BETH SHAPIRO KAUFMAN

Finally, Legislation! Congress Kicks the Can Down the Road

Unless you have been living under a rock, you know by now that Congress enacted legislation in December 2010 that avoided the reversion of the estate and gift taxes to pre-2001 levels.[1] The legislation contained some unexpected gifts: a $5 million exemption level and 35% rate, along with reunification of the estate and gift tax and portability of the unified credit. It was also booby trapped: None of the Act's provisions are permanent; Congress merely kicked the can down the road by moving the EGTRRA sunset provision from 12/31/2010 to 12/31/2012.

Did we avoid the train wreck?

In prior columns,[2] I warned of the potential of a train wreck at the end of 2009, but in reality there were two train wrecks to be averted:

1. The Democrats did not want the one-year repeal to occur.
2. The Republicans (and others) did not want the law to revert to pre-EGTRRA law on 1/1/2011.

When looked at that way, the Republicans clearly won this round. They ended up with the full benefit of the one-year repeal for 2010 and avoided reversion to pre-2001 law for 2011 and 2012. Thus the answer to the question, "Did we avoid the train wreck?" is "yes and no."

The consequences of the one-year repeal have been well documented in the press. Several notable deaths occurred in 2010—including Yankees owner George Steinbrenner[3] (estimated to have been worth over a billion dollars) and energy magnate Dan Duncan[4] (estimated to have been worth $9 billion)—and those estates have forever escaped federal estate tax at this generation. The losses to the federal government run in the billions of dollars. In fact, it can be expected that the losses are greater than the $25 billion of revenue that was collected in 2008 because presumably some estates that would have deferred estate tax through the use of a marital deduction have instead avoided estate tax for the generation through disclaimers and other planning techniques, some of which may have served to avoid tax in future generations as well. (For statistics on transfer tax receipts in selected years, see Exhibit 1.)

Similarly the losses from the two-year compromise to increase the estate tax exemption to $5 million in 2011 and 2012 are easy to quantify. Because most 2011 decedent's estates would not pay estate tax until 2012, that is a good year to examine. According to estimates, the estate tax with a 55% rate and a $1 million exemption would have produced revenue of approximately $57 billion in 2012.[5] By comparison, the estate tax that will actually be in effect will produce about $13 billion in revenue in 2012.[6] Thus over a 24-month period, the 2010 changes will lose about $88 billion in revenue.

Did TRA10 at least solve the technical problems with EGTRRA?

TRA10 resolved most of the technical problems with the end of EGTRRA and the repeal year. The solution came largely in the form of two provisions in the legislation:

1. With respect to 2010 decedents, TRA10 provides a $5 million exemption and a 35% rate as the default law.
2. If the estate prefers, however, it may elect to have the provisions of EGTRRA—no estate tax and a modified carry-over basis—apply.

With this solution, Congress avoided the constitutional challenge

BETH SHAPIRO KAUFMAN, of the District of Columbia and Maryland Bars, is a partner in the Washington, D.C., office of the law firm of Caplin & Drysdale, Chartered. She is also a Fellow of the American College of Trust and Estate Counsel, and has written and lectured extensively on estate planning.

EXHIBIT 1
Actual and Projected Number of Taxable Estates and Revenue Produced from the Estate, Gift and Generation Skipping Transfer Taxes in Selected Years

Year	Number of Taxable Estates	Percent of Deaths	Tax Receipts (in billions)
1940	12,907	1.04	.357
1950	17,411	1.33	.698
1961	45,439	2.93	1.606 (est)
1970	93,424	5.20	3.644
1977	139,115	7.65	5.0 (est)
1990	23,215	1.08	11.500
2000	51,159	2.12	29.010
2004	19,294	.80	24.831
2007 (est)	17,100	.67	27.0
2009 (est)	9,600	.39	21.8
2010 (est)	- 0 -	- 0 -	19.0
2011 (est)	6000	.24	12.0

Sources: "History, Present Law and Analysis of the Federal Wealth Transfer Tax System," Joint Committee on Taxation, JCX-108-07 (11/13/2007); "Summary Tables, S-3 Adjusted Baseline by Category, Fiscal Year 2012 Budget of the U.S. Government," Office of Management and Budget.

that surely would have been brought had it attempted to reinstate the estate tax retroactively for all 2010 decedents. Congress also eliminated the complaint that some 2010 decedent's estates (e.g., those with just under $3.5 million in assets, low basis, and no surviving spouse) were better off under 2009 law than under the repeal provisions of EGTRRA. By providing those estates with a $5 million exemption, a 35% rate, and the normal basis rules under Section 1014, no decedent would be worse off in 2010 than in 2009.

