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Estate Tax Legislation in 2009: Avoiding the Train Wreck

When Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001¹ (“EGTRRA”), 2010 seemed like a time in the distant future. EGTRRA contained the promise of a one-year repeal of the estate tax, in 2010, followed by a reversion to prior law (with a \$1 million exemption) in 2011. Now 2010 is nearly upon us, and Congress needs to act swiftly to avoid the train wreck that they put into play in 2001. All indications are that 2009 will be the year to stop the train.

What is in play

The obvious issues in play are the estate tax exemption levels and rates. Also under discussion are whether to make the exemption portable between spouses, whether to re-unify the gift tax and the estate tax, and whether to reinstate the state death tax credit. We’ll review each of these issues in turn.

Exemption levels. Prior to the enactment of EGTRRA, the exemption level for the gift tax, the estate tax and the generation-skipping transfer (“GST”) tax was \$1 million. In 2001, Congress enacted a series of changes to the exemption level for the estate tax and the GST tax, but left the gift tax exemp-

tion at \$1 million. Specifically, the estate tax exemption increased to \$1.5 million in 2004, \$2 million in 2006, and \$3.5 million in 2009. For the year 2010, the estate tax was to be repealed and, due to the operation of a sunset provision, in the year 2011, the estate tax was to return with a \$1 million exemption level. While some Republicans claimed to have repealed the estate tax, the truth was that Congress simply set the scene for further legislation by putting untenable provisions into law.

Actual reduction of the exemption level is politically difficult. Thus, during the presidential campaign season, Democratic candidates proposed to freeze the exemption level at its 2008 level of \$2 million. Now that the \$3.5 million exemption has gone into effect in 2009, President Obama has proposed to freeze the exemption at that level. While the President’s proposal still lacks detail, Congress has moved forward in the budget debates. The concurrent resolution

on the budget, as passed by both houses of Congress, calls for the estate tax exemption to be made permanent at \$3.5 million.² Again, there is no detail on the proposal, only a policy statement that says that only a small fraction of people should be subject to the estate tax, and the general statement that 2009 law should be made permanent.

While Republican members of Congress continue to introduce stand-alone bills calling for repeal of the estate tax,³ the rumor in Washington is that Republican Congressmen know that there are not nearly enough votes for estate tax repeal to carry the day. Consequently, according to the rumor, the Republicans’ real position now is to support a \$5 million exemption level in lieu of repeal.

At the other end of the spectrum, Rep. McDermott (D-WA) has reintroduced his “Sensible Estate Tax Act of 2009,” H. R. 2023 (introduced on 4/22/09). This bill provides for the estate tax exemption level to go down to \$2 million. Mr. McDermott also provides for the exemption amount to be indexed, to avoid increasing the pool of estate tax payers over time. Hence, the range of possible exemption levels appears to have narrowed from last year. It seems clear

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at this point that the exemption level will wind up somewhere between \$2 million and \$5 million. With the political momentum opposed to a reduction in the exemption level, and with the cost limitations prohibiting a large increase in the exemption, the most likely outcome is a permanent \$3.5 million exemption.

Tax rates. Prior to the enactment of EGTRRA, the estate tax was imposed at a 55% marginal rate on estates in excess of \$3 million. A surtax on estates between \$10 million and \$17,184,000 created a flat 55% tax on estates in excess of \$17,184,000. EGTRRA repealed the surtax and called for a gradual reduction of the top rate to 45% over a period of several years. Furthermore, because the exemption level was increasing, the lower marginal rates were swallowed up by the exemption and now, in 2009, we have a flat 45% estate tax rate.

The concurrent resolutions passed by Congress call for a continuation of 2009 rates—that is, a flat 45%. Others have called for even lower rates, reminiscent of Sen. McCain's campaign platform and its 15% estate tax rate. Mr. McDermott's Sensible Estate Tax Act of 2009, however, would

impose new graduated rates, starting with the 45% rate for estates up to \$5 million, with a 50% marginal rate applicable to estates between \$5 million and \$10 million, and restoring the 55% rate bracket for estates in excess of \$10 million. McDermott would also index the rate brackets, as is done with the income tax rate brackets.

Again, the most likely outcome is to retain the status quo, a flat 45% tax rate. A lower tax rate would cause too much loss of revenue, and a higher tax rate, unless it applies only to very large estates, seems unlikely. Retaining a flat 45% rate would be consistent with both President Obama's budget proposal and the concurrent resolutions of Congress.

Portability. Probably the most advocated change to the estate tax is to make the estate tax exemption portable between spouses. With portability of the exemption, any unused portion of the estate tax exemption of the first spouse to die could be transferred to the surviving spouse, who could then use the credit—in addition to her own—at the time of her death. Portability of the exemption would retire the credit shelter trust (or bypass trust) as a planning technique; only in very limited situations would any client choose to set up a credit shelter trust if it did not have its current tax benefits.

