General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals

Estate + Gift Tax Proposals
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MODIFY ESTATE AND GIFT TAX PROVISIONS

RESTORE THE ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER (GST) TAX PARAMETERS IN EFFECT IN 2009

Current Law

The current estate, GST, and gift tax rate is 40 percent, and each individual has a lifetime exclusion of $5 million for estate and gift tax and $5 million for GST (indexed after 2011 for inflation from 2010). The surviving spouse of a person who dies after December 31, 2010, may be eligible to increase the surviving spouse’s exclusion amount for estate and gift tax purposes by the portion of the predeceased spouse’s exclusion that remained unused at the predeceased spouse’s death (in other words, the exclusion is “portable”).

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the maximum tax rate was 55 percent, plus a 5-percent surcharge on the amount of the taxable estate between approximately $10 million and $17.2 million (designed to recapture the benefit of the lower rate brackets). The exclusion for estate and gift tax purposes was $675,000 and was scheduled to increase to $1 million by 2006. Under EGTRRA, beginning in 2002, the top tax rate for all three types of taxes was reduced incrementally until it was 45 percent in 2007. In 2004, the exemption for estate taxes (but not for gift taxes) began to increase incrementally until it was $3.5 million in 2009, and the GST tax exemption and rate became unified with the estate tax exemption and rate. During this post-EGTRRA period through 2009, the gift tax exemption remained $1 million. Under EGTRRA, for 2010, the estate tax was to be replaced with carryover basis treatment of bequests, the GST tax was to be not applicable, and the gift tax was to remain in effect with a $1 million exclusion and a 35-percent tax rate. The EGTRRA provisions were scheduled to expire at the end of 2010, meaning that the estate tax and GST tax would be inapplicable for only one year.

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRUIRJCA) retroactively changed applicable law for 2010 by providing a top estate tax rate of 35 percent for taxpayers electing estate tax rather than carryover-basis treatment. It retroactively reinstated the GST tax and unified the exemption for estate, GST, and gift taxes beginning in 2011 with a $5 million total lifetime exclusion for estate and gift tax and for GST tax (indexed after 2011 for inflation from 2010). It also enacted the portability of the exemption between spouses for both gift and estate tax purposes. The TRUIRJCA provisions were scheduled to expire at the end of 2012.

The American Taxpayer Relief Act of 2012 (ATRA) permanently raised the top tax rate for estate, GST, and gift taxes to 40 percent. It also made permanent all the substantive estate, GST and gift tax provisions as in effect during 2012.
Reasons for Change

ATRA retained a substantial portion of the tax cut provided to the most affluent taxpayers under TRUIRJCA that we cannot afford to continue. The United States needs an estate tax law that is fair and raises an appropriate amount of revenue.

Proposal

The proposal would make permanent the estate, GST, and gift tax parameters as they applied during 2009. The top tax rate would be 45 percent and the exclusion amount would be $3.5 million for estate and GST taxes, and $1 million for gift taxes. There would be no indexing for inflation. The proposal would confirm that, in computing gift and estate tax liabilities, no estate or gift tax would be incurred by reason of decreases in the applicable exclusion amount with respect to a prior gift that was excluded from tax at the time of the transfer. Finally, the unused estate and gift tax exclusion of a decedent electing portability and dying on or after the effective date of the proposal would be available to the decedent’s surviving spouse in full on the surviving spouse’s death, but would be limited during the surviving spouse’s life to the amount of remaining exemption the decedent could have applied to his or her gifts made in the year of his or her death.

The proposal would be effective for the estates of decedents dying, and for transfers made, after December 31, 2016.
EXPAND REQUIREMENT OF CONSISTENCY IN VALUE FOR TRANSFER AND INCOME TAX PURPOSES

Current Law

Section 1014 provides that the basis of property acquired from a decedent generally is the fair market value of the property on the decedent’s date of death. Similarly, property included in the decedent’s gross estate for estate tax purposes generally must be valued at its fair market value on the date of death. Although the same valuation standard applies to both provisions, until the enactment on July 31, 2015, of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the Act), there was no requirement that the recipient’s basis in that property be the same as the value reported for estate tax purposes. This Act amended section 1014 to provide generally that the recipient’s initial basis in property as determined under section 1014 cannot exceed the final value of that property for estate tax purposes. This consistency requirement applies to property whose inclusion in the decedent’s gross estate increases the estate’s liability for federal estate tax.

