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Estate Taxes

Potential for Estate Tax Repeal Grows Despite New Obama Capital Gains Proposal

Wealth planners began thinking seriously in 2015 about the possibility that the estate tax could be repealed, with dwindling estate tax revenue putting what could be the final nail in the coffin, practitioners told Bloomberg BNA.

Not even a surprise proposal from President Barack Obama to tax capital gains at death could put them off their belief. In fact, they said Obama's proposal may have been designed to give him a bargaining chip when the estate tax repeal bills start to roll in.

Revenue from estate tax is down considerably from its peak, which is helping to make the case for repeal, Beth Kaufman, Caplin & Drysdale member and former Treasury Department associate tax legislative counsel, said Jan. 20.

For fiscal year 2013, estate tax revenue was about $12.7 billion, which is about half what it was before cuts to the estate tax began in 2001, she said. From 2001 through 2012 the estate and gift tax exemptions were increased $1 million to the current $5.43 million, and the top marginal rate was reduced from 55 percent to the current 40 percent.

Dwindling Taxable Returns. In addition, the number of taxable returns was down to less than 5,000 in fiscal year 2013, which reflects 0.2 percent of the people who died in that year.

Revenue from estate and gift tax is considerably less than 1 percent of the tax revenue from all sources, Kaufman said.

''Previously supporters argued that the fisc could not withstand the loss of revenue that would result from repeal, but these data points minimize the importance of that argument,'' she said. ''Furthermore, the estate tax now only hits a handful of decedents, so the idea that we maintain the estate and gift tax structure to collect tax from 5,000 estates each year lends support to those who favor repeal.''

Add to that a Republican-controlled Congress, and until now, little opposition from Obama to lowering rates and raising exemptions, and some said repeal is looking more likely.

The idea has put a glint in the eye of Republicans for a decade, with a bill offered by Ways and Means Committee member Rep. Kevin Brady (R-Texas) in 2014 garnering support from a majority of lawmakers in the House.

Previously, there may have been some reluctance by Republicans to put repeal of the estate tax on the table for fear of losing traction on some of their recent gains, like a high lifetime exemption amount indexed annually for inflation, Dana Foley, an associate with Arnold & Porter LLP, said Jan 15. With the new Republican majority in both houses of Congress, their position may be changing, she said.

Preemptive Strike. Obama's plan to tax capital gains at death could be a preemptive strike, Kaufman said. ''He may have put this measure out there as a backstop so that if Congress passes a bill repealing the estate tax, the president can negotiate by agreeing to estate tax repeal only if Congress accepts his proposal to tax capital gains at death,'' she said.

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BETH KAUFMAN
CAPLIN & DRYSDALE

Obama latched onto estate taxes in his Jan. 20 State of the Union address, proposing to eliminate the step-up in basis that allows the wealthy and even not-so-wealthy to pass appreciated assets on to their heirs without paying capital gains tax.

Lewis J. Saret, of the Law Office of Lewis J. Saret in Washington, pegged the probability of repeal at less than 50 percent for 2015. But the probability has increased substantially given the new congressional leadership, he said Jan. 20.

He agreed that Obama may be positioning himself for possible estate tax repeal negotiations. ''I could possibly see a compromise where the proposal is enacted and the estate tax is eliminated,'' Saret said.

The president's proposal to tax capital gains at death bears a resemblance to the Canadian tax system, Saret said, with one major difference. Obama didn't propose eliminating the current estate tax.

''If the proposal were enacted as proposed, there would be both an estate tax and the proposed capital gains tax at death—almost certainly something that Republicans, with their consistent stance against any tax increases, would not agree to,'' he said.

Dropping a 28 percent capital gains tax on the wealthy in addition to the 40 percent estate tax rate was

described by Kaufman as ''a huge amount of tax,'' that isn't likely to be considered by the current Congress.

The president's proposal would boost the top rate to 28 percent, from the current 23.8 percent, for married couples with incomes of more than about $500,000.

Meanwhile, Senate Democrats in previous Congresses have been split on the question of hiking estate taxes, instead opting to give up that fight to win the bigger battle of middle-class tax relief.

Unexpected Proposal. Until now, fighting a relaxation of the estate tax hasn't been a priority for Obama, so the capital gains proposal came as somewhat of a surprise.

''Obama has given up at least twice, in 2010 and 2012,'' Saret said. ''So clearly, prior to this, it wasn't all that important to him.''

