

Death Taxes: Confusion Reigns



By D. Randall Gibson and
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“...[I]n this world nothing can be said to be certain, except death and taxes.”

B. FRANKLIN “Letter to Jean-Baptiste Leroy” (Nov. 13, 1789).

Leave it to the 111th Congress to prove wrong this famous maxim of Benjamin Franklin – at least with respect to the Federal Estate Tax. Nothing is certain about the Federal Estate Tax these days except uncertainty. It is the epitome of confusion, and estate planners are left guessing when trying to plan clients’ estates.

The current landscape for the Federal Estate Tax appears to be ideal – the tax was repealed as of Jan. 1, 2010. However, the repeal is temporary and will last only until Jan. 1, 2011, when the 2001 Federal Estate Tax will be resurrected with its 2001 Unified Credit Against Estate Tax (“exemption equivalent amount”) and the 2001 tax rates, unless Congress acts to adopt a higher exemption equivalent amount and lower tax rates. Numerous bills are before Congress to do just that, but none appear to have the necessary support for passage (and that could change at any time). So estate planners struggle to plan through this morass of uncertainty and clients wait.

How did we get here?

On June 17, 2001, Congress enacted the Economic Growth and Tax Relief

Reconciliation Act of 2001 (“EGTRRA”).¹ Over the course of the last decade, EGTRRA has provided for a graduated increase in the exemption equivalent amount and a graduated decrease in the maximum tax rate imposed upon taxable estates.

For decedents dying in 2001, the exemption equivalent amount was \$1 million, and the maximum tax rate imposed upon a taxable estate was 55 percent. During the last decade, EGTRRA increased the exemption equivalent amount to \$1.5 million in years 2004 and 2005; \$2 million in years 2006 through 2008; and \$3.5 million in 2009. Also, over the last decade EGTRRA decreased the maximum tax rate imposed upon taxable estates to 49 percent in 2003; 48 percent in 2004; 47 percent in 2005; 46 percent in 2006; and 45 percent in years 2007 through 2009. These changes were adopted in EGTRRA based upon the belief that “tax relief [is needed] for all decedents’ estates, decedents’ heirs and businesses, including small businesses, family-owned businesses and farming businesses.”² Estate planning attorneys and their clients have come to expect and rely on this needed tax relief from the “unduly burdensome” estate and generation skipping transfer taxes. As noted in the Senate Report to EGTRRA “[t]he Committee further believes that it is inappropriate to impose a tax by reason of the death of a taxpayer.”³

Where are we?

For this year, 2010, EGTRRA has brought Federal Estate Tax bliss to those potentially subject to the Tax – the Federal Estate Tax is repealed. However, the repeal came with a catch (i.e., an additional cost to estates and their beneficiaries) - EGTRRA imposes a significant change for 2010 with respect to the stepped-up basis rules available for estates and their beneficiaries under Internal Revenue Code Section 1014.⁴

EGTRRA repeals the stepped-up basis rules of Code Section 1014 with respect to decedents dying after Dec. 31, 2009. These rules generally provided that with respect to the estates of decedent’s dying prior to Jan. 1, 2010, the basis of the property inherited from a decedent equaled, in the hands of the beneficiaries, the fair market value of the property at the date of the decedent’s death. EGTRRA replaces Code Section 1014 with Code Section 1022.

For decedent’s dying after Dec. 31, 2009, Code Section 1022 provides that the basis to beneficiaries in the property received from the decedent’s estate equals the *lesser* of the decedent’s adjusted basis in such property or the fair market value of the property at the decedent’s date of death. Code Section 1022 also provides some relief from the repeal of the stepped-up basis rules by permitting a step-up in basis of \$1.3 million with respect to certain assets passing from a decedent to the decedent’s beneficiaries (plus an additional \$3 million where the beneficiary is a surviving spouse) (the “Section 1022 Step-up in Basis”).

