applicable exclusion amount. Currently, the cap on the special use valuation reduction is $1 million, the statutory cap of $750,000 indexed for inflation since 1999.

   e. S. 722 removes the 2011 "sunset" on all transfer tax changes (except repeal), including the changes affecting the allocation of the GST exemption.

5. The portability provisions of S. 722 are identical to those in ETETRA, except that the iterative portability of the unified credit to spouses of spouses is prohibited.

   a. In other words, if Husband 1 dies after 2009 without using his full exclusion amount, and his widow, Wife, marries Husband 2 and then dies, Wife's estate could use her own exclusion amount plus whatever amount of Husband 1's exclusion amount was not used. Husband 2's estate could use his own exclusion amount plus whatever amount of Wife's basic exclusion amount was not used. But Husband 2's estate could not use any of Husband 1's unused exclusion amount transmitted through Wife's estate. Some commentators describe this as requiring **privity** between the spouses.

b. Husband 2's estate could still use the unused exclusion amount of any number of his predeceased wives (and S. 722 would make that explicit), subject only to the overall limitation that the survivor's exclusion amount could be no more than doubled.

6. As "middle class" tax relief, S. 722 would also address the individual alternative minimum tax, the regular and capital gains tax rates for lower- and middle-income taxpayers, the child tax credit, marriage penalty relief, the dependent care credit, the adoption credit and adoption assistance programs, and the earned income tax credit. That grouping of hot topics, plus the support the bill has – in addition to Chairman Baucus, it is cosponsored by two other Finance Committee Democrats, Senators Rockefeller (D-WV) and Schumer (D-NY) – make S. 722 a serious legislative proposal.

7. Significant traction for S. 722 in the Finance Committee and in the Senate will be noticed by those who draft tax legislation in the House, especially since S. 722 includes AMT relief, which is a priority for Chairman Rangel (D-NY) of the Ways and Means Committee. Alternatively, all or part of S. 722 could be added as a Senate amendment to a House-passed tax bill.

G. The McDermott Bill (H.R. 2023)

1. On April 22, 2009, Rep. Jim McDermott (D-WA), the fourth most senior Democrat on the Ways and Means Committee, introduced H.R. 2023, called the "Sensible Estate Tax Act of 2009." Virtually identical to H.R. 6499, which he had introduced in 2008, H.R. 2023, effective January 1, 2010, would provide

   a. a $2 million exemption equivalent, indexed for inflation after 2010,

   b. an initial rate of 45% (over $1.5 million in the tax table), a rate of 50% over $5 million, and a rate of 55% over $10 million (with these amounts also indexed for inflation after 2010),

   c. restoration of the credit for state death taxes and repeal of the deduction for state death taxes,

   d. gift tax exemptions and rates re-conformed to the estate tax,

   e. retention of a stepped-up basis at death for appreciated assets,

   f. repeal of the 2011 "sunset" for the other transfer tax provisions of EGTRRA, and

   g. portability of the unified credit between spouses (as in PETRA and ETETRA, not requiring "privity" between spouses as in S. 722).

2. The staff of the Joint Committee on Taxation estimated that H.R. 2023 would cost $202 billion over ten years, or about 37% of current-law revenue estimates (compared to 43% of current-law estimates for the cost of the Administration proposal to make 2009 estate tax law permanent).

H. Additional Budget Options Analyzed by the Congressional Budget Office

In August 2009, the Congressional Budget Office released the 266-page current version of its periodic revenue and expense estimates, covering 66 budget options gathered from various sources. The report may be viewed on the CBO's website at http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf. Option 48 is entitled "Modify the Estate and Gift Tax Provisions of EGTRRA" and, without making any recommendations, evaluates the revenue loss from fiscal 2010 through fiscal 2014 of four alternatives that have come to the CBO's attention. All four alternatives are assumed to take effect January 1, 2010, and are compared to current law (which includes repeal in 2010 and return to pre-2002 law in 2011).

