



## A Mid-Year Report, 2004

By Robert L. Moshman

We mark the passage of the first half of 2004 with estate-related platform positions for Presidential candidates, a status report on the estate tax repeal, a review of recent tax proposals, and an update on how a number of states are reacting to the phaseout of the state death tax credit.

### Candidate Positions on Estate Tax

Senator John Kerry, the likely Democratic nominee for President, has indicated that he favors an elimination of the repeal of the estate tax. His approach would include the following:<sup>1</sup>

- A \$2-million estate tax exemption
- A top estate tax rate of 48%
- A \$5-million Qualified Family Business Tax Exemption.
- Top income tax rates (and dividend tax rates) of 39.6% and 36%
- Capital gains tax rate of 20% for taxpayers in the top two tax brackets

Third-party candidate Ralph Nader recently outlined his position on the estate tax in an interview with Patrick Buchanan for the American Conservative. He would not repeal the estate tax nor return to top rates of 55%. He favors a top rate of 35% for estates over \$10 million and a lower rate for estates over \$500,000. He also favors a "wealth tax" of 1% annually and a ¼-cent tax on transactions of stocks, bonds, and derivatives.

President George W. Bush has continued to support efforts to make the repeal of the estate tax "permanent." To that end, the President and 258 members of Congress (as of June, 2004) have signed a "no new taxes" pledge that is designed to make the estate tax repeal a reality. Whether this pledge will be effective or is a good idea or not is subject to interpretation.<sup>2</sup>

### Other Proposals

In recent months, Congress has turned its attention to a repeal of the tax on extraterritorial income.<sup>3</sup>

This was one aspect of a package of changes that have been grouped under the American Jobs Creation Bill (H.R. 4520). Other provisions address depreciation and incentives for manufacturers, small businesses, and farmers and alternative minimum tax (AMT) relief.

A separate bill to increase the minimum wage by \$1.00 was voted down in June, 2004. The Democrats had proposed an increase of \$1.50 (from \$5.15 to \$6.65) in two \$.75 installments, one immediate and one next year.

### Transfers Without Taxation

Are we there yet? If, by way of analogy, the repeal of the estate tax were a summer vacation, the car ride would be halfway across the United States and the kids in the back seat would have every right to be restless.



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Estate tax repeal had two unsuccessful efforts during the Clinton administration. The second effort in 2000 actually was passed by the legislature, vetoed by President Clinton, and failed to secure enough votes to override the veto. But the following year, on the third attempt, the legislation sailed right through by Memorial Day and President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) shortly thereafter.

Two weeks later, by mid-June of that year, four of the most respected names in the field of estate planning, Jonathan Blattmachr, Howard Zaritsky, Sanford Schlessinger, and Stephen Leimberg, went on the Ricki Lake daytime talk show and unanimously predicted that the repeal would never arrive.

By the end of 2001, it had become fashionable to jump on the no-repeal bandwagon. We reported, "And just in case one is inclined to disregard these cognoscenti, there is an amazing sunset provision which, courtesy of the obscure Byrd rule, would operate like some undo button that will reinstate the estate tax at 55% in 2011, wiping out a decade's worth of rates and credits being adjusted."

Three years later, we are still on track for a repeal of the estate tax. However, we remain five and half years and a mighty leap of faith away from the repeal's taking place. Consider how different a place the world has become during this time.

- The nation's brief experience with budget surpluses quickly ended, and we have returned to deficit spending.
- Terrorists attacked our nation on September 11, 2001, and we have since responded by investing financial resources in Afghanistan and Iraq.
- Capital gains taxes have been reduced, and the financial markets have fluctuated, placing more pressure on the government to raise revenues from other sources.
- Elections in 2004 and 2008 could shift the balance of power in Washington.

It may be an understatement to conclude that no, we aren't there yet as far as the actual repeal of estate tax is concerned. But maybe the focus on permanent repeal is just an illusion anyway. Transfers without taxation are already taking place.

