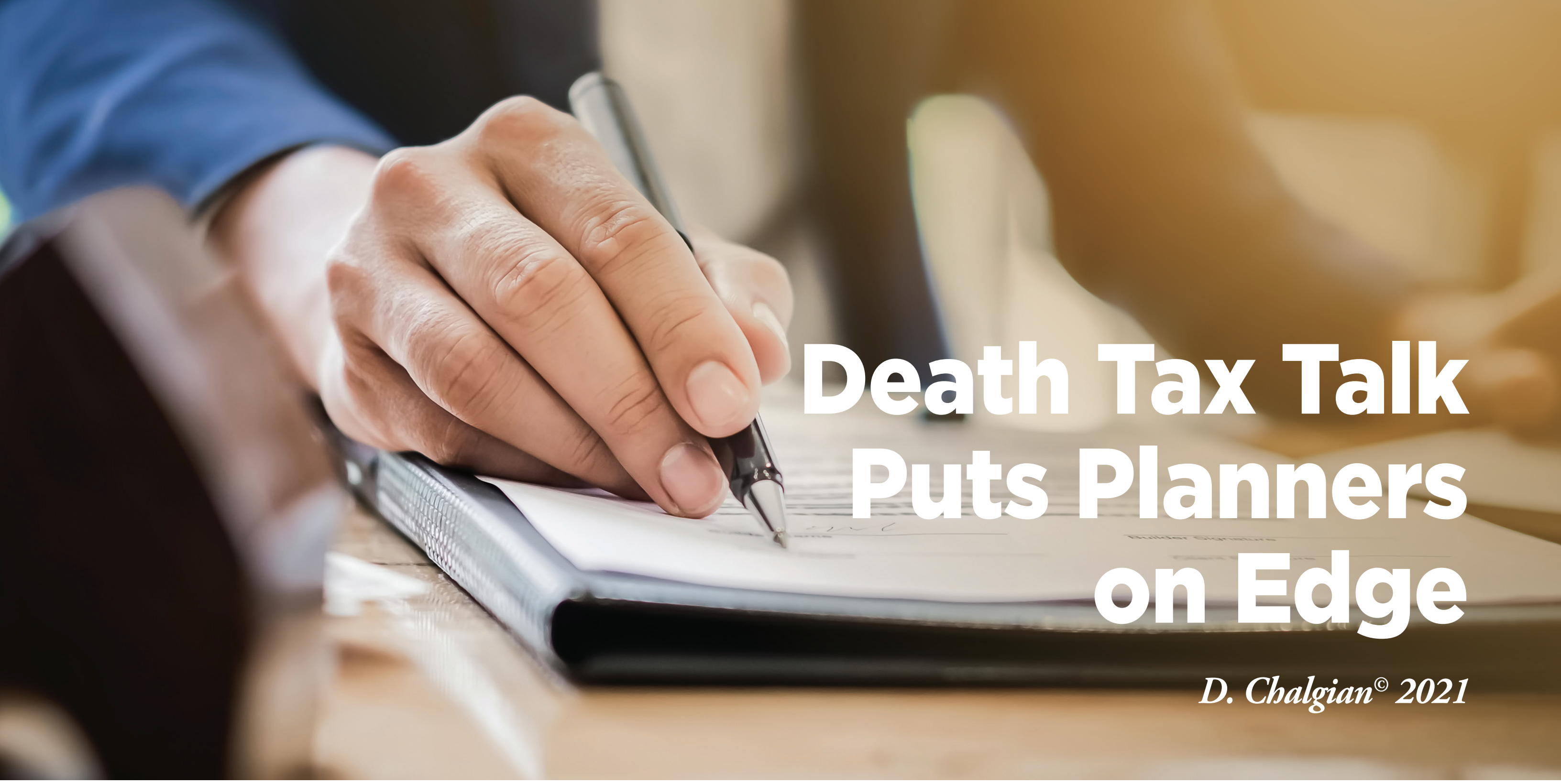

Death Tax Talk Puts Planners on Edge

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With a new administration in Washington, comes increased attention to our tax laws, including laws that tax assets when people die. For estate planning attorneys, this increased interest brings with it the possibility that changes may come which will impact their clients, and which may change the way they should be planning for clients in the future.

The centerpiece of the system that taxes wealth at death is what is called the Federal Estate and Gift Tax (aka the "Estate Tax," aka the "Death Tax"). This tax is complicated enough on its own. But other taxes, including the income taxes associated with tax-deferred retirement accounts, as well as capital gains taxes on investments that have appreciated (or depreciated), also have rules that apply when the owner of the retirement account or investment die.

Let's look at how estates and trusts get taxed now, and make some best guesses about where and what changes might be forthcoming.

The Death Tax

The Estate Tax is a tax on the assets a person owns when they die, whether their assets are in a probate estate, in trust, or pass otherwise by joint ownership or beneficiary designation. Essentially, this law operates by adding up all of those assets and imposing a hefty tax on the amount that exceeds an exemption amount. The exemption amount used is a function of the year in which they die. So, for instance, if someone dies with a "gross estate" of 10 million dollars, in a year in which the exclusion amount is 5 million dollars, the first 5 million will pass free from the estate tax and the second 5 million will be subject to the tax.

The system is of course more complicated than this simple example suggests.

