CCH Tax Briefing:

FEDERAL ESTATE TAX (H.R. 4154)

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Special Report

HIGHLIGHTS of H.R. 4154:

- ✔ *$3.5 million estate tax exclusion amount*
- ✔ *Top estate tax and gift tax rate of 45 percent*
- ✔ *Not indexed for inflation*
- ✔ *No portability of spouse's unused exclusion*
- ✔ *Continuation of stepped-up basis*
- ✔ *Permanent repeal of state death tax credit*

Inside

Estate Tax Extension Passes House, Fails In Senate; Carryover Basis Effective January 1, 2010

On December 3, the House approved the Permanent Estate Tax Relief for Families, Farmers and Small Businesses Bill of 2009 (H.R. 4154), which would permanently extend the top federal estate tax rate of 45 percent with a $3.5 million exclusion ($7 million for married couples who fully utilize their exclusions). The House Bill also provides for continuation of the gift and generation-skipping transfer (GST) tax provisions as they exist in 2009. However, after several year-end parliamentary maneuvers, the bill failed to win support in the Senate, as did a temporary stop-gap measure to extend the 2009 estate tax regime through March 2010.

Impact *As the law now stands, the estate tax will not apply to decedents dying after December 31, 2009 and before January 1, 2011. Also, beginning in 2010, the stepped up basis at death rules are replaced with modified carryover basis at death rules applicable to estates holding assets with unrealized capital gains of more than $1.3 million. In addition, the GST tax will not apply to generation skipping transfers made after December 31, 2009. The gift tax is retained but in modified form. However, this treatment is expected to be temporary. A legislative "fix" is expected to be enacted in 2010. Congress has a nine-month window to extend the 2009 estate tax regime retroactively to January 1, 2010 before the estates of decedents dying on January 1, 2010 would be required to file an estate tax return.*

Impact *Although much attention has focused on large estates and the $3.5 million exclusion, many smaller estates would be impacted by the carryover basis at death rules. Carryover basis, some practitioners will recall, was tried once before, in the late 1970s, and was not met with much enthusiasm. Congress has retroactively repealed carryover basis at death once before: in 1980 when it retroactively repealed the carryover basis at death rules under the Tax Reform Act of 1976.*

Comment Commentators are questioning whether retroactive imposition of an estate tax would raise Constitutional issues. It is arguable whether a challenge to a retroactive estate tax as an unconstitutional *ex post facto* law would be sustained by the courts. For example, in *J. Carlton*, 94-1 USTC ¶60,116, the U.S. Supreme Court rejected an estate's due process claim concerning the retroactive application of an amendment limiting an estate tax deduction to direct ownership of certain securities the decedent sold to an ESOP before death.

ESTATE TAX

The House Bill would nix the one-year repeal of the federal estate tax and the carryover basis regime for decedents dying after December 31, 2009, and before January 1, 2011, scheduled to take effect under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). In its place, the House Bill retains the federal estate tax at its current 2009 levels on a permanent basis beginning in 2010. Accordingly, the maximum estate tax rate would be permanently set at 45 percent and the estate tax exclusion amount would be permanently set at $3.5 million ($7 million for married couples). The House Bill's $233 billion cost over 10 years is not offset.

Comment Under the House Bill's exclusion and rate schedule, a taxable estate of $4 million would pay $225,000 in federal estate taxes. A taxable estate of $5 million would pay $675,000.

Comment Unlike the income tax brackets, these estate tax bracket amounts in the House Bill are not adjusted for inflation.

Comment One of the largest stumbling blocks to passage of an extension of the 2009 estate tax regime in the Senate is the $3.5 million exclusion. Many senators from both parties favor a higher exclusion, reaching $5 million. The House and Senate will need to reconcile their differences over the size of the exclusion amount.

CARRYOVER BASIS

The House Bill retains the traditional stepped-up basis regime for all assets included in the gross estate. Under the stepped-up basis rules, the income tax basis of property acquired from a decedent at death generally is stepped up (or stepped down) to its value as of the date of the decedent's death (or the estate tax alternate valuation date, if elected).

Carryover basis. Effective for decedents dying on or after January 1, 2010, and on or before December 31, 2010, EGTRRA repeals the stepped-up basis rules and replaces them with a modified carryover basis regime. Thus, the income tax basis of property acquired from a decedent's estate holding significant appreciated property generally must be carried over from the decedent under this repeal. EGTRRA allows executors to partially increase the basis of property by up to $1.3 million ($3 million in the case of property passing to a surviving spouse); further appreciation will be subject to tax when the asset is sold. This rule leaves the property's gain possibly being taxed on its sale by either the estate or beneficiaries at the maximum capital gains tax rate (currently 15 percent). EGTRRA does not allow for a "fresh-start rule," whereby an asset's basis would be stepped up to the value as of a certain date (such as the date carryover basis is first effective).

