The Estate Tax After the 2017 Tax Act

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Although Benjamin Franklin once stated that death and taxes are the only certainties in life, the timing of death and the amount of taxes owed are certainly not. The Tax Cuts and Jobs Act of 2017 (TCJA, Pub. L. 115–97) leaves the federal wealth transfer tax system in place, but temporarily doubles the exclusion amount for estate and gift taxes to $11.18 million per individual or $22.36 million per married couple until the end of 2025. In 2026, absent congressional action, the base exclusion amount will revert to $5 million, indexed for inflation. This issue brief examines the implications of this change for taxpayers as well as its impact on federal and state governments.

BACKGROUND OF THE FEDERAL ESTATE TAX

Complexities of the Estate Tax Landscape

If the increased exclusion amount and its subsequent sunset sound familiar, it is because similar events happened in the not so distant past. The temporary nature of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 unexpectedly created a one-year repeal of the estate tax for taxpayers who died in 2010. Executors for those estates could choose either to follow the retrospectively reinstated 2011 rule, which set the exclusion at $5 million for a maximum estate tax rate of 35 percent and full basis step-up, or follow the EGTRRA rule where no estate tax was due but with limited basis step-up. The unusual opportunity executors faced, in part, reflected a choice between paying estate tax and capital gains tax. The choice might appear intuitive, as large estates would prefer paying the capital gains tax at approximately 20 percent while small estates would favor paying estate tax due to the more limited tax liability. The 2011 and 2012 estate tax returns did show large reductions in revenue collection. However, several studies found that complexities of asset composition and the investment history of assets prevented these executors from making one-size-fits-all conclusions about the actions they should take resulting from the changes in estate tax rules. Another complicating factor was that the change occurred right after the Great Recession, when many asset values were depressed. This highlights the intricacy of the estate tax system—a seemingly straightforward change of rules could have different impacts on two estates that have the same values but different asset structures.

Current Federal Transfer Tax System

Although recent discussions focused on the increased estate tax exclusion, the federal wealth transfer tax system actually encompasses three taxes: estate tax, gift tax, and generation-skip transfer (GST) tax. The gift tax allows carryover basis (the heir assumes the cost basis of the decedent) and complements the estate tax in that it deters wealth transfers over an individual’s lifetime to avoid transfer taxes at death. The GST tax is a special transfer tax that focuses on transfers to beneficiaries who are more than one generation younger than the transferor, typically grandchildren or more remote descendants of the transferor. Other
than the basic exclusion limit, an inflation-indexed annual gift exclusion of $15,000 per recipient is also available, which does not count against the basic exclusion. Finally, gifts and bequests to a spouse or charity are not subject to a gift or estate tax.

Federal Wealth Transfer Taxes and Federal Revenue

Statistics showed that an estate tax is collected for only 2 out of every 1,000 people upon their death. For the 5,219 taxable estate tax returns filed in 2016, the total value of gross estates was $108 billion, which resulted in $18 billion in tax revenue. For gift and GST taxes, 2,719 taxable returns collected more than $2 billion in 2016. Estate and gift taxes combined collected over $21 billion in 2016, which represented less than 0.7 percent of the federal government’s revenue.

The Joint Committee on Taxation (JCT) estimated that after the TCJA doubled the exclusion, less than 2,000 estate tax returns filed will be taxable, representing a 60 percent reduction in taxable returns. Over the next 10 years, this provision would reduce federal tax revenue by $83 billion, which encompasses a reduction of $8 to $10 billion on an annual basis.

Researchers have cited several different reasons for this phenomenon of low revenue collection. Some indicate that high exclusion amounts as well as the unlimited spousal and charitable contribution deductions are the main causes, while others say it is a consequence of extensive and effective planning, making the estate tax a “voluntary tax.” For the GST tax, some argue that the low revenue collection actually means the system is effective, as more taxpayers are opting to make transfers to their children instead of to heirs that are two or more generations younger.

