Reform or Repeal the Transfer Tax System?

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The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phases out the estate and generation-skipping transfer (GST) taxes over nine years, followed by a one-year repeal in 2010. The gift tax remains in place during the repeal and is accompanied by a modified-carryover-basis regime for assets passing at death in 2010. The EGTRRA reinstates the estate and GST taxes in 2011. Its provisions create significant uncertainty and complexity for clients in estate and financial planning matters.

In light of this, a Task Force on Federal Wealth Transfer Taxes was formed in late 2001, comprised of representatives from the American College of Trust and Estate Counsel, the American Bar Association's Sections of Real Property, Probate and Trust Law and of Taxation, the AICPA, the American College of Tax Counsel and the American Bankers' Association. Its purpose was to:

1. Prepare a comprehensive report analyzing technical and transitional consequences of the EGTRRA changes to the gift, estate and GST taxes; and

2. Examine various alternative legislative measures to eliminate the substantial ambiguity under the current transfer tax system.

The report, *Report on Reform of Federal Wealth Transfer Taxes,*[1] does not consider policy questions on (1) the economic effects of a transfer tax system as compared to other forms of taxation or (2) whether wealth redistribution is an appropriate tax system goal. The report's central concern is to assess—on the basis of simplicity, compliance and consistency of enforcement—the temporary repeal of the estate and GST taxes, the phaseout period, the continuation of the gift tax after repeal, Sec. 1022's modified-carryover-basis rule and alternatives to transfer tax repeal. While the report suggests options for Congress to consider, it does not make specific regulatory or legislative recommendations.

The report was approved by the sponsoring organizations, published in summer 2004 and distributed to Congress and Treasury. It is organized in four parts, plus an appendix.

Part I considers issues pertaining to the phaseout period of the estate and GST taxes and their reinstatement in 2011. Part II addresses issues arising from the retention of the gift tax after reduction and ultimate repeal of the estate and GST taxes. Part III discusses issues stemming from implementation of the modified-carryover-basis rule that takes effect on repeal of the estate and GST taxes. Part IV identifies issues resulting from the current estate, gift and GST tax law and suggests alternative ways of resolving them through modifications to the current wealth transfer tax system. The Appendix evaluates alternatives to the system, including replacing it with (1) an accessions tax, (2) an income-inclusion system or (3) a deemed-realization system. Some of the issues included in the report are discussed below.

Part I: Planning under a Lengthy Phaseout Period

The estate and GST taxes' lengthy phaseout period causes financial and estate planning complexities and uncertainties. The EGTRRA's treatment of gift and GST taxes during the phaseout period further exacerbates these problems. If Congress chooses to make repeal permanent, alternatives discussed include reducing the phaseout period and reunification of the estate and gift tax systems during this period, coupled with immediate repeal of the GST tax. Such repeal would have minimal revenue effect, because, in most situations, taxpayers will not find it difficult to defer imposition of the GST tax until the end of the phaseout period.

Temporary repeal: The one-year estate tax repeal and the introduction of the modified-carryover-basis rule create uncertainties, inequities, complexities and planning difficulties. Congress could promptly make the repeal permanent or reinstate the estate tax. An extension of the repeal period, without making it permanent, would not substantially improve the uncertain tax climate. If repeal remains in place for one year, Congress could allow personal representatives of the estates of decedents who die in 2010 to elect to subject the estate to the 2009 law, rather than the 2010 law. Such an election would ameliorate the disparate treatment that arises merely because a decedent happens to die in 2010, rather than 2009, and would eliminate the modified-carryover-basis rule's recordkeeping problems.

GST tax repeal: The temporary repeal and reinstatement of the GST tax create unique transition problems. If repeal is not made permanent, Congress could enact transition rules to clarify how it applies to trusts that span years when the tax is phased out, repealed and reinstated. It could provide that the GST tax will not apply to any trusts (or portions of trusts) that transferors fund in 2010, either by *inter vivos* or testamentary transfers. The effect would be to treat dispositions in trust the same as outright dispositions during 2010, when the GST tax is not in effect.

