OUTSIDE THE BOX ON ESTATE TAX REFORM: REVIEWING IDEAS TO SIMPLIFY PLANNING

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I thank you for inviting me to testify about simplifying planning to address the payment of federal estate taxes. I am testifying on my own behalf and do not speak for any other person, organization, or entity. My testimony is based on my 30 years' experience in private practice representing individual clients, particularly closely held business owners, and assisting my clients in planning to deal with the burden of federal gift, estate and generation-skipping taxes. (I will refer to these taxes collectively as "transfer taxes.")

I applaud this Committee's efforts to resolve this year the uncertainty concerning the transfer tax laws. Taxpayers can deal more effectively with the federal transfer tax burden on their property when taxpayers know what the law will be in the foreseeable future. I have heard many complaints from clients about being unable to plan for the federal transfer tax burden given the uncertainty under the existing transfer tax laws.

I will testify about two matters (1) the *Report on Reform of Federal Wealth Transfer Taxes*, which addresses numerous aspects of federal transfer taxes, and (2) an issue of importance to closely held business owners, the installment payment of estate taxes attributable to a closely held business under Internal Revenue Code section[1] 6166.[2]

REPORT ON REFORM OF FEDERAL WEALTH TRANSFER TAXES

I was the Chair of the Task Force on Federal Wealth Transfer Taxes which produced the *Report on Reform of Federal Wealth Transfer Taxes*. The Task Force was formed by seven organizations representing professionals who advise clients on federal wealth transfer taxes.[3] The Task Force members were some of the most knowledgeable professionals in the United States who advise clients in transfer tax planning. The organizations participating in the Task Force were:

- The American College of Trust and Estate Counsel,
- The American Bar Association Section of Real Property, Trust and Estate Law,
- The American Bar Association Section of Taxation,
- The American Institute of Certified Public Accountants,

- The American Bankers Association, and
- The American College of Tax Counsel.

The purpose of the Task Force was to produce a report that would provide expert analysis of the changes enacted by the Economic Growth and Tax Relief ReconciliationAct of 2001 (the 2001 Tax Act) regarding federal wealth transfer taxes. The Task Force did not consider policy questions having to do with the economic effects of a wealth transfer tax system as compared to other systems of taxation or whether redistribution of wealth was an appropriate goal of the transfer tax system. The Task Force's central concern was to assess on the basis of simplicity, compliance, and consistency of enforcement, the temporary repeal of the estate and generation-skipping transfer taxes, the phaseout period, the continuation of the gift tax after repeal, the modified carryover basis rule, and alternatives to federal wealth transfer tax repeal.

The Task Force prepared the Report to provide diverse views and perspectives on a wide range of issues concerning the current federal wealth transfer tax system and the changes the 2001 Tax Act made to that system. The Report suggested options that Congress may consider but did not make any specific recommendations for regulatory or legislative action. The Task Force members and sponsoring organizations support the analysis of the alternative solutions to the issues identified but did not endorse any specific solution.

I believe the two most significant changes suggested in the Report are:

- Reunification of the gift and estate tax systems, and
- Portability of the unified credit and the GST exemption.

The Task Force distributed a copy of the Report to each member of the Congressional tax writing committees and their staff. The Report can be found athttp://www.abanet.org/tax/pubpolicy/2004/04fwtt.pdf.

I hope that the Committee and its staff will call upon the Task Force as you consider changes to the federal wealth transfer tax system.

PAYING THE FEDERAL ESTATE TAX IN INSTALLMENTS ON CLOSELY HELD BUSINESS INTERESTS

Significance of Closely Held Businesses

Family owned businesses are a major part of the United States economy, making up 80 to 90 percent of all businesses in North America and contributing significantly (in excess of $5 trillion) to the United States Gross Domestic Product.[4] In a study of the companies making up the S & P 500, one study[5] found that one-third of these companies have deep family connections.[6] These families are heavily invested in the family business, and, on average, 69 percent of the family's total wealth is invested in the family enterprise. Because of the large, concentrated investment, family businesses operate in unique and efficient ways, including looking to the long term future of the business and the reputation of the family. The study also found that family businesses generally out-perform non-family businesses, posting a 6.65 percent greater return on assets than non-family businesses.[7]

The death of a closely held business owner often foretells the death of the business. Only 30 percent of all privately owned businesses survive past the first generation.[8]Although it is the goal of many business owners to transfer ownership of the business to future generations, only

12 percent of private businesses survive into the third generation, and a mere three percent are still in existence at the fourth generation and beyond.[9] There are many reasons for the lack of survival of closely held business for future generations including lack of succession planning, business failure, and inability to meet liquidity needs (some of which is caused by the federal transfer tax laws).

The Statistics of Income Division of the Internal Revenue Service produces data files from samples of tax and information returns filed with the Internal Revenue Service. The Statistics of Income Division publishes information on the number of returns filed, the amount of tax collected, and other tax return information. The Statistics of Income Division released recently a report entitled “Estate Tax Returns Filed in 2006: Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax and Tax Credits, by Size of Gross Estate.”[10]

The Statistics of Income Report showed that approximately 49,000 estate tax returns were filed in 2006 and approximately 15 percent (7,567) of the tax returns listed as an asset stock in one or more closely held businesses.[11]

The Statistics of Income Report also showed that those estates classified as the largest gross estates (greater than $20 million) held a higher percentage of stock in a closely held business than smaller estates. Approximately 50 percent of those estates greater than $20 million listed stock in a closely held business as an asset. In addition, the Statistics of Income Report showed that closely held stock was approximately five percent of the gross estate for all estates, but closely held stock constituted approximately 14 percent of the gross estate of estates greater than $20 million. It appears that for estate tax returns filed in 2006, the larger the estate, the more likely the estate will own a higher percentage of closely held stock. From a review of statistics for years before 2006, there is a similar pattern of ownership of closely held stock in prior years. Accordingly, notwithstanding that the assets that can pass free of federal estate tax is scheduled to increase to $3,500,000 in 2009, there will still be a significant number of closely held business owners who will be subject to federal estate tax and whose estates will need relief in the form of the installment payment provision.

Because of the illiquid nature of a closely held business, federal transfer taxes present a serious obstacle to a closely held business surviving the death of the business owner. The shortfall of sufficient liquid assets to pay the federal transfer taxes incurred as a result of the business owner’s death may necessitate a forced sale or liquidation of the business, thereby preventing the continuation of the business.

For many closely held business owners, the business represents the most valuable, and usually the most illiquid, asset in the business owner’s estate. During the business owner’s lifetime, the business is generally the primary vehicle of economic and emotional support for the business owner’s family. As the primary asset of the business owner’s estate, the business will be the source of funds to pay federal and state transfer taxes, debts, and administration expenses, as well as to pay for the support of the business owner’s surviving spouse and other dependents. With careful planning to ensure the availability of the installment payment provision, the family may be able to retain the business and not sell the business to meet liquidity needs. If the family is forced to sell the business, the sale may occur at an inopportune time, either because of external forces, such as a downturn in the economy, or internal forces, such as a lack of business succession planning, internal strife, and emotional distress.

There are several provisions of the Internal Revenue Code offering benefits to the estate of a closely held business owner, including sections 303, 2032A, 2057, and 6166.Section

303 provides an income tax benefit by allowing the transfer of assets from a closely held business for an amount equal to the federal and state estate taxes and costs of administration. Section 2032A provides an estate tax benefit by valuing real property (generally farm real property) for federal estate tax purposes at the use value of the real property instead of the fair market value of the property. Until section 2057 terminated in 2003, section 2057 provided an estate tax benefit by excluding $675,000 in value from certain family businesses. Section 6166, the installment payment provision, provides an estate tax benefit by allowing the installment payment of the federal estate taxes attributable to a closely held business interest over a 14-year period at a bargain interest rate.[12]

If certain stringent requirements are met, each of the above provisions can offer relief to the estate of a closely held business owner. Unfortunately, there are issues that make planning to meet the qualification for this relief uncertain. The purpose of my testimony is to discuss the issues that I believe Congress should address associated with the installment payment of estate taxes attributable to a closely held business.

