Federal Estate and Gift Taxes Are a Mortality Risk

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ABSTRACT

For nearly 18 years, the federal transfer tax system has been a political football, causing gift and estate taxation to vary radically from year to year. Particularly in an environment in which a repeal of the estate tax is proposed (as of August 2017, the president had proposed a repeal of "death taxes," but no specifics are known), there is a tendency by clients and planners alike to ignore this topic. However, the mortality risk associated with federal estate and gift taxes remains very real for the wealthy, and advisors should factor this exposure into their estate and financial planning.

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In the 1970 antiwar song "Lucky Man," musical group Emerson, Lake & Palmer lamented that, even if you're rich, you're not lucky if you've died.[1] Mortality is fatal, and it afflicts rich and poor alike. Yet the wealthy sometimes fail to factor unexpected death into their planning. While wealth can be a buffer against financial ruin due to death, it can also magnify the financial risks associated with dying. Under current law, a unique mortality risk reserved for the wealthy is the federal estate, gift, and generation-skipping-tax system. These wealth transfer taxes can be insidious to the uninformed and can undermine an otherwise effective estate plan. This column explores the mortality risk specifically associated with federal gift and estate taxes, and then offers some possible ways to manage this risk.

The Estate Tax Challenge

The estate tax can be thought of as a cliff tax in that it doesn't apply until the taxpayer has acquired sizeable wealth (over $5.49 million per individual) but is confiscatory once it applies (a 40 percent flat rate due 9 months after death).[2] This estate tax is effectively a tax on principal, not income or gain, and it applies to wealth that, arguably, has oftentimes already been taxed. Consider the percentage of a taxable estate that can be lost to the federal estate tax, depending on the size of the estate:

- $5 million—0 percent
- $10 million—18.0 percent

- $100 million—37.8 percent
- $500 million—39.6 percent.[3]

The challenge of this tax is exacerbated by the fact that in many cases the value of the decedent's estate is not known until death. Since a wealthy individual's personal wealth often comprises real estate and private business interests, the decedent's assets are subject to both uncertainty and volatility in valuation. Additionally, in some cases the value of the estate's primary asset is intrinsically tied to the decedent. Consider, for example, the multimillion-dollar dispute between the IRS and Michael Jackson's estate. The bottom-line issue being debated is the good will value of the Michael Jackson brand as of the date of his death.

The Interplay between Gift and Estate Taxes

The federal wealth transfer system is anything but simple, particularly since it involves more than one tax regime. It is peculiar in its math, and this can lead to surprising, and sometimes financially devastating, results. Using the example of a single person named Pat, who has a large taxable estate ($100 million), Table 1 demonstrates the interplay between gift and estate taxes, depending on the strategies employed and the date of Pat's death. In many ways, the results are neither predictable nor logical.

Scenario 1

If Pat dies, having retained all $100 million, her estate tax will be $37,804,000.

Scenario 2

If, instead, while still alive Pat gifts half of her wealth, $50 million, to an intended heir, she potentially lowers her total wealth transfer taxes. Her gift tax is $17,804,000, which lowers her remaining wealth by the gift plus the gift tax paid. When she dies later, the estate tax on her remaining estate will be $12,878,400. Adding this to the gift tax she already paid, her combined federal transfer tax bill is $30,682,400. By gifting half of her wealth during lifetime, her tax bill is reduced by $7.1 million, approximately a 19 percent savings.

Scenario 3

It may be unrealistic to assume that Pat's wealth stayed flat during the years between the gift and her date of death. Scenario 3 accounts for this issue by assuming her remaining assets appreciate before she

TABLE 1
The Interplay between Gift and Estate Taxes in Pat's Estate

Pat is a single taxpayer with $100 million in net worth Facts	Gift Tax	Estate Tax	Combined Taxes
Scenario 1 Pat dies with $100 million in estate.	$0	$37,804,000	$37,804,000
Scenario 2 Pat gifts $50 million; dies more than 3 years later.	$17,804,000	$12,878,400	$30,682,400
Scenario 3 Pat gifts $50 million; remaining assets grow equal to gift tax.	$17,804,000	$20,000,000	$37,804,000
Scenario 4 Scenario 3, except Pat dies within 3 years of gift.	$17,804,000	$27,137,600	$44,941,600
Scenario 5 Scenario 3, except gift brought back into estate under IRC Sec. 2036.	$17,804,000	$40,000,000	$57,804,000

dies. Specifically, it assumes her assets appreciate by an amount equal to the gift tax she paid (approximately a 55 percent growth in the estate's value, resulting in a $50 million taxable estate when she dies).

Pat's estate tax is now $20 million, and added to the gift tax she already paid, her combined transfer taxes are $37,804,000. It is not a coincidence that this is the exact same amount she would have paid had she not made a gift in the first place—i.e., in Scenario 1. It is the result of the fact that the federal gift and estate tax system is unified. For estate tax purposes, previously taxable gifts are added back into the estate, and then credit is given for any gift taxes paid. But for the time value of money, gift taxes and estate taxes are the same.

The mortality risk in this system of taxation is obvious. There is no way to project the date of death, and therefore no way to know in advance the exact estate tax owed. A gifting strategy may or may not help save transfer taxes. And add to this challenge the uncertainty of the inclusionary sections discussed below.

The Effect of Inclusionary Sections in the Estate Tax

The federal estate tax system is 100 years old. In that time, there has been a constant cat-and-mouse game between the government and the wealthy. Advisors leverage loopholes in the wealth-transfer tax system, and the government then closes them down. Sometimes, however, these regulatory curbs on perceived tax abuses have led to severe results. Specifically, there are four Internal Revenue Code Sections (IRC Secs.) that have the effect of significantly increasing an estate's exposure to transfer taxes. These sections (IRC Secs. 2035–2038) are commonly referred to as inclusionary sections, and they can compound the mortality risk associated with taxes on the wealthy.