Alternatively, Congress could allow transferors who make lifetime gifts in trust in 2010 to allocate GST exemption to those trusts in that year. It could clarify whether the GST tax applies to testamentary transfers to trusts by decedents dying in 2010. If Congress modifies the definition of a transferor to allow the GST tax to apply to trusts funded at death, it could allow an estate to allocate GST exemption to the trust in 2010. Congress could make the EGTRRA technical provisions, which were intended to help taxpayers avoid inadvertent imposition of the GST tax, permanent. These provisions are not controversial and have no significant revenue effect. In the absence of Congressional action, these provisions will sunset in 2011 (along with the rest of the EGTRRA).

Part II: The Gift Tax

The EGTRRA's treatment of the gift tax is not a well-tailored solution for addressing the potential income tax abuse from transfers between U.S. taxpayers. In addition, the retention of the gift tax creates enforceability problems, encourages avoidance strategies and interferes with nontax estate planning goals. Alternatives identified in the report have three common goals. The first is to develop approaches that maximize ease of enforcement and administration. Enforcement and administration problems prompt the development of alternatives that rely on the income tax to address the tax avoidance issues that lifetime transfers between U.S. taxpayers potentially generate.

The second goal is to present alternatives that minimize interference with intrafamily transfers of wealth and maximize the orderliness of intergenerational wealth succession. This objective is consistent with the underlying rationale for Congress's repeal of the estate and GST taxes. The third goal, which is integrally related to the first two, is to tailor the alternatives carefully to the specific potential abuses.

Congress could repeal the gift tax and mandate Treasury to issue regulations that treat a U.S. transferor as the continuing owner of an asset, if the U.S. transferee has implicitly or explicitly agreed to return the asset (either directly or indirectly) to the transferor. It could repeal the gift tax and treat a gift as a realization event, unless the donor elects to continue to be treated as the owner of the property for all income tax purposes. Or, it could repeal the gift tax and enact a provision that taxes the sale or other disposition of an asset received as a gift at the highest applicable tax rate, if the taxpayer sells or disposes of the asset within a stated period after having received it.

Further, Congress could provide that an asset's character stays as it was in the donor's hands, or deny donees the right to offset capital gains from the sale or disposition of gifts against losses from the disposition of other assets. It could retain the gift tax, but allow a donor to avoid it by electing grantor trust treatment. This alternative is an expansion of the approach Congress adopted under the EGTRRA—Sec. 2511(c) states that, effective after 2009, transfers in trust are taxable as gifts, unless the trust is treated as wholly owned by the donor or his or her spouse, for income tax purposes. Congress could adopt a rule that denies an annual exclusion when a transfer is solely to avoid income tax.

Part III: Modified-Carryover-Basis Rules

A comparison of the differences in how basis is determined in property acquired from a decedent before and after repeal of the estate tax reveals simplification opportunities, including elimination of the different treatment of *inter vivos* and testamentary transfers of property with a fair market value (FMV) less than the transferor's basis at the time of transfer. Congress could amend Sec. 1022, Treatment of property acquired from a decedent dying after December 31, 2009, to provide that a recipient takes a carryover basis in the property, except that, if basis exceeds FMV at the decedent's death, the recipient's basis is the asset's FMV at the decedent's death, in determining loss on a subsequent sale or exchange. (This rule would correspond to Sec. 1015.)

Alternatively, Congress could amend Sec. 1015 to correspond to Sec. 1022 and require a donee to take a basis equal to the lesser of the donor's basis or the asset's FMV at the time of the gift. A third approach is to adopt a strict carryover basis rule for both *inter vivos* and testamentary transfers of assets that have depreciated in the transferor's hands. Regardless, Congress could amend Sec. 1223, Holding period of property, to attribute the transferor's holding period to the recipient, even if Secs. 1015 and 1022 require the recipient to take a basis equal to the asset's FMV at the time of the transfer. Or, it could provide a Sec. 1014-type allowance, in addition to a smaller allowance for basis increases based on unrealized appreciation, for tangible personal property not held for investment or used in a trade or business.