Reasons for Change

Because the consistency requirement enacted in 2015 applies only to the particular items of property that generate a federal estate tax, the requirement does not apply to property transferred by gift, or to property that qualifies for the estate tax marital or charitable deduction, or to any property of an estate with a total value that does not exceed the applicable exclusion amount ($5,450,000 for 2016). Although the exclusion of property given on death to charities (tax-exempt organizations) has only a minimal impact for income tax purposes, there is a possible effect on the annual excise tax imposed on certain such organizations. However, the exclusion from the application of the consistency requirement of property qualifying for the estate tax marital deduction is significant because an unlimited amount of property may qualify for the estate tax marital deduction in a decedent’s estate tax proceeding. Although it is true that the value of such property passing to the decedent’s surviving spouse may be increased without incurring any federal estate tax, and a high estate tax value provides a high cap on the recipient’s permissible basis, current law contains provisions to prevent an inaccurately high estate tax valuation. Specifically, the executor certifies to the accuracy of the information on the estate tax return under penalties of perjury, and significant underpayment penalties are imposed on the understatement of capital gains and thus income tax that would result from an overstatement of basis.

Proposal

The proposal would expand the property subject to the consistency requirement imposed under section 1014(f) to also include (1) property qualifying for the estate tax marital deduction, provided a return is required to be filed under section 6018, even though that property does not increase the estate’s federal estate tax liability, and (2) property transferred by gift, provided that the gift is required to be reported on a federal gift tax return.

The proposal would be effective for transfers after the year of enactment.
MODIFY TRANSFER TAX RULES FOR GRANTOR RETAINED ANNUITY TRUSTS (GRATS) AND OTHER GRANTOR TRUSTS

Current Law

Section 2702 provides that, if an interest in a trust is transferred to a family member, any interest retained by the grantor is valued at zero for purposes of determining the transfer tax value of the gift to the family member(s). This rule does not apply if the retained interest is a “qualified interest.” A fixed annuity, such as the annuity interest retained by the grantor of a GRAT, is one form of qualified interest, so the value of the gift of the remainder interest in the GRAT is determined by deducting the present value of the retained annuity during the GRAT term from the fair market value of the property contributed to the trust.

Generally, a GRAT is an irrevocable trust funded with assets expected to appreciate in value, in which the grantor retains an annuity interest for a term of years that the grantor expects to survive. At the end of that term, the assets then remaining in the trust are transferred to (or held in further trust for) the beneficiaries. The value of the grantor’s retained annuity is based in part on the applicable Federal rate under section 7520 in effect for the month in which the GRAT is created. Therefore, to the extent the GRAT’s assets appreciate at a rate that exceeds that statutory interest rate, that appreciation will have been transferred, free of gift tax, to the remainder beneficiary or beneficiaries of the GRAT.

If the grantor dies during the GRAT term, the trust assets (at least the portion needed to produce the retained annuity) are included in the grantor’s gross estate for estate tax purposes. To this extent, although the beneficiaries will own the remaining trust assets, the estate tax benefit of creating the GRAT (specifically, the tax-free transfer of the appreciation during the GRAT term in excess of the annuity payments) is not realized.

Another popular method of removing an asset’s future appreciation from one’s gross estate for estate tax purposes, while avoiding transfer and income taxes, is the sale of the asset to a grantor trust of which the seller is the deemed owner for income tax purposes. A grantor trust is a trust, whether revocable or irrevocable, of which an individual is treated as the owner for income tax purposes. Thus, for income tax purposes, a grantor trust is taxed as if the deemed owner had owned the trust assets directly, and the deemed owner and the trust are treated as the same person. This results in transactions between the trust and the deemed owner being ignored for income tax purposes; specifically, no capital gain is recognized when an appreciated asset is sold by the deemed owner to the trust. For transfer tax purposes, however, the trust and the deemed owner are separate persons and, under certain circumstances, the trust is not included in the deemed owner’s gross estate for estate tax purposes at the death of the deemed owner. In this way, the post-sale appreciation has been removed from the deemed owner’s estate for estate tax purposes.

Reasons for Change

GRATs and sales to grantor trusts are used for transferring wealth while minimizing the gift and income tax cost of transfers. In both cases, the greater the post-transaction appreciation, the
greater the transfer tax benefit achieved. The gift tax cost of a GRAT often is essentially
eliminated by minimizing the term of the GRAT (thus reducing the risk of the grantor’s death
during the term), and by retaining an annuity interest significant enough to reduce the gift tax
value of the remainder interest to close to zero. In addition, with both GRATs and sales to
grantor trusts, future capital gains taxes can be avoided by the grantor’s purchase at fair market
value of the appreciated asset from the trust and the subsequent inclusion of that asset in the
grantor’s gross estate at death. Under current law, the basis in that asset is then adjusted (in this
case, “stepped up”) to its fair market value at the time of the grantor’s death, often at an estate
tax cost that has been significantly reduced or entirely eliminated by the grantor’s lifetime
exclusion from estate tax.

