SMALL BUSINESS LEGISLATIVE COUNCIL

ESTATE TAX RELIEF

STATUS

The American Taxpayer Relief Act (ATRA), Public Law 112-240, signed into law on January 2, 2013 made permanent all of the provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA), with the exemption of increasing the top marginal estate tax rate to 40 percent.

The exemption is$5 million per person and $10 million per couple, indexed. The exemption amount was indexed beginning in 2012 and was $5,120,000. For 2013, it is $5,250,000.

The executor of a deceased spouse's estate is allowed to transfer any unused exemption to the surviving spouse.

Prior to the 2003 changes, the estate and gift taxes were unified, creating a single graduated rate schedule for both. That single lifetime exemption could be used for gifts and/or bequests. The 2003 changes decoupled these systems. Tthe estate and gift taxes have been reunified.

THE STATE OF THE LAW

In General

In general, a gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation skipping transfer tax generally is imposed on certain transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

Exemption equivalent amounts and applicable tax rates

Before 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single effective exemption amount of the unified credit applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.

The estate tax applicable exclusion amount is $5 million and is indexed for inflation and the maximum estate tax rate is 40percent. For gifts, the gift tax is reunified with the estate tax, with an applicable exclusion amount of $5 million indexed and a top estate and gift tax rate of 45 percent.

The generation skipping transfer tax rate for transfers is equal to the highest estate and gift tax rate in effect - 40 percent.

<u>Basis in property received</u>

In general

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property, with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Basis in property received by lifetime gift

Property received from a donor of a lifetime gift generally takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of the gift.

Basis in property received from a decedent

Property passing from a decedent generally take a "stepped-up" basis. In other words, the basis of property passing from such a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up in basis generally eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death. If the value of property on the date of the decedent's death was less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent's estate. This stepped-down basis eliminates the tax benefit from any unrealized loss.

<u>State death tax credit; deduction for State death taxes paid</u>

A credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes ("death taxes") actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which is 16 percent, based on the size of the decedent's adjusted taxable estate. Most States impose a "pickup" or "soak-up" estate tax, which serve to impose a State tax equal to the maximum Federal credit allowed.

Exclusions

Gift tax annual exclusion

Donors of lifetime gifts are provided an annual exclusion of $13,000 (for 2012) on transfers of present interests in property to each donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $26,000 for 2012.

Transfers for spouses

Portability of unused exemption between spouses

Any applicable exclusion amount that remains unused as of the death of a spouse (the "deceased spousal unused exclusion amount"), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount. If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the lesser of $5,000,000 (indexed) or the unused exclusion of the last such deceased spouse. A surviving spouse may use the predeceased spousal carryover amount in addition to such surviving spouse's own $5,000,000 (indexed) exclusion for taxable transfers made during life or at death.

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the estate of the predeceased spouse otherwise is required to file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, the Secretary of the Treasury may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse.

Transfers to a surviving spouse

A 100-percent marital deduction generally is permitted for estate and gift tax purposes for the value of property transferred between spouses. Transfers of "qualified terminable interest property" are eligible for the marital deduction. "Qualified terminable interest property" is property: (1) that passes from the decedent; (2) in which the surviving spouse has a "qualifying income interest for life"; and (3) to which an election applies. A "qualifying income interest for life" exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse's life; and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

Provisions affecting small and family-owned businesses and farms

Special-use valuation

For years when an estate tax is in effect, an executor may elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business real property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years immediately preceding the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction

An estate is permitted to deduct the adjusted value of a qualified family-owned business interest of the decedent, up to $675,000. (The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of $675,000 is elected, then the unified credit effective exemption amount is $625,000, for a total of $1.3 million. Because of the coordination between the qualified family-owned business deduction and the unified credit effective exemption amount, the qualified family-owned business deduction would not provide a benefit in any year in which the applicable exclusion amount exceeds $1.3 million.) A qualified family-owned business interest generally is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns, in the case of the 70-percent and 90-percent rules, at least 30 percent of the trade or business.

To qualify for the deduction, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death. The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death within which a disqualifying event occurred.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period can be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

Installment payment of estate tax for closely held businesses

Estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1.34 million (as adjusted annually for inflation occurring after 1998; the original amount for 1998 was $1 million) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of $1.34 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (i.e., 45 percent of the Federal short-term rate plus two percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

For purposes of these rules an interest in a closely held business is: (1) an interest as a proprietor in a sole proprietorship; (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership was included in the decedent's gross estate or the partnership had 15 or fewer partners; and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation was included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

The decedent may own the interest directly or, in certain cases, indirectly through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the two-percent interest rate do not apply. The value of any interest in a closely held business does not include the value of that portion of such interest attributable to passive assets held by such business.