Alternatively, Congress could allow an adjustment to basis for state death taxes under Sec. 1022 and for state gift taxes under Sec. 1015; it could also adjust basis under Sec. 1022 for foreign death taxes. Through the end of this year, Sec. 2011 permits an estate a credit against the Federal estate tax for state death taxes paid; thereafter, in calculating the Federal taxable estate, a Sec. 2058 deduction is available for state death taxes paid. On repeal of the estate tax and adoption of Sec. 1022's modified-carryover-basis rule, there is no corollary provision under which an estate or heir can offset state death taxes. This issue may grow in importance as states revise their wealth transfer tax laws in light of the EGTRRA's changes to the treatment of state death taxes under the Federal estate tax.[2]

Congress could also allow a personal representative to elect to treat all or a part of an estate's administration expenses as (1) a deduction in computing an estate's (or trust's) taxable income or (2) a Sec. 1022 basis adjustment. This would prevent estate administrative expenses from remaining unused if the estate had insufficient income to offset them.

Property subject to debt: Sec. 1022(g) (which disregards liabilities in excess of basis in determining whether gain is recognized on a property acquisition) creates opportunities for tax avoidance at the same time that it creates potential unfairness for a recipient, who may have a tax liability in excess of the equity in property acquired from a decedent. Congress could allow a recipient of encumbered property to recover from the other recipients of a decedent's assets the income tax liability attributable to the difference between the encumbrance and the encumbered property's carryover basis, to the extent that the liability exceeds the recipient's equity in the asset at the time of sale or other disposition. It could also allow an executor to elect to avoid the right-of-recovery rule by recognizing gain on an encumbered asset based on the difference between the debt and the modified carryover basis.

Alternatively, Congress could increase the basis of an encumbered asset by the difference between the decedent's carryover basis and the encumbrance (whenever debt exceeds basis) and reduce the $1.3 million aggregate basis increase (under Sec. 1022(b)(2)(B)) by adjusting the encumbered property's basis. It could allow a recipient of property encumbered with debt in excess of adjusted basis to elect an excise tax, coupled with a basis step-up rule similar to Sec. 1014. Congress could treat the transfer at death of property encumbered with debt in excess of adjusted basis as a realization event to the extent of the debt, unless the estate demonstrates that the decedent had not obtained the loan and secured it with the property for tax avoidance purposes.

IRD and installment obligations: The distinction that Sec. 1022 makes between a decedent's appreciated assets held in qualified retirement plans and IRA accounts and his or her other appreciated assets, and the inability to use installment sales or promissory notes for Sec. 1022 basis increases, could be viewed as unfair. Congress could allow an executor to allocate these basis increases to assets held in such accounts, but only to the extent of the growth in such accounts. Or, it could allow an executor to allocate basis increases at an accelerated rate to such assets. This rate would take into account the difference between the ordinary income and capital gain rates. Congress could also allow an executor to allocate basis increases to assets held in retirement accounts, but only to the extent of the available basis increases that the executor could not have allocated to other assets.

As to installment sales, Congress could permit an executor to allocate basis increases to a promissory note received in exchange for property to the extent that the note's value has appreciated or the note represents unrecognized gain.

State death taxes: Neither Sec. 691 nor 1022 provides an adjustment to basis for state death taxes paid on items of income in respect of a decedent (IRD). If, as is likely, states continue to impose state death taxes after the repeal of the estate tax, Congress could amend Sec. 691(c), which deals exclusively with the Federal estate tax, to allow an income tax deduction for state death taxes attributable to an IRD item. The deduction's effect would be to ameliorate the double tax on an IRD item (i.e., Federal income tax and state death taxes). Congress could amend Sec. 1022 to allow a basis increase to an IRD item for state death taxes attributable to said item.