WHY DO PEOPLE SUPPORT OR OPPOSE WEALTH TRANSFER TAXES?

Given the small amount of revenue it generates, the estate tax gathers a disproportionate amount of attention in policy discussions. Even with the passage of the TCJA and the potentially even smaller revenue collection it will produce, discussions on a repeal or an increase of the estate tax are still active, and the debate is far from settled.

Supporters of the estate tax believe the current provision is unfair because it is not extensive enough. They point to large government deficits and the increasing concentration of wealth in the U.S., which indicate that a repeal would provide windfalls to the affluent and worsen the deficits. The JCT estimate shows that a full repeal of the estate tax would reduce tax revenue by $270 billion over 10 years, three times the cost of doubling the exclusion under the TCJA. In addition, because the estate tax is viewed as one of the most progressive taxes in the federal tax system, the lack of a wealth transfer tax if it is repealed would likely limit intergenerational mobility.

A large volume of economic literature is devoted to determining why people leave bequests. The nature of the motive for a bequest will have significant implications for the design of the transfer tax system across wealth groups. There has been no consensus about this issue; however, some research argues that if the concentration of wealth is a concern to a society, there should at least be an estate tax on the wealthiest taxpayers regardless of bequest motives.

Another line of support for the estate tax hinges on the deductibility of charitable bequests. Because it encourages charitable bequests, a generous exclusion level (or repeal of the estate tax) would lead to a decrease in bequests. Empirical estimates show that there is a difference regarding the magnitude of a potential reduction in charitable bequests between a policy that increases the exclusion level and one that repeals the estate tax. A repeal would trigger more than double the reduction in charitable bequests compared to a policy that increases the exclusion level. This is because a higher exclusion level increases the absolute amount of wealth available for people who have estates between $5 million and $10 million as well as those worth over $10 million, so both groups will presumably leave more to charity. However, for those who have gross estates between...
$5 and $10 million, their tax benefits will disappear under the TCJA because their relative cost for giving to charity is no longer cheaper than giving to their heirs. For this group, charitable giving may fall or increase, depending on which effect dominates.\footnote{Opponents of the estate tax also believe the current provision is unfair, but for a different reason. It effectively taxes the same income twice: once when it is earned and again when it is passed on to beneficiaries.\footnote{Some also argue that the estate tax would treat two households that incurred the same amount of income over their lifetime differently and discourages saving; the household that spends most of its wealth would have to pay substantial amounts of consumption tax, whereas the household that saves would face an even larger estate tax.}}

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Another issue has to do with employment and job creation. Some opponents point to the concern that heirs of certain family farms or small, closely held businesses may be forced to liquidate assets to pay estate taxes. The JCT’s report recognizes that such concern is valid, but points to strategies currently available to avoid forced liquidation, such as allowing installment payments or taking out life insurance to ensure that heirs can pay estate taxes. Based on available data, the report stated that there is no clear evidence to conclude that the magnitude of forced liquidation is substantial.

