Summary of 2017 Estate Tax Repeal Legislation to Date

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With a Republican President and a Republican majority in the House and the Senate, many speculate that 2017 will be a year of tax reform. Both President Trump and the House Republicans have included estate tax repeal in their lists of priorities. Although we have not yet seen comprehensive tax legislation in 2017, there have already been several bills introduced in Congress that would repeal the estate tax.

This paper discusses the estate tax repeal legislation that has already been proposed in 2017 and the potential impact on stepped-up basis and incomplete non-grantor trusts.

Overview of the Proposed Estate Tax Repeal Legislation to Date

Several pieces of legislation were proposed in January 2017. Each of the proposed acts would fully repeal the estate tax, but there are significant differences between several of the proposals. Each of the proposed acts is discussed below.

The January 3 Acts

Two acts—H.R. 30 and H.R. 198—were introduced on January 3, 2017. These two acts differ only in the title. H.R. 30 is titled the *Farmers Against Crippling Taxes Act* and H.R. 198 is titled the *Death Tax Repeal Act of 2017*. Both acts would fully and permanently repeal Subtitle B of the Internal Revenue Code, which includes the estate tax, the gift tax, the generation-skipping transfer tax, related valuation rules, and rules for gifts and bequests for expatriates. Repeal would be effective on the enactment date and would apply to all gifts and generation-skipping transfers made and estates of decedents who die after that date.

The January 11 Act

H.R. 451, titled the *Permanently Repeal the Estate Tax Act of 2017,* was introduced on January 11, 2017. The act would fully repeal chapter 11 of the Internal Revenue Code for decedents dying after December 31, 2017. Unlike the first two acts, H.R. 451 would repeal only the estate tax (chapter 11), leaving the gift tax, generation-skipping transfer tax, and related provisions of Subtitle B intact.

The January 24 Acts

On January 24, 2017, two acts were introduced—H.R. 631 in the House and S.B. 205 in the Senate. Like H.B. 198, both acts are titled the *Death Tax Repeal Act of 2017.* Both acts are substantially similar to each other. They would repeal the estate tax for all decedents dying after the date of enactment. They would also repeal the generation-skipping transfer tax for all generation-skipping transfers made after the date of enactment. The gift tax would remain in place at a maximum rate of 35 percent. Both acts also have transition provisions to continue taxing preexisting qualified domestic trusts for ten years.

The Senate version of the act resurrects IRC § 2511(c), a provision that was included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (*EGTRRA*):

> TREATMENT OF CERTAIN TRANSFERS IN TRUST–Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1.

Under this provision, unless a trust is a grantor trust, any transfer into the trust is treated as a taxable gift. The purpose of IRC § 2511(c) is to clarify that transfers to non-grantor trusts qualify as gifts for purposes of claiming the marital and charitable deduction.[1]

When this provision was first considered in 2001, it was thought that clarification was needed to ensure that transfers to non-grantor trusts were deductible in circumstances where the grantor retained an interest in the trust. This retained interest meant that gifts to the trust were incomplete. But in 2012, the IRS issued a Chief Counsel Memorandum that largely addressed the issue. CCA 201208026 dealt with a grantor's retained testamentary limited power of appointment over trust principal without any corresponding right to control the income interest in the trust.[2] The Chief Counsel ruled the grantor made a completed gift of the income interest even though the gift of the remainder interest was incomplete.

When read with the valuation rules of IRC § 2702(a)(2) and Treas. Reg. § 25.2702(a)(4) that treat the value of the retained interest as zero, CCA 201208026 supports the proposition that the value of gifts to non-grantor trusts with retained interests is the full value of the transferred property, without regard to the value of the retained interest, and thus qualifies for the charitable and marital deduction. As a result, there is probably no need to include the "clarification" of IRC § 2511(c), especially since (as discussed below) IRC § 2511(c) would have unintended consequences that thwart existing planning techniques.

Analysis of the Estate Tax Repeal Acts to Date

Aside from the obvious benefit to taxpayers of estate and—in some cases—gift and generation-skipping transfer tax repeal, there are both pros and cons to the proposed legislation.