Unused loss carryovers and built-in losses: Sec. 1022(b)(2)(C)'s basis adjustments for net operating losses and capital loss carryovers raise the question of whether this relief provision includes (or should include) other loss carryover rules, such as those for passthrough entities and the at-risk and passive activity rules. Alternatives include limiting those increases to estate assets that triggered the losses.

Other issues: The EGTRRA's approach to basis modifications creates complexities and uncertainties that may lead to litigation. The law does not explicitly acknowledge that decedents' directives regarding allocation are controlling and does not allocate basis increases if the personal representative fails to do so. The modified-carryover-basis rule raises new compliance and finality issues, which may increase the instances of inconsistent reporting by the estate and heirs.

Part IV: The Wealth Transfer Tax System

If the estate tax repeal is not made permanent, Congress could consider modifications to the current wealth transfer tax system. Among issues discussed in Part IV of the report are modifying the limits, requirements and dollar amounts for annual exclusion gifts; allowing a surviving spouse a "portable" applicable exclusion amount; and establishing valuation guidelines, safe harbors and other law changes to reduce valuation uncertainty and the controversy it produces.

Part IV discusses issues arising from discrepancies between the tax-inclusive estate tax and the tax-exclusive gift tax, the need for special rules for annuity and life insurance contracts, the need for the so-called "string" provisions of Secs. 2036–2038 and the determination of the proper treatment of jointly owned property as to basis issues and for gift tax purposes. Also addressed are estate liquidity problems, including modifying (1) Sec. 6166 to provide more effective and useful relief and (2) the Sec. 2057 qualification requirements.

Finally, Part IV considers a variety of issues on the GST tax and discusses alternatives, such as excluding from the tax all transfers that qualify for the gift tax annual exclusion (regardless of whether they are outright transfers, transfers to trusts or direct skips) and expanding the previously taxed property credit to allow a credit when a GST by reason of death occurs within a stated period of a previous GST or gift or estate tax transfer. Other alternatives include providing a deduction for state death taxes to replace the credit for state GST taxes under Sec. 2604, excluding direct skips as GSTs or reducing the rate of the GST tax on direct skips, and excluding transfers to nonrelatives from the GST tax or amending the generation assignments of nonrelatives to better reflect the transferee's actual generation.

Appendix: Alternatives to Present Transfer Tax System

The Task Force reviewed three alternatives to the existing transfer tax system: an accessions tax (i.e., a separate tax on an individual's cumulative receipts of gratuitous transfers), inclusion of receipts of gratuitous transfers in gross income (repealing Secs. 101(a) and 102(a)) and treating a gratuitous transfer as a deemed-realization event for income tax purposes.

Under an accessions tax, the tax base is established by reference to the transferee's cumulative lifetime gratuitous receipts and the tax is imposed directly on the transferee. In the income-inclusion system, the tax is likewise imposed on the transferee and calculated with reference to the taxpayer's other income and deductions incurred in the year of receipt. Many of the problems with the present system would arise under one or more of the alternatives. For example, the deemed-realization system would entail rules for determining the basis of deemed-realization assets that would be formulated in part with reference to options available for carryover basis. Valuation is an issue with each alternative.

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[1]Taxes, which included more than 30 Dennis I. Belcher chaired the Task Force on Federal Wealth Transfer participants. Mary Louise Fellows served as the task force's reporter and the report's primary author. AICPA Tax Section members Evelyn Capassakis, Annette Nellen and Roby B. Sawyers served on the Task Force. The report is available at https://www.cpa2biz.com/ResourceCenters/Tax/Estate%2c+Gift%2c+Trust%2c+Fiduciary/TransferTaxReport.htm. Questions and comments should be addressed to roby_sawyers@ncsu.edu.

[2] For a detailed discussion, see Godfrey, "The Phaseout of the Federal State Death Tax Credit," Part I, 35 *The Tax Adviser* 96 (February 2004) and Part II, 35 *The Tax Adviser* 148 (March 2004).