History of Installment Payment of Estate Taxes Attributable to Closely Held Business Interests

In 1958, Congress provided the first installment payment provision for the estate tax attributable to closely held businesses by enacting section 6166. In the 1958 version,section 6166 provided payment in installments over nine years for the estate tax attributable to closely held business interests if the business interests constituted more than 35 percent of the decedent's adjusted gross estate or 50 percent of the decedent's taxable estate. The 1958 version of section 6166 did not provide any bargain interest rate.

In 1976, Congress expanded the installment payment relief by designating the 1958 version of section 6166 as new section 6166A and enacting a replacement section 6166. The new section 6166 expanded the installment payments by providing for a four-year period of interest only payments followed by ten equal payments of the federal estate tax (a fourteen-year deferral period) if the business interests constituted more than 65 percent of the decedent's adjusted gross estate. In addition, the 1976 version of section 6166provided for a bargain interest rate of four percent for a portion of the federal estate tax.

In 1981, Congress, as a part of the Economic Recovery Tax Act of 1981, repealed section 6166A and reduced the percentage test of qualifying for installment payments under section 6166. Under the 1981 version of section 6166, Congress changed the closely held business interest percentage test from 65 percent to 35 percent and retained the fourteen-year payout period. The Tax Reform Act of 1984 added a provision dealing with the treatment of stock of any holding company that represents direct or indirect ownership and a provision dealing with passive assets held by business entities.

The last significant change to the installment payment provision occurred in 1997 when Congress reduced the interest rates charged on the unpaid tax and increased the amount of unpaid tax eligible for the reduced interest rate. In exchange for the lower interest rates, Congress eliminated the federal estate and income tax deduction of the interest paid on the tax deferred under the installment payment provision. In 2001 Congress amended the installment payment provision to provide special rules for closely held business interests in qualifying lending and finance businesses and also amended the holding company rules.

Although installment payments of federal estate tax attributable to a closely held business can be a helpful alternative to a closely held business owner's estate, closely held business owners have encountered difficulties concerning the application, operation and interpretation of the installment payment provision. I have observed the following significant issues with the installment payment provision:

- **Closely Held Business Owners Need the Ability to Pay Estate Taxes in Installments**. Closely held business owners need the ability to pay the estate taxes attributable to their business interests in installments. Closely held businesses are illiquid and cannot be converted to cash. Without the ability to pay federal estate taxes in installments, some closely held businesses will fail.

- **Congress Should Modernize the Installment Payment Provision**. The installment payment provision has not kept pace with modern business practices. The installment payment provision addresses the corporate and partnership forms of doing business but does not address new forms of doing business such as limited liability companies, limited liability partnerships, or business trusts. A closely held business owner must select carefully the type of business entity for the business enterprise to preserve the ability for the business owner's estate to pay the estate tax in installments under the installment payment provision. Congress should modernize the installment payment provision to reflect the new forms of business entities and treat limited liability companies, partnerships, and business trusts the same as corporations.

- **Congress Should Cure the Inadequate Treatment of Holding Companies under the Installment Payment Provision**. Under modern business practices, closely held business owners will frequently use a holding company and subsidiary structure (referred to as "tiered entities") to conduct various business activities. The installment payment provision does not deal adequately with holding companies and tiered entities. Because of the complex and confusing holding company rules under the installment payment provision,[13] a closely held business owner needs to consult a knowledgeable (i.e. expensive) tax advisor when using a holding company structure so as to preserve the benefits of the installment payment provision.

- **Congress Should Improve the Definition of Passive Assets under the Installment Payment Provision**. Because the benefits of the installment payment provision are intended to be limited to active businesses, the installment payment provision precludes the installment payment of the federal estate taxes attributable to assets not used in the business (called "passive assets").[14] The present definition of passive assets under the installment payment provision,[15] however, needs modification to accommodate the way closely held business owners are conducting businesses. Otherwise, a business owner is forced to artificially structure the owner's business entities to comply with the rigid requirements of the installment payment provision.

- **Congress Should Allow Business Owners to Obtain Advance Rulings from the Internal Revenue Service on Whether the Business Owner's Estate Will Meet the Requirements of the Installment Payment Provision**. Unlike many tax planning situations where a taxpayer can request an advance ruling from the Internal Revenue Service on the tax effect of a proposed business structure, a closely held business owner cannot request the Internal Revenue Service to rule on whether the business owner's assets will qualify for installment payment of the estate tax. Congress should authorize and direct the Internal Revenue Service to issue advance rulings so a business owner can determine whether the deferral under the installment payment provision is available under the business owner's current business structure.

- **Congress Should Improve the Burdensome Lien Procedures under the Installment Payment Provision**. The Internal Revenue Service has implemented lien procedures to maximize the collectibility of the federal estate tax deferred under the installment payment provision. These lien procedures have been implemented unevenly by Internal Revenue Service agents in the field and can create an undue and unnecessary impediment to the closely held business owner's successors. Congress should change the lien procedures so as to minimize the administrative impediments for a closely held business owner's estate.

I will discuss briefly each of these issues.[16]

Closely Held Business Owners Need the Ability to Pay Estate Taxes in Installments

Estate taxes are due nine months after a business owner's death. The executor of a closely held business owner's estate generally needs liquidity to pay estate taxes, debts, beneficiary needs, and costs of administration. In some instances, the closely held business owner has sufficient liquidity because of planning through the use of life insurance and other techniques. In those instances where the business owner's estate does not have sufficient liquidity (the business owner may have been uninsurable or the business may have grown faster than the business owner could plan), the business owner's executor generally faces a difficult time in raising funds to meet liquidity needs, particularly funds to pay estate taxes (estate tax payments provide no new benefit to the business and only maintain the status quo). Accordingly, the executors of some closely held business owners' estates are faced with the need to raise significant funds at the most inopportune time, when the closely held business is in transition because of the death of an owner.

Modernization of the Installment Payment Provision

Before a closely held business owner's estate can receive the benefits of the installment payment provision, the estate must meet several requirements. One requirement is that the estate must have an interest in a "closely held business."[17] The Internal Revenue Code defines a closely held business under the installment payment provision[18] as a proprietorship, a partnership, and a corporation and does not mention a limited liability company, a limited liability partnership, or a business trust.

Business owners have changed the way they do business since the installment payment provision was enacted in 1976. When the installment payment provision was first enacted, most business owners conducted their businesses either in the form of a corporation or partnership. Since the enactment of the installment payment provision, new business forms, such as limited liability companies, limited liability partnerships, and business trusts, have been used by business owners to conduct their business operations. Unfortunately, the definition of a closely held business for purposes of the installment payment provision has not kept up with the times.

Although I have not encountered personally an instance where the Internal Revenue Service has denied the benefits of the installment payment provision where the closely held business was a limited liability company, the definition of the installment payment provision should be brought up to date to make sure that the benefits of the installment payment provision are available to a business owner's estate regardless of the business form.

In addition to the inadequate definition of a closely held business interest, the installment payment provision does not treat all business forms uniformly. For example, stock in a corporation will qualify as a closely held business interest if 20 percent of more of the voting stock is owned by the estate[19] while a partnership interest will qualify if 20 percent or more of the total capital interest is owned by the estate.[20] A better rule would be to allow qualification if a business owner's estate included either a 20 percent voting interest or a 20 percent capital interest. There are other examples under the installment payment provision of inconsistent treatment of business forms.[21]

Recommendation: *Amend the definition of "closely held business" under the installment payment provision to make it clear that all forms of businesses qualify for the benefits of the installment payment provision. Provide for the consistent application of the requirements under the installment payment provision regardless of business form.*

Holding Companies and the Installment Payment Provision

Many closely held business owners now conduct their business operations in multiple entities owned by a holding company. The installment payment provision has not adapted to these changes which creates significant uncertainty for the business owner in determining whether the installment payment provision will be available upon the business owner's death.

