First Bankers Trust Services

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Tax reform for Christmas?

In mid-October the Republican chief deputy whip for the House, Rep. Patrick T. McHenry (R-N.C.), predicted that tax reform would finish in the House and Senate on Christmas Eve. The next day, House Speaker Paul D. Ryan (R-Wis.) promised to keep the House in session until Christmas if necessary to get the job done. That will be quite an achievement.

The Tax Cuts and Jobs Act of 2017, H.R. 1, would defer the repeal of the estate and generation-skipping transfer taxes until 2024. In the meantime, the amount exempt from federal transfer taxes would double, to $10 million per taxpayer, plus inflation adjustments. No change is made to basis step-up at death in the bill.

The federal gift tax would be retained in 2024 and later years, presumably to prevent intra-family transfers to reduce taxes on capital gains. The top gift tax rate would be 35%, and it would apply after taxable gifts exceed the gift tax exemption by $500,000.

COMMENT: President Trump hedged the timeline in October when he said of tax reform that "I would like very much to see it be done this year. . . . If we get it done, that's a great achievement. But don't forget, it took years for the Reagan administration to get taxes done." Treasury Secretary Mnuchin later echoed that thought, including how long tax reform took in the Reagan administration.

Evidently, both men were alluding to the Tax Reform Act of 1986, which was a triumph of bipartisanship. However, it must be noted that before that historic legislation was finished, President Reagan had signed the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, and the Tax Reform Act of 1984. Whether any of these bills qualify as "historic tax reform," it should be noted that President Reagan "got taxes done" in about eight months after his inauguration.

Revoked!

After a six-hour public hearing and some 28,000 comments (mostly negative), the IRS has declared a truce in its war on discounts for intrafamily transfers of family business interests. The proposed regulations under IRC §2704 have been withdrawn.

The withdrawal came pursuant to President Trump's executive order instructing the Treasury Department to review all regulations issued in 2016 to identify any regs. that impose an undue financial burden on U.S. taxpayers, add undue complexity to the federal tax laws, or exceed the IRS' statutory authority. With *Notice 2017-38*, 2017-30 IRB 147, the IRS identified eight regulatory projects that may meet the requirement for burden reduction. Among them was the proposed valuation regulation under IRC §2704.

On October 2 Treasury Secretary Steven Mnuchin released his report on the eight regulatory projects. The §2704 regulations were described as "a web of dense rules and definitions" that " would have narrowed longstanding exceptions and dramatically expanded the class of restrictions that are disregarded under Section 2704." The objections from the comments were summarized. The conclusion was surprisingly political, and quite harsh:

"After reviewing these comments, Treasury and the IRS now believe that the proposed regulations' approach to the problem of artificial valuation discounts is unworkable. In particular, Treasury and the IRS currently agree with commenters that taxpayers, their advisors, the IRS, and the courts would not, as a practical matter, be able to determine the value of an entity interest based on the fanciful assumption of a world where no legal authority exists. Given that uncertainty, it is unclear whether the valuation rules of the proposed regulations would have even succeeded in curtailing artificial valuation discounts."

The proposed Regs. were withdrawn by the Treasury on October 20.

—REG-163113-02; 82 F.R. 48779-48780

DSUE lookbacks are forever

Frank died in 2012. His estate elected the deceased spousal unused exclusion (DSUE), in an amount of $1.2 million. An estate tax return was filed showing no estate tax due, and the IRS sent a closing letter to the estate.

Frank's surviving spouse, Minnie, died in 2013. Even with the additional exclusion, her estate was large enough to trigger a federal estate tax of over $700,000. Minnie's estate tax return was selected for audit. She and Frank had made taxable gifts of nearly $1 million about ten years before they died. The gifts had been reported properly on gift tax returns when they were made, but, apparently, the taxable gifts were not handled properly on the estate tax returns. More than three years after Frank's death, the IRS took another look at his estate tax return, and it determined that the DSUE should have been much lower, by about $1 million. That didn't change the estate tax for Frank's estate, but it did boost taxes for Minnie's estate, to the tune of another $788,165.