With a \$1.5-million exemption for each spouse, lifetime gifts, charitable deductions, and useful valuation techniques, many moderately sized estates are already experiencing transfers without taxation. In 18 months (by 2006), the exemption amount will rise to \$2 million for each spouse. With careful planning, even very large estates can be transferred without estate tax.

With careful planning and enough time, most estates can already be protected from transfer taxation as well as exposure to other liabilities. So reliance on an outright repeal of estate taxation may be misplaced. Good planning has always tried to anticipate all of the reasonable possibilities and that continues to include the possibility that estate tax repeal will never actually arrive. Maybe we are already there after all.



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## The Gift Tax Goes Solo

It should be noted that even if the estate tax is ultimately repealed, taxation of gift transfers will continue. In fact, there has already been a parting of the ways between the estate and gift tax.<sup>4</sup>

Prior to 1976, there were 25 federal estate tax brackets ranging from 3% to 77% and gift tax rates were 75% of the estate tax rates. The Tax Reform Act of 1976 combined estate and gift tax rates into a single, unified schedule with 21 brackets that went up to 70%.

While the exclusion amount for estates and generation-skipping transfers has increased to \$1.5 million this year and will continue to be increased in the future, the exclusion for gifts remains at \$1 million and is not adjusted for inflation.

For the short term, with a gift tax exclusion of \$1 million and an estate tax exclusion of \$1.5 million, estates have great flexibility. As for larger estates, until the estate tax repeal is made permanent, all bets are off. And the potential for a carry-over basis on a portion of assets held at death could affect the assets selected for lifetime gifts as well.

Down the road, the taxation of lifetime gifts could become a significant factor. Consider the context: The nation's budget surplus disappeared and has become a profound deficit. Expenses in the Middle East and from the Social Security payments that are coming due will require new tax revenues.

It is possible that income tax rates would go higher in the future, making it worthwhile to make lifetime transfers of income-producing assets to low-bracketed family members. Congress may anticipate such transfers and impose limits on the annual gift tax exclusion.

## State Death Taxes

The end of the federal credit for state death taxes after 81 years is triggering a variety of reactions from states around the nation.<sup>5</sup>

As of December 2003, a majority of states are eliminating their estate taxes based on the changes made by EGTRRA. Starting in 2005, 28 states will have no estate, inheritance, or successions tax. They will be joined by Connecticut in 2006, Wisconsin in 2008, Illinois in 2010, and Vermont in 2010 (if the federal estate tax actually expires).

Several states have adopted rules and reconsidered. For example, Illinois initially allowed the EGTRRA provisions to phase out the state estate tax, but in 2003 adopted legislation that temporarily "decouples" the state estate tax from federal law until 2010. Kansas initially adopted a successions tax in 2002 but then repealed it in 2003. Ten states have anchored their estate tax to the tax in effect on a particular date. Approximately 17 states also had separate inheritance taxes.

This remains a dynamic area. Professionals must remain alert to circumstances in which states have decoupled local death taxes, causing assets which are not exposed to federal taxes to be subject to local taxes.



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## A Shareholder's Undistributed Earnings

Decedent owned all stock of a corporation. After Decedent's death, his executor made a Section 2032(a) election to value Decedent's assets as of six months after Decedent's date of death. During those six months, the corporation retained earnings without distributing them to Decedent's estate. Decedent's stock was valued as of the six-month date without including the undistributed earnings. Could such earnings be excluded from Decedent's estate? The estate's counsel argued that such earnings constituted "excluded property" under Reg. §20.2032-1(d)(4).

The IRS ruled that the value of Decedent's stock on the alternate valuation date should have included the accrued earnings. Under the regulations in question, earnings that are distributed as dividends during the alternate valuation period would be excluded property.

This follows the case of, *Maass v. Higgins*, 312 U.S. 443 (1941), in which the Supreme Court concluded that rents, interest, and dividends are income. The exception to this rule is where the "dividend" being distributed is, in essence, a partial liquidation of the corporation. In the case at hand, the earnings were not distributed. They were became part of the stock value on the alternate valuation date and their value was therefore includable in Decedent's estate. TAM 200343002.

