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TESTIMONY OF ROBY B. SAWYERS BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE

Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning
April 3, 2008

Mr. Chairman, Ranking Member Grassley, and Members of the Committee, thank you for the opportunity of testifying today on issues related to simplifying planning associated with the estate and gift tax including the re-unification of the estate and gift tax exemption amounts.

My name is Roby Sawyers. I am a practicing CPA and professor in the College of Management at North Carolina State University. I am also a member of the American Institute of Certified Public Accountant's (AICPA) Tax Executive Committee, chaired the AICPA's Transfer Tax Reform Task Force and was a contributing member of the Joint Task Force on Federal Wealth Transfer Taxes. Much of my testimony today comes from the previous reports issued by those task forces.

In order to provide certainty to taxpayers, the AICPA encourages Congress to make permanent changes to the estate tax prior to its scheduled repeal in 2010. A written statement for the record outlining the AICPA's priority list of seven suggested reforms of the transfer tax system was provided to this Committee for consideration following last month's hearing on alternatives to the federal estate tax system.

My testimony today focuses on three issues surrounding the decoupling of the estate and gift tax exemptions:

- First, taxpayers and practitioners face planning difficulties as a result of decoupling the estate and gift tax exemption amounts in 2004. Under the law prior to the passage of the

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA),[1] the estate and gift tax exemption was unified and could be used to offset both lifetime gifts and bequests at death. This policy was well understood by taxpayers and simplified estate and gift tax planning by reducing the number of tax and non-tax variables that must be considered in deciding whether to transfer assets during life or at death. However, under current law, while the estate tax exemption and generation skipping transfer (GST) tax exemption stand at $2 million in 2008 and increase to $3.5 million in 2009, the gift tax exemption remains at $1 million.[2]

- Second, as a result of the decoupling, taxpayers including small business owners may be discouraged from making orderly lifetime gifts of property and to engage in business succession planning. Historically, the gift tax has been less expensive than the estate tax, providing an incentive for taxpayers to make intrafamily transfers during life.[3] That policy has several advantages including a potential acceleration of tax revenue to the

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[1] P.L. 107-16

[2] Concern that taxpayers might make tax-free gifts of low-basis or income-producing assets to taxpayers in lower tax brackets and thus erode the income tax apparently led Congress to limit the gift tax exclusion amount to $1 million. For further discussion of this issue, see Part II (The Gift Tax) of the *Report on Reform of Federal Wealth Transfer Taxes* published by the American Bar Association in 2004.

[3] Before 1977, gift tax rates were lower than estate tax rates. Today, while the estate and gift tax use the same tax rate schedule, the gift tax is calculated on a tax exclusive basis while the estate tax is calculated on a tax inclusive basis. As demonstrated in the following example, this results in an effective gift tax rate that is lower than the effective estate tax rate: A taxpayer dies with a taxable estate of $3 million subject to a 50 percent tax rate. The estate tax on the $3 million is $1.5 million ($3 million x 50 percent) leaving the taxpayer's heir $1.5 million. The estate pays an effective tax rate of 50 percent ($1.5 million estate tax divided by $3 million of assets). With the same $3 million of assets, the taxpayer could have made a gift during life of $2 million subject to the same 50 percent tax rate. The tax on this $2 million gift is $1 million for an effective tax rate of 33.3 percent ($1 million of gift tax divided by $3 million of assets). Valuation rules and the annual exclusion also increase the benefit of making lifetime gifts as opposed to bequests at death. The decoupling of the gift and estate tax exemptions has the opposite effect and may make lifetime gifts more expensive. In addition, taxpayers must weigh the advantage of lower transfer taxes with the potential for higher income taxes. Under IRC Section 1014, a taxpayer receiving inherited

Government. However, the primary advantage is that it encourages the lifetime distribution of family capital to younger generations. It encourages small business owners to plan for the orderly transfer of management and control of their businesses during life. It encourages older taxpayers to make gifts of cash and other property to younger generations. It is these younger taxpayers, who need the capital in order to buy homes, raise and educate their children and purchase other goods and services. Reunification of the estate and gift tax exemption should result in a greater propensity to make both taxable and nontaxable gifts and provide a stimulus to the economy.

- The third issue is a direct result of the uncertainty surrounding the future of the estate tax. A donor's making of both nontaxable and taxable gifts often reflects prudent tax planning in the face of a future estate tax. However, the prospect of no estate tax in 2010 may make individuals reluctant to make taxable lifetime gifts that otherwise would be sensible for nontax reasons including business succession planning.[4] It also puts CPAs and other tax practitioners in an awkward position as properly advising a client as to the benefits of making lifetime gifts requires an assumption as to whether the estate tax will indeed be repealed. The uncertainty concerning the future of the estate tax makes the decision much more difficult for taxpayers and their advisors.

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property generally receives a basis equal to the property's fair market value at death while under IRC Section 1015, a taxpayer receiving a gift generally receives a carryover basis equal to the donor's basis.

[4] In a recent report, the Congressional Research Service finds that gift tax revenues fell by approximately half (as a percent of total estate and gift tax revenues) after the enactment of the EGTRRA ("Estate and Gift Tax Revenues: Past and Projected in 2008," Nonna A. Noto, RL34418, March 19, 2008).

Recommendations:

In summary, the AICPA suggests that the estate, GST, and gift tax exemptions be re-unified. Reunification will simplify planning for taxpayers and avoid all the cumbersome number juggling now required, provide an incentive for small business owners to make business succession plans, and provide an incentive for taxpayers to make intrafamily transfers of wealth during life.

If the estate tax and GST tax are permanently repealed, the AICPA encourages Congress to reunify the estate and gift taxes during any phase-out period and repeal the GST tax immediately. Immediate repeal of the GST tax would have minimal revenue effect, because, in most situations, taxpayers are not going to find it difficult to defer imposition of this tax until the end of the phase-out period. Likewise, if the current estate tax system is retained, we encourage Congress to immediately reunify the estate tax, gift tax and GST tax exemption amounts in order to simplify planning and provide an incentive for small business owners to plan for orderly succession of their business interests and others to make lifetime transfers of property to family members.

We hope you and others in Congress will consider these suggestions in the debate about estate tax reform. We look forward to working with Congress to achieve simplicity, effectiveness, and efficiency as Congress considers changes to the current estate and gift tax system. Thank you for the opportunity to share these views with you.