Some research states that because the estate tax deters saving and investment, it has a particularly negative effect on entrepreneurship.\footnote{Studies show that inherited wealth enhances the likelihood of entrepreneurship\footnote{or the survival of an entrepreneur’s business\footnote{and point to the possibility that wealth transfer taxes might discourage entrepreneurship. However, there is less consensus in the economic literature about the estate tax’s impact on saving or investment.\footnote{For example, a higher estate tax increases the after tax cost of leaving a bequest, but it is unclear whether this will prompt people to increase or decrease the size of their bequests. On the one hand, a higher estate tax may discourage potential transferors from accumulating the assets necessary to make a bequest; on the other hand, if taxpayers desire to leave a certain size of bequest, they will save more in order to reach that target.\footnote{Both supporters and opponents of the estate tax criticize a contentious feature of the current system, but, not surprisingly, they have different views about how to modify it. Under the current system, capital gains are only taxed upon realization, and the basis of assets is stepped-up to their fair market value at the time of the benefactor’s death, meaning that the accumulated capital gains are not taxed if the owner holds the assets until death. Some estate tax advocates propose switching to a carryover basis to capture the untaxed capital gains, while others appeal for defining death as a capital gains realization event. Estate tax opponents point to the same features and believe that, in addition to double taxation, the tax code incentivizes taxpayers to hold assets until death, which prevents these assets from being sold to owners who can use them more productively. The root of the issue therefore involves estimating the importance of untaxed wealth in bequeathed estates, which will also answer the question regarding the extent to which estates are composed of wealth that has already been taxed. As expected, available simulation results in the literature show that the importance of unrealized capital gains generally increases with the size of the estates. Smaller estates (less than $5 million) have less than a third of unrealized capital gains in gross estate value, whereas over half of the largest estates (over $10 million) consist of unrealized capital gains.\footnote{However, the results also show that there is no straightforward solution to the policy debate—switching from the current estate tax system to taxing capital gains at death would generate lower total revenue. Small estates would pay more taxes under the capital gains tax regime than under the current estate tax system, whereas large estates would pay less tax under the capital gains tax system. In other words, although taxing capital gains at death has the potential to alleviate perceived unfairness by both sides, it instead raises additional distributional equality concerns.}}}}}}}}

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STATE ESTATE TAX TRENDS

Before the EGTRRA, taxpayers could use state estate taxes paid as credits against the federal estate tax. Because credits reduce taxpayers’ tax liability dollar for dollar, the federal credits essentially eliminated the impact of state estate tax on state residents up to the amount of credit. In other words, states could use this “pick up” tax to generate revenue without having to impose extra burdens on their residents—the net effect is that the credits essentially transfer funds from the federal government to the states. As a result, all 50 states and Washington, D.C., imposed estate taxes directly linked to the maximum value of federal estate tax credits. The credits made the estate tax effectively uniform across the states and eliminated the incentive of interstate competition, which also simplified the tax compliance regulations for estates with properties in multiple states.

To reduce the total cost of the EGTRRA, Congress replaced the credits with less generous deductions that allowed the federal government to capture much of the revenue that states previously collected.23 This changed the dynamics of state estate tax systems.24 States responded in three different ways: some simply repealed their estate taxes, others decoupled from the federal law, but most states simply did nothing—effectively eliminating their estate taxes but leaving in place the legislation that set their estate taxes equal to federal credits.25

Since 2001, states have gradually moved away from the estate tax as a stable revenue source. Many states either repealed the tax or increased the exclusion amounts. In 2018, only 12 states plus Washington, D.C., levy estate taxes, all with different structures from the federal code.26 New Jersey and Delaware dropped their estate taxes within the last year, even though both have budget shortfalls. State officials stated that a major reason for eliminating the estate tax was tax competition—they believe that if wealthy senior citizens do not move to other states to avoid paying state estate taxes, the state may eventually collect more revenue from state personal income taxes, property taxes, or sales taxes to recoup the lost estate tax revenue. Therefore, states’ overall tax systems not only affect their relationship with in-state residents, but also their relationship with nonresidents.

Six states have an inheritance tax, which is imposed on a beneficiary receiving a transfer from a decedent instead of the estate itself.27 Essentially, it is a tax on the rights to receive assets from a decedent’s estate. Maryland is the only state that has both inheritance and estate taxes, but it is currently in a multiyear process to gradually increase the state exclusion level.28 One unique feature of an inheritance tax is that the tax rate varies depending on a beneficiary’s relationship to the decedent—the closer the relationship, the lower the rate.