To qualify for the Section 1022 Step-up in Basis, the property received by a beneficiary must have been owned by the decedent (1) individually, (2) through a revocable trust, or (3) through a trust over which the decedent possessed the right to alter, amend or terminate the trust. However, EGTRRA specifically excludes from the Section 1022 Step-up in Basis all assets gifted to the decedent within three years of the decedent’s

death (other than gifts from the decedent's spouse) for which a Federal Gift Tax Return was required to be filed.

At the end of the day, EGTRRA permits the Section 1022 Step-up in Basis for the aggregate "qualified" assets held by a decedent's estate up to \$1.3 million (or \$4.3 million in the case of a surviving spouse). For all non-qualified assets and those qualified assets over and above those amounts, the basis of the beneficiaries in such property is the *lesser* of the decedent's adjusted basis in such property or the fair market value of the property at the decedent's date of death.

EGTRRA also changed the return filing requirement for estates of decedents dying in 2010. In prior years, Code Section 6018 only required estates to file a Federal Estate Tax Return if the gross estate of a decedent exceeded the exemption equivalent amount. However, in light of EGTRRA's repeal of the Federal Estate Tax coupled with its changes to the stepped-up basis rules, EGTRRA amended Section 6018 to require the Executor of an estate for a resident decedent dying in 2010 to file a return with the Internal Revenue Service if: (a) the decedent's estate exceeds \$1.3 million; or (b) the decedent's estate contains property gifted to the decedent within three years of the decedent's date of death for which a Federal Gift Tax Return was required.

Where are we going?

Over the course of the last decade as EGTRRA gradually increased the exemption equivalent amount and gradually decreased the maximum tax rate, most practitioners and clients expected Congress to fix the uncertainty of future exemption amounts and tax rates for the Federal Estate Tax by making permanent the 2009 exemption equivalent amount and tax rates or by increasing the exemption and decreasing the tax rate from the 2009 numbers. These practitioners and clients never expected Congress to permit the repeal of the Federal Estate Tax. However, Congress failed to meet those expectations, leav-

ing both clients and practitioners in a state of uncertainty. What are those possible future scenarios?

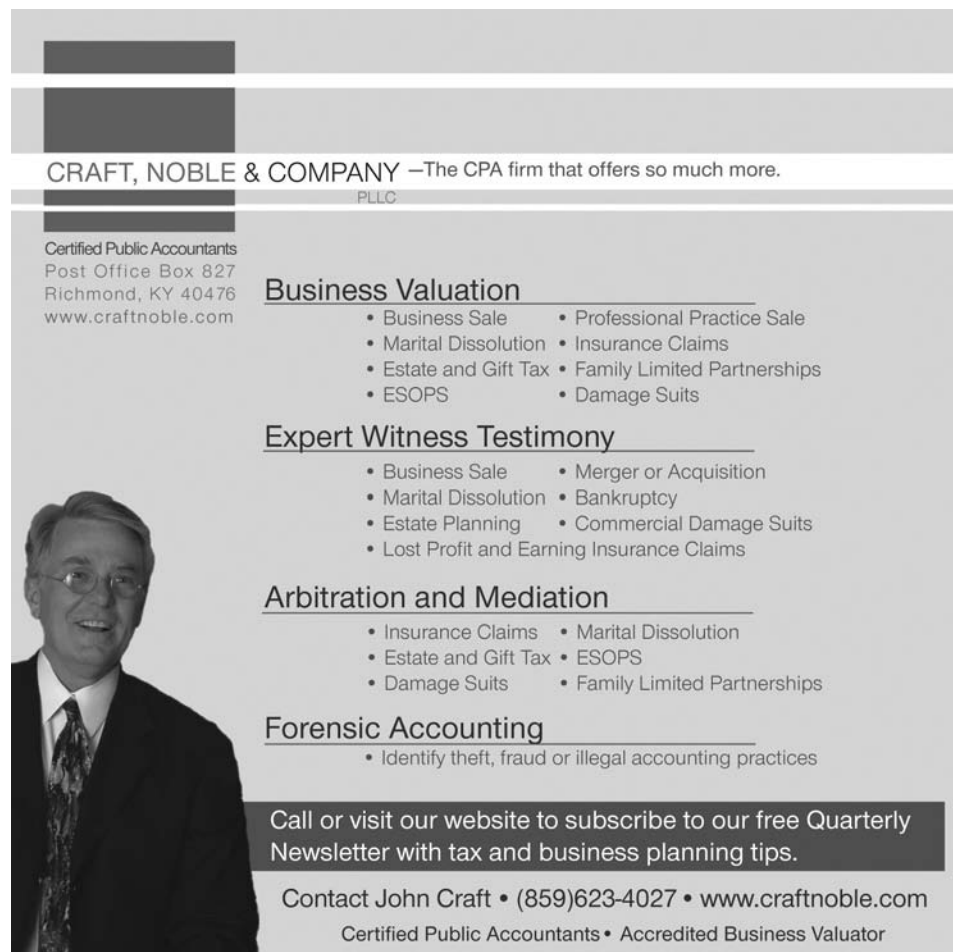
If Congress continues down the very likely path of "doing nothing," the Federal Estate Tax will, like a phoenix rising from the ashes, be resurrected circa 2001. If, as Congress noted, this tax was "unduly burdensome" in 2001, it will be more burdensome ten years after the enactment of EGTRRA. The exemption equivalent amount will be \$1 million, the maximum rate of tax imposed upon an estate will be 55 percent and stepped-up basis will return. If Congress is simply looking to generate revenue, then this will likely be the chosen option.

