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Repeal of the Death Tax?

As part of the “Unified Framework for Fixing Our Broken Tax Code,” President Trump and Congressional Republicans plan to repeal the “death tax” – a controversial tax that affects the wealthiest .002% of Americans. In addition to repealing the estate tax, the framework calls for repealing the generation-skipping transfer (“GST”) tax. It is not clear whether the carry-over basis exemption rules would continue to apply or if there would be a recognition event at death. For reasons described below, the repeal will not be permanent. This makes estate tax planning, with the unpredictable timing of death—perhaps decades away, extremely difficult.

On October 19, 2017, the Senate approved a budget resolution for the 2018 fiscal year which allows the deficit to increase by up to $1.5 trillion. In order to comply with the budget reconciliation process, the deficit must not increase beyond a 10-year period. Therefore, it is likely that some tax cuts will "sunset" 10-years after the bill is enacted. The bill will be analyzed by the Congressional Budget Office and the Joint Committee on Taxation to determine whether it meets the requirements of the reconciliation process (to allow 51 votes as opposed to 60 for passage).

Sound familiar? This is the path that President Bush took with EGTRA in 2001. The 12 years that followed EGTRA (including the two-year “patch” which deferred the sunset until 2013), made planning extremely difficult. In 2001, the amount each person could pass free of estate tax (the “exemption”) was $1 million and the highest tax rate on additional assets was 55%. As of 2012, the exemption was $5 million ($10 million per couple) and the rate had dropped to 35%. That year, wealthy individuals and their advisors scrambled to make irrevocable gifts to use their exemptions before they disappeared. In the end, President Obama signed “ATRA,” which provided for “permanent” tax reform: an exemption of $5 million subject to inflation (for 2017 the exemption is $5.49 million, for 2018 the exemption will be $5.6 million) and a rate of 40%.

On a more positive note, valuation discounts are not going away anytime soon, as Treasury’s priorities have changed with the new Administration. On October 2, 2017, the Treasury Department characterized the proposed regulations which sought to limit valuation discounts as unworkable, and plans to withdraw them in their entirety.

POSTED:

Oct 23, 2017

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Wealthy individuals may once again be in the unenviable position of guessing what the law might be 10 years from the effective date of the proposed tax act, and having to calculate how likely it might be that they (and spouse) will die during the repeal. If the estate tax returns before the client dies, 10 additional years of growth, particularly if the client owns a closely held business, could mean tens of millions of dollars in taxes that could have been avoided through smart leveraging of the exemption.

Well advised individuals will continue to pursue lifetime gifting options. Low-interest rate assumptions, coupled with structures like Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Intentionally Defective Grantor Trusts (IDGTS) can easily move tens of millions of value “off ledger” and into irrevocable trusts that can perpetually avoid having the assets be subject to the estate and generation-skipping transfer tax.

The terms of any irrevocable structures should be flexible so that the planning can be reversed. Planning should be binary–working towards minimizing estate taxes if relevant, while also retaining the ability to modify or even reverse the planning if estate taxes are irrelevant. It makes sense now more than ever to ensure that trust documents incorporate provisions allowing modifications through powers given to trustees, directed parties or trust protectors, and through powers of appointment and other rights that can be given to trust beneficiaries. Binary planning can allow wealthy individuals to protect against estate taxes without wondering whether they will later regret that decision.

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