Changes In Estate Tax Could Have Effect On Lower-Income Filers

Among the significant changes included in the tax reform plan released Sept. 27 by the Big Six tax negotiators and the White House is a repeal of the estate and generation-skipping taxes. Repealing the estate tax, which is levied on property passed from a deceased person to heirs, has long been a Republican priority, and may be one of the likelier measures to be included in a final package.

"I think if they pass something, it's probably fairly likely that [tax reform] would include repeal of the estate tax," said Joseph Rosenberg, senior research associate at the Tax Policy Center. However, the fact the tax affects high-income taxpayers "makes the politics of this rather challenging."

Estate and Generation-Skipping Taxes Are Set at 40%, with Inflation-Adjusted Thresholds

Estate taxes have been an element of the federal tax code since 1797. The modern estate tax was first established in 1916. In 1991, the Economic Growth and Tax Relief Reconciliation Act began a reduction of the estate tax that concluded in 2009, followed by a one-year elimination of the tax in 2010 — the tax would have been reinstated in 2011 when the estate tax, which was scheduled to sunset, was re-established in December 2010 and again adjusted in January 2013. The rate is now set at 40 percent, with an inflation-indexed threshold.

The Joint Committee on Taxation reports taxable estates represented more than 6 percent of deaths in the mid-1970s, but only 0.2 percent of deaths in 2013. While the tax affects a relatively small amount of taxpayers, it is one of the more divisive elements of the tax code. Estates are taxed on the combined value of the estate and qualifying lifetime gifts. In 2017, the threshold for taxation is set at $5.49 million for individuals and $10.98 million for married filers; anything above these levels is subject to taxation.

Estate taxes are normally paid by a person’s heir upon a beneficiary’s death. The heir could sell the stock at $100 per share without incurring capital gains tax. However, if the heir sells the stock at $100 per share without incurring capital gains tax, the heir would then have a new basis value at $100 per share. When the heir sells the stock at $100 per share, the basis for calculating capital gains would remain at $100 per share, but in this case, the stock’s value would increase to $100 per share from its basis value of $10. The heir then would realize a $90 increase in basis value.

Whenever a person inherits capital assets, whether from a capital gains tax or an estate tax, they receive a step-up in basis at the time of death. This step-up is used to calculate future capital gains taxes when the property is sold. If the person does not sell the stock in their lifetime, a new basis value is set, to its value at the time of their death. The heir could sell the stock at $100 per share without incurring capital gains tax.

Estate and generation-skipping taxes are subject to a step-up in basis at the time of the owner’s death. This step-up is used to calculate future capital gains taxes. The step-up may be at risk if the estate tax is eliminated. Opinions are split on whether the step-up is at risk if the estate tax is repealed. "If they repeal the estate tax... it’s likely that they’re going to take away the step-up in basis," Fax said.

"The framework that was released in late September... had one sentence related to the topic," Meier said. "There are a number of different ways the issue could be managed."

"Both sides of the estate tax repeal fight are highly energized and the concept of the estate tax means a lot politically to both of them," said Steven Meier, partner at Seyfarth Shaw and chair of the group’s National Tax Practice. "In a world where there’s growing income inequality, the estate tax represents a clearly progressive element of the tax system that, if repealed, simply shifts more wealth to the already wealthy persons."

Sources: IRS, Joint Committee on Taxation, St. Louis Federal Reserve, OECD, Tax Policy Center, Tax Foundation

By Taylor Thomas, POLITICO Pro DataPoint