Effect on Adjusted Basis Under IRC § 1014

No bill proposed to date would repeal the taxpayer-friendly basis adjustment for property acquired from a decedent under IRC § 1014 or resurrect the IRC § 1022 modified carryover basis rules introduced by EGTRRA. One of the bills—H.R. 451—even states that its purpose is to "repeal the estate tax *and retain stepped-up basis at death.*"

Although the lack of any explicit repeal or modification of IRC § 1014 is a positive sign, the absence of language will not be enough to ensure that the benefits of basis adjustment remain in place. If full basis step-up is to be preserved, it is likely that additional modifications will need to be made to IRC § 1014 to coordinate it with the repeal of the estate tax. This is especially important for QTIP trusts, which obtain a basis step-up on the surviving spouse's death based on the inclusion of the QTIP trust property in the surviving spouse's estate. In other words, if the QTIP trust is not included in the surviving spouse's estate under IRC § 2044, there may be no basis adjustment under IRC § 2014(b)(10).

Similarly, the full basis step-up for community property on the death of the first only applies if "at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's

gross estate."[3] If the predeceased spouse no longer has a "gross estate" for estate purposes, the full basis step-up on the first spouse's death may no longer apply.

Effect on Incomplete Non-Grantor Trusts

Incomplete non-grantor trusts are a popular state income tax saving strategy. As the name suggests, an incomplete non-grantor trust is designed so that transfers to the trust are considered incomplete for federal gift tax purposes. This allows grantors to transfer assets to the trust without any gift or estate tax consequences. An incomplete non-grantor trust is also designed to avoid classification as a grantor trust. It has its own taxpayer identification number and files its own tax returns. This allows the trust to be subject to income tax apart from the grantor.

Incomplete non-grantor trusts—referred to as INGs, NINGs (if created in Nevada), or DINGs (if created in Delaware)—are often used to save state income taxes when the grantor resides in a jurisdiction with high income tax rates. They are established in jurisdictions with favorable income tax laws (usually Nevada or Delaware).[4] The income earned by the trust can be removed from the grantor's state of residence, assuming proper precautions are followed. These precautions include ensuring that the trust is structured properly, that there is no nexus with the grantor's home state, that there is no income that is sourced in the grantor's home state, and that the home state does not determine taxation of trust income based on the grantor's domicile.

Incomplete non-grantor trusts only work if the trust is not a grantor trust and transfers into the trust are incomplete gifts. As discussed above, S.B. 205 would reintroduce IRC § 2511(c) into the Internal Revenue Code. Under this provision, unless a trust is a grantor trust, any transfer into the trust is treated as a taxable gift. This provision would make it impossible to have a trust that is both a non-grantor trust and an incomplete trust for gift tax purposes. As a result, the income tax savings strategies associated with incomplete non-grantor trusts would no longer be available.

Takeaways

All of the bills discussed above are no more than proposals, many of which have been unsuccessfully proposed in prior years. The House legislation has been referred to the Committee on Ways and Means and the Senate legislation has been referred to the Committee on Finance. Although there is perhaps a greater chance that the bills will become law this year than in the past several years, it remains to be seen whether any of these bills will make it out of committee.

Given the uncertain status of these bills and the prospect of a more comprehensive tax reform package, it may be premature to make tax-driven decisions based on these proposals. For clients that are already considering strategies involving incomplete non-grantor trusts, conservative practitioners should consider moving sooner rather than later. Having the trust in place—or at least drafted—could be beneficial if it becomes more likely that IRC § 2511(c) will be reenacted.

As stated above, the adverse impact of IRC § 2511(c) is likely unintended. Congress is probably not concerned with enacting a provision that would prevent state income tax savings. Practitioners should write to their Senator to explain the adverse effects of IRC § 2511(c) and recommend that it not be included in any estate tax repeal bill.

[1] General Explanation of Tax Legislation Enacted in the 107th Congress, Joint Committee on Taxation, JCX-03-01, available at http://www.jct.gov/s-1-03.pdf, pages 249-250.

[2] IRS CCA 2012-08026 (Feb. 24, 2012).

[3] I.R.C. § 1014(b)(6).

[4] Delaware law does not require Delaware trusts to file an income tax return if none of the beneficiaries are in Delaware and the trust does not have Delaware-source income. Delaware also allows a deduction for income accumulated for beneficiaries that reside out-of-state. 30 Del. C. Secs. 1635(a); 1636(a). Nevada does not have state income tax and has a constitutional prohibition against enacting a personal income tax. Art. 10, Section 1, Subsection 9, Nevada Const.

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