

THE FEDERAL ESTATE AND GIFT TAX: A CASE STUDY IN UNCERTAINTY

Beth Shapiro Kaufman

This paper uses the Federal estate and gift tax to illustrate the existence of uncertainty in the tax law. After a brief description of the historical circumstances of these taxes and recent legislation, two examples of the effects of uncertainty are discussed. Finally, the negative consequences of uncertainty in the tax law are explored.

Keywords: estate taxation, gift taxation, uncertainty

JEL Codes: H2, H24, K34

“In this world nothing is certain but death and taxes.”

– Benjamin Franklin, in a letter to M. Leroy, 1789

Since the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), nothing has been certain in the estate tax area. EGTRRA put into place a series of changes in rates and exemption levels, but also provided for a one-year repeal of the estate tax for 2010 only, elimination of the state death tax credit, and a complete sunset of all of the changes in the Act on January 1, 2011. Had the sunset provision taken effect on January 1, 2011, it would have reduced the exemption amount from a high of \$3.5 million to \$1 million (plus some indexing), and increased the top marginal rate from 45 to 55 percent. Only days before the sunset would have occurred, Congress acted to move the sunset date back two years, so that those changes are now slated to occur on January 1, 2013. For the estate tax, this seems to be the decade of uncertainty.

I. HISTORICAL PERSPECTIVE

Historically there have been many changes in the estate tax; the exemption level has only increased over time, while rates have trended down since World War II.¹ The estate tax was first adopted by Congress in 1916. Prior to the imposition of the first federal

¹ A concise history of the wealth transfer tax system in the United States is available in Joint Committee on Taxation (2007).

estate tax, taxes at death had been the purview of the states, and the first federal foray into the area was a modest one. The first estate tax featured an exemption of \$50,000 and rates ranging from 1 to 10 percent. To help fund the war effort, the top estate tax rate was increased to 25 percent on assets in excess of \$10 million in 1917.

In 1924, the top estate tax rate was increased to 40 percent with a credit for state death taxes of up to 25 percent, but in 1926, the maximum rate was decreased to 20 percent with an 80 percent credit for state death taxes and a \$100,000 exemption. The decrease was only temporary, however, and when other sources of revenue declined during the depression, the top rate soared to 60 percent in 1934 and 70 percent in 1935. The exemption was reduced to \$40,000.

To help fund World War II, estate tax rates were increased again in 1940 and in 1941, bringing the top marginal rate to 77 percent, where it remained for 35 years. The gradual decline in rates began with the Tax Reform Act of 1976, which brought the top rate down to 70 percent. The Economic Recovery Act of 1981 put into place further rate reductions so that by 1985 the maximum rate was 50 percent, however the rate reduction to 50 percent was delayed by subsequent legislation, leaving the maximum rate at 55 percent through 2001. The 1981 Act also gradually increased the exemption amount to \$600,000 in 1987. The Taxpayer Relief Act of 1997 provided for further increases in the exemption amount to \$1 million in 2006.

II. RECENT HISTORY

With considerable popular support, Congress enacted EGTRRA in June 2001, which further reduced the top estate tax rate to a low of 45 percent in 2009, and increased the exemption level to a high of \$3.5 million.² In addition, EGTRRA called for repeal of the federal estate tax in 2010, but only for that one year, due to the inclusion of a sunset clause designed to prevent revenue losses outside of the 10-year budget window. Absent action by Congress, all of EGTRRA would sunset on December 31, 2010 and prior law — in this case a top estate tax rate of 55 percent and an exemption level of \$1 million — would be restored.

In 2001, most commentators believed that Congress would act well in advance of 2010 to avoid both the year of repeal in 2010 and the reversion to 2001 rates and exemption levels in 2011. As things developed, most commentators were wrong. Attempts to arrive at a compromise in 2005 were interrupted by Hurricane Katrina. By the time Congress was done dealing with the hurricane's destruction and all of the accusations of wrongdoing by FEMA, the momentum for compromise had been lost. The political climate did not allow another serious effort to avoid the repeal, despite a last-ditch effort by the House of Representatives in December 2009. On January 1, 2010, the estate tax — along with the generation skipping transfer tax — was temporarily repealed.

² A table summarizing the year-by-year changes in the estate tax under EGTRRA is included in Congressional Budget Office (2009).

The uncertainty wrought by repeal was made worse by constant rumors that Congress might retroactively restore the estate tax. As the months passed, it became increasingly clear that Congress was not going to act and there would in fact be a year of repeal, creating numerous incentives for tax planning. Not only was there no estate tax for the year (although planning to die was an idea that all advisors were hesitant to recommend), but the gift tax applied at the historically low rate of 35 percent (with a \$1 million exemption).