Example *Sam's father died on January 2, 2009, and left him 1,000 shares of ABC Co. stock. At the time of his death, Sam's father had a basis of $100 per share and each share had a fair market value of $1,000. Therefore, Sam's basis per share will step up to its date of death value of $1,000. Assuming no further appreciation in the value of the stock prior to sale, when Sam sells the stock he avoids tax on $900 in capital gains. Under a carryover basis regime, assuming the general basis step-up amount of $1.3 million is not available, the father's basis of $100 would become Sam's basis. Thus, Sam would pay tax on the $900 of gain when he sells the shares.*

Comment Under the stepped-up basis rules, an owner's poor recordkeeping and/or general ignorance of an asset's basis can be "cured" at his or her death, since the asset's basis would be stepped up to its date-of-death value.

Impact *The lack of action in the Senate on the estate tax has an immediate impact on the investment decisions of executors administering the estates of decedents dying after December 31, 2009. Due to the immediate effective date of the modified carryover basis regime, executors will be faced with an additional level of complexity with respect to decisions concerning whether to sell or hold appreciated assets if the total appreciation exceeds $1.3 million. Hopefully, Congress will make its intent clear early in 2010 to eliminate the angst of executors placed in these circumstances.*

Comment EGTRRA provides executors the power to allocate the $1.3 million basis increases to property of their choosing. General principles of fiduciary law require that this allocation be made fairly.

Comment Both of the basis increase provisions (the $1.3 million general basis increase and the $3 million spousal property basis increase) can be applied to property passing to a surviving spouse.

Portability. The House Bill does not provide for "portability." Generally, portability would allow a surviving spouse to elect to take advantage of the unused portion of the estate tax exclusion of his or her predeceased spouse, thereby providing the surviving spouse with a larger exclusion amount.

GIFT TAX

Under EGTRRA, the gift tax is retained despite repeal of estate and GST taxes

after December 31, 2009. However, the retained gift tax differs from the current gift tax regime. For gifts made after December 31, 2009, the gift tax will be computed using a rate schedule having a top marginal rate of 35 percent and a maximum applicable exclusion amount of $1 million.

Under the House Bill, the applicable exclusion amount for *gift tax* purposes remains $1 million for 2010 and later years, the same as it has been since 2002. The highest gift tax (and estate tax) rate is 45 percent for 2010 and later years—again the same as it has been in 2009.

Comment In contrast, the applicable exclusion amount for *estate tax* purposes in the House bill is $3.5 million for decedents dying in 2010 and later years, the same as it has been in 2009. As has previously been the case, however, the estate tax exclusion continues to be "unified" with the gift tax at least in the sense that any portion of the lifetime gift tax exclusion that is used operates to reduce the $3.5 million exclusion amount available against the estate tax.

Impact *The significantly lower gift tax exclusion potentially makes giving away wealth during life more expensive than at death. Use of the annual gift tax exclusion, the unlimited exclusion for tuition and medical payments, certain types of trusts and other strategies, however, may ameliorate this disadvantage in many instances.*

The federal gift tax is imposed on the fair market value of gifts made during the donor's life. The gift tax is applicable only to the value of the gift or gifts given to any particular person during a calendar year that exceeds the annual gift tax exclusion amount. The annual gift tax exclusion amount, which is inflation indexed, is $13,000 for 2009 and 2010. If a donor elects to split gifts with his or her spouse, the first $26,000 of gifts to a particular individual during a calendar year is excluded from the gift tax. To the extent the value of the gift exceeds the annual exclusion amount it is subject to gift tax.

The gift tax may be offset by the lifetime credit against gift tax, which is $345,800 based on an applicable exclusion amount of $1 million. However, this amount drops to $330,800 in 2010 because of the lower 35-percent maximum rate effective for gifts made in that year).

Comment Lifetime transfers between spouses are free from gift tax. The first $133,000 of gifts in 2009 ($134,000 in 2010) to a non-citizen spouse is generally gift-tax free. These rules continue under the House bill.

GENERATION-SKIPPING TRANSFER TAX

Under current law, the Generation-Skipping Transfer (GST) tax ensures that the transfer of wealth will be taxed on a generational basis. The GST tax is imposed on taxable terminations, taxable distributions and direct skips (a skip person may be a natural person who is one or two generations below that of the transferor).

Under EGTRRA, a new deemed allocation rule applies to lifetime "indirect skips." If an individual makes a lifetime indirect skip, any unused portion of the individual's GST tax exemption is allocated to the property transferred to the extent necessary to make the inclusion ration for such property equal to zero. If the amount of the indirect skips exceeds the unused portion, then the entire unused portion is allocated to the property transferred.

The House Bill makes permanent the 2009 treatment of the GST tax. The GST tax exemption is equal to the applicable exclusion amount for estate tax purposes ($3.5 million) and the GST tax rate is determined using the highest estate and gift tax rate (45 percent).

