Observations for Planners Regarding House Republicans and President-Elect Trump Proposals Regarding Tax Reform (Including the Transfer Tax); Process for Tax Reform Changes; Planning Implications for Planners

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Brief Summary of Proposals

The House Republican tax reform package is described in a document published on June 24, 2016 entitled Blueprint for Tax Reform. The tax reform measures include:

- Individual: Top rate-33%; Capital gains and dividends-50% exclusion (equivalent to a top rate of 16 ½%); No itemized deductions except mortgage interest and charitable deduction; No AMT;
- Business: Corporate top rate-drop from 35% to 20%; Pass through business income top rate of 25%; and
- Repeal estate and GST tax.

The Trump/Pence website summarizes the Trump tax reform proposals, which include:

- Individual: Top rate-33%; Capital gains and dividends-20%; Cap itemized deductions at $200,000 (joint), $100,000 (single); No AMT; No 3.8% tax on NII;
- Business: Corporate top rate-drop from 35% to 15%; Pass through business income top rate of 15% (in the first Trump plan); and
- Transfer tax: "repeal the death tax, but capital gains held until death and valued over $10 million [presumably that is per couple] will be subject to tax to exempt small businesses and family farms. To prevent abuse, contributions of appreciated assets into private charity established by the decedent or the decedent's relatives will be disallowed."

  The proposal does not clarify whether the $10 million exemption is applied per couple or per individual. Also, the proposal is not clear as to whether it would impose capital gains at death or merely establish a carryover basis on gains.

Interestingly, Hillary Clinton also announced a rather startling proposal on September 22, 2016 regarding transfer taxes *and* gain realization for gifts and bequests. (The Clinton proposal would have reduced the estate, gift and GST exemption to $3.5 million and increased the rate, with a top rate of 65%.)

Process

The process for getting tax reform legislation (including the possibility of a repeal of the estate tax) will likely be under a budget reconciliation act. The Congressional Budget Act of 1974 (Titles I - IX of the Congressional Budget and Impoundment Control Act of 1974) modified and clarified the role of Congress in the federal budgetary process. It governs the process of annual budget resolutions and budget reconciliations. Title II created the Congressional Budget Office (CBO) to give Congress independent economic analysis; previously the Executive Branch controlled budgetary information. Standing budget committees in the House and Senate were created and additional staffing was authorized for committees involved with budget decisions. Title III specifies procedures for the adoption of an annual budget resolution, which is a concurrent resolution that is not signed by the President, that sets out fiscal policy guidelines for Congress (but Congress does not adopt a budget

resolution in all years). (The budget resolution cannot be filibustered in the Senate.) The budget resolution does not enact spending or tax law, but sets targets of overall receipts and expenditures, based on CBO estimates, for other committees that can propose legislation changing spending or taxes. The limits on revenue and spending that it establishes may be enforced in Congress under "points of order" procedural objections (which requires 60 votes in the Senate to waive). Budget resolutions set spending and revenue levels for a budget window (at least five years but typically10 years). The budget resolution is rather straightforward, simply stating how much should be spent in each of 19 broad spending categories, and specifying how much total revenue the government will collect for each year in the budget window.

The budget resolution can specify that a budget reconciliation bill will be considered to "reconcile" the work by various committees working on budget issues and to enforce budget resolution targets. Like the budget resolution, it cannot be filibustered in the Senate and only requires a majority vote. The reconciliation directive directs committees to produce legislation by a certain date that meets specified spending or tax targets. The various bills are packaged into a single bill with very limited opportunity for amendment. The reconciliation bill, when ultimately approved by the House and Senate, goes to the President for approval or veto.

While the reconciliation act is not subject Senate filibuster, under the "Byrd rule" any single Senator can call a point of order against any provision or amendment that is "extraneous" to the reconciliation process for various prescribed reasons—one of which is that entitlement increases or tax cuts will cost money beyond the budget window of the reconciliation bill (typically ten years) unless other provisions in the bill fully offset these costs. The offending provision is automatically stripped from the bill unless at least 60 Senators waive the rule.

The reconciliation process has proved instrumental in being able pass measures connected with the budget process without the necessity of garnering 60 votes in the Senate. For example, reconciliation was instrumental in the passage of the 2001 and 2003 tax cuts, healthcare reform in 2010, and welfare reform in 1996.