At the end of the repeal year, EGTRRA was scheduled to sunset, which would have caused the exemption level to decline and the rates to increase for the first time since World War II. This time, however, Congress intervened to postpone the sunset. On December 17, 2010, the President signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which put the estate tax back into place for 2011 and 2012 with a \$5 million exemption and a 35 percent maximum rate. In addition, because EGTRRA had tied the repeal of the estate tax to a modified carryover basis capital gains tax regime, some estates could owe more overall tax with a decedent dying in 2010 than they would have had the decedent died in 2009. To avoid that result, Congress reinstated the estate tax for 2010 with a \$5 million exemption and 35 percent rate, but provided an election for an estate to opt for the repeal provisions of EGTRRA instead. For most very high net worth decedents, EGTRRA produced a lower overall estate tax bill and the 2010 Act allowed them to elect to keep the benefit of that law. Such uncertainty in estate tax law has given rise to several problems.

III. DRAFTING PROBLEMS CAUSED BY UNCERTAINTY

The estate tax provides for an unlimited marital deduction. Thus, a typical estate plan for a married couple with assets in excess of the amount that is exempt from estate tax is to put the exemption amount into a “credit shelter trust” (also sometimes referred to as a “bypass trust,” because the assets in that trust *bypass* the spouse’s estate), and leave the remaining assets to the surviving spouse either outright or in trust. Since the amount of exemption is always in flux, this division is typically written as a formula. Some attorneys draft a pecuniary marital bequest followed by a residuary bequest to the credit shelter trust, perhaps using language like: “fund the marital trust with the minimum amount necessary to reduce the estate tax to zero.” Other attorneys draft a pecuniary credit shelter bequest with the residuary going to the spouse, perhaps using language like: “fund the credit shelter trust with the maximum amount that can pass free of estate tax by reason of the unified credit.” In normal times, these two formulations would produce the same fundamental result.

During the repeal year, however, these two formulas produced dramatically different results. Consider a situation in which the decedent is survived by his second wife and children from his first marriage. The goal of the formula division in the will is to divide the estate between a trust for the children and a bequest to the second wife. If there is no estate tax, however, the two sample clauses above will produce dramatically different results.

If the marital bequest is funded with the minimum amount necessary to produce no estate tax, and there is no estate tax in effect, then the marital bequest receives nothing and the entire estate passes to the credit shelter trust. In that scenario, the second spouse gets no money and the children from the first marriage take it all — clearly not what the decedent intended! If the other formula is used — fund the credit shelter trust with the maximum amount that can pass free of estate tax by reason of the unified credit — the credit shelter trust would get no funding under 2010 law. In 2010, there was no unified credit in effect so the maximum amount that could pass free of tax by virtue of the unified credit was zero. In that scenario, the second spouse gets all of the money and the children from the first marriage are disinherited. Again, not the intended result! Because neither formula was drafted with the possibility of repeal in mind, neither formula produced the result anticipated by its drafter or the decedent.

In 2010, state legislatures in nearly half of the states tried to intervene to prevent unanticipated results from formula drafting for 2010 decedents, but those efforts also failed. Most of the legislation followed one of two models. First, several states provided that if there was no estate tax in 2010, formulas should be construed using the values in effect in 2009.³ The exemption level in 2009 was \$3.5 million. For an estate of \$5 million or \$7 million, the \$3.5 million assumption produced a reasonable result. But what about a decedent with an estate of \$100 million? The state legislation would have divided the \$100 million — \$3.5 million to the credit shelter trust and \$96.5 million to the marital bequest (to be taxed in a later year in the surviving spouse's estate). It seems highly unlikely that would be the result preferred by the decedent.

The second approach used by states was to allow extrinsic evidence of the decedent's intent.⁴ While in some cases there might be persuasive extrinsic evidence — a letter from the lawyer or illustrations provided to the client of the result at different wealth and exemption levels — in many cases there will be no extrinsic evidence other than an heir's statement that "Dad wanted to save taxes." A court would have difficulty dividing the \$100 million between the second spouse and the children from the first marriage on the basis of that statement.

The attempts to legislate a solution became even more murky when Congress in the Tax Reform Act of 2010 gave the estates of 2010 decedents the option to elect out of the estate tax. Because the estate tax *could* apply in 2010 if the election was not made, it was no longer clear whether some state savings statutes would apply under any circumstances.

IV. TO GIFT OR NOT TO GIFT

A second dilemma created by the uncertainty in 2010 was whether or not to make gifts. While the gift tax was not repealed in 2010, it was in effect with a 35 percent rate, a much lower rate than the effective rate in effect for the prior 70 years. If one

³ States that enacted this kind of savings legislation included Delaware, Michigan, New York, Pennsylvania, and Virginia (Zaritsky, 2011).