1. Alternative 1 assumes a $5 million exemption indexed for inflation, a rate equal to the top rate on general capital gains (15% in 2010 and 20% thereafter), and elimination of the deduction for state death taxes. The CBO estimates that this would lose $128 billion over five years and that in 2014 approximately 5,300 estates would pay tax (compared to about 58,000 estates under current law).
2. Alternative 2 is the same as Alternative 1, except that, as in H.R. 498, taxable transfers above $25 million (indexed for inflation) would be taxed at 30%. The CBO estimates that this would lose $117 billion over five years. (In other words, the effect of the 30% rate over $25 million would be to save about $11 billion of revenue.)
3. Alternative 3 assumes 2009 law, with a $3.5 million exemption and a 45% rate, except that, as in S. 722, the $3.5 million exemption would be indexed for inflation. The CBO estimates that this would lose $65 billion over five years and that in 2014 approximately 9,400 estates would pay tax.
4. Alternative 4 assumes that the 2010 estate tax repeal and carryover basis enacted in EGTRRA would be made permanent. The CBO estimates that this would lose $163 billion over four years.

I. Comparison of Pending Bills

The following is a comparison of four bills that have been introduced in Congress:

	H.R. 2023	H.R. 436	S. 722	H.R. 498
Sponsor	McDermott	Pomeroy	Baucus	Mitchell
Date introduced	4/22/09	1/9/09	3/26/09	1/14/09
Effective date	1/1/10	1/1/10	1/1/10	1/1/10
Estate and GST tax exemption	$2 mil.	$3.5 mil.	$3.5 mil.	$5 mil.
Exemption phased in				By 2015
Exemption indexed for inflation	Yes		Yes	Yes
Estate tax rate(s)	45%/50%/55%	45%	45%	15%/30%
Brackets	$5 mil/$10 mil			$25 mil.
Brackets indexed for inflation	Yes			Yes
5% surtax		Yes		
Gift tax reunified with estate tax	Yes	Yes	Yes	Yes
Credit for state death tax restored	Yes			
Deduction for state tax repealed	Yes			Yes
Unified credit made portable	Yes		Yes	Yes
Privity between spouses required			Yes	
Stepped-up basis retained	Yes	Yes	Yes	Yes
GST, etc. rules made permanent	Yes	Yes	Yes	
Other provisions		Discounts limited	§2032A; AMT, etc	15% income tax rate

J. Clues for the Future

With respect to Congress, although the models of 2006 – H.R. 5638 and H.R. 5970, PETRA and ETETRA – could be abandoned in favor of a totally new start, that rarely happens. The experience of 2006, as well as the Senate floor debate and Finance Committee hearings of 2007-08 and the budget proposals and S. 722 in the current Congress, teach us to look for the following features in the "permanent" estate tax fix, if and when it comes.

1. Tax decreases (if any, which is doubtful) may be **phased in** over a number of years, in order to contain the cost by pushing the revenue losses out as far as possible in the ten-year "budget window." (One of the most striking differences between PETRA and ETETRA was the phase-in of the increased exemption and the reduced top rate from 2010 through 2015.)

2. After any phase-in period, exemptions (and brackets, if any) may be **indexed for inflation**. (Another significant difference between PETRA and ETETRA was the indexing of the top $25 million bracket, not just the $5 million exemption.)

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

   b. In reviewing their situations, clients should remember that Congress (as it has in the past) can always change the law.

c. Congress might also leave the law unchanged, meaning that the intent should be made clear for the case where the estate tax does not apply (or has been repealed). (Section 2210 states that "[t]his chapter shall not apply ... to the estates of decedents dying after December 31, 2009" – not "is repealed.")

3. The **GST exemption and rate** will remain tied to the estate tax exemption and rate, whatever they are. The **gift tax exemption and rates** may be **recoupled** with the estate tax and GST exemptions and rates, although this is instinctively a fragile feature that could be jettisoned.

   a. Since gift and estate tax conformity cannot be counted on, there may continue to be a premium on early planning and the use of leveraged gift strategies (for example, GRATs, sales to grantor trusts, and charitable lead trusts).

   b. Because what are popularly called the gift and estate tax "exemptions" are really the effect of a cumulative "unified credit," calculations will not always be what they seem. For example, it is natural to assume that a person who has used $800,000 of the $1,000,000 gift tax "exemption" can now make another $200,000 of gifts tax-free, or that, with a $3,500,000 million estate tax exemption equivalent, a person who has made $1,000,000 of gifts could leave an additional $2,500,000 free of estate tax. Those types of generalizations have never been universally true and can create unpleasant surprises.

   c. If the gap between the gift tax exemption and the GST exemption persists, it can be expensive to implement effective lifetime GST tax planning techniques. It will still be important to be alert for opportunities to create, update, merge, divide, or extend generation-skipping trusts.