Legislative Considerations

- Timing of drafting—the various reform proposal are complex, but the House has been working on its reform measures for some time and legislation has been drafted. Including draft language in a reconciliation bill by the summer is a practical possibility.
- Priorities—The Trump administration has announced several major initial priorities, including repealing and replacing Obamacare (the "replacing" part will be difficult and controversial), immigration reform (and deporting specified categories of illegal immigrants), additional infrastructure spending, ending sequestration and building up the military, and tax reform.
- Political pressures—While estate tax repeal is a popular Republican position, at some point, decisions will have to be made about how to allocate "political capital" to the most important of the priorities. A variety of the tax reform measures will particularly benefit wealthy high income earners, and adding estate tax repeal (benefitting couples with over $11 million of assets) may become sensitive for some Congressmen.
- Budget hawks—To what extent will "budget hawks" focus on budget deficits? The tax reform plans have a very large reduction of federal revenues in absolute terms. (The Tax

Foundation estimates that the Republican tax proposal would reduce federal revenues by $2.4 trillion over ten years, but estimates a reduction of only $191 billion with assumptions of increased economic growth that will be generated by the tax cuts. Other groups have estimated even significantly larger revenue decreases.) But the cost of repeal of the estate and GST tax is much smaller (about 2-3% of the total cost), and may not generate as much ire from "budget hawks."

- Phase-in—The reforms of the estate and gift tax in the 2001 Act were phased in over 10 years—in order to allow other higher priority income tax cuts to take effect earlier.
- 10-year sunset—If estate tax repeal passes, will be it sunset, like it was in the 2001 Act because of the Byrd rule?
- Timing of tax cuts—Even if a reconciliation act is passed this year with significant tax reform, will the tax cuts take effect in 2017 or beginning in 2018? Would they be retroactive to January 1, 2017?
- Realization at death—If the tax reform includes realization at death concepts, those are entirely new concepts for the American tax system, and will take a significant amount of work (and time to structure and draft). A host of peripheral issues will arise. What exemptions? Realization on gifts as well? Impact of having assets owned by trusts (some countries that have realization at death tax the appreciation on trust assets every 21 years)? Is it realization at death or carryover basis?

Planning Implications of Possible Transfer Tax Repeal

- Do not make such large gifts that significant gift taxes will be due currently.
- For clients that want to make large gifts that would generate gift tax, consider delaying the gift until sometime after 2016 in case the gift tax is repealed retroactively to January 1, 2017. Another alternative is to provide that the gifted assets will be returned to the donor if the donee disclaims the gift. (If the gift tax is repealed within nine months of the gift, the donee could disclaim the gift, which would "undo" the prior gift for gift tax purposes. The donor might choose to make the transfer later when no gift tax would be incurred, but there must be no prearrangement for the disclaimer to be a qualified disclaimer.)
- Having a Republican President, Senate and House likely means that the §2704 proposed regulations will not be implemented. (Indeed, will the IRS even devote the substantial resources that will be needed to revise the proposed regulations, in light of all the technical comments and concerns about the regulations, if a Trump administration is likely to dictate that the regulations not be finalized?)
- Great uncertainty for planning. The "permanence" of the transfer tax following the "great compromise" made in the 2012 Act is now a laugher. Planning in the current environment of uncertainty about future tax laws is extremely difficult. Do we worry about removing assets from gross estates, or do we assure estate inclusion to achieve a stepped-up basis without any estate tax? Will we again see formula based estate plans, based on whether or not there is an estate tax, realization at death, etc.?
- Review formula clauses in existing documents. For example, a classic bequest of the maximum amount possible without incurring estate taxes may become a bequest of the entire estate if the estate tax is repealed. Confirm that is the client's intent.