Many business owners place assets used in an active business in separate entities with the entities being owned by a holding company. For example, an individual may create a limited liability holding company called "Brookdale Farms Holding Company." The individual may transfer: (1) the farm real property to a separate limited liability company called "Brookdale Farm Real Estate Company," (2) cattle and other livestock to a third limited liability company called "Brookdale Farm Livestock Company," and (3) the operating equipment to a fourth limited liability company called "Brookdale Farm Operating Company." Brookdale Farms Holding Company would own all of the interests in the three separate limited liability companies. If the individual wants to take advantage of the installment payment provision, the individual must be careful in making gifts and how the individual conducts the business activities. Otherwise, the installment payment provision may not be available.

Business owners use a holding company structure for many reasons, including estate planning (giving interests in the farm real property limited liability to one child and giving interests in the operating business to another child) and the limitation of tort liability. Because the Internal Revenue Service took the position that a corporation with its sole asset stock of another corporation is not a closely held business,22 Congress amended the installment payment provision to allow the portion of stock of a holding company that directly or indirectly owns stock in a closely held active trade or business to be considered stock in the business company for purposes of the installment payment provision.23 Before the holding company stock may qualify for installment payment, however, the holding company stock must meet several requirements and the executor must make an election.

The holding company structure presents numerous issues. What is the level of activity required by a subsidiary in order to qualify as a closely held business under the installment payment provision? Are intra-company loans (a loan from Brookdale Farms Operating Company to Brookdale Farms Real Estate Company) considered passive assets and not entitled to installment payment? Because the installment provision uses the term "company" in describing personal holding entities, is the application of the installment provision limited to corporate entities?

Recommendation: *Amend the definition of "holding company" under the installment payment provision to combine all interests owned by the closely held business owner for all purposes of the installment payment provision.*

Definition of Passive Assets

The installment payment provision limits the installment payment of estate taxes attributable to business interests that conduct an active trade and business. Passive assets held by an interest in an entity conducting a trade or business are excluded in determining whether the estate qualifies for the benefits of the installment payment provision and the amount of estate tax that can be paid in installments. A passive asset is defined as "any asset other than an asset used in carrying on a trade or business."[24] Although the limitation is a proper goal, the passive asset rules are unclear.[25]

The provisions of the installment payment provision do not provide when the amount of passive assets are to be deducted in determining the value of the closely held business interests. The Senate Committee Report relating to the provisions of the installment payment provision dealing with passive assets stated:

The committee intends that the Treasury Department issue regulations defining the circumstances under which partnership and corporate assets are to be treated as passive investments, and therefore, disregarded for purposes of the installment payment provision.[26]

Because Treasury has not issued these regulations, closely held business owners have no or little guidance as to the definition of passive assets.

Recommendation: *Amend the definition of "passive assets" under the installment payment provision to make it clear what is a passive asset and how the amount of passive assets is to be deducted in determining the value of a closely held business interest.*

Ability to Obtain Advance Ruling

In many tax planning situations, a taxpayer can request an advance ruling from the Internal Revenue Service on the tax effect of a proposed business structure. Under current law, however, a closely held business owner cannot request the Internal Revenue Service to rule on whether the business owner's assets will qualify for installment payment of the estate tax while the business owner is alive and able to make appropriate changes. This creates significant uncertainty for some business owners. Congress should authorize and direct the Internal Revenue Service to establish procedures for the issuance of advance rulings so a business owner can determine whether the deferral under the installment payment provision is available under the business owner's current business structure.

Recommendation: *Allow taxpayers to request advance rulings from the Internal Revenue Service on issues relating to the installment payment provision.*

Lien Procedures

In March 2000, the Treasury Inspector General for Tax Administration issued a Final Audit Report - The Internal Revenue Service Can Improve the Estate Tax Collection Process. In the Report, the Inspector General found that the United States Treasury was owed $1.4 billion of estate taxes unpaid attributable to closely business interests under the installment payment provision and of this amount $1.3 billion was not secured by liens. The Report recommended that the Internal Revenue Service secure liens for the amount of the unpaid tax at the time of the approval of the installment payment election. The Internal Revenue Service has been implementing this recommendation.

Section 5.5.6.1 of the Internal Revenue Manual covers the installment payment provision dealing with bonds and liens to secure the unpaid federal estate tax. According to theManual, the Internal Revenue Service has these options to secure payment of the estate tax deferred under the installment payment provision:

- Require the estate to furnish a performance bond with a face value up to double the amount of tax being deferred, or
- Allow the estate to substitute the filing of a special lien (Form 668J) pledging the estate's right, title, and interest to specific property to the government.

Although the Federal Register lists approximately 100 acceptable bonding companies, one individual with the Internal Revenue Service stated that she was not aware of any bond ever having been written for an estate that elected the installment payment provision. Because a bond is impractical (no bonding company will issue a bond for a 14-year period without marketable collateral equal to the amount of the bond), the Internal Revenue Service requires a lien to secure the amount of the unpaid estate tax. Although this is a reasonable position in theory, the issue arises as to what is the proper collateral for the unpaid estate tax.

A general estate tax lien[27] arises upon the decedent's death and attaches to all assets in the decedent's estate and lasts ten years which cannot be extended. When an estate elects to pay the estate tax in installments, the Internal Revenue Service is secured by the general estate tax lien for only the first nine years and three months of the installment payment period unless the Internal Revenue Service obtains a special lien for the estate tax paid in installments.[28]

The Internal Revenue Service agents in the field determine what collateral is necessary to secure the unpaid tax. Many agents are acting responsibly and are accepting as collateral the property owned by the decedent that qualifies for the installment treatment. This is usually stock in a closely held corporation or a partnership interest in a limited partnership, and is generally not disruptive to most business operations. Without definitive statutory guidance, however, some Internal Revenue Service agents are not accepting the closely held business interests as collateral for the deferred federal estate tax and are requiring an executor to put up other assets, such as real estate or marketable securities owned by the estate or owned by members of the decedent's family, to secure the lien. Because a lien on these assets may prevent the decedent's family from borrowing funds necessary to operate the business, this is very disruptive to the business of the closely held business owner.

Recommendation: *Amend Section 6324(a) to extend the general estate tax lien for estates electing to pay the federal estate tax in installments under section 6166 for the duration of the installment payment period plus a reasonable period of time (such as one year) to provide the Internal Revenue Service sufficient time to collect if there is a default in payment by the estate. Provide that the Internal Revenue Service can only require as collateral assets that were owned by the decedent unless the executor elects to provide other collateral.*

Conclusion

I hope that the Committee and its staff will call upon the Task Force who prepared the*Report on Reform of Federal Wealth Transfer Taxes* as you consider changes to the federal wealth transfer tax system. In addition, the estates of private business owners need the ability to pay in installments the federal estate taxes attributable to a closely held business interest. I encourage the Committee and its staff to address the following significant issues with the installment payment provision:

- Modernize the installment payment provision,
- Cure the inadequate treatment of holding companies, 2 0
- Improve the definition of passive assets,
- Improve the burdensome lien procedures, and
- Allow advance rulings.

I thank you for allowing me to express my views on this important subject.

[1] Each reference to "section" is a reference to a section of the Internal Revenue Code of 1986, as amended.

[2] I will use the term "installment payment provision" to refer to section 6166.

[3] The American College of Trust and Estate Counsel Foundation, the American Tax Policy Institute and the American Bar Association Section of Real Property, Trust and Estate Law provided grants to enable the Task Force to publish their *Report on Reform of Federal Wealth Transfer Taxes*.

[4] J.H. Astrachan and M.C. Shanker, "Family Businesses' Contribution to the U.S. Economy: A Closer Look," Family Business Review, September 2003.

[5] Anderson, Ronald C., Mansi, Sattar A. and Reeb, David M., "Founding Family Ownership and the Agency Cost of Debt" (hereinafter "Anderson, Mansi, Reeb Study"). Available at SSRN: http://ssrn.com/abstract=303864

[6] The study defined a "deep family connection" to be the family responsible for starting the company was still heavily invested in the company, and has, on average, 18 percent of company equity.

[7] Anderson, Mansi, Reeb Study.

[8] Raymond Institute/MassMutual, American Family Business Survey, 2003.

[9] Raymond Institute/MassMutual, American Family Business Survey, 2003.

[10] The Report can be found at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html.