## Duty of Consistency

Section One of Husband's will bequeathed a life estate in "all oil paintings" to Wife. But Section Two of Husband's will bequeathed a life estate and a general power of appointment in all personal property to Wife.

Because an appraisal identified one painting as a "pastel," executors concluded that it was transferred to Wife under Section Two of the will. The executors included the "pastel" painting in Husband's estate and claimed a marital deduction for it.

However, after Wife's death, it was concluded that the painting fell under the "oil painting" category and should have passed under Section One of Husband's will. Since Wife never had a power of appointment over the painting, her executors did not include the painting in her estate. The IRS included the painting in Wife's estate under the duty of consistency doctrine because 1) Husband's estate claimed a marital deduction for the property; 2) the IRS relied upon that representation; and 3) the Wife's estate was attempting to alter that representation after the statute of limitations for Husband's estate had expired.

In addition, there was privity between the estates of Husband and Wife, binding Wife's executors to the representations made by Husband's executors. The two estates functioned as a single economic unit. TAM 200407018.

## When Underreporting Becomes Fraud

An estate tax return reported an estate worth \$12 million. The IRS said the true value was closer to \$35 million. The Tax Court concluded that the estate failed to report \$4.5 million of omitted assets and imposed a 75% fraud penalty under §6663.

The U.S. Court of Appeals for the Ninth Circuit remanded the case for the Tax Court (*Trompeter*



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*Est.*, CA-9, 2002-1), which explained how the existence of gems, jewelry, furniture, cash, coins, rugs, and jade and ivory collections was substantiated by receipts and checks relating to purchases made by the decedent, a creditor claim filed against the estate, the contents of safe deposit boxes, and conversations with the decedent's friends.

The co-executors' willful failure to disclose the estate's assets and their intentional undervaluation of other assets, constituted clear and convincing evidence of fraud.

As to preferred stock valued by the estate at \$15,335 and valued by the IRS at \$1.95 million, the Tax Court had originally set the value at \$2.71 million with a 4% discount. However, after the case was remanded, a 12.5% discount rate was applied to arrive at a value of \$2.23 million. A larger discount was based on the risk of the company's redeeming stock for less than full value. No marketability discount was provided because the stock was already discounted below freely traded values. *Trompeter Est.*, TC.

## TECHNICAL REFERENCES

<sup>1</sup> Source: The April, 2004 report from the nonpartisan Urban Institute is based on Senator Kerry's policy papers and speeches. It can be found on [taxpolicycenter.org](http://taxpolicycenter.org).

<sup>2</sup> William G. Gale, a Senior Fellow of economic studies with the Brookings Institute, has authored a paper in June, 2004 that is critical of the no-new-taxes pledge: "Although it is intended to restrict the size of government, the pledge probably hinders rather than helps efforts to restore fiscal responsibility." The analysis can be found online at [brookings.edu](http://brookings.edu).

<sup>3</sup> Regarding the repeal of the tax on extraterritorial income, the changes contemplated by the H.R. 4520 and S. 1637 in the House and Senate, respectively, could trigger more aggressive tax sheltering, warned Gregory Jenner, acting assistant Treasury secretary for tax policy. Appearing at a Las Vegas meeting of the American Institute of Certified Public Accountants (AICPA), Jenner said, "These bills would cause a sea change in the way that we tax business income, and it's a change that I don't think is for the better."

<sup>4</sup> Estate and gift taxes were unified for 28 years (1976 through 2003). Tax rates and exemptions were unified. Instead of separate exemptions of \$60,000 for estate tax and \$30,000 for gift tax, TRA '76 provided a unified credit of \$30,000.

<sup>5</sup> The federal credit for state death taxes remained a part of our tax system even longer than the unified credit. A full credit for state death taxes was provided for 78 years (1924 through 2001). The credit was phased out 25% in 2002, 50% in 2003, and 75% during 2004. It will be gone in 2005 entirely, after 81 years in the tax code. A summary of how states are reacting to the phaseout of the state credit was assembled by the Minnesota Legislature and can be found online at <http://www.house.leg.state.mn.us>.



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