However, there are multiple bills currently before Congress that propose changes to the Federal Estate Tax to provide some additional taxpayer relief from this "unduly burdensome" tax. HR 4154 closely mirrors the Obama administration's proposal related to the Federal Estate Tax. HR 4154 was passed by the

House of Representatives on Dec. 3, 2009, and is currently in the Senate for consideration. In reviewing the various bills currently before Congress and known positions taken on the Federal Estate Tax, including the Obama administration's proposal, a number of issues are being considered and a number of changes *could* be coming for the Federal Estate Tax, including:

Unified Credit Against Estate Tax:

HR 4154, as passed by the House of Representatives, would fix the exemption equivalent amount at \$3.5 million without an inflation index. This fix mirrors the changes in the Obama administration's "Green Book" published by the U.S. Department of Treasury.⁵ However, it appears that a \$3.5 million credit amount will receive some push-back in the Senate, as Sen. Jon Kyl (R-AZ) and Sen. Blanche Lincoln (D-AR) made an alternative proposal in H.R. 5297 that would phase in a \$5 million credit over ten years with an inflation index (the "Alternative



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Proposal”).⁶ The Alternative Proposal was not included in the version of H.R. 5297 passed by the Senate on Sept. 16, 2010, but could receive support in a future Federal Estate Tax bill.

Neither HR 4154 nor the Alternative Proposal appear to address portability of the exemption equivalent amount whereby a surviving spouse is permitted to claim a deceased spouse's unused exemption equivalent amount, but this issue continues to receive support on Capitol Hill and could surface in a Federal Estate Tax bill.

Maximum Rate of Tax: HR 4154 would set the maximum tax rate imposed upon an estate at 45 percent. The Alternative Proposal, however, proposes a maximum tax rate fixed at 35 percent.

Carry-Over Basis: HR 4154 and the Alternative Proposal would repeal EGTRRA's carry-over basis rules. Since the law that will be in effect if Congress does nothing before Jan. 1, 2011, also repeals the EGTRRA carry-over basis rules, it appears likely that the stepped-up basis rules of Section 1014 will

return and continue into the future because a full repeal of the Federal Estate Tax is not likely to occur.