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

4. The credit for **state death taxes** is not coming back, and even retention of the deduction for state death taxes is doubtful.

   a. Restoration of the credit would be too expensive, unless it were redesigned as an addition to the regular federal tax that is forgiven in the case of an offsetting state tax, in which case it would amount to a politically unpalatable tax increase in "coupled" states.

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

5. **Portability between spouses** of the exemption/unified credit seems to have caught on as a concept and, subject to resolution of technical issues, may be a part of any package. It is particularly compelling as a way to provide "middle class"

relief at the low end and middle of the range of taxable estates.

a. With or without portability, with an increased estate tax exemption, the ways and proportions in which a husband and wife own property between them will continue to be important for many clients.

b. Although transferability of a predeceased spouse's exemption to the surviving spouse would simplify estate planning for some married couples, a credit shelter trust would still offer advantages, including

   i. sheltering intervening growth in value and accumulated income from estate tax,

   ii. permitting use of the predeceased spouse's GST exemption,

   iii. permitting tax-free "gifts" to be made to children and other beneficiaries during the surviving spouse's life (a benefit especially if the gift tax exemption remains less than the estate tax exemption), and

   iv. avoiding the limited reconsideration of previous valuations under the portability proposals.

c. On the other hand, for many couples, income tax basis will become a more important factor.

d. In addition, although the federal estate tax rate above the exemption amount has been relatively flat for the past few years and completely flat from 2006 through 2009, any return of multiple brackets would, for married persons with estates near or above that level, revive interest in so-called "estate equalization" techniques to subject some of the combined estates to a lower tax at the death of the first spouse to die.

e. Techniques that once were viewed with skepticism for estate planning purposes, such as owning property jointly with right of survivorship (facilitated by the disclaimer rules in Reg. § 25.2518-2(c)(4) since 1998), may become more important, while less settled techniques such as using joint trusts in non-community property states may warrant more attention.

f. The proposed portability of the unified credit between spouses might

   i. apply to estate and gift taxes, but not GST tax,

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

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

6. Significant relief for **family farms, ranches, and other businesses** – such the

increase in the special use valuation cap in S. 722 – is a strong possibility.

7. A **stepped-up basis** at death (for appreciated assets) will continue to be the general rule.

8. Although "artificial sweeteners" with no direct connection to the estate tax (extension of expired provisions, increase in the minimum wage, relief for the timber industry, and the like) failed to attract the necessary 60 votes in the Senate, some "natural sweeteners" more directly related to the estate tax might be considered.

    a. One approach, presaged in the April 3, 2008, Finance Committee hearing (see part VI.C.3 on page 25), might be to try to "target" relief to family farms and other family businesses.

    b. In addition, it is a time-honored tactic to **combine rate relief with "base-broadeners."** These could include the Administration's revenue proposals described in the following Part VII.K.

    c. Legislation might give Congress the opportunity to examine structural issues such as those identified in the 2004 report of the Task Force on Federal Wealth Transfer Taxes, comprised of representatives from the American Bankers Association, the American Bar Association Section of Real Property, Trust and Estate Law and Section of Taxation, the American College of Tax Counsel, the American College of Trust and Estate Counsel, and the American Institute of Certified Public Accountants. The 200-page Report is reprinted at 58 TAX LAWYER 93 (Fall 2004) and may be viewed on-line at http://www.abanet.org/rppt/section_info/tttf/home.html. The Report includes discussion of issues arising under present law (long phase-out, one-year repeal, and sunset), carryover basis, the retention of the gift tax, and alternatives to a transfer tax system. The Report also discusses "portability" of the unified credit (or exemption) between spouses. But with all the other distractions Congress has, it is probably unrealistic to expect such wide-ranging structural improvement of the estate tax law to be a high priority.