[11] It does not appear that farm assets, including farm land, limited partnerships or limited liability companies are classified as closely held business interests for purposes of these statistics. If these assets were included, there would be a significantly larger percentage of estates holding closely held businesses.

[12] For estates of individuals dying in 2008, the interest rate on the unpaid tax is two percent on the tax attributable to the first $1,280,000 of value of closely held business interests (or two percent interest rate on $576,000 of estate taxes) and 45 percent of the interest rate applicable to underpayment of tax (3.15 percent with an underpayment rate of seven percent). Section 6166 does not reduce the estate taxes payable and the savings under section 6166 relate solely to the deferral of the payment of estate taxes and the bargain interest rate.

[13] Section 6166(b)(8).

[14] Section 6166(b)(9).

[15] Section 6166(b)(9)(B).

[16] For a detailed discussion of these issues and other deficiencies with the installment payment provision, see Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee, Steven B. Gorin, E. Burke Hinds, Benjamin H. Pruett, Don Kozusko, and Michael Patiky Miller, Real Property, Probate and Trust Journal, page 73 - 121 (Spring 2006).

[17] Section 6166(a)(1).

[18] Section 6166(b)(1)(B) and (C).

[19] Section 6166(b)(1)(B)(i).

[20] Section 6166(b)(1)(C)(i).

[21] Sections 6166(b)(8) and (9). See Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee, Steven B. Gorin, E. Burke Hinds, Benjamin H. Pruett, Don Kozusko, and Michael Patiky Miller, Real Property, Probate and Trust Journal, page 73 - 121 (Spring 2006).

[22] Technical Advice Memoranda 8219007 and 8134012; Private Letter Rulings 8448006 and 8130175; and R.E. Moore (DC) 87-2 USTC ¶ 13,741.

[23] Section 6166(b)(8) and (9).

[24] Section 6166(b)(9)(B).

[25] See Practical Drafting, 1757 – 1776 (R. Covey, ed., July 1989).

[26] S. Rep. No. 98-169, 98th Cong., 2d Sess., at 715 (1984).

[27] Section 6324(a).

[28] The Internal Revenue Service may obtain a special lien under section 6324A for the estate tax deferred under section 6166.

I. Preliminary Remarks

It is an honor to appear before this distinguished Committee to testify regarding portability of the estate, gift, and generation-skipping tax ("GST") exemptions[1] to a surviving spouse. Portability would simplify estate planning and estate administration for married couples; carry out our clients' nontax goals; and increase consistency with existing tax policy without creating any new tax benefit.

Although I am chair of the Transfer Tax Study Committee of the American College of Trust and Estate Counsel ("ACTEC"), I am here as an invited witness in my individual capacity. However, the legislative proposal that appears as Exhibit A to my written testimony was prepared by ACTEC's Transfer Tax Study Committee and was unanimously approved by ACTEC's Board of Regents on March 10, 2008. Accordingly, when I speak in support of that proposal, I am authorized to speak on behalf of ACTEC, as well.

ACTEC is a non-profit professional association of approximately 2,600 trust and estate lawyers selected on the basis of professional reputation and ability in the field of trusts and estates and substantial contributions to that field through lecturing, writing, teaching, and bar leadership activities. ACTEC does not take positions on matters of tax policy and politics, including rates, exemptions, effective dates, and phase-ins. Nevertheless, on the basis of the extensive experience of our members in working with the estate, gift and generation-skipping transfer taxes as applied to our clients' circumstances, ACTEC offers technical observations concerning how the tax laws work and recommendations for making them operate more effectively to carry out the policies expressed by Congress.

In my view, portability may be the best estate tax planning idea for a surviving spouse since the unlimited marital deduction in 1981. Portability has already received significant attention from Congress. Specifically, portability was an important feature of H.R. 5970, in the 109th Congress, which was passed by the House of Representatives on July 29, 2006, and set before the Senate as the subject of the cloture motion that failed by a 56-42 vote on August 3, 2006, as part of the effort of a number of Senators to work out a compromise on the future of the estate tax.

In my remarks today I will first describe portability, second, discuss reasons that compel me and my ACTEC Fellows to recommend the passage of estate tax legislation that includes portability, third, make a few observations regarding the use of portability in practice, and lastly compare H.R. 5970 to the ACTEC Proposal.

II. The Case for Portability

A. What is "Portability"?

In general, portability is the transfer of a the deceased spouse's unused exemption to the surviving spouse. Specifically, under current law, each citizen or resident has a $2 million exemption from estate tax. It is common to say that a married couple has twice that, or $4 million. That is not an accurate picture of how the estate tax system works. Rather, under current law, upon the death of the first spouse and the transfer of all assets to the surviving spouse, the $2 million exemption of the deceased spouse is lost. When the surviving spouse dies, her estate may contain the assets of both spouses, but the estate of the surviving spouse will only have a single $2 million exemption. In order to avoid wasting the deceased spouse's exemption, the deceased spouse must either transfer assets to someone other than the surviving spouse, or place the exemption amount in an irrevocable bypass trust. Those two options are often counter to what the couple desires. Portability solves this dilemma.

B. <u>Evaluation of Portability.</u>

In general, we recommend portability for four important reasons, namely to:

(1) Simplify transfer tax planning and after-death administration;

(2) Satisfy client desires to provide security and flexibility for the surviving spouse;

(3) Achieve greater consistency with existing tax policy that treats a married couple as a unit; and

(4) Importantly, accomplish by statute the same results that a married couple may achieve by complicated planning and estate administration.

1. <u>Simplification</u>. The most obvious feature of portability is that it vastly simplifies estate planning and after-death administration for a married couple.

a. With portability, a married couple would no longer have to create a bypass trust upon the death of the deceased spouse, in order to use the exemption of the deceased spouse. Although “bypass” is easy to say, a number of complications come to mind in the use of a bypass trust.

First, estate planners commonly use a marital deduction formula clause in drafting a bypass trust. The purpose is to ensure that the bypass trust receives the greatest amount possible covered by the exemption but does not go over the exemption thereby triggering estate tax. Instead, any amount in excess of the exemption amount would go to the survivor's trust, which qualifies for the marital deduction so that the two trusts together would make maximum use of the deceased spouse's exemption while protecting any excess from tax with the marital deduction. The result of making this optimal use of the exemption by a deceased spouse is a complicated formula virtually impossible to explain to anyone who is not an estate planning attorney or other professional.

A second complication is that an irrevocable bypass trust is a separate taxpayer. This means the bypass trust needs a separate ID number and a separate income tax return. With portability, there would be no separate trust, the surviving spouse would continue to use her own social security number and would not have to file a separate income tax return in addition to the survivor's individual 1040.

Third, after the death of the first spouse to die, the division of assets between the marital deduction trust and a bypass trust is typically accomplished after the filing of a federal estate tax return, due initially nine months after death. As a result, there needs to be a preliminary trust to hold the decedent's assets between the date of death and the funding of the trusts. The administrative trust in turn is a separate taxpayer, requiring yet another new ID number and an additional income tax return. With portability, there would be no need for an administrative trust; the decedent's assets would be treated as transferred to the surviving spouse on the date of death of the first spouse to die.

b. Another complexity under current law is that the estate of the first spouse to die must contain sufficient assets to use the exemption of the deceased spouse. Unless the couple is confident of which spouse will die first, this means that each spouse must have assets in his or her name sufficient to use the exemption. The result is that complicated tax planning drives how a married couple hold title to their property, rather than nontax, personal reasons. This may require asset transfers from the spouse with the higher net worth to the other spouse, which might otherwise be unnecessary, undesirable, impractical, or in some other way be inconsistent with the couple's overall planning.

Even in a community property state, such as California, clients frequently have inheritances, property brought from a non-community property state, or assets owned before marriage that are separate property and create a different net worth for each spouse. With portability, the deceased spouse's unused exemption would pass to the surviving spouse, regardless of the value of the deceased spouse's estate.

2. <u>Conformity to Client Nontax Goals</u>.