Exemption. Under current law, for purposes of determining the GST tax, each individual is entitled to a lifetime GST exemption. As noted, the lifetime GST exemption is equal to the amount that is excludable from estate tax. The lifetime exemption amount for 2009 is $3.5 million.

EGTRRA's Estate Tax Reduction

Year	Highest Tax Rate	Exclusion Amount	Corresponding Credit Amount
2002	50%	$1 million	$345,800
2003	49	1 million	345,800
2004	48	1.5 million	555,800
2005	47	1.5 million	555,800
2006	46	2 million	780,800
2007	45	2 million	780,800
2008	45	2 million	780,800
2009	45	3.5 million	1,455,800

Example *Claire makes a lifetime taxable gift to her grandson of $1.5 million in 2009. Claire has the ability to allocate $1.5 million of her $3.5 million lifetime GST tax exemption to this gift. Therefore, no GST tax would be due as a result of the gift.*

RETAINED EGTRRA CHANGES

The House Bill does not repeal all of the EGTRRA transfer tax provisions. In addition to the $1 million lifetime gift tax exclusion amount already mentioned, the House Bill retains EGTRRA's:

- Repeal of the state death tax credit in favor of a state death tax deduction
- Repeal of the qualified family-owned business deduction
- Modification to qualified conservation easements
- Modification to the estate tax installment payment rules; and
- Modification of certain GST tax rules.

The House Bill makes EGTRRA's state death tax deduction permanent. Under EGTRRA, the state death tax credit, which allowed a decedent's estate to claim a federal credit for state death taxes paid, was gradually phased out beginning in 2002 and was eventually repealed entirely and replaced with a deduction (Code Sec. 2058) for estates of decedents dying after December 31, 2004. For estates of decedents dying after December 31, 2004, the value of a decedent's taxable estate is determined by deducting from the gross estate the amount of any estate, inheritance, or other death tax paid to any state.

Impact *The change from a credit to a deduction effectively reduced the benefits for many taxpayers (and the revenue flowing to states that had pegged their estate tax law to the federal state death tax credit). The credit was subtracted from the tax itself up to a statutory allowed maximum. The deduction, on the other hand, is subtracted from the gross estate, resulting in a reduction in the amount of property subject to estate tax.*

Comment Many states de-coupled their estate tax regimes from the federal regime because of EGTRRA. Currently, 12 states and the District of Columbia have de-coupled from the federal estate tax law; 5 have imposed estate taxes not tied to the federal tax; and 8 have imposed an inheritance tax.

Family-owned business deduction

The House Bill makes permanent EGTRRA's repeal of the family-owned business deduction (Code Sec. 2057).

The Taxpayer Relief Act of 1997 (P.L. 105-34) provided an exclusion from the gross estates of individuals holding certain qualified family-owned business interests. Subsequent legislation changed the provision to a deduction. EGTRRA repeals the deduction for the estates of decedents dying after December 31, 2003, based upon complaints that it was overly complicated and that higher general estate tax exclusions solved the underlying issue just as effectively.

Installment payment of estate tax

The House Bill makes permanent EGTRRA's provisions relating to the installment payment of estate tax.

The estate tax generally must be paid within nine months of the decedent's date of death. If the decedent's gross estate includes a closely-held business, the time to pay the estate tax attributable to the value of that interest is extended to 14 years and may be paid in installments. Generally, the value of the closely-held business must exceed 35 percent of the decedent's adjusted gross estate.

EGTRRA increased the maximum number of allowable partners and shareholders that a closely-held business can have to qualify for installment payments from 15 to 45. EGTRRA also made installment payments available for lending and finance businesses and clarified the application of the installment payment rules to holding companies.

Impact *One argument made by those in favor of complete repeal of the estate tax is that the estate tax liability created by the value of a small business or farm in an otherwise modest estate often forces family businesses to liquidate the enterprises to pay the estate tax. They argue that simply deferring that tax burden is not enough to prevent the business from having to liquidate.*

Qualified conservation easements

The House Bill makes permanent EGTRRA's provisions relating to estate (or gift) tax charitable deductions for conservation easements.

An estate (or gift) tax charitable deduction is allowed for qualified conservation easements. The amount of the exclusion generally is 40 percent of the value of any land subject to a qualified conservation easement from the decedent's gross estate up to a maximum of $500,000 with a reduction by two percentage points for each percentage point by which the value of the qualified conservation easement is less than 30 percent of the overall value of the land as determined without regard to the value of the easement.

Under EGTRRA, the exclusion for a qualified conservation easement is generally available for any otherwise qualifying real property located in the United States or in any U.S. possession for decedents dying on or before December 31, 2010. Prior to EGTRRA, the exclusion generally applied to a conservation easement located within 25 miles of a metropolitan area, national park, or wilderness area, or within 10 miles of an urban national forest.