K. The Administration's Revenue Proposals

The Treasury Department's "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" ("Greenbook") was released on May 11, 2009. See http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf. The Appendix, on page 125, confirms that "[e]state and gift taxes are assumed to be extended at parameters in effect for calendar year 2009 (a top rate of 45 percent and an exemption amount of $3.5 million)." At pages 119-23, as revenue raisers dedicated to health care reform, the following three revenue-raising proposals are described under the heading "Modify Estate and Gift Tax Valuation Discounts and Make Other Reforms." (A fourth proposal under that heading addresses the tax treatment of alternative fuels, and on page 112, under the heading "Insurance Companies and Products," the Greenbook proposes to "modify the transfer-for-value rule [applicable to life insurance policies] to ensure that exceptions to that rule would not apply to buyers of polices" in life settlement transactions.)

1. "Require Consistency in Value for Transfer and Income Tax Purposes"

   a. Currently, under section 1014(a)(1), the basis of property acquired from a decedent is "the fair market value of the property at the date of the decedent's death," with appropriate adjustments in section 1014 for the alternate valuation date and so forth. It is possible for the recipient of property from a decedent to claim, for income tax purposes, that the executor somehow just got the estate tax value too low, and that the recipient's basis should be greater than the estate tax value. Usually, of course, such claims are made after the statute of limitations has run on the estate tax return. Such claims can be accompanied by elaborate appraisals and other evidence of the "real" date-of-death value that, long after death, is hard to refute. Invoking principles of "privity," the Service is able to insist on using the lower estate tax value when the recipient was one of the executors who signed the estate tax return, but otherwise it has had no tool to enforce such consistency.

   b. This proposal would require the income tax basis of property received from a decedent or donor to be equal to the estate tax value or the donor's basis.

      i. On September 8, 2009, the staff of the Joint Committee on Taxation released a publication entitled "Description of Revenue Provisions in President's Fiscal Year 2010 Budget Proposal, Part One: Individual Income Tax, Estate and Gift Tax Provisions." Regarding this Administration proposal, the JCT publication states (emphasis added):

> The proposal requires that the basis of property received by reason of death under section 1014 generally must equal the value of that property *claimed* by the decedent's estate for estate tax purposes....
>
> Under the proposal there would be instances in which the value of an asset *reported* by an executor to an heir differs from the ultimate value of the asset used for estate tax purposes. For example, if the IRS challenges an estate valuation and prevails, the executor will have reported to the heir a valuation that is artificially low, and the heir may arguably be overtaxed on a subsequent sale of the asset. This same problem exists under present law to the extent the initially reported estate tax value is presumptively the heir's basis. To provide complete consistency between estate tax valuation and basis in the hands of an heir may be impractical as ultimate determination of value for estate tax purposes may depend upon litigation, and an heir may sell an asset before the determination of value for estate tax purposes.
>
> By requiring the value of an asset reported for transfer tax purposes to be reported and used by the heir or donee in determining basis, however, the proposal has the salutary effect of *encouraging a more realistic value determination in the first instance*. This salutary effect would be lost if there were a relief mechanism for transferees and transferors (and recoupment for the government) if the basis used by transferees differed from the fair market value ultimately determined

for transfer tax purposes. Thus, the proposal does not contain any such relief mechanism.

ii. It is hard to reconcile this with the Greenbook's statement that "[t]his proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property *as determined for estate or gift tax purposes* (subject to subsequent adjustments)" (emphasis added).

c. In a possibly unintended change from current substantive law, the proposal would apparently require the basis of even property acquired by gift to be no greater than the gift tax value. Under section 1015(a), the basis for determining the donee's gain can be greater than the gift tax value if that was the donor's basis.

d. The executor or donor would be required to report the necessary information to both the recipient and the Service. Regulations (i) could extend this reporting requirement to annual exclusion gifts and estates for which no estate tax return is required and (ii) could provide relief for the surviving joint tenant or other recipient who has better information than the executor.

e. It is not clear how the proposed changes would deal with adjustments based on tax payments, such as the increases in basis for the gift tax and GST tax attributable to appreciation, under sections 1015(d) and 2654(a). It will not always be easy to get finality under these rules, especially the rules governing the payment of GST tax on taxable terminations occurring at death, which depend on the relevant inclusion ratio. Under Reg. § 26.2642-5, this inclusion ratio is not final until the later of the running of the statute of limitations on the transferor's estate tax or the running of the statute of limitations with respect to the first GST tax return filed using that inclusion ratio.

f. The proposal would be effective as of the date of enactment and is estimated to raise tax revenue by $1.87 billion over ten years.

i. The similar proposal floated by the staff of the Joint Committee on Taxation in 2005, described in Part V.D on page 18, was estimated to raise less than $50 million over ten years.

ii. The June 11, 2009, Joint Committee on Taxation estimates scored the ten-year revenue gain from the Administration proposal at $935 million, exactly half the Administration estimate.