Valuation Discounts: The Green Book proposes changes to Code Section 2704 related to disregarding certain restrictions placed upon “family-controlled” entities for valuation purposes. The proposal would add a category of restrictions to be disregarded in valuing an interest in a “family-controlled” entity. The restrictions proposed to be disregarded include: (a) limitations on an owner's right to liquidate his or her interest that are more restrictive than a standard to be identified in regulations and (b) limitations on a transferee's ability to be admitted as a full partner or to hold an equity interest. This would have the effect of eliminating certain discounts and increasing the value of an affected estate and as a result, increasing the potential tax due. Currently,



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these provisions are not in either HR 4154 or the Alternative Proposal.

Unification of Gift and Estate Tax Credits:

Although HR 4154 would not unify the Gift and Estate Tax Credit amounts, many of the bills before Congress would unify these credits. If passed, the Gift Tax exemption equivalent amount (currently \$1 million) would be increased to equal the Estate Tax exemption equivalent amount.

Can Congress retroactively apply any FET legislation?

Will Congress make any adopted Federal Estate Tax bill effective for decedents dying after Dec. 31, 2009? HR 4154 clearly is intended to be retroactive. The Alternative Proposal, however, gives the taxpayer the option of having the new law applied retroactively but does not mandate it. Many Senators and Congressmen have indicated that any Federal Estate Tax legislation would be retroactive. However, can Congress make any such Federal Estate Tax fix retroactive?

Courts have wrangled with issues regarding the retroactivity of laws throughout much of American jurisprudential history, and have more often than

not been deferential to Congressional decisions. Aside from a line of cases decided in the 1920s, courts have relied on a rational basis test to uphold tax laws with retroactive application as constitutional and as satisfying the requirements of due process. *U.S. v. Carlton*⁷ outlines the standard for due process as it relates to retroactive legislation.

In that case, the Supreme Court held that “[t]he due process standard to be applied to tax statutes with retroactive effect, therefore, is the same as that generally applicable to retroactive economic legislation: ‘provided that the retroactive application of the statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive provinces of the legislative and executive branches.’”⁸

Carlton satisfied the due process standard because (1) Congress’ purpose was deemed not to be illegitimate or arbitrary, but rather to “correct what it reasonably viewed as a mistake in the original 1986 provision that would have created a significant and unanticipated revenue loss;” and (2) the legislation was a rational means of achieving this purpose because it corrected the mistake and “Congress acted promptly and established only a modest period of retroactivity.”⁹

With every day that passes, Congress gets further and further from being able to fulfill *Carlton*’s “modest period of retroactivity” element to the rationality test. Moreover, in support of the “modest period of retroactivity,” Justice

Sandra Day O’Connor in her concurring opinion to *Carlton* pronounced that “the governmental interest in revising the tax laws must at some point give way to the taxpayer’s interest in finality and repose.... A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions.”¹⁰

The only thing certain about the current state of the Federal Estate Tax is uncertainty and both clients and practitioners want precisely what Justice O’Connor spoke of in *Carlton*, finality and repose. ☺

ENDNOTES

1. 1 Pub. L. No 107016, 115 Stat. 38 2001.
2. H.R. Report 107-37 at 19 (2001).
3. S. Report 107-30 at 51 (2001).
4. All Code Section references are to the Internal Revenue Code of 1986, as amended.
5. U.S. Treasury Department, General Explanations of the Administration’s Fiscal Year 2011 Revenue Proposals, at 122 (Feb. 2010).
6. <http://lincoln.senate.gov/newsroom/2010-7-14-1.cfm>; TaxProf Blog, June 11, 2010.
7. *U.S. v. Carlton*, 512 U.S. 26, (1994)
8. *Id.* at 30-31 (quoting *Pension Benefit Guaranty Corporation v. R.A. Gray and Co.*, 467 U.S. 717, 729-730 (1984).
9. *Id.* at 32-33.
10. *Carlton*, 512 U.S. at 38.



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