For instance, if the deceased person leaves a surviving spouse, there are rules that allow the spouse to receive property which property would not be subject to the tax until that surviving spouse dies.

There are also rules about gifts, which rules say that any substantial gifts made by a person during their life must be added back into the calculation of the value of the "gross estate" when they die. [Not surprisingly, the practice advising wealthy people about how to make lifetime gifts to avoid or minimize their inclusion in their estate at death comprises a large area of legal work all by itself.]

Best Guess: The Estate Tax is an obvious place where one might expect the law to change. This could be a change (presumably a reduction) in the exemption amount for years to come, or an increase in the rate at which gross estates that exceed the exemption amount are taxed, or both. But this is politics and it's probably worth noting that there has historically been a consistent and bipartisan dislike of this tax. In recent times, both Democrats and Republicans have pushed the exemption amount higher and higher, so that in the past 20 years we have seen a tax that once haunted the middle class become a concern to only the wealthiest of the wealthy. [The exemption amount in 2001 was $675,000. In 2021, it is

$11,700,000.] On the other hand, this dramatic increase over time could just as easily make it easier to sell the idea of paring back the exemption now. It's probably a safe bet to expect some reduction in the exemption amount at some point in the foreseeable future, along with perhaps an increase in the rate of taxation for estates that exceed the exempt amount.

Income Tax

In the past few decades, the retirement planning system in the United States has shifted from a system based on traditional pensions, to a system based almost exclusively on tax-deferred retirement accounts. Whereas in times past, people would work for a set number of years for an employer, retire, and be rewarded with a pension check every month for as long as they lived; these days almost no employer offers such pensions. Instead, during their working years, employees are invited to contribute a portion of their earnings into retirement accounts (which employers may contribute to as well), which accounts move with the employee from job to job, and which accounts the employee then draws upon as a source of income when they retire.

The primary feature of these retirement accounts is that the money that is earned by the employee and placed in such accounts is not subject to income taxation when the contribution occurs. But when the employee reaches an age when they can begin to take those funds back out of the account (when they retire), the funds they withdraw from these accounts are taxed. The rules of "minimum required distributions" that apply to these accounts are designed to force the owner to take the money out before they die so that income taxes can finally be collected by the government.

These "tax-deferred" retirement accounts also have rules about what happens to any funds remaining in these accounts when their owners die. How long a person who inherits such an account can continue to defer payment of income tax, is complicated and depends on several variables, including the age of the person who inherits the account as well as their relationship to the deceased owner. In 2019, new federal legislation (the "Secure Act of 2019") changed those rules in a way that was designed to force the people who inherit these accounts to withdraw the funds and pay the taxes more rapidly than had been the case before that Act.

Best Guess: It seems reasonable to think that the recent passage of the Secure Act will satisfy reformers with respect to this tax, and that another change to the taxation of tax-deferred retirement accounts may be unlikely at this time.

Capital Gains

Another hot topic in estate planning and taxes has to do with the capital gains tax structure.

Capital gains is the tax that is imposed on the money that someone gets when they sell an asset for more than what they paid for it. In other words, the capital gains tax taxes appreciation in the value of assets when those assets are sold.

The amount of the sale proceeds that is taxed as a capital gain is the difference between what was paid for it (called the "cost basis") and what is received upon the sale.

When someone gives an asset away during their life and the new owner subsequently sells that asset, that new owner has to pay tax on the difference between what the prior owner paid for it and what they sold it for. This concept of having to keep track of what a prior owner paid for the thing in order to calculate the capital gains tax is called "carryover basis." That is, the cost basis from the original owner carries over to the new owner(s).

The important aspect of the capital gains tax that relates to death is the concept of a "stepped up basis." This is the rule that says if someone dies and leaves another person an asset (through their will, trust or otherwise), and that asset has unrealized capital gain (appreciated value) associated with it, that tax obligation is forgiven. The cost basis is "stepped up" to the value of that asset as of the date of the death of the person who died owning the asset.

So, for instance, if Parent bought stock in Apple for $100 and it was worth $200 when Parent died, and if Child inherited the property from Parent and two years later sold that stock for $250, Child would only pay capital gains tax on $50 (the difference between the value when Parent died and when they sold it). The capital gains tax that would have been paid by Parent had they sold this stock before they died is never realized. That is, the appreciation of the Apple stock from $100 to $200 is never taxed.

Best Guess: Perhaps the dark horse in this tax reform derby is the possibility that carryover basis be eliminated or modified. The current step-up basis rules are very generous and could easily be targeted in the name of reform. Although arguably the most sensible change to the tax system relating to assets that pass at death, it's hard to predict the likelihood that politicians will dive into something that has been accepted for so long, or that the public will be able to understand the issue sufficiently to allow it to become politically palatable.

Conclusion

To say that the tax laws embody public policy is an understatement. No area of the law has a more direct impact on social class, wealth acquisition, or wealth disparity. So, not surprisingly, when politicians seek to "reform the system," tax law changes are always front and center. And that is especially true of those taxes that come into play when people die.

But the laws that tax assets at death are complicated. To those looking for a more equitable tax code, the tax laws discussed above would seem to be obvious targets for reform. Regardless of whether such changes occur, the process of debating these topics is in itself unsettling for lawyers who work with clients to plan for their estate