2. "Modify Rules on Valuation Discounts"

a. The Greenbook recalls that sections 2701-2704 were enacted to curb techniques designed to reduce transfer tax value but not the economic benefit to the recipients.

i. Specifically, the Greenbook points out that section 2704(b) provides that certain "applicable restrictions" that would otherwise justify valuation discounts are ignored in intra-family transfers of interests in family-controlled corporations and partnerships, but adds that "[j]udicial decisions and the enactment of new statutes in most states have, in effect, made section 2704(b) inapplicable in many situations."

ii. The Greenbook also states that "the Internal Revenue Service has identified additional arrangements designed to circumvent the application of section 2704."

iii. Section 2704(b) applies to an "applicable restriction," which section 2704(b)(2) defines as "any restriction (A) which effectively limits the ability of the corporation or partnership to liquidate, and (B) with respect to which either … (i) [t]he restriction lapses, in whole or in part, after the transfer … [or] (ii) [t]he transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction." Section 2704(b)(3) provides exceptions for "(A) any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either, or (B) any restriction imposed, or required to be imposed, by any Federal or State law."

iv. Under section 2704(b)(4), Treasury has the authority to "provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

b. Using section 2704(b) as a framework, the proposal would create a more durable category of "disregarded restrictions."

i. Disregarded restrictions would "include" restrictions on liquidation of an interest that are measured against standards prescribed in Treasury regulations, not against default state law.

ii. Although the Greenbook does not say so, it is possible that the "disregarded restrictions" in view, which "include" certain limitations on liquidation (the current scope of section 2704(b)(2)(A)), may also include other restrictions, such as restrictions on management, distributions, access to information, and transferability. If so, it might call for reconsideration of the famous disclaimer in the 1990 conference report that "[t]hese rules do not affect minority discounts or other discounts available under [former] law." H.R. REP. NO. 101-964, 101ST CONG., 2D SESS. 1137 (1990). After all, even the regulation authority under section 2704(b)(4) extends to "other restrictions."

iii. On the other hand, the September 8, 2009, Joint Committee staff's publication states that "because the proposal targets only marketability discounts, it would not directly address minority discounts that do not accurately reflect the economics of a transfer." The JCT staff points out that other possible approaches include the "look through" rules of the Clinton Administration's budget proposals (Part II.E.1 on page 6) and the JCT staff's own 2005 proposals (Part V.B beginning on page 16) and the aggregation rules of the 2005 proposals and the Reagan Administration's "Treasury I" (Part II.D.1.d on page 5).

iv. Disregarded restrictions would also include limitations on a transferee's ability to be admitted as a full partner or other holder of an equity interest, thus apparently denying the opportunity to value a transferred interest as a "mere" "assignee" interest and possibly applying in an unspecified way to "carried interests."

v. Treasury would be empowered by regulations to treat certain interests owned by charities or unspecified "others" as if they were owned by the transferor's family.

vi. In any event, the Greenbook is careful to cast its references in terms of "entities," not just corporations and partnerships.

c. The Greenbook includes some references that might be reassuring.

i. Regulations could "create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met." While no details are given, it is hard to imagine regulations that prescribe "safe harbor" discounts, and it is particularly odd that a proposal to limit opportunities to "circumvent" section 2704 would contemplate that section 2704 could be avoided simply by the way governing documents are drafted. But perhaps this authority could be used to protect actual family operating businesses or to protect the holder of a restricted noncontrolling interest received from others (including ancestors) if that holder did not create those restrictions and never had a meaningful opportunity to remove those restrictions.