Scenario 4

If an individual can lower total transfer taxes through gifting (as in Scenario 2), a person contemplating death would likely make substantial deathbed gifts. To discourage the use of this strategy, one of the inclusionary sections, IRC Sec. 2035(b), creates an arbitrary rule that when gifts are made within 3 years of death, the gift taxes paid on these gifts must be added back into the estate. The problem with this statute is that it can actually increase the estate tax that is otherwise payable. This increase can be a penalty on a taxpayer who is not trying to trick the system. In Scenario 4, Pat makes a $50 million gift and her estate appreciates enough to gain back the gift taxes she paid (as in Scenario 3), but she dies in an automobile accident within 3 years of making the gift. Her taxable estate would increase to $67,804,000 ($50 million plus the gift tax she paid), and her estate tax liability would be over $27 million. Combining this tax with the gift tax she paid, her total wealth transfer taxes would be nearly $45 million. This can be a mortality risk that is not easily absorbed.

Scenario 5

IRC Secs. 2036–2038 are sections intended to discourage taxpayer manipulation of lifetime transfers. They cover transfers with retained life enjoyment, transfers taking effect at death, and revocable transfers. In sum, when a completed gift has the effect of allowing the decedent to retain sufficient use, control, enjoyment, or power over the property, the transfer is added back into the estate at its date-of-death value. The challenge is that these inclusionary sections have the potential to cause a form of double taxation. The transfer is taxed as a gift and yet is still included in the estate. In Scenario 5, Pat makes a $50 million taxable gift, and her estate appreciates enough to gain back the gift taxes she paid (as in Scenario 3), but her gift is deemed to violate one of the inclusionary sections. For example, the gift is in trust, and Pat controls the appointment of the trustee, a potential violation of IRC Sec. 2036. Her taxable estate returns to $100 million, even though she has already paid gift tax on the $50 million gift. The net result is a $17 million gift tax plus a $40 million estate tax. Pat's initial $100 million wealth has incurred more than $57 million in transfer taxes.

Other Mortality Risks Associated with Federal Transfer Taxes

The above scenarios demonstrate some of the mortality risks associated with federal transfer taxes. But there are other mortality risks than these. For example, in Scenario 5, what if the gifted assets appreciated in value between the time of the gift and Pat's death? The gifts are brought back into the estate at their date of death value, and the estate tax would be even higher.

Another tax area that causes significant exposure at death is Chapter 14 of the IRC (Secs. 2701–2704). These are some harsh rules aimed at discouraging tax abuses involving privately held business interests. These sections attempt to capture transfer taxes at the time of the gift rather than through inclusionary provisions applying to the estate tax. The problem is that the taxpayer and the government don't always interpret these provisions the same way, and the tax dispute often doesn't arise until the taxpayer's death. If the IRS wins the tax battle, there are not just more taxes to pay—the bill also includes interest and penalties. Further exacerbating the mortality risk is the fact that the estate must deal with the time delay and litigation costs of the tax challenge.

For the ultra-high-net-worth estate, the generation-skipping tax is a third transfer tax. As its name implies, this tax is aimed at taxing wealth at least once in each generation. Mortality risk-planning must include this additional tax as a factor when significant family wealth is involved.

Managing the Mortality Risk

Estate and gift tax planning is a subset of estate and financial planning. It is a particularly important aspect of planning for the wealthy because, in many ways, these taxes are largely avoidable. Until the taxpayer is very wealthy, gift and estate taxes can be avoided altogether through careful planning. For example, many of the inclusionary sections already discussed are intended as penalties for abusive tax schemes. In reality, often the tax strategy employed wasn't an abusive scheme, but rather a legal blunder due to lack of awareness or bad advice. Avoid the tax trap, and the taxpayer avoids the tax.

Still, mortality risk remains a given in estate tax planning. As shown in Scenario 4, an unexpected death can cause a well-planned gifting strategy to backfire because of the 3-year rule. And, because the valuation of assets is dependent of the date of death value, it is difficult to predict and project estate taxes.[4]

Four key strategies should be considered in managing the mortality risk of estate and gift taxes.

1. The client must have an appropriate attitude about taxes. So many bad estate tax outcomes are the result of greed rather than incompetence. Unrealistic business valuations, deathbed transfers, and form-without-substance practices rarely work. Play by the rules, and the mortality risks associated with gift and estate taxes can be minimized.
2. The client needs good advice. Estate tax planning for the wealthy should not be in the realm of the general tax practitioner. The client needs a team of experts to assess, fund, and manage the mortality risk inherent in transfer taxes.
3. Time is a key factor in estate tax planning. Estate-tax freezes and tax-reduction strategies typically need years, if not decades, to work effectively.
4. Finally, financial products should be factored into estate tax planning. Life insurance in particular can provide liquidity and help absorb any remaining estate taxes. Effective estate tax planning should be a combination of legal and product strategies. ■

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(1) "Lucky Man," Greg Lake, 1975, Cotillion Records.
(2) 2017 exclusion rate. This amount is indexed and may change as frequently as annually.
(3) All estate and gift calculations, including those in Table 1, assume the decedent died in 2017. For simplicity, all tax calculations assume a constant estate tax exclusion and estate tax rate.
(4) Under IRC Sec. 2032, the executor may choose to value the gross estate at an alternative date. This date is 6 months after the date of death if the property is not otherwise sold, distributed, or disposed of within those 6 months.