Before the Tax Court, Minnie's estate argued that the IRS was barred from reexamining Frank's estate tax return, either because of the three-year rule or because a closing letter had been issued. Neither reason is applicable in this case, the Tax Court held. The section of the tax code that grants the taxpayer's right to claim an unused exclusion amount also explicitly gives the IRS the power to re-examine the facts giving rise to the exclusion without regard to any time limits whatsoever. The estate tax deficiency was upheld.

—Sower, Estate of Minnie Lynn et al. v. Commissioner; No. 32361-15

COMMENT: The advent of the DSUE has been a boon to married couples in their estate planning, as they can double the amount of the federal exclusion without resorting to multiple trusts. However, the lack of finality over the value of the DSUE is a lingering problem that deserves legislative attention.

Inflation adjustments

The IRS has announced that in 2018 the unified credit against the estate and gift tax will rise to $5.6 million per taxpayer, and the annual exclusion gets its first bump in many years, to $15,000 per year per donee.

— Rev. Proc. 2017-58; 2017-45 IRB 1

Steady rise

Both the number of estate tax returns and estate tax revenue collected rose in 2016, according to a report released in October from the Statistics of Income division of the IRS. The number of taxable estate tax returns rose by 6.1%, from 4,918 in 2015 to 5,219 last year. Collected revenue grew from $17.1 billion to $18.3 billion, a 7.2% increase, on gross taxable estates of $108 billion.

Nearly half of the taxable estate tax returns were in the range of $5 million to $10 million, but they provided only 16% of the revenue. The 300 estates of $50 million and more, less than 6% of the total taxable filings, paid 49% of the total estate tax. About 20% of the taxable estates were of California residents.

There were also 7,192 nontaxable returns filed in 2016, reporting assets of $84 billion. They were nontaxable primarily due to bequests to surviving spouses ($50 billion), to charities ($7 billion), the deceased spousal unused exclusion ($1.7 billion), and the allowable unified credit ($15.7 billion).

—IRS, Statistics of Income Division, Estate Tax Returns Study, October 2017.

Compliance costs

An Issue Brief by the National Taxpayers Union Foundation puts the cost of complying with federal estate and gift tax regulations at $123 million, based upon paperwork estimates from the Office of Management and Budget. The calculation assumes the cost of professionals working in this area to be $58.90 per hour. That comes to roughly $10,000 per estate tax return filed, whether taxable or not. The study does not attempt to estimate the costs of hiring attorneys and accountants to develop estate plans and strategies to minimize transfer taxes, which it characterizes as "a dead-weight loss of funds that could otherwise be used to invest in products and services."

—www.ntu.org/foundation/detail/death-and-a-thousand-paper-cuts-the-compliance-burden-of-the-estate-tax

COMMENT: An earlier version of this study put the compliance cost for estate taxes at an eye-popping $18 billion, nearly as much as the collected estate tax revenue! However, that draft included the cost of complying with estate and trust income tax regulations, which takes roughly 100 times more hours than does the estate tax. Form 1041 has to be filed every year, after all, while Form 706 normally is only filed once. The currently available version of the Issue Brief includes the correction.

Scrivener's oversight

Grantor created an irrevocable trust for his spouse and their descendants. The trust granted the spouse a testamentary power of appointment over the trust assets, to be exercised in favor of any person or charity the spouse may desire. However, the power did not include the required words of limitation, excluding from the exercise "Spouse, the estate of Spouse, the creditors of Spouse or the creditors of Spouse's estate." As such, it could be construed as a general power of appointment, taxable in Spouse's estate under IRC §2041. That would not be the result hoped for by Grantor.

Grantor contended that the failure to include the words of limitation was a scrivener's error, and petitioned the local court to reform the trust. The court entered the order, retroactively reforming the trust. Now the question becomes, will the IRS respect the reformation? Or will it instead consider the change in the trust to be a taxable exercise or release of the power of appointment, thus triggering a taxable gift?

Good news for this taxpayer—no taxable gift, and the trust will be excluded from the spouse's estate.

—Private Letter Ruling 201737001

Our trust team is looking forward to working with you!

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