A second important reason we support portability is that clients typically prefer that the surviving spouse be the full owner of the couples' combined estate upon the death of the first spouse. A bypass trust divides ownership of the deceased spouse's estate between the income beneficiary and the remaindermen who receive the assets upon the death of the surviving spouse. Even if the surviving spouse holds a limited power of appointment over the bypass trust so that the survivor controls who owns the remainder, the surviving spouse is still faced with less than outright ownership of the assets in the bypass trust. This separate ownership raises issues of fiduciary duties owed to the remainder beneficiaries by the trustee, whether the trustee is the surviving spouse or someone else.

3. <u>Consistency with Existing Tax Policy</u>.

A third reason that portability makes sense is that it is consistent with other ways the tax law recognizes a married couple as, in effect, a single economic unit, e.g., joint income tax returns, gift-splitting for gift tax purposes, and the unlimited marital deduction.

a. For example, in 1981, when the marital deduction for transfers between spouses was made unlimited, the Finance Committee stated that “[t]he committee believes that a husband and wife should be treated as one economic unit for purposes of estate and gift taxes, as they generally are for income tax purposes.” S. Rep. No. 97-144, 97th Cong., 1st Sess. 127 (1981).

b. In addition, portability would permit the actual result for a married couple to match the way the exemption is often viewed and discussed, including by lawmakers, as, for example “$2 million per person, and $4 million for a married couple”. Rarely do we hear the exemption referred to as $2 million per person, and $4 million per married couple who retains legal counsel and engages in careful, complex planning.

4. <u>Portability Does Not Open a New Door</u>.

Not only are there significant reasons that favor portability, it is important to keep in mind that portability does not open a new door. Under current law, a married couple can achieve the same goal of use of the deceased spouse's exemption as portability does. The difference is that current law (1) requires a married couple to engage in complicated planning and put up with complex administration; and (2) impairs the security of sole ownership that a surviving spouse could otherwise enjoy.

In summary, portability would (I) simplify estate planning and estate administration for married couples; (2) carry out clients' nontax goals; and (3) increase consistency with existing tax policy. All these benefits can be obtained without giving a married couple a new tax benefit.

C. Who Will Benefit from Portability?

1. Portability should be most useful to a married couple with a combined estate of more than $2 million but no more than $4 million at the time of death of the surviving spouse. For convenience when I refer to $4 million, I am referring to double one exemption, which is currently $2 million per person. In these circumstances, the couple could use portability to both avoid all estate tax on their combined estate and avoid the use of a bypass trust for estate tax planning.

2. The greater the combined net worth of a married couple, the less useful portability will be. This is for two reasons: First, the higher the net worth, the more likely the couple will make distributions to children on the first death thereby using the exemption of the first spouse. Second, the larger the combined estate, the greater role that appreciation of the deceased spouse's estate in the survivor's estate will play.

III. H.R. 5970 and the ACTEC Proposal

A. H.R. 5970 and the "Break-through".

One of the technical challenges to implementing portability was the tracing problem. Tracing refers to tracking assets from the deceased spouse to the surviving spouse in order to determine how much unused exemption should be transferred to the surviving spouse's estate. H.R. 5970 solved this problem by transferring the entire unused exemption of the deceased spouse to the estate of the surviving spouse but capping the amount of unused exemption the survivor's estate can use to the same amount as the survivor's exemption. Therefore, the total exemption in the surviving spouse's estate would never exceed twice the amount of a single exemption.

Moreover, "capping" not only avoids difficult tracing, it also prevents abuse by a surviving spouse who would marry a series of ill paupers in order to accumulate their unused exemption. The unused exemption of all predeceased spouses would be capped at the amount of the surviving spouse's exemption.

ACTEC recognizes this technical break-through in H.R. 5970, and the ACTEC Proposal incorporates the capping technique.

I will turn now to the differences between H.R. 5970 and the ACTEC Proposal.

B. Relieve Burden of the Required Election.

First, under H.R. 5970, new section 2010(c)(6)(A) permits portability only if the executor of the deceased spouse's estate so elects. We believe that the election will be desirable in virtually every situation, and that a required election will be burdensome and a trap for the unwary.

A required election for portability is likely to result in the same confusion produced when we had a qualified terminable interest property trust (“QTIP”) election for the marital deduction. The IRS required that simply listing assets on Schedule M of the federal estate tax return was not sufficient to obtain the marital deduction. An affirmative check-the-box election had to be made. This rule led to several private letter rulings that disallowed the marital deduction. As a result of these unfavorable rulings, and approximately 10 years later, a new rule was finally adopted that did not require a box to be checked to make the QTIP election.

C. Give Option to File Estate Tax Return or Income Tax Return for Deceased Spouse.

H.R. 5970 requires that the unused exemption of a deceased spouse cannot be transferred to the estate of the surviving spouse unless a federal estate tax return is filed for the deceased spouse. (As mentioned above, ACTEC recommends that the executor not be required to make an election for portability to apply.) Although the ACTEC proposal requires the timely filing of an estate tax return for the deceased spouse, we also suggest that there be an option of filing a special schedule to the deceased spouse's final income tax return as a substitute for an estate tax return.

The reason for the income tax filing option is that in any situation where portability would apply, then, by definition there would be no tax due on the deceased spouse's estate, and frequently, no estate tax return would be necessary, except to establish there was unused exemption. If there were tax, then there would be no unused exemption to transfer to the survivor's estate. The income tax option is offered as a less onerous way of complying with the need to notify the Internal Revenue Service (IRS) that portability would apply upon the death of the surviving spouse.

Although some might view the income tax return as an inappropriate vehicle for providing the fair notice the Service needs, the ACTEC proposal does not automatically allow any statement on an income tax return to suffice. We believe that the concern for fair notice should be addressed by Treasury, which would be authorized to issue “instructions, regulations, directions or forms”.

D. Extend Portability to the Generation-Skipping Transfer Tax (section 102(a) & (b) of H.R. 5970 and Section 2631 (c) of the Code).

Second, H.R. 5970 makes the exemption portable for gift and estate taxes, but not for the generation-skipping tax exemption. Our experience is that taxpayers who make taxable transfers often consider gifts at death to grandchildren. Moreover, linking the GST exemption to the estate and gift tax exemption will simplify planning and there is no reason to make the GST exemption different than the other transfer taxes. Like the gift and estate tax exemption, portability of the GST exemption is available under current law to taxpayers who engage in sophisticated estate planning. For these reasons, ACTEC recommends extension of portability to the GST exemption.

E. Clarify Whether Privity is Required.

Privity means that the exemption would only be portable between a married couple. Without requiring privity, there could be a transfer of an exemption from a deceased husband to a surviving wife, who would in turn transfer both her unused exemption and her first husband's unused exemption to a second husband.

H.R. 5970 did not appear to require privity, but that is not entirely clear. We believe if Congress intends to allow portability without privity, it is not entirely clear that Congress explicitly considered this issue or its implications. If the policy judgment regarding privity was not considered in H.R. 5970, that judgment should be made now. While ACTEC acknowledges that this is the type of judgment call that lawmakers should make, we believe that a privity requirement would adversely affect very few spouses and that most spouses would find privity to be a natural and acceptable requirement.

F. Clarify That a Surviving Spouse's Estate Can Receive Unused Exemption from More than One Deceased Spouse. (Section 102(a) of H.R. 5970 and New Section 2010(c)(4) and (5) of the Code).

It is relatively clear from H.R. 5970 that a surviving spouse who has lost two or more spouses to death may use the unused exemption of all such predeceased spouses, subject to a cap of the amount of the surviving spouse's exemption. Apparently H.R. 5970 permits a surviving spouse to accumulate exemptions from all prior deceased spouses but caps the amount of exemption that may be accumulated. We propose clarifying H.R. 5970 by inserting the word “all”.

G. Broaden Treasury's Regulation Authority (Section 102(a) of H.R. 5970 and New Section 2010(c)(7) of the Code).

We recommend that Treasury be given broader authority to issue what are often viewed as “legislative regulations”. The deliberate process of drafting regulations, with solicitation of public input through the notice and comment process and otherwise, is well-suited to fleshing out the administrative rules to govern the details of implementing portability.

In conclusion, portability is a great idea. I sincerely hope that with the support of this Committee, portability will be a great idea whose time has come.

