



2010 Sunset Provisions

9:00am-10:15am

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Jeffrey S. Glaser is special counsel with the law firm Saul Ewing LLP. His primary areas of practice include estate planning, probate law, charitable giving, family succession planning, tax and corporate. Mr. Glaser has spoken to various business groups, civic groups, and charitable organizations on these matters. Mr. Glaser has lectured for and is co-author of the "Basic Estate Tax Planning" course and the "Using and Drafting Trusts in Estate Planning" course for the Maryland Institute for Continuing Professional Education of Lawyers (MICPEL). He has also authored materials for and lectured to other continuing education organizations and professional organizations, including MACPA. Mr. Glaser earned his B.A. from Boston College, his M.A. from the University of Maryland Graduate School (economics) and his J.D., cum laude, from the University of Maryland School of Law. He is a member of the Baltimore Estate Planning Council, the Maryland State Bar Association (member, Estate and Trust Law section), the Baltimore Charitable Planned Giving Roundtable, and the Maryland State Bar Association Gift and Estate Tax study group.

Will The Estate Tax Sunset As Planned? Remembering Yesterday, Forecasting Tomorrow

September 17, 2009

Maryland Association of CPA's

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I. REMEMBERING YESTERDAY: TRANSFER TAXES IN 2001.

The federal Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) was signed into law on June 7, 2001. EGTRRA made numerous and substantial changes to federal transfer taxes. Prior to the enactment of EGTRRA, highlights of the federal transfer tax scheme could be summarized as follows:

A. Estate Taxes

1. Tax Rates. For estates over \$3,000,000, the marginal tax rate reached 55%. In addition, a 5% surtax was imposed on estates between \$10,000,000 and \$17,184,000. The effect of the surtax was to phase out the benefit of graduated rates. Estates over \$17,184,000 were, effectively, taxed at a flat rate of 55%.
2. Applicable Exclusion Amount. For death in 2001, \$675,000 was excluded from the estate tax. This exclusion amount was slated to gradually increase to \$1,000,000 per person by 2006, and remain at this level thereafter. Between spouses, in 2001 it was possible to shelter \$1,350,000 of assets from the estate tax. By 2006, the total sheltered amount increased to \$2,000,000 per couple.
3. State Death Taxes. To the extent a state imposed a death tax, the federal estate tax was reduced dollar for dollar, up to a formula cap. This credit had been in effect since 1924.
4. Family Owned Business Deduction. In determining the value of a decedent’s estate, a deduction of up to \$675,000 against the gross estate could be taken for the value of a qualified family owned business.
5. Basis of Assets. Other than assets that are deemed to constitute income in respect of a decedent, assets that are subject to an estate tax received an adjustment to the basis equal to the date of death (or alternate valuation date) value of that asset.

B. Gift Taxes

1. Applicable Exclusion Amount and Tax Rates. In 2001, the gift tax and estate tax were unified. The lifetime exclusion from the gift tax was \$675,000 and was slated to gradually increase to \$1,000,000 per person by 2006, and remain at this level thereafter. These exemptions were identical to the estate tax exemptions. Similarly, the gift tax rates were in lockstep with the estate tax rates.

C. Generation-Skipping Transfer Taxes

1. Exemption Amount. Prior to EGTRRA, the Generation-Skipping Transfer Tax (“GSTT”) was not unified with the federal estate and gift tax.

Beginning in 1999, the GSTT exemption was \$1,000,000 with an inflation indexed adjustment. By 2001, the GSTT exemption was \$1,060,000. This exemption was not slated to increase as were the estate and gift tax exemptions, except to the extent of inflation.