⁴ States that took this approach include Florida and South Carolina (Zaritsky, 2011).

believed that there would be an estate tax in effect at death and that the client had assets in excess of what the future exemption might be, making gifts in 2010 was desirable. If one believed that the estate tax might revert to a 55 percent rate and a \$1 million exemption, making gifts in 2010 was a splendid idea. When added to the normal advantages of gifts over bequests — the gift tax is a tax-exclusive tax while the estate tax is a tax-inclusive tax — taking advantage of the 35 percent rate seemed like a clearly beneficial strategy. Many attorneys recommended making gifts and paying gift tax, but most also recommended waiting until close to the end of the year.

No one predicted that the 2011 law might be even more favorable to taxpayers than that of 2010, but that is essentially what happened. In the Tax Reform Act of 2010, Congress extended the 35 percent gift tax rate for two more years, to gifts made in 2011 and 2012. However, for 2011 and 2012, the exemption level was increased to \$5 million in place of the \$1 million exemption in effect for 2010. Thus, a gift of \$3 million made on December 31, 2010, would cause the imposition of a \$700,000 gift tax, whereas the same gift made on January 1, 2011, would pass under the exemption and require no payment of tax.

For the ultra-wealthy, the new law was just another opportunity to make additional gifts and use the newly granted exemption, but some of the “merely wealthy” asked their attorneys if they could unwind their 2010 gifts and re-make them in 2011 to use the exemption rather than pay gift tax. The ability to rescind a gift depends on state law and the facts of the particular transfer. It might also be possible to undo a 2010 gift through the use of a qualified disclaimer. In most cases, however, it is demonstrable that the 2010 gift — even with the attendant requirement to pay tax — is advantageous from an estate planning perspective. Assuming the client has enough other assets to use the new exemption amount, the 2010 gift would only be disadvantageous if: (1) the estate tax is not in effect when the client dies; (2) the value of the gifted property declines; or (3) the gift and estate tax rate falls further. Unfortunately all of these future conditions are unknown, uncertain, and within the realm of possibility.

V. THE COSTS OF UNCERTAINTY

Uncertainty in the law is more than inconvenient. By enacting short-term solutions and retroactive statutes, Congress prevents taxpayers from planning their estates as they wish. Formula clauses are efficient from a tax perspective, but not if they thwart the taxpayer’s dispositive intentions. The uncertainties with respect to exemption amount, rates, and even whether there would be an estate tax in 2010 resulted in tortured interpretations of wills, the necessity for court construction of documents, intervention of state legislatures, and increased post-mortem planning by lawyers and accountants.

In planning post-EGTRRA and pre-2010, attorneys knew that there was uncertainty in the law. As a result, many documents drafted in that period were complex in an attempt to anticipate many possible outcomes. Even the complex drafting, though, could not anticipate the law that was finally enacted by Congress to govern in 2010. Because Congress has still not provided a long-term statute to govern the estate tax, drafting remains complex in order to try to allow for all possible contingencies. In addition,

complexity in drafting is not desirable. Complex provisions make it harder for taxpayers to understand what they are signing, and it increases the possibility of errors. It should not be necessary to have a 30-page will to fulfill a decedent's wishes to minimize taxes.

The two-year extension for 2011 and 2012 raises the possibility that estate taxes will join the ever growing list of so-called "extender items," tax provisions that are re-enacted every year or two for a short period of time. Clients should not have to review their estate planning documents every two years to make sure they have captured the latest nuance. Moreover, the continual need to revise documents supports the arguments of those who maintain that the costs of complying with the estate tax exceed its revenue value, so that the economy would be better off without the tax. From that perspective, providing stability in the estate tax area would help to preserve the law.

In the final analysis, perhaps uncertainty is being used as a tool to undermine the tax laws. Frequent changes in the law, which require new planning techniques and documents, encourage disrespect for the law, increase taxpayer costs, and create complexity; they thus can be used as arguments to encourage repeal of these taxes. The longer this uncertainty persists, the more this nefarious motivation appears to be a reasonable explanation of recent events. The more uncertainty, the greater the complexity; the greater the complexity, the more resentment toward the law; the more disrespect for the law, the greater the incentive to support repeal. If the goal, however, is to promote respect for and compliance with the law, uncertainty must be replaced with a long-term viable statute.

REFERENCES

Congressional Budget Office, 2009. *Federal Estate and Gift Taxes*. Economic and Budget Issue Brief. Congressional Budget Office, Washington, DC, http://www.cbo.gov/ftpdocs/108xx/doc10841/12-18-Estate_GiftTax_Brief.pdf

Joint Committee on Taxation, 2007. *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System*. JCX-108-07. Joint Committee on Taxation, Washington, DC.

Zaritsky, Howard M., 2011. "Issues for Electing Out of the Estate Tax for 2010 Decedents." *Probate Practice Reporter* 23 (2), 1-12.