CCH Tax Briefing:

PERMANENT ESTATE TAX RELIEF FOR FAMILIES, FARMERS, AND SMALL BUSINESSES BILL OF 2009

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Special Report

HIGHLIGHTS:

- ✔ *$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*

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House Passes Permanent Estate Tax Relief Bill; Fate in Senate Uncertain

The House on December 3, 2009, passed long-awaited legislation, the Permanent Estate Tax Relief for Families, Farmers and Small Businesses Bill of 2009 (H.R. 4154), permanently extending 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 225 to 200 vote reflected the urgency felt by some House lawmakers to provide certainty to estate planning planning and disagreement over whether to abolish the tax entirely or provide for a lower exclusion. The House Bill also provides for continuation of the gift and generation-skipping transfer (GST) tax provisions as they exist in 2009. The $233 billion cost over 10 years of the House Bill is not offset.

It is unclear if the Senate will take up the House Bill before year-end. The Senate's schedule for is dominated by debate on health care reform, leaving little time for action on an estate tax bill. One possible scenario is that the Senate will approve the House bill by unanimous consent shortly before starting its holiday recess. One of the biggest stumbling blocks to passage in the Senate is the House's decision not to index the $3.5 million exclusion for inflation.

Impact *The House Bill is not as generous to the gift tax, retaining the same gift tax regime put in place by the Economic Growth and Tax Relief Reconciliation Act of 2009 (EGTRRA). The gift tax lifetime exclusion amount remains at $1 million after 2009.*

Comment At the same time, House lawmakers appear to be maneuvering to pass additional year-end legislation. House tax writers have introduced a tax technical corrections bill. House leaders may also try to move a package of "extenders," popular but temporary tax breaks, a FY 2010 Treasury and IRS appropriations bill, an alternative minimum tax (AMT) "patch" and more before the end of 2009.

Comment The House considered its estate tax bill under pay as you go (PAYGO) procedures. However, as a previous Congress established the estate tax, the House bill was not deemed new policy to be offset by revenue raisers.

ESTATE TAX

The House Bill eliminates 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. 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 is permanently set at 45 percent and the estate tax exclusion amount is permanently set at $3.5 million ($7 million for married couples).

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 are not adjusted for inflation.

CARRYOVER BASIS

The House Bill leaves in place the traditional stepped-up basis regime for all assets included in the gross estate, a regime that was about to change in 2010 under EGTRRA. EGTRRA calls for modified carryover basis rules in 2010. 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).

Repealed regime. Effective for decedents dying on or after January 1, 2010, and on or before December 31, 2010, EGTRRA would have repealed the stepped-up basis rules and replaced them with a modified carryover basis regime. Generally, the income tax basis of property acquired from a decedent would have been carried over from the decedent. EGTRRA allowed 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).

H.R. 4154 permanently extends the top federal estate tax rate of 45 percent and the $3.5 million exclusion ($7 million for married couples)

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 $900 in capital gains. Under a carryover basis regime, assuming the general basis step up amount of $1.3 million was not available, the father's basis of $100 would have become Sam's basis.*

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 permanent end of any consideration of carryover basis is being greeted by most executors, beneficiaries, and their accountants with great relief, in terms of both the potential tax and the bookkeeping nightmares that would likely have ensued. If EGTRRA were to continue, all estates with more than $1.3 million built-in appreciation of assets would be saddled with carryover basis rules, which even preliminary guidance had shown to be extremely complex. With most inherited property treated as capital assets, heirs (except those in the lowest tax brackets) would have been paying at least 15 percent on decedent-allocated appreciation upon sale of an asset (or 20 per-*

Unified Rate Schedule: Gift and Estate Tax

A Taxable amount over	B Taxable amount not over	C Tax on amount in column A	D Rate of tax on excess over amount in column A Percent
$ 0	$ 10,000	$ 0	18
10,000	20,000	1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	....	555,800	45

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cent under the Obama Administration's plans to raise the capital gains rate on higher-bracket taxpayers after 2010).

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 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 is $3.5 million for decedents dying in 2009 and later years. 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 extent the value of the gift or gifts given to any particular person during a calendar year exceeds the statutorily provided annual 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 (which may be offset by the lifetime credit against gift tax, which is $345,800 based on an applicable exclusion amount of $1 million).

Comment Transfers between spouses made during lifetime are free from gift tax. The first $133,000 of gifts in 2009 ($134,000 in 2010) to a non-citizen spouse is generally not subject to gift tax. These rules continue under the House bill.

GENERATION-SKIPPING TRANSFER TAX

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).

The GST tax is imposed on every generation-skipping transfer. A GST may take one of three forms: a taxable termination, a taxable distribution, or a direct skip. A GST can also arise from a disclaimer of property.

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.

Example *Claire makes a lifetime taxable gift to her grandson of $1.5 million. 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.*

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

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.

State death tax deduction

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 repealed 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.

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