

Atlantic Trust White Paper

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Whatever Happened to Estate Tax Reform?

As the fantasy repeal of the estate tax quickly approaches in 2010, you may wonder, “Whatever happened to estate tax reform?” To answer that question, it is important to consider the rules and events that have made the reform process painfully slow, if not seemingly impossible. Change has repeatedly been thwarted due in part to voting issues that have blocked reform within the Senate. Add in various political maneuvers of the last decade, and you are left with the current state of confusion.

The Wealth Strategies Group

at Atlantic Trust seeks to integrate estate, financial and investment planning through sophisticated assessment of goals to achieve multi-generational capital preservation, family business continuity and strategic philanthropic objectives.

With year-end around the corner, planners and advisors continue to hope for definitive rules that will determine what will likely happen moving forward and what will be required from a planning perspective.

What Are the Current Estate Tax Rules?

As 2009 comes to a close, the final year of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA)¹ is now in sight. Enacted in 2001, EGTRRA provides the rules that govern estate planning, as described below. EGTRRA provisions “sunset” in 2011, meaning they return to provisions in effect before the Act became effective unless legislation is enacted to make these changes permanent.

Why Was EGTRRA Enacted?

Senate voting rules present a major impediment to permanent estate tax reform. To enact *permanent legislation* in the Senate, 60 votes of the 100 members, or three-fifths, are required. By contrast, *temporary changes* can be made within budget bills by a majority vote.

The Congressional Budget Act of 1974 (2 U.S.C. Sec. 621 *et seq.*) provides the procedures by which Congress may adopt spending and taxing priorities and the process for implementing those priorities. EGTRRA was enacted as a budget reconciliation bill for the purpose of returning projected 2001 budget surpluses to taxpayers in the form of tax relief. As a budget reconciliation bill, it was enacted to create procedures and priorities for spending and outlays.

¹ Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16

The Congressional Budget Act was amended in 1985, however, to provide that Congress may not include in a budget reconciliation bill new outlays beyond the period considered in the bill. Since the 2001 Act generally covered 10 years, spending and other outlays associated with the budget surplus required a specific shelf life—in this case, through 2010. Therefore, any tax relief included in the 2001 budget bill had to expire by the end of 2010.

Over the last 10 years, some of EGTRRA's provisions have been made permanent as votes allowed. However, as 2010 looms closer, the 60 Senate votes needed to cement estate tax changes contained in EGTRRA simply have not been found.

Politicians, advisors and independent citizens have been seeking stability in the estate tax arena since 2001. Estate planning over the last 10 years has been hampered by uncertainty and contingency planning. Moreover, there has been no preparation for the carryover basis provisions that are to accompany repeal of the estate tax. The Treasury Department has issued no regulations to provide guidance on how to move forward with carryover basis. If these provisions become the rule in 2010, taxpayers and their advisors will, once again, be forced to grapple with uncertainty.

2009 (EGTRRA rules)

- \$3.5 million estate and generation skipping tax (GST) exemption
- 45% maximum estate tax rate
- \$1 million lifetime gift tax exemption
- No state death tax credit

2010 (EGTRRA rules)

- Estate and GST tax repealed
- \$1 million lifetime gift tax exemption remains
- Estate tax replaced with carryover basis for income tax purposes (Under current law, heirs receive property from a decedent with a basis stepped up to date of death values.²)

2011 ("Sunset" year, returning to pre-EGTRRA rules)

- \$1 million exemption (indexed for inflation)
- 55% maximum estate tax rate
- State death tax credit reinstated

How Did We Get Here?

Continued ambiguity in the estate tax area does not mean that efforts at change have languished. Over the past 10 years, Congress has repeatedly attempted to enact reform. The impediment generally has been the elusive 60-vote requirement in the Senate. Throughout the decade, congressional representatives have sought to make repeal permanent. After repeated failure to gain a permanent repeal solution, numerous compromise bills were sponsored in both the House and the Senate.

² This legislation was first tried unsuccessfully in the 1970s and repealed almost as quickly as it was enacted. It resurfaced in EGTRRA.

Senator Jon Kyl (R-Arizona) was one of the early proponents of estate tax reform, sponsoring a resolution³ in 2003 providing for state tax repeal to extend beyond 2010, pending permanent repeal. However, he was unable to garner the necessary support for passage.