After the TCJA, states may feel more pressure to raise their exclusion levels or repeal the estate taxes altogether. With a lower federal estate tax to deduct against a state estate tax, the real cost of a state estate tax is higher for residents. States may need to balance the costs of managing the system, the volatility of revenue, and the amount of revenue collection to make informed decisions about whether to keep the estate tax.29 Additionally, if the federal estate tax is repealed in the future, states would have to bear the full administrative burden of collecting estate taxes themselves—they would no longer be able to rely on the IRS to issue guidance, regulations, and private letter rulings, which would further increase the costs of collection.

DEVELOPMENTS AFTER THE TCJA

How have tax and legal practitioners responded to the TCJA’s changes to the estate tax? Despite the uncertainty surrounding the temporarily increased exclusion amount, the tax bill provides planning opportunities for taxpayers with over $11.18 million in assets and relief for taxpayers with $5.49 to $11.18 million in assets. Practitioners expect a surge of planning activities in the near term, both

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Since the structure of wealth transfer tax is not affected, the popular planning techniques remain unchanged, although the higher exclusion amount triggers the need to review planning vehicles with built-in distribution formulas. The idea of estate planning is generally to pass assets to the next generation early and out of a transferor’s taxable gross estate. Once the assets are in the hands of beneficiaries, there are many more lifetime or annual exclusions available to shield money from estate taxes. Without any complicated planning, simple annual exclusion gifts can also shield a large amount of assets from gift or GST taxes. For example, assume a couple has two adult children, and that each child has a spouse and two children. If the couple starts making annual gifts of $15,000 to each of the eight decedents when they turn 65, they could shield $4.8 million from gift taxes over the course of 20 years. In this scenario, when the couple passes away and leaves assets to their children, they can still utilize the lifetime exclusion on the bequest.

Sales to intentionally defective grantor trusts (IDGTs) and grantor retained annuity trusts (GRATs) are more complex. A grantor with a successful, operating business can establish an IDGT and sell his business to the trust in exchange for a promissory note. The legal structure has a purposeful flaw ensuring that the grantor continues to pay income tax on the income earned from trust assets, because it is designed such that income tax laws do not view the assets as being separated from the individual. However, assets in the IDGT and their subsequent growth are excluded from the estate for gift and estate taxes. The trust is therefore effective for estate tax purposes but intentionally defective from an income tax perspective. For gift and estate tax purposes, the grantor essentially swaps his assets from high-growth businesses into low-yield promissory notes. With the increased exclusion amount under the TCJA, certain taxpayers may find gifting the trust an amount equal to the balance due on the promissory notes, essentially paying off the notes, beneficial.

Because there is typically an operating business involved, some taxpayers leverage this strategy further by obtaining valuation discounts for the transferred business. This usually includes applying for minority ownership discounts or discounts for lack of marketability. Although there were concerns of abuse, the courts have validated these discounts in various cases over time, and the U.S. Treasury Department recently withdrew proposed regulations that were intended to restrict the use of valuation discounts. Therefore, applied appropriately, valuation discounts will be intact for the near future, and the IDGT remains an effective tool for those substantially above the exclusion threshold.

Prior to the TCJA, a grantor might be subject to a personal income tax rate of 39.6 percent and an operating business in an IDGT might face a tax rate of 35 percent or 39.6 percent, depending on the form of business. The tax rate differential between the grantor’s personal income tax rate and the business tax rate is nonexistent or not significant. Under the TCJA, the grantor’s highest personal income tax rate would be 37 percent, while the business tax rate would be either 21 percent or 29.6 percent. To a certain extent, this generates conflicting interests that a grantor needs to balance. On the one hand, the lower C-corporation or pass-through tax rate enhances the attractiveness of an IDGT; on the other hand, the grantor’s personal income tax rate is now higher than the business income tax rate.