2. Tax Rates. The GSTT rate is equal to the highest marginal estate tax rate, multiplied by the “inclusion ratio”. The inclusion ratio is a number between 0 and 1 and generally represents the fraction of the property to which GSTT exemption has been allocated. An inclusion ratio of 0 indicates that sufficient GSTT exemption has been allocated to the property so that all of the property is exempt from GSTT. An inclusion ratio of 1 indicates that no GSTT exemption has been allocated to the property. In 2001, the GSTT rate was 55% multiplied by the inclusion ratio. The 5% estate tax surtax on estates between \$10,000,000 and \$17,184,000 was not applicable to generation skipping transfers
3. Automatic GSTT Exemption Allocation. Prior to EGTRRA, when an individual made a gift to a trust, that individual was generally required to file a gift tax return in order to allocate his or her GSTT exemption. This was true even if the entire gift qualified for the annual gift tax exclusion. This would typically be accomplished by giving the trust beneficiary a right to withdraw the gift. Except in very limited circumstances, there was no automatic allocation of GSTT exemption for gifts to a trust
4. Retroactive Allocation of GSTT Exemption. Prior to EGTRRA, if an individual made a gift to a trust and did not allocate GSTT exemption and there was a death of a beneficiary that resulted in a “taxable termination”, a GSTT would be triggered, even if the individual who made the original gift had unused GSTT exemption. In other words, retroactive allocation of GSTT was not permissible. For example, it was common for an individual not to allocate GSTT exemption for a gift to a trust in which the trust beneficiary was a “non-skip” person and it was expected that the trust would distribute all its assets to that non-skip person before his or her death. The GSTT would be triggered if there was an out of order death and the non-skip person died before expected, or died before the individual who made the original gift
5. Severance of Trust. Prior to EGTRRA, once a trust with a positive inclusion ratio was established, it was not possible to sever that trust into two separate trusts, in order to create a trust with an inclusion ratio of 0 and another with an inclusion ratio of 1.
6. Relief for Late Election to Allocate GSTT Exemption. GSTT Exemption is allocated on a timely filed gift tax return. Prior to EGTRRA, late allocation of GSTT exemption was not subject to any statutory or regulatory framework that specifically recognized late allocation. Late

allocation was made under the rules set forth in Treasury Regulations §301.9100.

II. TRANSFER TAXES TODAY.

EGTRRA substantially altered the federal transfer tax scheme. Highlights of the transfer tax scheme for 2009 are summarized as follows:

A. Estate Taxes

1. Tax Rates. The highest marginal estate tax rate is now 45%. Because of the increase in the applicable exclusion amount, the federal estate tax is now effectively a flat tax of 45% of the estate over the applicable exclusion amount.
2. Applicable Exclusion Amount. The applicable exclusion amount is now \$3,500,000 per person. Between spouses, it is possible to shelter \$7,000,000 of assets from the estate tax.
3. State Death Taxes. The state death tax credit has been repealed and replaced by a deduction. Instead of the state death taxes reducing the federal estate tax dollar for dollar, state death taxes are now deducted against gross estate before the federal estate tax is calculated. The effect of this change has been monumental for a variety of reasons, including the effective repeal of many states' death taxes and the implementation by many states of their own separate estate tax. In Maryland, the repeal of the state death tax credit resulted in the enactment of a separate Maryland estate tax with an exclusion amount of \$1,000,000 per person. The Maryland estate tax and the federal estate tax are now "decoupled". Other local jurisdictions with a separate estate tax are Washington, D.C. and Delaware. Neither Virginia nor Pennsylvania have a separate estate tax.
4. Family Owned Business. The family owned business deduction has been repealed.
5. Basis of Assets. The law regarding adjustment to assets in an estate remains the same in 2009 as pre-EGTRRA.

B. Gift Taxes

1. Applicable Exclusion Amount and Tax Rates. In 2009, the gift tax and estate taxes have been decoupled. The lifetime exclusion from the gift tax is now \$1,000,000 per person, substantially lower than the estate tax exclusion amount. The gift tax rates remain identical to the estate tax rates: gifts over the lifetime exclusion are taxed at a flat rate of 45%.

