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AALU Bulletin No: 10-93

September 22, 2010

Subject:    **JCT Describes Provisions of Obama's FY 2011 Budget Proposals, Including Proposed Changes to Taxation of Life Insurance and Estate and Gift Taxes**

Major References:    [\*Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal \(JCS-2-10\) \("JCT Report"\)\*](#)

Prior AALU Washington Reports:    10-15; 09-50; 09-46; 09-27; 08-9; 03-110; 03-67; 02-77; 00-16; 01-16; 00-88

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*In August 2010, the Joint Committee on Taxation (JCT), released their analysis of the Obama Administration's FY 2011 budget, and the Treasury's General Explanations thereof (commonly know as the "Greenbook"). As reported in our Bulletin No. 10-15, key life insurance and transfer tax provisions were included in the Budget, as were a number of other changes affecting individuals, including higher rates, reduced deductions, automatic enrollment in IRAs, and other provisions of interest to AALU members. The recently released JCT Report adopts a more analytical approach to the budget, particularly with respect to estate and gift taxes.*

In the Greenbook, it was noted, with respect to estate and gift tax rates that "[t]he Administration's primary policy proposals reflect changes from a tax baseline that modifies current law by . . . freezing the estate tax at 2009 levels." No further discussion was forthcoming as to the underlying rationale of the existing system, although specific policy proposals - such as the 10-year limit on GRAT terms, and restrictions on valuation discounts - were offered.

The JCT Report, in contrast, contains a long “Analysis” section, amply footnoted, that considers a number of complex issues, including the following:

### **TRANSFER TAX PLANNING ISSUES:**

- **Stability and consistency in the law:** The JCT Report notes that “[c]ommentators have advocated a stable and more predictable estate and gift tax system -- without constantly changing parameters, phase-outs, or sunsets -- arguing that the complexity of current law has made estate planning difficult and costly.” For example, formula clauses in existing estate plans that may be based on tax exemptions no longer in effect can have unintended consequences. As another example, the American Bar Association’s Task Force on Federal Wealth Transfer Taxes notes that “some taxpayers wish to maintain life insurance only if they will have an estate tax liability, but this is difficult to determine when the estate tax laws are unsettled and changing.”
- **“Decoupling” of the Estate and Gift Tax Exemptions (Respectively \$3.5 Million and \$1 Million per person):** The reports notes that there is an argument that the lower gift tax exemption (and resultant high cost of the gift tax) encourages taxpayers “to create complicated long-term trusts at death designed to avoid gift tax on transfers to successive generations . . . [and] to delay transfers until death, encouraging family wealth to remain ‘locked in’ older generations.” However, the JCT Report states, “the effect of the lower gift tax exemption amount from 2004 through 2009 is partially mitigated by a structural difference between the estate tax and the gift tax that generally benefits taxpayers who make inter vivos gifts: the gift tax is “tax exclusive,” whereas the estate tax is “tax inclusive.” In other words, under the estate tax, the assets used to pay the tax are included in the estate tax base. Thus, if the estate and gift taxes were fully reunified, the gift tax would be a less costly tax.” The Report also notes that the gift tax is viewed as being necessary to protect the income tax base, and a higher gift tax exemption might erode that base.
- **Treatment of State death taxes for Federal estate tax purposes:** Under EGTRRA, the amount of the allowable credit was reduced from 2002 through 2004, and for decedents dying after 2004, the credit was replaced with a deduction from the gross estate for State death taxes actually paid to any State or the District of Columbia. The budget proposal reinstates and makes permanent the State death tax deduction, thus (some argue) making it difficult for the States that have no independent death tax to raise critically needed revenue. Others argue, however, that “estate or other succession taxes, whether Federal or State, are undesirable and that the allowance of a Federal credit for State death taxes is a subsidy to States that encourages the enactment or retention of State-level death taxes.” Still others might argue that, “if the intended policy is to provide a funding mechanism for State governments, it would be more direct and efficient to provide a direct Federal government subsidy instead of making a tax expenditure through the tax system.”
- **Federal estate tax and basis of transferred assets:** The Report acknowledges that the one-year change from an estate tax coupled with basis step-up (or step-down) to estate tax repeal with carryover basis raises several behavioral and administrative issues, among them the taxpayer’s willingness (or lack thereof) to sell an appreciated asset during life, thus reducing the mobility of capital to potentially higher return investments. Conversely, opponents of carryover basis argue that it perpetuates lock-in because income tax liability for pre-death gains carries over to the heir, who also may refrain from selling an asset because of the adverse income tax consequences from sale. Carry over basis also causes administrative difficulties in “tracking” the basis of assets to establish historical cost. This difficulty may be particularly pronounced for certain types of personal assets, such as jewelry, classic cars, paintings and stamp collections. “In the absence of statutory presumptions, if an heir is unable to establish a decedent’s basis in property, a question is whether the IRS will consider the heir to have a zero basis in the property.”

A related question in a system in which an executor is required to supply carryover basis information to beneficiaries would be whether beneficiaries would be permitted to rely on the information and whether executors would be subject to penalties for failure to report correct or complete information. The Report notes that “[a]lthough the 2001 rules do not require an executor to provide basis information to beneficiaries, they do provide that an executor must allocate the permitted basis increases (the \$1.3 million and \$3 million amounts described previously) among estate assets, and they permit broad discretion in making the allocation . . .”.