- Plan for flexibility. The primary way of dealing with the extreme uncertainty in doing current planning for clients is to build in as much flexibility as possible. Examples:
  - Formula bequests based on whether an estate tax exists or other factors;
  - Using QTIP trusts (the QTIP election, with a Clayton provision allowing more flexible terms if the QTIP election is not made [or if the transfer tax does not apply], affords great flexibility);
  - Basis adjustment planning with uses of general powers of appointment to cause inclusion in beneficiaries' estates for basis step-up under §1014(a) will continue to be important (see Item 14.f);
  - Planning in contemplation of allowing the beneficiary to use the "Delaware tax trap" to case estate inclusion in beneficiaries' estates;
  - Liberal uses of limited powers of appointment to provide flexibility; and
  - Allowing broad discretionary distributions of trust assets by an independent trustee adds flexibility.
  - Consider giving an independent person broad flexibility to modify the trust based on changes in tax laws.
- Window of opportunity. If the estate and especially the gift tax is repealed, that might present of window of opportunity for planning. Will the transfer tax stay repealed? At some point, political winds will shift again; could the transfer tax be reinstated? If a 10-year sunset applies, uncertainty will persist as to whether the repeal would be reinstated after 10 years.
- Gift tax repeal? Neither the Republican House tax reform plan nor the Trump tax reform plan explicitly state that the gift tax would be repealed. (Various summaries of the plans have stated that they call for gift tax repeal, but gift tax repeal has not been addressed in the plans specifically. Indeed, the House Republican specifically mentions the estate and GST tax but does not mention gift taxes. The Trump plan just mentions "death taxes.") The gift tax was retained in the 2001 Act reportedly as a backstop to the income tax (to shield against gifting highly appreciated assets on the eve of a sale to lower bracket relatives). Admittedly, the gift tax is not as much of a backstop as it was in 2001 because of the large gift exemption that now applies. If the gift tax remains, transfer planning will continue in importance for families who do not want to make their children wait until they are in their 70s before they can start enjoying the family wealth.
- If the gift tax is repealed, some wealthy clients will consider making massive transfers to dynasty trusts, to achieve asset protection goals and as a way of avoiding transfer taxes that may be imposed by future legislatures. Some of these transfers will be made under the laws of "domestic asset protection trust states" allowing the donor to remain as a discretionary beneficiary in the discretion of an independent trustee.
- Realization at death? If realization at death passes as part of the estate tax repeal package, transfer planning may remain very important to remove assets from a person's ownership at death that would otherwise be subject to capital gains taxation. Planning to achieve both discounts and freezing (to reduce the amount realized at death) will be in play. Using QTIP

trusts may delay the realization until the surviving spouse's death. Funding SLATs may be a way to avoid estate inclusion for either spouse, and may avoid realization at death. To what extent could the client be a discretionary beneficiary of a trust created by that individual and still avoid realization at death? Using dynastic trusts will be favored if a system is not imposed automatically taxing the appreciation in trusts after a specified number of years.

- Carryover basis? If estate tax repeal is combined with carryover basis, a variety of additional factors in the process of planning appropriate alternatives.
    - The uncertainty of whether a carryover basis system would be implemented has a huge impact on planning. If the estate tax is repealed without carryover basis or realization at death, lifetime transfers of appreciated assets would generally be disadvantageous from a tax planning viewpoint because the transferred appreciated assets would not receive a basis adjustment at the transferor's death. On the other hand, if carryover basis applies, lifetime transfers would not lose a basis adjustment at the transferor's death.
    - Consider giving executors the flexibility to consider basis of assets in making funding decisions. The executor may consider making distributions that generally equalize the unrealized appreciation received by the various recipients. This could involve a wide variety of factors in particular situations, such as the tax brackets of the recipients, state income tax issues, the likelihood that particular assets would be sold, etc.
    - Under a carryover basis system, lifetime sales could be disadvantageous. A sale of appreciated assets to a grantor trust in return for a note could mean that no basis step-up is allowed for either the note or the assets in the trust, thus resulting in an eventual double realization (to the estate or estate recipient when the note is paid and to the trust when the assets are sold). This double realization could be avoided by bequeathing the note to the trust. (The sale to a grantor trust is not governed by the installment sales rules; if the installment sales rules applied, the transfer of an installment note to the obligor would be a realization event).
    - Similarly, under a carryover basis system, satisfying GRAT annuity payments with appreciated assets following the grantor's death could result in gain realization by the estate. (That gain realization issue is minimized under current law because the grantor's death during the GRAT annuity term likely results in most or all of the GRAT value being included in the grantor's gross estate and receiving a basis adjustment at the grantor's death.) A possible solution to this problem would be to bequeath the right to receive annuity payments to the GRAT so that the obligation of make the payments would disappear.
- Undoing prior planning. If the estate tax is repealed, planners will be very busy over the next several years undoing prior planning that was implemented to avoid the estate tax. Prior trust and other structures may no longer be helpful and indeed may be detrimental. (See Item 6.I.) This type of planning may include avoiding the funding of bypass trusts under the wills of clients who die without updating their wills, causing previously transferred low-basis assets to be included back in the donor's gross estate, undoing prior discount planning or life insurance trusts that are no longer needed, turning off grantor trust status, and causing inclusion of assets in a beneficiary's (or other third party's) estate.

