

Possible Repeal of the Estate Tax in 2017

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The election of Donald Trump as the next President, along with continued Republican party control of both the House and the Senate, could signal that 2017 will be the year that the estate tax is repealed. This confluence of events significantly elevates the possibility of success for tax reform, including estate tax repeal. This alert focuses primarily on the estate, gift, and generation-skipping transfer tax, and the treatment of basis at death. We have outlined potential changes to the individual income tax in a separate Alert.

President-Elect Trump's plan is light on details, but it is clear that he believes that the estate tax should be repealed. The fate of the gift tax and the generation-skipping transfer tax ("GST" tax) is less certain under the Trump plan, as is the step-up in basis on death that is available under the current estate tax regime. Other GOP proposals, including Speaker of the House Paul Ryan's plan, "A Better Way," are more clearly defined. *The situation is dynamic, but this alert describes the current state of play and discusses what clients—who have or might have taxable estates under current law—should discussing with their tax advisers now.*

What Is In Play?

Estate Tax. President-Elect Trump's proposal and all of the GOP proposals include repeal of the estate tax (which they most often refer to as the "death tax"). While a partial or complete phase out (such as the one in 2001 to 2009, which increased the exemption amount from \$1 million to \$5 million) is possible, it seems more likely that total repeal of the estate tax would take place either immediately upon passage, retroactive to January 1, 2017, or effective on January 1, 2018, although a midyear effective date is also possible.

Gift Tax. The rhetoric against the estate tax always labels it a "death tax." As such, the gift tax could remain unchanged. Neither Trump's proposal nor "A Better Way" indicates that the gift tax would be repealed. This outcome would be consistent with the April 2015 repeal bill and our experience in 2010. In the 2001 tax act (which enacted the 2010 one-year repeal), the gift tax was left in place to protect the income tax base. In other words, the belief was that the gift tax was needed to prevent taxpayers from "income shifting." For example, without the gift tax in place, a taxpayer could gift appreciated assets to family members in a lower tax bracket, have the lower-bracket taxpayer sell the asset and realize the gain, and then gift the net proceeds back to the original transferor. Another concern was that a U.S. person could transfer an appreciated asset to a foreign relative who could realize the gain without paying any U.S. income tax, and later gift the proceeds back to someone in the U.S. Repealing the gift tax would also greatly increase the revenue loss of the proposal. If these concerns remain, then repeal would not be likely to include the gift tax.

GST Tax. President-Elect Trump's proposal does not mention the GST tax, but inasmuch as his entire "death tax" proposal contains only two sentences, details are yet to emerge. "A Better Way" expressly includes repeal of the GST tax. Furthermore, the last time the House of Representatives voted to repeal the estate tax (in April 2015), repeal of the GST tax was included, and in 2010—the one year of estate tax repeal that resulted from the 2001 tax act—the GST tax rate was set to zero, which had the effect of a temporary repeal. Based on this history, we think it is likely that the GST tax would be repealed along with the estate tax.

Basis at Death. Under current law, in general, assets included in a decedent's estate get a fresh basis equal to the value of the asset on the date of death. While this is commonly referred to as a "step-up" in basis, it also conceivably could be a "step down" in basis if an asset has declined in value to less than its adjusted cost basis. A step-up in basis effectively forgives the capital gains tax that would otherwise be paid on appreciation that has accrued but has not been realized at the time of death. Historically, a basis adjustment was allowed at death on the principle that it would be too burdensome to subject these gains both to an estate tax and a capital gains tax. (Note that capital gains realized before death are subject to both capital gains tax and estate tax, but capital gains taxes paid before death have the effect of making the taxable estate smaller.)

In 2010, repeal of the estate tax included a carryover basis at death for most assets. (An executor was given a fixed amount of basis that could be allocated to assets included in the decedent's estate.) While that experience was not as much of a disaster as predicted, estate tax repeal bills since then have generally left the step-up in basis at death in place. Both the April 2015 House bill and "A Better Way" make no change to current law with respect to basis at death.

Trump's proposal states that "capital gains held until death and valued over \$10 million will be subject to tax to exempt small businesses and family farms." That statement implies that in the absence of an estate tax, Trump would treat death as a recognition event and tax capital gains on death. An exemption of \$10 million—it's unclear whether that is per person or per couple, and whether that is \$10 million of gain or \$10 million of assets—would apply. Although small businesses and family farms are mentioned, there is no indication that the \$10 million exemption would apply only to businesses and farms.

Taxing capital gains at death is the option that Canada selected when that country repealed its estate tax in 1971. However, like the imposition of an estate tax, taxing capital gains at death can be criticized as collecting a tax when there is no recognition event. Typically this problem would be addressed by allowing an estate with illiquid assets to pay the tax over time. Taxation of capital gains at death is not considered a favorable provision for the owners of closely-held businesses and farms, but at least the rate—a 20% capital gains rate vs a 40% estate tax rate—would be appreciably lower. Economists, on the other hand, generally see the loss of an incentive to hold assets until death as a positive development, because it tends to make transfer of capital more fluid.

On balance, we think it unlikely that Congress will enact a regime that includes death as a realization event. Far more likely is either retaining the existing step-up at death or replacing it with a carryover basis (or modified carryover basis) system.

Would There Be Sufficient Votes in Congress To Do This?

There are two procedural rules that could stand in the way of repeal of the estate tax. Both impact only the Senate consideration of a repeal bill. Right now it takes 60 votes to stop a filibuster. It seems unlikely that Senate Republicans could muster 60 votes to end a filibuster. In addition, the Senate might adhere to the "Byrd Rule," which requires a 60-vote majority to pass any bill that has a negative impact on revenue outside of the 10-year revenue window. However, both of these rules are procedural and could be changed in the next Congress.

Even with those rules in place, there are several potential paths to passage. First, it is our expectation that estate tax repeal will be a part of a larger tax reform bill. Such a bill could have sufficient bipartisan support to garner a 60-vote majority. Second, the bill is likely to be in the form of a budget reconciliation act, which is not subject to filibuster. Finally, it would be possible to make the bill revenue neutral in the “out” years (those years outside the 10-year Senate budget window), by adding a sunset provision like the one in the 2001 tax act. Consequently, we can envision several options leading to enactment of a tax reform bill that includes estate tax repeal.

How Should We Think About Planning In This Environment?

With a significant chance of estate and GST tax repeal next year, clients who have or might have taxable estates under current law should begin to review their estate plans proactively now with an objective to implement changes after the expected legislation takes shape.

- All formula clauses in estate planning documents should be reviewed to make sure they will work as intended if the estate and GST taxes are repealed.
- The overall estate plan should be reviewed to see whether it is appropriate in the event that the estate and GST taxes are repealed. It might be advisable to draft alternative provisions for the estate planning documents to take effect in the event the taxes do not apply.
- The estate plan should be sufficiently flexible to accommodate foreseeable future changes in law.
- In most circumstances, taxable gifts should be delayed until we see the Congressional proposals so that we can evaluate the provisions regarding gift tax and basis.
- Income tax and capital gain planning are likely to become more important if the estate tax is repealed.
- States (such as Maryland and New York) and the District of Columbia with estate taxes will likely continue to impose them, so some estate tax planning will still be helpful to residents of jurisdictions with state estate taxes.

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