Then, following the Senate's decision in the fall of 2005 in the aftermath of the devastation caused by Hurricane Katrina not to vote on HR-8, a House bill which would have made repeal permanent, Kyl took up HR-8 again in 2006. He filed a motion to consider the House-passed bill amended to provide for a \$5 million exemption and a maximum 15% rate. HR-8 was taken up by the Senate; however, Kyl's efforts again met with defeat.

With repeal seeming out of reach, The House took a new approach, sponsoring several bills taking a compromise position. Examples include the Permanent Estate Tax Relief Act of 2006 (PETRA)⁴ and the Estate Tax and Extension of Tax Relief Act of 2006 (ETETRA)⁵ providing increased exemptions and decreased rates while keeping the current structure of the estate tax intact.

PETRA

- \$5 million exemption
- Rate tied to the maximum capital gains tax rate in effect (15%) and doubled for estates over \$25 million
- Reunification of the gift and estate tax
- Portability (transferability) of the exemption between spouses

ETETRA

- \$5 million phased-in exemption
- Top rate delinked from capital gains rate, phased down from 40% to 30% in 2% increments
- Reunification of gift and estate tax
- Portability of the exemption between spouses

PETRA was not embraced by the Senate, despite the Bush administration dubbing it a "constructive step." Although ETETRA was taken up by the Senate, it was ultimately defeated 56-42.

Attention to the sunset provision regarding the state death tax credit – a credit that carves out of the federal revenue the amount paid to the state - is also an important ingredient in considering the impact of failure to enact reform. Repeal of the state death tax credit shifted a portion of the financial burden of the increasing exemption and decreasing rates onto the states. If the state death tax credit returns in 2011, it will negatively affect federal revenue resulting from increased rates and a decreased exemption. Moreover, the effective federal rate of taxation will be felt disproportionately by smaller estates. Estates above \$17 million will be at taxed at an effective rate of 39%, while a \$3.5 million estate will face an effective rate of 45%. The perception of this effect of a reinstated

³ Senate Judiciary Resolution 20 (SJ Res. 20)

⁴ House Resolution 5638

⁵ House Resolution 5970

state death tax credit must be an unappealing one to an Administration whose tax priority favors lower and middle taxpayers.

What Is Likely to Happen?

As the end of 2009 drew near, there were various proposals under consideration, all of which bear certain similarities in their approach to exemptions and tax rates. A Senate bill⁷ sponsored by Senator Max Baucus (D-Mont.), Chairman of the Finance Committee, contained a \$3.5 million exemption, 45% top rate, reunification of the gift and estate tax, and portability of exemption between spouses. Baucus is a strong proponent of reform as he seeks stability for families and the ability of farmers to pass down the family farm—something that is simply not possible with a \$1 million transfer tax exemption.

Rep. James McDermott (D-Wash.-7th) proposed a House bill⁷ with a \$2 million exemption, staggered top rates of 40%, 50% and 55%, depending upon the size of the estate, reunification of the estate and gift tax exemption, portability of exemption between spouses and restoration of the state death tax credit.

Finally, Rep. Earl Pomeroy (D-N.D.-At Large) proposed yet another House bill⁸ with a \$3.5 million exemption, 45% top rate, which was passed by the House on December 3 and sent to the Senate. To widespread amazement and consternation, the Senate defeated this proposal on December 16, paving way for the actual repeal of the estate tax at the end of the year.

Why Plan Anymore?

Regardless of the uncertain estate tax environment, people will still want to ensure that their assets pass in accordance with their wishes, regardless of level of exemption or rate of tax. Asset protection planning will remain vital, as will planning for incapacity, disability or spendthrift issues. Individuals will still need to create business succession plans and charitable plans, while considering the associated tax consequences. People who own homes or other property in more than one state will still need to factor this complexity into the planning process. Further, it will still be critical to make plans with regard to non-U.S. citizens and their spouses.

Finally, while the continued use of family limited partnerships or limited liability companies (LLCs) for valuation discount purposes are still uncertain, there are certainly many non-tax related reasons why those entities will remain important and valuable.

As we count down the days that herald the repeal of the estate tax that nobody believed would actually occur, we continue to hope for congressional action that will result in permanence and stability. While we wait, we will continue to help our clients plan for orderly, effective transfer of family wealth. ■

⁶ Senate Bill 722

⁷ House Bill 2023

⁸ House Bill 436

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