

Additional Information On Taxing Unrealized Appreciation at Death

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Administering estates (and revocable trusts) under the Administration proposal would be more complicated than administering such an entity under current law where all property receives a change in basis to its date of death (or alternate valuation date) value. With a surviving spouse, allocation of property between a marital deduction disposition (carryover basis) and a credit shelter disposition (appreciation tax at death) would often be required. The governing instrument should authorize non-pro rata distributions of property in kind. Such a power is often contained in a fiduciary powers act enacted by a state. A fiduciary's exercise of a non-pro rata power of distribution should be respected by the IRS, as well as what property is sold to pay debts, administration expenses and taxes.

An unanswered question is what effect the Administration's proposal, if enacted, would have, if any, on the tax policy of the various states. A related question is whether the federal government should allow a deduction for a state death tax imposed on unrealized appreciation similar to the IRC Sec. 2058 deduction for state death taxes.

Property subject to the Administration's proposed tax on unrealized appreciation may be eligible under IRC Sec. 6166 for deferral of payment of estate tax attributable to a farm or other closely held business. The requirements of the two provisions should be complementary. Changes were made in 1997 for payments of interest on unpaid estate tax (i) making them not deductible for income tax or estate tax purposes; and (ii) setting them at 2 percent on the "2-percent portion" which is defined as follows in IRC Sec. 6601(j):

2-percent rate on certain portion of estate tax extended under section 6166

(1) In general

If the time for payment of an amount of tax imposed by chapter 11 is extended as provided in section 6166, then in lieu of the annual rate provided by subsection (a)—

(A) interest on the 2-percent portion of such amount shall be paid at the rate of 2 percent, and

(B) interest on so much of such amount as exceeds the 2-percent portion shall be paid at a rate equal to 45 percent of the annual rate provided by subsection (a).

For purposes of this subsection, the amount of any deficiency which is prorated to installments payable under section 6166 shall be treated as an amount of tax payable in installments under such section.

(2) 2-percent portion

For purposes of this subsection, the term "2-percent portion" means the lesser of—

(A)

(i) the amount of the tentative tax which would be determined under the rate schedule set forth in section 2001(c) if the amount with respect to which such tentative tax is to be computed were the sum of \$1,000,000 and the applicable exclusion amount in effect under section 2010(c), reduced by

(ii) the applicable credit amount in effect under section 2010(c), or

(B) the amount of the tax imposed by chapter 11 which is extended as provided in section 6166.

(3) Inflation adjustment

In the case of estates of decedents dying in a calendar year after 1998, the \$1,000,000 amount contained in paragraph (2)(A) shall be increased by an amount equal to—

(A) \$1,000,000, multiplied by

(B) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting “calendar year 1997” for “calendar year 2016” in subparagraph (A)(ii) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of \$10,000, such amount shall be rounded to the next lowest multiple of \$10,000.

The Senate Finance Committees explained the reasons for the changes as follows:

The Committee believes that the installment payment provisions need to be expanded in order to better address the liquidity problems of estates holding farms and closely held businesses, to prevent the liquidation of such businesses in order to pay estate taxes. The Committee further believes that the protection of closely held businesses will preserve jobs and strengthen the communities in which such businesses are located. In addition, by eliminating the deductibility of interest paid on estate taxes deferred under section 6166 (and reducing the interest rate accordingly), the bill eliminates the need to file annual supplemental estate tax returns and make complex iterative computations to claim an estate tax deduction for interest paid.²¹

21 H.R. Rep. No. 148, 105th Cong., 1st Sess. 83 (1997); S. Rep. No. 33, 105th Cong., 1st Sess. 48 (1997).

A possible change providing a benefit for qualifying estates would be to apply the “2-percent portion” to the entire deferred amount, thus making that amount (2%) eligible for the entire deferred tax. An alternative would be to make the change based upon a 20 percent share of the interest rate under subsection (a) applicable as of the date of the decedent’s death. The 1997 changes leave little room for further reductions.

On page 17 of our Issue 2021-2, we quoted from the Administration’s proposal which said:

Payment of tax on the appreciation of certain family-owned and -operated businesses would not be due until the interest in the business is sold or the business ceases to be family-owned and operated. Furthermore, the proposal would allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which

the deferral election is made. The Internal Revenue Service (IRS) would be authorized to require security at any time when there is a reasonable need for security to continue this deferral. That security may be provided from any person, and in any form, deemed acceptable by the IRS.

The first two sentences are confusing. The meaning of the word "certain" needs an explanation. Does it refer only to businesses that qualify for IRC Sec. 6166 deferral? The second sentence suggests an alternative to the first sentence. Is this so? In other words, if the word "certain" is not met, relief appears to be still available under the second sentence other than for liquid assets and assets for which the deferral election is made. Does this mean no security would be required under the first sentence?

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On August 9, 2021, Senator Bernie Sanders, Chairman of the Senate Budget Committee, released a proposed current resolution which would provide instructions for a \$3.5 trillion fiscal 2022 budget. The resolution would provide guidance setting forth the congressional budget for the United States Government for fiscal year 2022 and setting forth the appropriate budgetary levels for fiscal years 2023 through 2031. The resolution does not deal with the sources of the tax increases necessary to cover the expense of the additional uses of the \$3.5 trillion. That subject is to be determined. The resolution contemplates that when the Senate returns after Labor Day, decisions will be made and reported to the Senate. The resolution passed the Senate on August 11 and the Senate adjourned until September 13. The Senate Budget Committee plans to present the package of changes during the week of September 15th. As noted in Issue 2021-2 on page 18, sufficient time would not seem to be available to permit necessary revisions of existing estate plans to reflect the new tax with an effective date of January 1, 2022.

An article "A 'Death Knell' Tax Threatens Family Farms and Businesses" by Senator Grassley of Iowa on page A17 of the August 12, 2021 issue of The Wall Street Journal criticizes the Administration's proposed tax on unrealized appreciation and states:

Democrats propose to go beyond even what Congress did in 1976 by generally treating a transfer of property at death as a taxable event, not only once it's [sic] sold. The Administration claims it would protect family businesses by making an exception for them. However, it merely defers the tax – the liability still exists. So, family operations would be in the same boat as 1976, potentially contending with both the estate tax and taxes on paper gains on the appreciation of any property that's sold. What's more, a tax lien could loom over the operations in preventing family owners from obtaining a business loan or other financing.

In conclusion, the Senate Finance Committee in the next several weeks must decide the fate of the Administration's proposal to tax unrealized gain. Funds could come from changing other transfer tax provisions, including a reduction in the applicable exclusion amount.

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