In the case of the GRAT, the grantor contributes assets to an irrevocable trust but retains an annuity over the term of the trust. At the end of the GRAT term, the remaining assets are passed on to beneficiaries tax-free. The generic form of the GRAT does require the grantor to pay a gift tax when the assets are transferred to the trust, and the taxable gift is calculated as the difference between the fair market value of the assets transferred and the value of the annuities retained by the grantor. A more creative variation, a
Advocate for changes; however, if history is any guide, changes to the exclusion amount—either permanency or reduction—are unlikely to happen until the dawn of 2026 is upon us.

Although the substantial increase in the estate tax exclusion changes the dynamics of estate tax planning and compliance, estate planning remains relevant to everyone for non–tax reasons. Having one’s family and financial affairs in order, such as naming guardians for minor children, arranging charitable giving to fulfill one’s lifelong passions, and selecting an individual to act on one’s behalf under the financial power of attorney in case of incapacitation, are all crucial reasons to consider planning for the inevitable.

ENDNOTES

2. The Tax Cuts and Jobs Act of 2017 (TCJA) states that the basic exclusion amount is doubled from $5 million to $10 million, indexed for inflation. The $5 million basic exclusion amount was set by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and the indexing was established by the American Taxpayer Relief Act of 2012.
3. The step-up of basis means the cost basis of an appreciated asset is adjusted to the market value when transferred to an heir. The limited basis step-up, or “modified carryover basis,” means that the tax basis step-up of inherited assets in this example was limited to $1.3 million, after which the tax basis of the heir equals the value of the asset at the time of the decedent’s death. The assets could receive an additional $3 million step-up in basis if a surviving spouse is the beneficiary.
4. This reflects a proxy for the combined federal and state and local rates, as in Gordon, Joufaian, and Poterba (2016).


11. For a detailed discussion about economic arguments for and against wealth transfer taxes, see George Zodrow and John Diamond, “The U.S. Experience with the Estate Tax and Its Implications for Wealth Transfer Taxation in Latin America,” Rice University’s Baker Institute for Public Policy, Houston, Texas, January 2006.


14. Congressional Budget Office, The Estate Tax and Charitable Giving (Washington, D.C., July 2004). This study simulated the effects of an earlier estate tax change and showed that substantially increasing the exclusion amount would reduce charitable giving by less than 3 percent, but the elimination of the estate tax will decrease donation by 6 to 12 percent.


23. The EGTRRA added IRC Section 2058, which created a deduction for estates that have paid state estate taxes and replaced the IRC Section 2011 that provided credits.


26. Connecticut, Oregon, and Washington’s estate tax structures bear little resemblance to the federal structure, whereas Maine, Maryland, Massachusetts, Minnesota, New York, Rhode Island, Hawaii, Illinois, Vermont, and Washington, D.C., have some similarity to the federal code.

27. These states include New Jersey, Nebraska, Iowa, Kentucky, Pennsylvania, and Maryland.


30. When valuing privately held businesses, analysts often apply discounts to the value of the business because, unlike publicly held businesses, private businesses do not trade on stock markets and therefore are relatively illiquid. Due to the lack of readily available market prices, it would be more costly to sell shares of privately held businesses.

31. Proposed Regulations under Section 2704 on Restrictions on Liquidation of an Interest for Estate, Gift and GST Taxes (REG-163113-02; 81 F.R. 51413). The Treasury Department withdrew this proposal in October 2017; see 82 F.R. 48013.


33. Under the TCJA, taxpayers can deduct up to 20 percent of qualified business income from a partnership, S-corporation, or sole proprietorship, leading to an effective tax rate of 29.6 percent for pass-through entities.


35. See Section 7520 of the IRC.

36. David Weinreb and Gregory Singer, “Rolling Short Term GRATs Are Almost Always Best,” Trusts and Estates, August 2008. The authors compared five of the rolling two-year short term GRATs with a long-term, 10-year GRAT. https://www.alliancebernstein.com/abcom/Perspectives_Web/IntheNews/PrivateClient/PDFs/Tande_RollingShortTermGrats_010808.pdf?uuid=c9291c04-4198-11df-a00c-33b6b4640398.

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