C. **Generation-Skipping Transfer Taxes**

1. Exemption Amount. The GSTT and estate tax are now unified. In 2009, the GSTT exemption is \$3,500,000 per person. There is no inflation indexed adjustment.
2. Tax Rates. In 2009, the GSTT rate remains equal to the highest marginal estate tax rate (45%), multiplied by the “inclusion ratio”.
3. Automatic GSTT Exemption Allocation. As a result of EGTRRA, gifts to a trust that are deemed to be a “GST Trust” result in the automatic allocation of the donor’s GSTT exemption. There is no need to file a gift tax return in order to allocate GSTT exemption (although good record keeping is extremely important). The definition of a GST Trust is complex. Generally, a trust is not a GST Trust if a non-skip trust beneficiary is entitled to at least 25% of the corpus before age 46 or the trust assets are included in the non-skip beneficiary’s estate at death.
4. Retroactive Allocation of GSTT Exemption. If a GSTT is triggered because of a “taxable termination” arising from an out of order death and the donor is still living and has unused GSTT exemption, it is now possible to allocate that exemption retroactive so as to avoid the GSTT. The trust beneficiary who dies out of order must meet certain requirements for retroactive allocation to apply.
5. Severance of Trust. It is now possible to sever a trust with a positive inclusion ratio into two separate and identical trusts, in order to create one trust with an inclusion ratio of 0 and another trust with an inclusion ratio of 1.
6. Relief for Late Election to Allocate GSTT Exemption. Late allocation of GSTT exemption is now recognized by statute. The Department of the Treasury is tasked with enacting regulations within this framework. To date, the regulations (published in April 2008) are simply proposed and have not been finalized.

III. **FORECASTING TOMORROW’S TRANSFER TAXES**

A. **EGTRRA in 2010**

1. Federal Estate Tax. The federal estate tax is scheduled to be repealed one year, for deaths in 2010. EGTRRA, by its own terms, sunsets after December 31, 2010. Consequently, the federal estate tax will be resurrected in 2011 if Congress does not act.
2. Maryland Estate Tax. Under Maryland law, if repeal of the federal estate tax becomes a reality in 2010, Maryland’s estate tax will continue as

though the federal tax had not been repealed. Maryland's estate tax will NOT be repealed.

3. Basis Rules. If the federal estate tax is repealed, assets that would otherwise be included in a decedent's estate will no longer receive an adjustment to basis equal to the date of death (or alternate valuation date) value. Instead, EGTRRA provides for a modified carryover basis regime. Generally, this can be summarized as follows:
 - a. These rules apply to property acquired from a decedent. Essentially, this is the property that would be included in the decedent's federal gross estate if the estate tax were in force
 - b. The property's basis is carried over from the decedent
 - c. The decedent's Personal Representative is given the authority to allocate up to \$1,300,000 of basis over and above the carry over basis, but not in excess of the value of the property on the date of death
 - d. The \$1,300,000 is increased by the decedent's unused capital losses and NOLs
 - e. In addition, the Personal Representative can allocate up to an additional \$3,000,000 for property passing outright to a surviving spouse or to a QTIP qualifying trust
 - f. The basis allocation is subject to an inflation adjustment
 - g. Certain property is not eligible for the adjustment, including property acquired from the decedent within 3 years of death and property that is IRD
 - h. Under the Tax Reform Act of 1976, Congress adopted a carryover basis scheme which, 4 years later, was repealed retroactive to the date of enactment because it proved to be difficult, if not impossible, to ascertain the decedent's basis
4. GST Tax. As with the estate tax, the GSTT is scheduled to be repealed for one year, 2010, and then return in 2011 if Congress does not act. Thus, there will be no GSTT imposed if there is a direct skip, a taxable distribution or taxable termination in 2010 unless Congress acts.
5. Gift Tax. The gift tax is NOT scheduled to be repealed in 2010. Taxable gifts must still be reported, and the \$1,000,000 lifetime exemption remains in effect. If a taxable gift is made in 2010 that results in all of the donor's lifetime exemption being used, then the taxable gift in excess of \$1,000,000 will be taxed at the top individual rate in effect.

B. What Happens in 2011 if Congress Does Nothing?

1. All of the provisions under EGTRRA that relate to transfer taxes are scheduled to sunset after December 31, 2010. In other words, if Congress does not act, effective January 1, 2011, the federal estate tax, generation-skipping transfer tax, and gift tax scheme that was in effect *before* EGTRRA will be resurrected. There may be some inflation adjustments, such as the GSTT exemption, but otherwise the provisions in effect prior to EGTRRA will be identical.