ii. The Greenbook promises to "make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions." This could override the harsh "reverse-*Chenoweth*" result seen in Technical Advice Memoranda 9050004 (Aug. 31, 1990) and 9403005 (Oct. 14, 1993) (all stock owned by the decedent valued as a control block in the gross estate, but the marital bequest valued separately for purposes of the marital deduction), relying on *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987) (estate of a decedent who owned all the stock of a corporation entitled to prove a control premium for a 51-percent block bequeathed to the surviving spouse for purposes of the marital deduction), and *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). Such a result would reinforce the fairness of the proposal and would be very welcome.

d. The proposal would apply to transfers – gifts and deaths – after the date of enactment. Consistent with section 2704 itself, the proposal would not apply to restrictions created on or before October 8, 1990. Under section 7805(b)(2), regulations issued within 18 months of the date of enactment could be retroactive to the date of enactment.

e. The proposal is estimated to raise revenue by $19.038 billion over the ten fiscal years from 2010 through 2019. The estimate of $667 million of additional revenue for fiscal 2010, which ends September 30, 2010, necessarily assumes that enactment will occur early enough to catch a substantial number of transfers in calendar 2009. (The June 11, 2009, Joint Committee on Taxation revenue estimates skipped this Administration proposal, because of its lack of specificity.)

3. "Require Minimum Term for Grantor Retained Annuity Trusts (GRATs)"

   a. After reciting the history of section 2702 and the use of GRATs, the Greenbook notes that "[t]axpayers have become more adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), in many cases to 2 years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability."

   b. While rumors have occasionally been heard of *congressional* plans to limit the attractiveness of GRATs by imposing a minimum gift tax value for the remainder (such as 10%), the Greenbook instead proposes to increase the mortality risk of GRATs by requiring a minimum ten-year term.

      i. A footnote compares the ten-year term to the minimum ten-year term of "*Clifford* trusts" under section 673 (before its amendment by the Tax Reform Act of 1986). Similarly, the September 8, 2009, Joint Committee staff's publication includes a summary of the grantor trust rules, not self-evidently connected to the issue of GRATs.

      ii. Both the Greenbook and the JCT staff publication focus on the effect of the proposal in increasing the mortality risk of a GRAT, not necessarily its effect in diminishing the upside from volatility.

      iii. The JCT staff publication notes that even a ten-year GRAT could be used "as a gift tax avoidance tool" and that a ten-year minimum term might encourage the use of GRATs by younger taxpayers. As an alternative way of achieving more accurate valuation, the JCT staff publication suggests valuation of the remainder interest for gift tax purposes at the end of the GRAT term when the remainder is distributed – embracing the "hard to complete" approach floated by the Reagan Administration's "Treasury I" (Part II.D.1.b on page 5).

   c. The discussion in the Greenbook actually ratifies the use of "zeroed-out" GRATs, within the constraint of a minimum ten-year term.

d. With currently depressed values, difficulty in predicting the timing of recovery, and relatively low interest rates under section 7520, many clients have recently been opting for GRATs with terms longer than the typical two years anyway.

e. But requiring a minimum ten-year term will encourage more customizing of the terms of a GRAT, including greater use of level GRATs or GRATs in which the annuity increases in some years but not others or increases at different rates in different years.

f. The proposal would apply to GRATs created after the date of enactment.

g. The proposal is estimated to raise revenue by $3.25 billion over ten years. (The June 11, 2009, Joint Committee on Taxation estimates scored the ten-year revenue gain from the Administration proposal at $2.28 billion.)

VIII. IMPORTANT AREAS OF PRACTICE BESIDES TRANSFER TAX PLANNING

1. Planning for the disposition of the client's assets upon death.
2. Asset protection planning.
3. Planning for marital and other dissolutions.
4. Planning for physical disability.
5. Planning for legal incapacity.
6. Business succession planning.
7. Using business entities to accomplish non-tax objectives.
8. Charitable giving (for its own sake, and for income tax reasons).
9. Retirement planning.
10. Planning for life insurance protection.
11. Fiduciary litigation.
12. Planning for clients with property in more than one state.
13. Planning for children with disabilities.
14. Planning for spendthrift children.
15. Planning for U.S. citizens or resident aliens who own property in other countries.
16. Planning for nonresident aliens with assets in the United States or who plan to move to the United States.
17. Planning for clients who intend to change their citizenship.
18. Planning to live with non-tax regulatory regimes, including Sarbanes-Oxley, the Patriot Act, HIPAA, and charitable governance reform.

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