Effective for estates of decedents dying after December 31, 2001, EGTRRA expanded the definition of a closely held business for purposes of installment payment of estate tax. EGTRRA increased from 15 to 45 the maximum number of partners in a partnership and shareholders in a corporation that may be treated as a closely held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

Generation-skipping transfer tax rules

In general

A generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (as defined above). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption generally equal to the estate tax effective exemption amount is provided for each person making generation skipping transfers.

The generation skipping transfer tax exemption for decedents dying or gifts made is equal to the applicable exclusion amount for estate tax purposes ($5 million indexe). Therefore, up to $5 million (indexed) in generation skipping transfer tax exemption may be allocated to a trust created or funded, depending upon the amount of such exemption used by the taxpayer. The generation skipping transfer tax rate for transfers is equal to the highest estate and gift tax rate in effect.

The exemption may be allocated by a transferor (or his or her executor) to transferred property. A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. Natural persons or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation skipping transfer tax exemption to a trust prior to the taxable distribution, generation skipping transfer tax may be avoided.

The tax rate on generation skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred in a generation skipping transfer indicates the amount of "generation skipping transfer tax exemption" allocated to a trust. The allocation of generation skipping transfer tax exemption effectively reduces the tax rate on a generation skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

For lifetime transfers made to a trust that were not direct skips, the transferor had to make an affirmative allocation of generation skipping transfer tax exemption; the allocation was not automatic. If generation skipping transfer tax exemption was allocated on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time of the transfer.

If, however, the allocation was not made on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time the allocation of generation skipping transfer tax exemption was made.

An election to allocate generation skipping transfer tax to a specific transfer generally may be made at any time up to the time for filing the transferor's estate tax return.

HISTORY

Some form of the estate tax has been used as a revenue-raiser over the past two centuries. Each of the four times the estate tax was enacted was to raise money to help with our nation's defense. In three of the instances, the Quasi-War with France at the end of the 18th Century, the Civil War, and the Spanish American War at the end of the 19th Century, the tax was repealed after it was no longer needed. However, after the fourth time it was created, under the Revenue Act of 1916, a year before the U.S. entered World War I, it was not repealed, as the federal government realized that there are numerous ways to spend our money even after the original need passes. This law set the top rate at 10 percent for estates valued over $5 million and provided a $50,000 exemption. A year later, under the Revenue Act of 1917, the top rate increased to 25 percent on estates worth more than $10 million.

In response to this tax, individuals began to give their money away before they died to avoid any tax. The federal government responded by passing the Revenue Act of 1924, which established a gift tax. The gift tax included a lifetime exclusion of $50,000 and $500 annually per recipient. This bill also increased the top rate on estates over $10 million to 40 percent. However, the gift tax was repealed a couple of years later and the estate tax rate was reduced to 20 percent on estates worth more than $10 million. The exemption was also increased from $50,000 to $100,000.

The estate tax became particularly burdensome during the Presidency of Franklin Roosevelt. Under the Revenue Act of 1932, the estate tax exemption went back to $50,000, with the remaining estates were taxed at a graduated rate ranging from 1 percent on estates worth up to $100,000 to 45 percent on estates above $10 million. This bill also reestablished the gift tax at a rate of 75 percent of the estate tax. The lifetime exclusion was again set at $50,000 with an annual exclusion of $5,000 per recipient.

The top rate was increased again in 1934 to 60 percent and then to 70 percent on estates over $50 million a year later. The 1935 tax measure also reduced the exemption for both estates and gifts to $40,000. During World War II, President Roosevelt signed into law the Revenue Act of 1940, which added a 10 percent surtax to the income, estate, and gift taxes. The following year, he signed into law the Revenue Act of 1941, which produced a graduated estate tax rate from 3 percent on estates worth less than $5,000 to 77 percent on estates over $50,000,000. The gift tax experienced similar increases, as it remained at 75 percent of the estate tax rate.

The estate tax and the gift tax were officially unified under the Tax Reform Act of 1976. This legislation created a single, graduated tax rate imposed on both lifetime gifts and testamentary dispositions. The estate and gift tax rates were graduated to a maximum tax rate of 70 percent on cumulative gifts or taxable estates of more than $5,000,000. Furthermore, it set the exemption at $161,000 before 1980 and $175,625 thereafter.

In 1981, President Reagan signed into law the Economic Recovery Tax Act, which increased the exemption from $175,625 to $600,000 over a six-year period. The law also reduced the top rate from 70 percent to 50 percent over a three-year period on estates worth more than $2.5 million. However, this reduction was halted by the Deficit Reduction Act of 1984, which froze the top rate at 55 percent.