The idea of portability has been discussed by policy makers for at least ten years. Over the years, concerns have been expressed over a few specific fact patterns. One initial question was how many exemptions a surviving spouse could accumulate. For example, if Martha and George were married and George passed away without using all of his estate tax exemption, Martha would obtain the use of George's unused exemption. Then suppose

that Martha married Andrew, whom she also outlived. How many exemptions could Martha accumulate? Portability provisions have been drafted to limit the number of exemptions Martha can accumulate to two. For example, section 7 of H. R. 2023, the Sensible Estate Tax Act of 2009, limits the "aggregate deceased spousal unused exclusion amount" to the lesser of \$2 million or the sum of the deceased spousal unused exclusion amounts of the surviving spouse.

Another issue that has bothered policy makers is the question of whether there would be a market in unused exemptions. For example, suppose that James, who is a poor, unmarried man, is near death. Priscilla, who is wealthy and divorced with children, arranges to pay James a fee in order to marry him. When he passes away a short time later, she obtains use of his exemption, which effectively doubles the amount she can leave to her children free of estate tax. Although the draft language for portability provisions does not address this particular fact pattern, Regulations presumably would provide that the marriage must be a bona fide marriage, and not one entered into for the purpose of obtaining tax benefits.

There is, in fact, little opposition to the enactment of portability. The only real problem with such a provision is that it is costly. Because not everyone engages in the planning necessary to use both spouses' exemptions, portability would result in increased use of exemptions, and thus it has an associated revenue cost. The policy reasons

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¹ Pub. L. No. 107-16 (6/7/01).

² H. Con. Res. 85 (111th Cong., 2009); S. Con. Res. 13 (111th Cong., 2009).

³ See, e.g., H. R. 205, introduced on 1/6/09 by Rep. Mac Thornberry (R-TX); H. R. 1960, introduced on 4/2/09 by Rep. Joseph Pitts (R-PA); and S. 296, introduced on 1/22/09 by Sen. Saxby Chambliss (R-GA).

to support portability are strong. The themes of simplification and avoidance of unnecessary lawyering and trusts resonate with policy makers, so enactment of portability is not out of the question.

The version of portability included in H.R. 2023 (which also appears in other bills calling for portability—for example, S. 722, introduced by Sen. Max Baucus (D-MT) on 3/26/09) has two other attributes that merit discussion. First, the bill requires that an election be made by the executor of the deceased spouse on a timely filed estate tax return. This requirement is contrary to the policy behind portability, as it will limit portability to the well-advised person who has the federal estate tax on her radar screen. Consider, for example, a married couple of modest wealth. The husband dies, but has assets well below the threshold for a required filing of an estate tax return, so no federal estate tax return is filed. Later, after husband's death, wife wins \$5 million in the lottery. Even though husband did not use his exemption, wife will not have the benefit of the exemption because the election was not made. Requiring an election to be made on a timely-filed estate tax return undermines the goals of portability.

The second provision of note in the portability provision of H.R. 2023 is its effective date. The provision is effective with respect to the surviving spouse of any deceased spouse dying after 12/31/09. This effective date holds down the revenue loss from this provision. The revenue loss associated with portability occurs when the surviving spouse dies, not when the first spouse dies. Because, on average, there is a period of seven to eight years between the death of the first spouse and the death of the surviving spouse, one would expect it to take years for the revenue

impact of portability to be felt. Furthermore, Congress examines the revenue impact of legislation only over a five- (Senate) or ten- (House) year period. Therefore, the use of a wholly prospective portability provision would put most of the revenue loss from portability outside the revenue window Congress deems relevant.

Given the popularity of the portability provision, its appeal on the grounds of simplicity, and the ability to postpone its revenue impact, the probability of enactment of portability is probably greater than 50-50.

Reunification of the estate and gift tax exemption. One of the unfortunate byproducts of EGTRRA was the dis-unification of the estate and gift tax. Specifically, the estate tax exemption level was gradually increased to \$3.5 million while the gift tax exemption has been held at its 2001 level of \$1 million. The purpose of limiting the gift tax exemption was to protect the income tax base in the case of repeal. In other words, Congress believed that in the absence of an estate tax, people would transfer assets to family members in a lower tax bracket in order to minimize income taxes. To prevent erosion of the income tax base, Congress opted to limit the amount that could be transferred free of gift tax, and \$1 million (current law in 2001) was chosen.

Now that it seems clear that the estate tax will not be repealed, many in the estate planning community are advocating increasing the gift tax exemption to match the estate tax exemption. This proposal is another change in the interest of simplification and avoidance of complicated planning techniques. The major objection is lost revenue, although it is not clear that a lot of revenue would be lost.

Consider individuals in the following situations. An individual with a net worth of less than \$3.5 million is not likely to be paying gift tax under present law. For most people of that net worth, the \$1 million gift tax exemption is more than sufficient, as they are unlikely to want to give away a greater percentage of their net worth. If they did want to make a larger gift, their tax advisors would argue against it, suggesting instead that they make an interfamily loan, since all their assets would pass tax-free at death. It does not make sense to pay gift tax if your entire estate could pass free of estate tax, so it is unlikely that significant gift tax receipts are being generated from individuals in that wealth range.

At the other extreme, individuals with a net worth significantly in excess of the estate tax exemption

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