EXHIBIT A

2008 Report on Study of Statutory Proposal for Simplification of Transfer Tax Planning for the Unified Credit and GST Exemption

In 1992, the Transfer Tax Study Committee recommended a proposal for the simplification of federal estate and generation-skipping transfer tax planning and compliance through the enactment of amendments to sections 2010 and 2631 of the Internal Revenue Code of 1986. The Committee updated this report in 2004 and is now further updating the proposal. This proposal is based on HR 5970 and not the version approved in 1992, except that this Report unlike HR 5970 applies to the GSTT as well as the gift tax and the estate tax. Like HR 5970, this Report assumes unification of the gift and estate tax.

The proposal would amend subsections 2010(c) and 2505(a), providing for the transfers of any unused portion of the applicable credit amount (unified credit) of a deceased spouse to the surviving spouse. For the most part the proposal adopts the amendments to section 2010(c) set forth in the “Estate Tax and Extension of Tax Relief Act of 2006,” H.R. 5970 (109th Congress), which the House of Representatives passed on July 29, 2006. The amount of the transferable credit would not be limited to the tax that the property transferred to the spouse would generate but instead would be equal to the transferor spouse's entire (otherwise unused) applicable exclusion amount. This proposal would also amend subsection 2631 to create a new Section 2631(c) allowing the transfer of any unused portion of a decedent's GST exemption to the decedent's surviving spouse.

The Committee recommends re-adoption of the proposal as set forth and explained in this report. The Committee's report first explains the provisions of current law and the need for change, and then describes the proposed amendments to sections2010, 2505 and 2631.

Current Law

By operation of the applicable credit amount, each decedent's estate is entitled to exclude a portion of its assets from estate taxation. The amount that is excludable is known as the “applicable exclusion amount,” as set forth in section 2010(c)(2).

As amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), the applicable exclusion amount for estate tax purposes is $2,000,000 in the case of decedents dying in 2008 and $3,500,000 in the case of decedents dying in 2009 reduced, in effect, however by the amount of the credit used to offset gift taxes otherwise payable. For gift tax purposes, the credit is equal to the tax generated by the first $1,000,000 of taxable transfers made by the individual.

Under EGTRRA, no estate taxes are imposed for decedents dying in 2010.

To the extent that the applicable credit amount is not used against taxable transfers by the individual, it is lost.

Each individual is entitled to a GST tax exemption under section 2631. Since 2003, the GST exemption is equal to the estate tax applicable exclusion amount. To the extent that the exemption is not allocable to GST transfers made by the individual during life or at death, it similarly will be lost.

Marital Deduction Planning

Under sections 2056 and 2523, transfers to the decedent's (surviving) spouse are deductible from taxable transfers, and thus do not generate a transfer tax against which the applicable credit amount can be taken. In other words, an individual who transfers all property to his or her spouse does not pay a tax but does not utilize the otherwise available credit. On the spouse's subsequent death, however, all of such property then remaining will be includible in that spouse's estate.

In the case of spousal estates of more than the applicable credit amount, accepted estate planning makes some of the assets taxable at the death of the first spouse to die, and the balance at the death of the surviving spouse, so that the applicable credit amount of each can be used. In the simple case of combined assets of $4,000,000 (in 2008), for example, the usual plan would result in $2,000,000 being subject to taxation in the estate of the first spouse to die, but not in the estate of the survivor. This result typically is obtained in estate planning documents through a formula that takes into account gifts made during lifetime that reduce the applicable credit amount as well as other adjustments. At least $2,000,000 is subject to taxation in the estate of the survivor. In each estate, the tax generated by the transfer tax is sheltered by that individual's applicable credit so no estate taxes are owed.

This type of transfer tax planning necessitates the creation of trusts to manage some or all of the family's joint assets. The only practicable way to prevent the property protected by the applicable credit amount of the deceased spouse from being subject to transfer taxation in the estate of the surviving spouse is to put the property in a trust over which the surviving spouse does not have any “strings” that would trigger gross estate inclusion. Even if the surviving spouse does not need a trust for property management purposes, such a trust must be created for tax planning reasons.

GST Exemption Planning

Each spouse is entitled to a $2,000,000 GST exemption (in 2008). It therefore is possible for a husband and wife collectively to shelter $4,000,000 worth of assets from the generation-skipping transfer tax (the “GST Tax”). In order to do so, however, each spouse must make a transfer of $2,000,000 that will be subject to the GST tax.

Unless the surviving spouse has sufficient assets to effectively use his or her GST exemption, the only practicable way to effectively utilize both spouses' GST exemptions, while preserving the resources for the use of the surviving spouse, is to create trusts. Generally, one or more trusts are structured so that the transferor's GST exemption can be applied to them (a credit shelter trust and/or a “Reverse QTIP Trust”). The balance of the assets then will pass to the surviving spouse in such a way that they will be includible in his or her gross estate (that is, either outright or in a marital trust), so that the surviving spouse will be, or will be deemed to be, the “transferor” of those assets under section 2631(a), allowing his or her GST exemption to be allocated to it.

For both estate tax and generation skipping transfer tax purposes, the amount that can be potentially sheltered from tax increases to $3,500,000 per individual in 2009. There is no GST tax for transfers occurring in 2010. The provisions of EGTRRA cease to apply after 2010 in accordance with the “sunset” provisions of EGTRRA.

Reasons for Change

Current transfer tax law can unnecessarily dictate the testamentary plans of decedents because trusts must be created to take advantage of the applicable credit amount and GST exemption allocable to the first spouse. Testators who otherwise would want to leave the entire estate to the surviving spouse outright are forced to put the property in trust in order to take advantage of these amounts.

In addition, in order for the estate of the first spouse to die to take advantage of the applicable credit amount, he or she must have in his or her estate assets at least equal to the “applicable exclusion amount” (that is, the amount of assets sheltered from tax by the applicable credit amount). This may require asset transfers from the wealthier spouse to the poorer spouse that might otherwise be unnecessary, undesirable, not practical either legally or practically, or otherwise inconsistent with the couple's overall planning.

This issue became increasingly acute under EGTRRA because the amount that can potentially be protected from the estate and GST tax has increased in steps to $2 million currently and

$3,500,000 for 2009. In order to take maximum advantage of these exclusions, each of the spouses must have at least this amount in each's individual name. Further, assuming if the “sunset provisions” of EGTRRA take effect, that is, the amounts that can be protected are reduced to pre-EGTRRA levels after 2010, the amount so transferred will prove to have been unnecessary.

Married couples should be able to transfer assets with the protection of their combined applicable credit amounts regardless of the happenstance of who dies first, and regardless of their level of sophistication.

Couples can continue to utilize credit shelter trust planning if they prefer for tax or other reasons. Credit shelter trusts can result in somewhat lower overall estate tax costs for a couple since the appreciation of the assets held in such a trust will not be subject to estate tax whereas it would be if held by the surviving spouse outright. In addition, couples may prefer to leave all or a portion of their assets in trust for a survivor for non-tax reasons, e.g. financial management, protection against remarriage, an improvident spouse and the like.

Under the proposal, an individual cannot retransfer to a subsequent spouse any applicable credit amount or GST exemption that such individual acquires from a deceased spouse and does not use during such individual's lifetime or at his or her own death. The credit can be used by a surviving spouse only if a United States citizen or resident at time of death.

Proposed Amendment of Sections 2010(c)

Section 2010(c)

(c) Applicable Credit Amount-

(1) IN GENERAL- For purposes of this section, the applicable credit amount is the amount of the tentative tax which would be determined under the rate schedule set forth in section 2001(c) if the amount with respect to which such tentative tax is to be computed were the applicable exclusion amount.

(2) APPLICABLE EXCLUSION AMOUNT- For purposes of this subsection, the applicable exclusion amount is the sum of:

(A) the basic exclusion amount, and
(B) in the case of a surviving spouse, the aggregate deceased spousal unused exclusion amount.