As discussed here in my December 2010 column,[7] the most complex issues for 2010 under EGTRRA pertained to the one-year repeal of the generation-skipping transfer (GST) tax. TRA10 also resolved those issues by reinstating the GST tax for 2010 but setting the rate at 0%. That simple change provided answers to issues of whether there was a transferor, whether exemption could be used, and whether the relief provisions (i.e., qualified severance, 9100 relief, and substantial compliance) continued to be available. All of these issues were resolved favorably to the taxpayer, providing both certainty and a good outcome.

Did TRA10 solve all of the problems?

Not all of the EGTRRA issues have been resolved, however, and TRA10 did manage to create a new issue of its own. The unresolved issue is with respect to the sunset language itself, which remains with all of its ambiguities. In fact, the only change the draftsmen made to the sunset language was to change "December 31, 2010" to "December 31, 2012." As a result, we still do not know what the sunset provision means when it says that after 12/31/2012, it shall be "as if" EGTRRA and TRA10 "had never been enacted."

The TRA10 experience does give us comfort on two levels. First, if Congress acts to make permanent the provisions of TRA10, the sunset provision will not be effective. In that situation, we will not need to know what it means. Second, it seems that Congress, in TRA10, went out of its way to make sure that taxpayers were not adversely affected by the end of EGTRRA. Thus, if Congress remains similarly benevolent, we can assume that the "had never been enacted" language of TRA10 will also be construed generously to make sure that taxpayers receive all of the benefits bestowed by law in the 2001 to 2012 period.

Hopefully that philosophy also will carry over to another new technical problem created by the sunset provision in TRA10. The new problem, known as the "clawback" problem, raises the possibility that a person who takes advantage of the $5 million gift tax exemption in 2011 or 2012 could lose the benefit of that exemption at death in the calculation of the adjusted gross estate if the estate tax exemption is less than $5 million at the time of death. In other words, in com-

1 The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, P.L. 111-312 (12/17/2010) (referred to herein as "TRA10").

2 Kaufman, "Estate Taxation in 2009: Avoiding the Train Wreck," 36 ETPL 37 (July 2009); Kaufman, "2010: The Anatomy of a Train Wreck," 37 ETPL 42 (May 2010).

3 Mayores and Mayores, "Steinbrenner Goes Out a Real Winner," Forbes 7/20/10.

4 Saunders, "Too Rich to Live," Wall St. J. 7/10/2010; Kocieniewski, "Legacy for One Billionaire: Death But No Taxes," N.Y. Times, 6/8/2010.

5 "History, Present Law and Analysis of the Federal Wealth Transfer Tax System," Joint Committee on Taxation, JCX-108-07 (11/13/2007).

6 "Summary Tables, S-3 Adjusted Baseline by Category, Fiscal Year 2012 Budget of the U.S. Government," Office of Management and Budget.

7 Kaufman, "Happy New Year: Out With the Old, In With the . . . Older!," 37 ETPL 43 (December 2010).

puting the estate tax due, the adjusted taxable gifts are added to the assets included in the estate, and a tentative tax is calculated on that sum. The gift tax "payable" on the gifts is computed and subtracted from the tentative tax.[8] Only after those computations is the exemption amount in effect for the year of death subtracted. The concern about this issue is fueled primarily by the current worksheet in the Form 706 instructions, which follows the steps just outlined.

A worksheet is only a worksheet; it is not the law. However, the statutory language is ambiguous and not comforting. The Code makes it clear that the "gift tax payable" is not necessarily the gift tax paid, but rather the amount that would have been paid if the estate tax rates in effect at the date of death had been applicable to the gifts at the date of the gift. What is not clear is whether the exemption in effect at the date of the gift is given any effect.

Neither the legislative history nor private discussion with staff indicates that Congress had any intention to use the sunset provision to take away the benefit of the $5 million gift tax exemption in effect for 2011 and 2012. Nevertheless, if the exemption level does decline for 2013 or thereafter, a technical correction likely will be needed unless the IRS acts quickly to clarify the ambiguity.

Where are we going?

There are at least four possible roads Congress could follow for 2013 and beyond. Which road is taken will be determined by a combination of factors, including the prognosis for and outcome of the 2012 presidential and congressional election, the budget deficit, and—hopefully—good tax policy.

1. *Extend 2012 law (or some close variant of it) permanently.* Permanent extension of 2012 law is probably the resolution that most people expect. This solution would represent a compromise position between those who want repeal of the estate tax and those who feel that the estate tax is an important part of our progressive tax system. Whether compromise is achievable probably turns on the projected and actual outcomes of the 2012 elections. If we end up with a divided Congress, or a president from one party and at least one chamber of Congress led by the other party, some sort of compromise will be required.