C. What Is Up Congress' Sleeve?

1. My crystal ball is no better than the old Magic Eight Ball toy which randomly gave positive, negative and non-committal answers. But there are some clues as to what is likely to occur. In any case, the events of the past 12 months reflect
 - a. government revenues are significantly below what was projected when EGTRRA was enacted
 - b. government expenditures have ballooned
 - c. the national debt has skyrocketed
2. A political band-aid. Congress may enact a one year extension of 2009 estate tax exemption and estate tax rates rather than hammer out an agreement for a more permanent solution. The one year solution could simply expire on December 31, 2010, as does EGTRRA. Congress could not act. The pre-EGTRRA provisions are resurrected without repeal
3. Many bills have been introduced that attempt a permanent solution. Here are some that are possible contenders to make it out of committee: S. 722, H. R. 436, H. R. 498, and H. R. 2032
 - a. Senate Bill 722 would:
 - (i) Make the \$3,500,000 exclusion permanent and the 45% tax rate permanent. The exemption would be indexed for inflation
 - (ii) reunify the estate and gift tax applicable exemption amount, meaning the lifetime gift tax exemption would be \$3,500,000 and indexed for inflation
 - (iii) allow the surviving spouse to inherit the unused gift tax exemption and estate tax exemption of the first spouse to die (known as "portability")

- (iv) increase the special use valuation reduction to \$3,500,000

This bill is sponsored by Max Baucus (D, MT) with John Rockefeller (D, WV) and Charles Schumer (D, NY) as cosponsors. The bill also addresses AMT and income tax rates.

b. House Bill 436 would:

- (i) Make the \$3,500,000 estate tax exemption and GSTT exemption permanent and the 45% tax rate permanent.
- (ii) reunify the estate and gift tax applicable exemption amount
- (iii) limit the valuation discount for certain family limited partnerships and the like
- (iv) provide strict valuation rules for transfer of non-business assets

This bill is sponsored by Earl Pomeroy (D, ND). No cosponsors. This is the 3rd time Mr. Pomeroy has introduced this bill. This bill has never before made it out of committee, but the chatter surrounding the valuation issues makes it a bill of interest. It is unlikely to make it out of committee.

c. House Bill 498 would:

- (i) Reunify the lifetime gift tax exemption to equal the estate tax exemption
- (ii) Increase the estate tax exemption between 2010 to 2015, from \$3,500,000 to \$5,000,000, by \$250,000 annually. The \$5 million exemption would become permanent, but subject to an inflation adjustment after 2015
- (iii) The estate and gift tax rates would be based upon the capital gains tax rate
- (iv) restore the state death tax credit
- (v) Provide for estate tax exemption portability to the surviving spouse

This bill is sponsored by Harry Mitchell (D, AZ) along with 7 other cosponsors

- d. House Bill 2023 would:
- (i) make permanent the exemption level at \$2 million, indexed for inflation
 - (ii) establish progressive tax rates: 45% for estates between \$2 million and \$5 million; 50% for estates between \$5 million and \$10 million; and 55% for estates over \$10 million
 - (iii) reunify the estate and gift tax
 - (iv) create exemption portability
 - (v) restore the state death tax credit

This bill is sponsored by James McDermott (D, WA). There are no cosponsors

4. Other significant developments and points to note:

- a. The Obama Administration, in the 2009 Green Book, stated that an objective was to require that any Grantor Retained Annuity Trust have a minimum term of 10 years. Currently, it is common to create a GRAT with a 2 year term. The Obama Administration stated that GRATs “have proven to be a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers. . . .Taxpayers have become more adept at maximizing the benefit of this technique”
- b. Also in the 2009 Green Book, the Administration supported extension of the 2009 estate tax exemption into 2010 at the same 45% tax rate. The Joint Committee on Taxation estimated that this proposal, if made permanent and with an additional inflation index, would result in a revenue loss of \$256 Billion between fiscal years 2010 and 2019, as compared to the current law (one year repeal in 2010 and reinstatement of the \$1,000,000 exemption with rates up to 55%).
- c. Be cautioned: Just because Congress doesn’t act before December 31, 2009 does NOT mean that repeal is a certainty. The Supreme Court has ruled that a retroactive change to the estate tax is permissible and is not unconstitutional. In the case, *Carlton v. U.S.*, 114 S. Ct. 2188 (1994), the Court held that a statute that allowed an estate tax deduction could be retroactively changed to disallow the deduction. As such, it is possible for Congress to act sometime in 2010 and enact some form of estate tax, and provide that the tax is retroactive for decedents dying after December 31, 2009.