Proposal

The proposal would require that a GRAT have a minimum term of ten years and a maximum
term of the life expectancy of the annuitant plus ten years to impose some downside risk in the
use of a GRAT. The proposal also would include a requirement that the remainder interest in the
GRAT at the time the interest is created must have a minimum value equal to the greater of 25
percent of the value of the assets contributed to the GRAT or $500,000 (but not more than the
value of the assets contributed). In addition, the proposal would prohibit any decrease in the
annuity during the GRAT term, and would prohibit the grantor from engaging in a tax-free
exchange of any asset held in the trust.

If a person who is a deemed owner under the grantor trust rules of all or a portion of any other
type of trust engages in a transaction with that trust that constitutes a sale, exchange, or
comparable transaction that is disregarded for income tax purposes by reason of the person’s
treatment as a deemed owner of the trust, then the portion of the trust attributable to the property
received by the trust in that transaction (including all retained income therefrom, appreciation
thereon, and reinvestments thereof, net of the amount of the consideration received by the person
in that transaction) would be subject to estate tax as part of the gross estate of the deemed owner,
would be subject to gift tax at any time during the deemed owner’s life when his or her treatment
as a deemed owner of the trust is terminated, and would be treated as a gift by the deemed owner
to the extent any distribution is made to another person (except in discharge of the deemed
owner’s obligation to the distributee) during the life of the deemed owner. The proposal would
reduce the amount subject to transfer tax by any portion of that amount that was treated as a prior
taxable gift by the deemed owner. The transfer tax imposed by this proposal would be payable
from the trust.

The proposal would not change the treatment of any trust that already is includable in the
grantor’s gross estate under existing provisions of the Code, including without limitation the
following: grantor retained income trusts; grantor retained annuity trusts; personal residence
trusts; and qualified personal residence trusts. Similarly, it would not apply to any trust having
the exclusive purpose of paying deferred compensation under a nonqualified deferred
compensation plan if the assets of such trust are available to satisfy claims of general creditors of
the grantor. It also would not apply to any irrevocable trust whose only assets typically consist
of one or more life insurance policies on the life of the grantor and/or the grantor’s spouse.
The proposal as applicable to GRATs would apply to GRATs created after the date of enactment. The proposal as applicable to other grantor trusts would be effective with regard to trusts that engage in a described transaction on or after the date of enactment. Regulatory authority would be granted, including the ability to create exceptions to this provision.
LIMIT DURATION OF GENERATION-SKIPPING TRANSFER (GST) TAX EXEMPTION

Current Law

GST tax is imposed on gifts and bequests to transferees who are two or more generations younger than the transferor. The GST tax was enacted to prevent the avoidance of estate and gift taxes through the use of a trust that gives successive life interests to multiple generations of beneficiaries. In such a trust, no estate tax would be incurred as beneficiaries died, because their respective life interests would die with them and thus would cause no inclusion of the trust assets in the deceased beneficiary’s gross estate. The GST tax is a flat tax on the value of a transfer at the highest estate tax bracket applicable in that year. Each person has a lifetime GST tax exemption ($5.45 million in 2016) that can be allocated to transfers made, whether directly or in trust, by that person to a grandchild or other “skip person.” The allocation of GST exemption to a transfer or to a trust excludes from the GST tax not only the amount of the transfer or trust assets equal to the amount of GST exemption allocated, but also all appreciation and income on that amount during the existence of the trust.

Reasons for Change

At the time of the enactment of the GST provisions, the law of most (all but about three) States included the common law Rule Against Perpetuities (RAP) or some statutory version of it. The RAP generally requires that every trust terminate no later than 21 years after the death of a person who was alive (a life in being) at the time of the creation of the trust.

Many States now either have repealed or limited the application of their RAP statutes, with the effect that trusts created subject to the law of those jurisdictions may continue in perpetuity. (A trust may be situs anywhere; a grantor is not limited to the jurisdiction of the grantor’s domicile for this purpose.) As a result, the transfer tax shield provided by the GST exemption effectively has been expanded from trusts funded with $1 million (the exemption at the time of enactment of the GST tax) and a maximum duration limited by the RAP, to trusts funded with $5.45 million and continuing (and growing) in perpetuity.