One interesting phenomenon to note is the shift of the range of this debate over time. In 2001, Republicans argued for repeal of the estate tax, and most Democrats supported its continued existence with a $1 million exemption. By the time of the 2008 Presidential election, most of the Democratic candidates for President were arguing for retention of the status quo, which at the time was a $2 million exemption and a 45% rate. President Obama's budget proposal released this February, however, treats 2009 law as a baseline, effectively moving the left end of the spectrum to $3.5 million and a 45% rate. Notably, Republican candidates in the 2008 primary other than Sen. McCain all supported repeal. Sen. McCain advocated for a $5 million exemption and a 35% rate. In other words, the Democrats have gradually given up ground to the point that President Obama seems to have accepted $3.5 million and 45% as his expectation of the law in 2013, whereas the majority of those in the Republican party continue to advocate for repeal.

2. *Extend 2012 law for two years.* No one actually likes the idea of extending current law on a two-year basis, but there are scenarios in which this could happen. Congress generally looks at the ten-year revenue impact of any bill under consideration. The ten-year cost of extending 2012 law could be as high as $500 billion, depending on what is used as the baseline for revenue costs. Given the increased focus on our country's deficit, Congress may find it difficult to forego that level of revenue, amounts that otherwise would be paid by the richest 2% of the population dying in those years. In that case, it is possible that Congress could agree to a lower cost measure: adding the estate tax to the ever-growing list of extender items and authorizing its continued existence at 2012 levels for only two years.

If this seems inconceivable, consider that it is essentially the action taken by Congress and the President in December 2010. This result would give no certainty to taxpayers and would continue to disrupt the ability to do orderly estate planning. Notwithstanding these drawbacks—and we should be used to uncertainty by now!—budgetary considerations could drive Congress to this outcome.

3. *Return to pre-2001 law.* A third possible outcome is gridlock, that is, the inability to agree on any new law, resulting in a return in 2013 to a $1 million exemption and a 55% rate. This could occur temporarily, for example, during a lame-duck period, or it could reflect a deeper irreconcilable conflict that leads to the inability to pass any legislation in this area. Budgetary as well as political considerations need to be accounted for in determining the likelihood of this outcome.

The gridlock result would be a reprise of what happened in December 2009, when the House passed legislation to continue 2009 exemption levels and rates into 2010, overriding the one-year repeal on the books, but the Senate declined to vote on the measure. Here, howev-

[8] Section 2001(b).
[9] Summary Tables, *supra* note 6.

er, gridlock would result in high rates and low exemptions, not repeal, so the positions of the parties would likely be reversed. A difference of opinion on budgetary concerns could also lead to gridlock, as could an election outcome that results in a change of power. Note that gridlock is the only outcome that brings the sunset and clawback issues into focus because presumably legislation of any sort would resolve those issues. In short, as much as we dislike the outcome, gridlock must be considered a real possibility.

4. *Repeal.* The final possibility for 2013 is repeal. While many commentators feel that repeal is no longer a possibility, I think otherwise. The greatest obstacle to repeal over the past decade has been the revenue loss. With an exemption level of $5 million and a maximum rate of 35%, along with portability, the expected annual revenues from the estate tax have fallen to approximately $13 billion.[9] At a "mere" $13 billion of annual revenue, opponents of the estate tax will argue that the governmental costs of enforcement and the private costs of estate planning militate in favor of repeal of the estate tax. The costs of administering the estate tax, they will argue, outweigh the revenue benefits.

If revenue is a concern, repeal could open the door to other forms of taxation. We have already seen that carryover basis is unpopular. Twice it has been enacted, and twice it has been repealed. Other reform possibilities include taxation of capital gains at death and treating inheritances as income. Either of those options would be administrable through the existing income tax system and would not require the governmental infrastructure of a separate estate tax. Nevertheless, imposition of an income or capital gains tax at death seems highly unlikely in the present political climate.

When are we going to get there?

The timing of the potential legislation is also up in the air. Congress is unlikely to take up the estate tax issue before the November 2012 elections. As was the case in 2006, politicians will probably conclude that complaining about an opponent's position on the estate tax makes a better campaign speech than does bragging about a compromise. Political considerations clearly weigh in favor of delaying addressing the estate tax issue until after the election.

Once we get past November 2012, it would seem unlikely that a lame-duck Congress would pass a bill regarding the estate tax, but I would have said the same thing about 2010 and Congress did just that. The likelihood of that sequence of events repeating itself turns on the outcome of the November 2012 elections.

If the issue is not resolved before the end of the 2012 year, look for legislation of some sort in January or February 2013, after the inauguration, and retroactive to 12/31/2012. In my judgment, that is the most likely scenario for the timing of the legislation. ■