The Taxpayer Relief Act of 1997

In 1997, President Clinton signed into law the Taxpayer Relief Act, which would increase the exemption from $600,000 to $1 million by the year 2006. This bill created the Qualified Family-Owned Business Interest (QFOBI) provision, which protected from the estate tax $1.3 million in assets for farms and closely-held businesses. This provision expired in 2003. (However, it will be automatically revived in 2013, as explained above.)

The requirements for businesses to qualify for this exemption included: the family business must comprise at least half of the estate; the business must be passed to qualified heirs defined as family members or people employed by the business for at least 10 years prior to death; the business must be 50 percent owned by one family, 70 percent owned by two families or 90 percent owned by three families, as long as the decedent's family owns 30 percent of the business; (Family is defined as the spouse, ancestors, and lineal descendants of the individual, the individual's spouse, parents, and the spouses of the lineal descendants.) the decedent or a member of his family must have owned and materially participated in the business for a least five of the last eight years preceding death; and, each qualified heir, or a member of their family, must materially participate in the business for at least five of eight years after the decedent's death. Publicly-traded companies did not qualify.

Although QFOBI may look reasonable on paper, in practice it was a failure. Because it is so complex and vague, less than 3 percent of family-owned businesses were able to take advantage of QFOBI. In 1998, only 173 of 97,856 estate tax returns used QFOBI. In 1999, only 889 of 103,979 estate tax returns used QFOBI. In 2000, only 1,470 of 108,322 estate tax returns used QFOBI.

Economic Growth and Tax Relief Reconciliation Act of 2001

One of the top priorities for President Bush, dating back to his initial campaign in 2000, had been to ease the tax burden on American citizens. He immediately followed through on this pledge when he signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Among other things, this law began the process of phasing out the estate tax until its full repeal in 2010. However, the estate tax would return to its pre-EGTRRA levels of a 55 percent tax rate and a $1 million exemption in the year after full repeal. (In 2001, the exemption was $675,000 but under the then existing law it was scheduled to rise to $1 million in 2006.)

TAX AND ECONOMIC BACKGROUND

Since 1977, generally about 1 percent to 2 percent of adults who died each year have left estates large enough to be taxable. In 2000, before EGTRRA was enacted, 51,200 estates were taxable, representing 2.2 percent of adult deaths in that year. EGTRRA reduced the percentage of estates that were taxable. For example, 17,400 taxable estate tax returns were filed in 2007; most were for deaths in 2006, when the effective exemption amount was $2 million, representing about 0.7 percent of adult deaths in that year.

Larger estates pay a significant portion of the estate tax. In 2007, taxes on gross estates valued at more than $20 million were 36 percent of total estate taxes for that year, and taxes on gross estates valued at more than $10 million accounted for 55 percent of total estate taxes.

About 2.1 percent of farmers (1,137) and 2.4 percent of small-business owners (8,291) who died in 2005 had to file estate tax returns.

Since 1945, estate and gift tax receipts have consistently remained near or below 2 percent of federal revenues. In recent years, they have been less than 1.5 percent of federal tax revenues. Under current law, revenues from estate and gift taxes will total $420 billion, or 1.2 percent of revenues, over the 2010–2019 period, CBO forecasts. About $364 billion (87 percent) of that total is from estate tax receipts, and $56 billion (13 percent) is from gift tax receipts.

Congress' Joint Committee on Taxation surveyed what other countries do and found that inheritance tax is more common than an estate tax, as is imposed in the United States. An inheritance tax generally is imposed on the heir who receives a bequest the tax generally depends upon the size of the bequest received. The United States also imposes a generation-skipping tax in addition to any estate or gift tax liability on certain transfers to heirs two or more generations younger. This effectively raises the marginal tax rates on affected transfers. Countries that impose an inheritance tax do not have such a separate tax but may impose higher rates of inheritance tax on bequests that skip generations.

The committee compared total revenue collected by selected countries from estate, inheritance, and gift taxes to total tax revenue and to gross domestic product ("GDP") to attempt to compare the economic significance of wealth transfer taxes in different countries. Among these selected countries, in 2005, Belgium, Finland, France, Japan, the Netherlands, Spain, and the United Kingdom collected more such tax revenue as a percentage of the GDP than did the United States. Denmark, Germany, Ireland, Korea, Luxembourg, and Switzerland collected modestly less revenue from such taxes as a percentage of the GDP than did the United States. The remaining 16 countries collected less than half as much revenue as a percentage of GDP from such taxes as did the United States. As a percentage of tax revenue, Belgium, France, and Japan relied more heavily on their estate, inheritance, and gift taxes as a revenue source, although the Netherlands, Spain, and the United Kingdom each collected at least seven-tenths of one percent of total tax revenue from estate, inheritance, and gift taxes.