- In an environment of possible looming tax reform limiting deductions and lowering rates, generally consider deferring income and accelerating deductions (particularly the charitable deduction in light of proposals to limit overall itemized deductions to $100,000 per year [$200,000 for a married couple]).
- Revised charitable planning. Because no necessity would exist for an estate tax charitable deduction if the estate tax is repealed, a new paradigm would apply to charitable dispositions at death.
  - In a family with unified goals about charitable transfers, consider making bequests to individual family members and allowing them to make lifetime gifts to the same desired charities, giving the individuals an income tax deduction. (That type of planning may be limited for large charitable bequests if the tax reform measures limit charitable income tax deductions.)
  - Charitable bequests to trusts would no longer have to be in the form of a qualified interest. Assets could be left to a trust providing that all income would be paid to charity, which would allow the trust to receive a §642(c) income tax deduction, thus reducing the trust's DNI to $0, meaning that trust distributions to others would not carry out income to them.
- A practice concern is that fear of the estate tax is often what drives clients into planners' offices, and clients may never enter the planner's office to be informed of the many other reasons that careful planning is needed. In addition, avoiding the estate tax may be the justification, in the client's mind, for paying substantial fees for estate planning services.
- Remember all the many things that estate planners do beyond planning for the federal estate tax. Following the passage of ATRA, Lou Mezzullo, President of the American College of Trust and Estate Counsel, sent a letter to ACTEC Fellows reminding them of the many services that professionals provide to clients other than federal transfer tax planning. He provides the following list, not meant to be exhaustive, of some of those items (quoted with his permission).

  1. Planning for the disposition of the client's assets at his or her death.
  2. Asset protection planning.
  3. Planning for disability and incompetency.
  4. Business succession planning (without the estate tax to blame for failure of a business).
  5. Planning for marital and other dissolutions.
  6. Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, would not be affected at all).
  7. Life insurance planning (other than to provide funds to pay taxes).
  8. Fiduciary litigation (enhanced because more to fight over).
  9. Retirement planning.

10. Planning to pay state death taxes (in many states).
11. Planning to avoid or minimize gift taxes (and client desires to gift more than the $5 million indexed applicable exclusion amount for gift tax purposes).
12. Using business entities to accomplish nontax objectives.
13. Planning for children with disabilities.
14. Planning for spendthrift children.
15. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax).
16. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.
17. Planning for nonresident aliens with assets in the U.S. or who plan to move to the U.S.
18. Planning for citizens who intend to change their citizenship.
19. Planning for possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates.
20. Planning to pay education expenses, including contributing to I.R.C. §529 plans.
21. Planning to deal with non-tax regulatory issues, such as the Patriot Act, HIPAA, and charitable governance reform.
22. Identifying guardians for minor children, if and when needed.

All of these issues (and various other non-tax issues) would still be important for clients.

- Keep perspective. Michael Graham (Dallas, Texas) reminds planners of the importance of estate planning beyond saving estate taxes, pointing out that planners assist broadly in the "transporting" of capital from one generation to the next.

> I continue to maintain that not a single less person will die needing at least a Will, not a single less person will have, or be married to, children from a prior marriage. There will continue to be children of great promise and children faced with great challenges. The fact that my lovely wife June would not need to worry about the marital deduction any more doesn't mean she would give everything outright to me at her death. She knows me too well after 47 years of marriage.
>
> Even now, the truth is that for most of our planning, divorce is more likely than death. I did an Ethics presentation for the annual NAELA meeting this year on representing H and W. The statistics are that 70% of second marriages in which there are children from a prior marriage will end in divorce within 5.5 years. Think about that. Even now, we are drafting in anticipation of divorce, not death.
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> We are not the railroad unless we treat ourselves as such. We are transportation. We assist in transporting capital from one generation to the next.