Proposal

The proposal would provide that, on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate. Specifically, this would be achieved by increasing the inclusion ratio of the trust (as defined in section 2642) to one, thereby rendering no part of the trust exempt from GST tax. Because contributions to a trust from different grantors are deemed to be held in separate trusts under section 2654(b), each such separate trust would be subject to the same 90-year rule, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts would be deemed to have the same date of creation as the initial trust, with one exception, as follows. If, prior to the 90th anniversary of the trust, trust property is distributed to a trust for a beneficiary of the initial trust, and the distributee trust is as
described in section 2642(c)(2), the inclusion ratio of the distributee trust would not be changed to one (with regard to the distribution from the initial trust) by reason of this rule. This exception is intended to permit an incapacitated beneficiary’s share to continue to be held in trust without incurring GST tax on distributions to that beneficiary as long as that trust is to be used for the sole benefit of that beneficiary and any trust balance remaining on that beneficiary’s death would be included in that beneficiary’s gross estate for Federal estate tax purposes. The other rules of section 2653 also would continue to apply, and would be relevant in determining when a taxable distribution or taxable termination occurs after the 90th anniversary of the trust. An express grant of regulatory authority would be included to facilitate the implementation and administration of this provision.

The proposal would apply to trusts created after enactment, and to the portion of a pre-existing trust attributable to additions to such a trust made after that date (subject to rules substantially similar to the grandfather rules currently in effect for additions to trusts created prior to the effective date of the GST tax).
EXTEND THE LIEN ON ESTATE TAX DEFERRALS WHERE ESTATE CONSISTS LARGELY OF INTEREST IN CLOSELY HELD BUSINESS

Current Law

Section 6166 allows the deferral of estate tax on certain closely held business interests for up to fourteen years from the (unextended) due date of the estate tax payment (up to fourteen years and nine months from date of death). This provision was enacted to reduce the possibility that the payment of the estate tax liability could force the sale or failure of the business. Section 6324(a)(1) imposes a lien on estate assets generally for the ten-year period immediately following the decedent’s death to secure the full payment of the estate tax. Thus, the estate tax lien under section 6324(a)(1) expires almost five years before the due date of the final payment of the deferred estate tax under section 6166.

Reasons for Change

In many cases, the IRS has had difficulty collecting the deferred estate tax, often because of business failures during that tax deferral period. The IRS sometimes requires either an additional lien or some form of security, but these security interests generally are prohibitively expensive and damaging to the day-to-day conduct and financing of the business. In addition, unless these other security measures are put in place toward the beginning of the deferral period, there is a risk that other creditors could have a higher priority interest than the Government.

Proposal

This proposal would extend the estate tax lien under section 6324(a)(1) throughout the section 6166 deferral period.

The proposal would be effective for the estates of all decedents dying on or after the date of enactment, as well as for all estates of decedents dying before the date of enactment as to which the section 6324(a)(1) lien has not then expired.
MODIFY GENERATION-SKIPPING TRANSFER (GST) TAX TREATMENT OF HEALTH AND EDUCATION EXCLUSION TRUSTS (HEETS)

Current Law

Payments made by a donor directly to the provider of medical care for another person or directly to a school for another person’s tuition are exempt from gift tax under section 2503(e). For purposes of the GST tax, section 2611(b)(1) excludes “any transfer which, if made during the donor’s life, would not be treated as a taxable gift by reason of section 2503(e).” Thus, direct payments made during life by an older generation donor for the payment of these qualifying expenses for a younger generation beneficiary are exempt from both gift and GST taxes.

Reasons for Change

Some taxpayers have interpreted the language of section 2611(b)(1) as permitting the avoidance of GST tax through the use of a trust known as a HEET. A HEET provides for the medical expenses and tuition of multiple generations of descendants. Taxpayers using this technique take the position that section 2611(b)(1) exempts these trust distributions from GST tax (generally, in perpetuity) because the distributions are used for the payment of medical care expenses and tuition. The substantial amounts contributed to HEETs will appreciate in these trusts, and taxpayers claim that no estate, gift, or GST tax ever will be incurred after the initial funding of these trusts.

The intent of section 2611(b)(1) is to exempt from GST tax only those payments that are not subject to gift tax, that is, payments made by a living donor directly to the provider of medical care for another person or directly to a school for another person’s tuition.

Proposal

The proposal would provide that the exclusion from the definition of a GST under section 2611(b)(1) applies only to a payment by a donor directly to the provider of medical care or to the school in payment of tuition and not to trust distributions, even if for those same purposes.