(3) BASIC EXCLUSION AMOUNT-

(A) IN GENERAL- For purposes of this subsection, the basic exclusion amount is $_________
(B) INFLATION ADJUSTMENT- In the case of any decedent dying in a calendar year after 2010, the dollar amount in subparagraph (A) shall be increased by an amount equal to--

(i) such dollar amount, multiplied by
(ii) the cost-of-living adjustment determined under section1(f)(3) for such calendar year by substituting 'calendar year 2009' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $100,000, such amount shall be rounded to the nearest multiple of $100,000.

(4) AGGREGATE DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT For purposes of this subsection, the term .aggregate deceased spousal unused exclusion amount' means the lesser of--

(A) the basic exclusion amount, or
(B) the sum of all deceased spousal unused exclusion amounts of the surviving spouse.

(5) DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT- For purposes of this subsection, the term 'deceased spousal unused exclusion amount of the surviving spouse' means, with respect to each deceased spouse (of the surviving spouse) dying after December 31,2009, the excess (if any) of:

(A) the basic exclusion amount of the deceased spouse, over
(B) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

(6) SPECIAL RULES-

(A) RETURN REQUIRED- A deceased spousal unused exclusion amount may not be taken into account by a surviving spouse under paragraph (5) unless the executor of the estate of the deceased spouse files a timely filed (including extensions) estate tax return or sets forth adequate information on a timely filed (including extensions) income tax return, as provided in instructions, regulations or directions, or fon11s prepared by the Secretary, for the deceased spouse from which one can determine the deceased spouse's unused exclusion amount.

(B) EXAMINATION OF PRIOR RETURNS AFTER EXPIRATION OF PERIOD OF LIMITATIONS WITH RESPECT TO DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT Notwithstanding any period of limitation in section 6501, after the time has expired under section 6501 within which a tax may be assessed under chapter 11 or 12 with respect to a deceased spousal unused exclusion amount, the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection,

(7) REGULATIONS- The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

Proposed Amendment of 2505(a)

2505(a)

(a) GENERAL RULE.- In the case of a citizen or resident of the United States, there shall be allowed as a credit against the tax imposed by section 2501 for each calendar year an amount equal to-

(1) the applicable credit amount under section 2010(c) which would apply if the donor died as of the end of the calendar year, reduced by

(2) the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods.

Proposed Amendment of Section 2631

Section 2631 (c)

(c) GST EXEMPTION AMOUNT-

(1) IN GENERAL- For purposes of subsection (a), the GST exemption amount for any calendar year shall be the sum of: (A) the basic exclusion amount under section 2010(c) for such calendar year, and (B) in the case of a surviving spouse, the aggregate deceased spousal GST unused exemption amount.

(2) AGGREGATE DECEASED SPOUSAL GST UNUSED EXEMPTION AMOUNT- For purposes of this section, the term 'aggregate deceased spousal GST unused exemption amount' means the lesser of--

(A) the basic exclusion amount, or
(B) the sum of all deceased spousal GST unused exemption amounts of the surviving spouse.

(3) DECEASED SPOUSAL GST UNUSED EXEMPTION AMOUNT- For purposes of this section, the term ' deceased spousal GST unused exemption amount of the surviving spouse' means. with respect to each deceased spouse (of the surviving spouse) dying after December 31, 2009, the deceased spouse's unused GST exemption remaining after application of section 2632(e).

(4) SPECIAL RULES-

(A) RETURN REQUIRED- A deceased spousal GST unused exclusion amount may not be taken into account by a surviving spouse under paragraph (3) unless the executor of the estate of the deceased spouse tiles a timely tiled (including extensions) estate tax return or sets forth adequate information on a timely filed (including extensions) income tax return, as provided in instructions, regulations, directions, or forms prepared by the Secretary, for the deceased spouse from which one can determine the deceased spouse's GST unused exclusion amount.

(B) EXAMINATION OF PRIOR RETURNS AFTER EXPIRATION OF PERIOD OF LIMITATIONS WITH RESPECT TO DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT Notwithstanding any period of limitation in section 6501, after the time has expired under section 650 I within which a tax may be assessed under chapter 13 with respect to a deceased spousal GST 6 unused exemption amount, the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection.

(5) REGULATIONS- The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

Explanation of Amended Sections 2010 and 2505

Amended sections 2010 and 2505 provide that an individual transfers to the surviving spouse any unused portion of his or her applicable exclusion amount.

The amount of the credit that can be transferred to a surviving spouse is defined by proposed section 2010(c) as the basic exclusion amount in excess of the tax imposed on the transfer of the deceased spouse's estate. A taxpayer can accumulate credits from prior spouses but cannot transfer those accumulated credits to a surviving spouse. In other words, transfer of credit is allowed only between spouses who were in privity - that is, were married to each other. The aggregate amount that can be accumulated is the amount equal to the exclusion amount at the time of the surviving spouse's death.

The Committee believes that no estate would want to decline the transfer of an available credit. Accordingly, the proposal presumes that any unused exclusion amount is transferred to the surviving spouse; that is no election is required.

H.R. 5970 did not appear to require privity between spouses. It is unclear whether the drafters intended this result. The accompanying explanations do not provide insight into the drafters' intentions on this issue. The Committee believes that if Congress intends to allow portability from spouse to spouse to spouse without privity, it should make that policy judgment explicit. If the policy judgment underlying portability without privity was not considered in the drafting of H.R. 5970, that judgment should be made now. While acknowledging that this is a judgment call that lawmakers should make, the Committee believes that a privity requirement would adversely affect very few spouses and that most spouses would find privity to be a natural and acceptable requirement.

In some cases, there will be a revenue increase as a result of portability since the assets transferred outright to a surviving spouse may appreciate during the spouse's lifetime which appreciation then will be taxed at the death of the surviving spouse. If the first decedent creates a credit shelter trust the appreciation in the assets of the trust is not taxed at the death of the surviving spouse. On the other hand, revenue may be lost in the case of taxpayers who are not currently engaging in estate tax planning, including those whose estates consist primarily of jointly held property and other non-probate assets that pass entirely to the surviving spouse.

The examples below illustrate the application of the proposed amendments. Each example assumes that S has not made any lifetime gifts, unless otherwise stated.

Example (1): The Decedent, D, has made no prior taxable gifts and has a gross estate of zero. At D's death, the basic exclusion amount as defined in section 2010(c)(3) is $2,000,000. D's surviving spouse, S, dies un-remarried when the basic exclusion amount is $2,000,000. S's applicable exclusion amount is $4,000,000, which is the sum of the basic exclusion amount at S's death plus D's unused exclusion amount.

Example (2): Assume the facts in example (I), except D has separate assets of $2,000,000, all of which he leaves to S. S's applicable exclusion amount is $4,000,000, which is the sum of the basic exclusion amount at S's death plus D's unused exclusion amount.

Example (3): Assume the facts in example (I), except D has separate assets of $1,000,000 all of which he leaves to his daughter. S's applicable exclusion amount is $3,000,000 which is the sum of the basic exclusion amount at S's death of $2,000,000 plus D's unused exclusion amount of$I,OOO,OOO.

Example (4): Decedent, D, has made $500,000 of prior taxable gifts and has separate assets of $500,000, all of which he leaves to his daughter. At D's death, the basic exclusion amount is $1,000,000. D's surviving spouse, S, dies un-remarried when the basic exclusion amount is

$2,000,000. S's applicable exclusion amount is $2,000,000, which is S's basic exclusion amount. The deceased spousal unused exclusion amount is zero because the basic exclusion amount at D's death was $1,000,000, all of which was consumed by the $500,000 of prior taxable gifts and the $500,000 bequest to D's daughter.

Example (5): Assume the same facts in example (4), except after D's death, S marries D2. D2 has made no prior taxable gifts, and has a gross estate of $1,000,000 all of which he leaves to his daughter. At D2' s death, the basic exclusion amount is $2,000,000. S's applicable exclusion amount is $3,000,000 which is the sum of S's basic exclusion amount of $2,000,000 plus D2's unused exclusion amount of$I,OOO,OOO.