In 2010, the estate tax exemption was going to go back to $1 million, and there was talk of it being fixed at $3.5 million, Saret said, but at the last minute it got bumped up to $5 million, indexed for inflation, for two years. Obama didn't fight it.

In 2012, Republicans threw in permanently fixing the estate tax at $5 million, and Obama didn't oppose that, he said.

If repeal happens in the near term, it is more likely to happen in 2015 than 2016, he said, when the presidential election will keep legislators from tackling controversial issues.

Obama's latest proposal may be more symbolic than anything else, Ron Aucutt, McGuireWoods LLP partner, said Jan. 20. ''I suppose every president has asked for something just so he could say 'Well, I tried,' '' when it comes to getting his agenda enacted, Aucutt said.

However, he said the timing of it, right after Republicans took control of the Senate, along with the unusual step of putting out a fact sheet three days in advance of his State of the Union message, might make Obama's proposal stand out a little more than other presidents' proposals.

Trust Fund 'Loophole.' Aucutt also said Obama's reference to closing the ''trust fund loophole'' in the proposal was off-base. The date-of-death-value basis—''stepped up basis'' for appreciated assets—provided by Section 1014 of the tax code ''has nothing to do with trusts,'' Aucutt said.

''In fact, unless the decedent has certain powers over the trust, assets in a trust generally do not get the stepped-up basis, which is reserved only for assets acquired from that decedent,'' he said.

Amid the talk of repeal, some attorneys have already begun to revise their advice to clients. Kaufman said in the current environment, she isn't in favor of techniques that would require her clients to pay gift tax. ''They would be paying gift tax to reduce an estate tax down the road when they die,'' she said.

While it would be fine for a couple to make gifts that use up their approximately $11 million joint exemption, she said, the possibility of repeal is significant enough in their lifetimes that she wouldn't want to see them pay gift tax.

Material Participation Won't Materialize. While Internal Revenue Service officials have said they would like to complete a project defining what material participation is for estate and trusts sooner rather than later, attorneys contacted by Bloomberg BNA don't expect this to happen.

''With the 2014-2015 IRS priority guidance plan running 34 pages in length, and given the reduced IRS budget for fiscal year 2015, I think it's not so much a question of what we will see in 2015 on the issue of material participation for estates and trusts, as it is a question of what we probably won't see,'' Foley said.

She said she doesn't anticipate the issuance of these regulations in 2015.

At a November 2014 meeting of the American Institute of CPAs, Adrienne Mikolashek, an attorney in the IRS Office of Chief Counsel (Passthroughs & Special Industries), said the project was opened with an eye toward answering the narrow question of how a trust or estate can be considered to be actively participating in a business.

The lack of guidance has led to practitioners taking different positions on whether material participation has occurred—even where trusts are in virtually the same situations.

For instance, a certified public accountant in one state may look at the issue and determine that the trust doesn't materially participate, while another might say it does, Saret said.

Tax preparers are looking at the same facts and reaching different, but reasonable conclusions, attorneys said. However, from a tax administration standpoint, they said this is inefficient, and potentially unfair to the taxpayer if different treatment results.

Long-Overdue Covered Expatriate Rules. The IRS has said the next bit of guidance to emerge will be proposed rules on ''covered expatriates'' under tax code Section 2801.

It has been seven years since enactment of the Heroes Earnings Assistance and Relief Tax Act of 2008, which subjects the recipients of gifts and bequests from certain expatriates to substantial tax liability, and the agency is under increasing pressure to produce regulations.

Agency officials deferred the reporting and tax obligations for covered gifts or bequests under the law, and time is running out to enforce those regulations retroactively, practitioners said. The project has been on the guidance plan since 2009.

A number of procedural problems have held up the issuance of the proposed rules, Cathy Hughes, Treasury Department estate and gift tax attorney-adviser, said at the November AICPA meeting.

Two of the problems are that the U.S. recipient of the gifts isn't even subject to Section 2801 unless the property comes from a covered expatriate, as defined by the law; furthermore, the gift must be a ''covered bequest.''

''But the problem with that is that the IRS is the only one who knows for sure the answers to those questions. Not the recipient,'' Hughes said.

Tax code Section 6103 limits the information the IRS can divulge to someone other than a particular taxpayer. ''We do not want to get to a place where we have to say 'everybody who gets something from somebody who was ever in the U.S. and has expatriated now has to assume they are subject to 2801,' '' Hughes said.

By Diane Freda

To contact the reporter on this story: Diane Freda in Washington at dfreda@bna.com

To contact the editor responsible for this story: Cheryl Saenz at csaenz@bna.com

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