Another open question concerns whether there should be a “grandfathering” rule - as with the 1976 carryover basis statute - with respect to amounts of appreciation that have occurred before the time of the rule change.

- **Retroactive application of the estate and generation skipping transfer taxes:** The President’s Budget makes “freeze 2009” effective for decedents dying and gifts made after December 31, 2009 - *i.e.*, it is retroactive. The report notes that there is an argument that the retroactive imposition of the estate and GST taxes may be unconstitutional or “simply unfair.” It views a constitutional challenge as a “virtual certainty.” On the other hand, the Report continues, “some may argue that retroactive application of the 2009 transfer tax and basis rules is both appropriate and fair.” In part, this is because taxpayers had some prior knowledge that the transfer tax and basis rules could be retroactively modified. In addition, “[t]he number of heirs who have the potential for greater capital gains tax liability under 2010 law likely far exceeds the number of decedents’ estates that will benefit from the absence of an estate tax under 2010 law.”

## ECONOMIC ISSUES

- **Wealth taxes, saving, and investment:** The Report notes that “there is no consensus in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment.” Theoretically, “it is an open question whether estate and gift taxes encourage or discourage saving, and there has been limited empirical analysis of this specific issue.” The Report posits the following example: “[On the one hand], a more expansive estate tax may discourage potential transferors from accumulating the assets necessary to make a bequest. On the other hand, a taxpayer who wants to leave a bequest of a certain net size might save more in response to estate taxation to meet that goal. For example, some individuals purchase additional life insurance to have sufficient funds to pay the estate tax without disposing of other assets in their estate.”

- **Wealth taxes and small business:** The Report acknowledges the existence of a deleterious effect of the estate tax on small business - either by forcing sales of those businesses or forcing them to borrow to pay the tax. Others argue that potential deleterious effects of the estate tax on investment by small or family-owned businesses are limited. In particular, there is little evidence that passing a business on from one family member to another increases the economic efficiency of that business. Nor is that much to indicate that a large number of small businesses fail or are sold as a result of the estate tax. One study, for example found only 2.4 percent of estates that reported closely held business assets and agricultural assets elected the deferral of tax under section 6166.

- **Wealth taxes and labor supply:** The Report observes that “[o]ver 100 years ago, Andrew Carnegie opined that ‘the parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would . . . .’” However, “while, in theory, increases in wealth should reduce labor supply, empirically economists have found the magnitude of these effects to be small.” It may even be that wealth transfer taxes could increase the work effort of heirs “as the benefits of the installment payment method, special-use valuation, and the exclusion for qualified family-owned business interests will be lost and recaptured if the assets fail to remain in a qualified use.”

- **Wealth taxes, the distribution of wealth, and fairness:** The effect that tax policy has on the distribution of wealth is difficult to quantify. The Report observes that there is evidence that the Great Depression of the 1930s and World War II substantially reduced the concentration of wealth in the United States, and that there had been no substantial change at least through the 1980s.
- **Federal estate taxation and charitable bequests:** The “price effect” says that “if something [*e.g.* charitable giving] is made cheaper, people will do more of it.” ON the other hand, the “wealth effect” says that “[g]enerally the wealthier an individual is, the more likely he or she is to make a charitable bequest and the larger the bequest will be. Because the estate tax diminishes the value of wealth to an heir, the wealth effect would suggest repeal of the estate tax could increase charitable bequests.” ON balance, however, most studies have concluded that, “after controlling for the size of the estate and other factors, deductibility of charitable bequests encourages taxpayers to provide charitable bequests.”
- **Federal transfer taxes and complexity:** Complexity encourages avoidance, according to critics of the estate tax. Some of this avoidance involves “complex legal structures and can be expensive to create.” This expense can be viewed as socially wasteful. However, “[t]here is disagreement among analysts regarding the magnitude of the costs of avoidance activities, [and it] is difficult to measure the extent to which any such costs incurred are undertaken from tax avoidance motives as opposed to succession planning or other motives behind gifts and bequests.”
- **Alternatives to the current U.S. estate tax system:** The choice of one form of wealth transfer tax system over another “necessarily will involve tradeoffs among efficiency, equity, administrability, and other factors.” Competing regimes include the current U.S. system, which imposes a tax on the transferor of wealth, others, such as Canada tax capital gains at death, and still others tax the transferee of a gift or bequest. Such systems include inheritance (or “accessions”) tax systems, under which a tax is imposed against the recipient of a gratuitous transfer. Still other jurisdictions do not impose a separate tax, but instead treat receipts of gifts or bequests as gross income of the recipient (an “income inclusion approach”). In all of these systems, however, the burden of the tax falls on the recipients of the wealth, “because the amount received effectively is reduced by the amount of tax paid by the transferor or realized by the transferee.

As we have noted in our prior Bulletins, we expect little progress on the estate tax and/or the budget until after the November elections. We will continue to monitor the progress of the Administration’s proposals as they move through the legislative process.

Any AALU member who wishes to obtain a copy of JCS-2-10 may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at [www.aalu.org](http://www.aalu.org), enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at [raglani@aalu.org](mailto:raglani@aalu.org) and include a reference to this *Washington Report*.

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