Example (6): Decedent, D, has made no prior taxable gifts and has separate assets of $2,000,000, all of which he leaves to his spouse S. At D's death, the basic exclusion amount is $2,000,000. After D's death, S marries D2. D2 has made no prior taxable gifts and has separate assets of $2,000,000, all of which he leaves to S. At D2's death, the basic exclusion amount is $2,000,000. S dies when the basic exclusion amount is $2,000,000. S's applicable exclusion amount is $4,000,000, which is the sum of S's basic exclusion amount of $2,000,000 plus the aggregate deceased spousal unused exclusion amount of $2,000,000. The aggregate deceased spousal unused exclusion amount as defined in section 2010(c)(4) is capped at the basic exclusion amount of $2,000,000 at S's death.

Example (7): Assume the same facts as in example (6), except the basic exclusion amount is $4,000,000 at S's death. S's applicable exclusion amount is $8,000,000, which is the sum of S's basic exclusion amount of $4,000,000 plus D's unused exclusion amount of $2,000,000 plus D2's unused exclusion amount of $2,000,000.

Example (8): Decedent, D, has made no prior taxable gifts and has separate property of $2,000,000 all of which he leaves to his spouse, S. At D's death, the basic exclusion amount is $2,000,000. S dies un-remarried with an estate of $3,000,000. At S's death the basic exclusion amount is $1,000,000. S's applicable exclusion amount is $2,000,000, which is the sum of the basic exclusion amount of $1,000,000 at S's death and the aggregate deceased spousal unused exclusion amount as defined in section 2010(c)(4) of $1,000,000, which is capped at the basic exclusion amount at S's death of $1,000,000 even though D had an unused exclusion amount of $2,000,000.

Example (9): Decedent has made no prior taxable gifts and has separate property of $2,000,000, all of which he leaves to his spouse, S. At D's death the basic exclusion amount is $2,000,000. After D's death, S marries D2. S has made no prior taxable gifts and has separate property of $4,000,000, all of which she leaves to D2. At S's death the basic exclusion amount is $2,000,000, and therefore S's applicable exclusion amount is $4,000,000, which is the sum of S's basic exclusion amount of $2,000,000 plus D's unused exclusion amount of $2,000,000. D2 dies un-remarried. At D2's death the basic exclusion amount is $3,000,000. D2's applicable exclusion amount is $5,000,000, which is the sum ofD2's basic exclusion amount of $3,000,000 plus S's unused basic exclusion amount of $2,000,000. This assumes D's unused exclusion amount is not carried over to D2, with whom D had no privity. If privity were not required, then D2's applicable exclusion amount would be $6,000,000, which is the sum ofD2's basic exclusion amount of $3,000,000 plus the lesser ofD2's basic exclusion amount of$3,000,000 or S's unused applicable exclusion amount of $4,000,000.

Example (10): Decedent has made no prior taxable gifts and has a gross estate of zero. At D's death the basic exclusion amount is $2,000,000. After D's death, D's surviving spouse, S, gifts

$4,000,000 during a year when the basic exclusion amount is $2,000,000. S's applicable exclusion amount is $4,000,000, which is the sum of the basic exclusion amount at the time of the gift and D's unused basic exclusion amount of $2,000,000. S incurs no gift tax in the year of the gift.

Explanation of Amended Section 2631

Amended Section 2631 would allow for the transfer of the decedent's unused GST exemption. The proposal allows a decedent to bequeath the entire estate to the surviving spouse and leave to the surviving spouse the making of generation-skipping transfers.

The proposal thus avoids the necessity for decedents to create GST trusts in which the surviving spouse has an interest, in order to utilize the GST exemption. The proposal does not prevent the creation of GST trusts by the decedent to take advantage of leveraging inherent in the time value of money.

The Committee believes that most estates with significant GST tax exposure already take advantage of the planning opportunities to avoid the GST tax. Thus, the proposal should merely simplifY the planning process, without significant loss oftax revenue.

The following examples illustrate the application of amended section 2631:

Example (1): Decedent D has made no prior gifts and dies owning $1,500,000, all of which D leaves to D's spouse S. D dies when the basic exclusion amount is $2,000,000. S dies un-remarried when the basic exclusion amount is $2,000,000. S's GST exemption is $4,000,000, which is the sum of the basic exclusion amount of $2,000,000 in the year of her death and D's unused GST exemption of $2,000,000.

Example (2): Assume the same facts in example (I), except D dies with no assets. S's GST exemption is $4,000,000, which is the sum of the basic exclusion amount of $2,000,000 in the year of her death and D's unused GST exemption of $2,000,000.

Example (3): Decedent D has made no prior gifts and dies owning $2,000,000, of which D leaves $1,000,000 to D's grandchild GC (the child of D's son) and $1,000,000 to D's spouse S. D's son survives D. D dies when the basic exclusion amount is $2,000,000. D's executor does not affirmatively allocate D's GST exemption instead relying on the GST deemed allocation rules. S dies un-remarried when the basic exclusion amount is $2,000,000. S's GST exemption is $3,000,000, which is the sum of the basic exclusion amount of $2,000,000 in the year of S's death and D's unused GST exemption of $1 ,000,000 remaining after the deemed allocation of $1 ,000,000 left to GC.

Example (4): Decedent, D, has made no prior gifts and dies owning $2,000,000, all of which he leaves to a trust which provides all the net income to his son for life with the trust assets passing to D's grandchild GC upon D's son's death. D dies when the basic exclusion amount is $2,000,000. D's executor does not affirmatively allocate GST exemption and affirmatively elects out of the GST deemed allocation rules as permitted by section 2632. D's spouse, S, dies un-remarried when the basic exclusion amount is $2,000,000. S's GST exemption is $4,000,000, which is the sum of the $2,000,000 basic exclusion of $2,000,000 and D's unused GST exemption of $2,000,000. S or S's executor cannot allocate S's GST exemption to the testamentary trust established by D since S is not the transferor of that trust.

Example (5): Decedent D has made no prior gifts and dies owning $2,000,000 all of which he leaves to his spouse S. D dies when the basic exclusion amount is $2,000,000. After D's death, S marries D2. S dies with $4,000,000, all of which she leaves to D2. S made no prior gifts. At S's death, the basic exclusion amount is $2,000,000, and therefore S's GST exemption is $4,000,000, which is the sum of S's basic exclusion amount of $2,000,000 plus D's unused exclusion amount of $2,000,000. D2 dies un-remarried when the basic exclusion amount is $3,000,000. D2's GST exemption is $5,000,000, which is the sum of the basic exclusion amount of $3,000,000 at D2's death and S's unused GST exemption (traceable to her own basic exclusion amount) of $2,000,000. This assumes that D's unused GST exemption goes unused and cannot be transferred to D2, with whom D had no privity. If privity were not required, then D2's GST exemption would be $6,000,000, which is the sum of D2's basic exclusion amount of $3,000,000 plus the lesser of D2's basic exclusion amount of $3,000,000 or S's GST exemption of $4,000,000.

BIOGRAPHY FOR SHIRLEY L. KOVAR FOR SENATE FINANCE COMMITTEE HEARING ON PORTABILITY, APRIL 3, 2008

Shirley L. Kovar is a trusts and estates attorney with the law firm of Branton & Wilson in San Diego, California. She is a certified specialist by the State Bar of California in trusts and estates law, and she speaks and writes on trusts and estates subjects. She is a Fellow in the American College of Trusts and Estates Counsel where she chairs the Transfer Tax Study Committee. Shirley is an academician in the International Academy of Estate and Trust Law. Shirley has also served as a member and adviser to the Executive Committee of the California State Bar Section on Trusts and Estates, where she chaired the Litigation Committee and served as Liaison of the Executive Committee to the California Law Revision Commission on the no contest clause. Shirley is past chair of the Trusts and Estates Section of the San Diego County Bar Association. Shirley is listed in Super Lawyer Magazine as among the top 5% of trusts and estates lawyers in Southern California, Shirley graduated from the University of Kansas Law School in 1974, where she served as Editor in- Chief of the Kansas Law Review and was a member of the Order of the Coif. Shirley lives in Coronado, California with her husband of37 years, Linn S. Kovar.

[1] The estate, gift and GST exemptions technically operate as a “unified (cumulative) credit” against the tax, but for simplicity they are commonly referred to as exemptions and in most cases operate exactly as exemptions would.