This proposal would apply to trusts created after the introduction of the bill proposing this change, and to transfers after that date made to pre-existing trusts.
SIMPLIFY GIFT TAX EXCLUSION FOR ANNUAL GIFTS

Current Law

The first $14,000 of gifts made to each donee in 2016 is excluded from the donor’s taxable gifts (and therefore does not use up any of the donor’s applicable exclusion amount for gift and estate tax purposes). This annual gift tax exclusion is indexed for inflation and there is no limit on the number of donees to whom such excluded gifts may be made by a donor in any one year. To qualify for this exclusion, each gift must be of a present interest rather than a future interest in the donated property. For these purposes, a present interest is an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (including life estates and term interests). Generally, a contribution to a trust for the donee is a future interest.

Reasons for Change

To take advantage of this annual gift tax exclusion without having to transfer the property outright to the donee, a donor often contributes property to a trust and gives each trust beneficiary (donee) a Crummey power. Crummey powers are used particularly in irrevocable trusts to hold property for the benefit of minor children.

In order for a Crummey power to convert a donor’s transfer into the gift of a present interest, the trustee of the recipient trust must timely notify each beneficiary of the existence and scope of his or her right to withdraw funds from the trust. If the appropriate records cannot be produced at the time of any gift or estate tax audit of the grantor, the gift tax exclusion may be denied to the grantor, thereby causing retroactive changes in the grantor’s tax liabilities and remaining applicable exclusion amount. Because of the common use of these withdrawal powers, the number of beneficiaries typically involved, and the differing terms of each such withdrawal power, the cost to taxpayers of complying with the Crummey rules is significant, as is the cost to IRS of enforcing the rules.

In addition, the IRS is concerned about the lack of a limit on the number of beneficiaries to whom Crummey powers are given. The IRS’s concern has been that Crummey powers could be given to multiple discretionary beneficiaries, most of whom would never receive a distribution from the trust, and thereby inappropriately exclude from gift tax a large total amount of contributions to the trust. (For example, a power could be given to each beneficiary of a discretionary trust for the grantor’s descendants and friendly accommodation parties in the hope that the accommodation parties will not exercise their Crummey powers.) The IRS has sought (unsuccessfully) to limit the number of available Crummey powers by requiring each powerholder to have some meaningful vested economic interest in the trust over which the power extends. See Estate of Cristofani v. Comm’r, 97 T.C. 74 (1991); Kohlsaat v. Comm’r, 73 TCM 2732 (1997).

Proposal

The proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion. Instead, the proposal would define a new category of transfers (without
regard to the existence of any withdrawal or put rights), and would impose an annual limit of $50,000 (indexed for inflation after 2017) per donor on the donor’s transfers of property within this new category that will qualify for the gift tax annual exclusion. This new $50,000 per-donor limit would not provide an exclusion in addition to the annual per-donee exclusion; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion. Thus, a donor’s transfers in the new category in a single year in excess of a total amount of $50,000 would be taxable, even if the total gifts to each individual donee did not exceed $14,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

The proposal would be effective for gifts made after the year of enactment.
EXPAND APPLICABILITY OF DEFINITION OF EXECUTOR

Current Law

The Code defines “executor” for purposes of the estate tax to be the person who is appointed, qualified, and acting within the United States as executor or administrator of the decedent’s estate or, if none, then “any person in actual or constructive possession of any property of the decedent.” This could include, for example, the trustee of the decedent’s revocable trust, an IRA or life insurance beneficiary, or a surviving joint tenant of jointly owned property.

Reasons for Change

Because the Code’s definition of executor currently applies only for purposes of the estate tax, no one (including the decedent’s surviving spouse who filed a joint income tax return) has the authority to act on behalf of the decedent with regard to a tax liability that arose prior to the decedent’s death. Thus, there is no one with authority to extend the statute of limitations, claim a refund, agree to a compromise or assessment, or pursue judicial relief in connection with the decedent’s share of a tax liability. This problem has started to arise with more frequency as reporting obligations, particularly with regard to an interest in a foreign asset or account, have increased, and survivors have attempted to resolve a decedent’s failure to comply.

In addition, in the absence of an appointed executor, multiple persons may meet the definition of “executor” and, on occasion, more than one of them has each filed a separate estate tax return for the decedent’s estate or made conflicting tax elections.

Proposal

To empower an authorized party to act on behalf of the decedent in all matters relating to the decedent’s tax liabilities (whether arising before, upon, or after death), the proposal would expressly make the tax code’s definition of executor applicable for all tax purposes, and authorize such executor to do anything on behalf of the decedent in connection with the decedent’s pre-death tax liabilities or obligations that the decedent could have done if still living. In addition, the proposal would grant regulatory authority to adopt rules to resolve conflicts among multiple executors authorized by this provision.

The proposal would apply upon enactment, regardless of a decedent’s date of death.