



American Institute of CPAs  
1455 Pennsylvania Avenue, NW  
Washington, DC 20004-1081

April 9, 2014

The Honorable Ronald L. Wyden, Chairman  
Senate Committee on Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510

The Honorable Dave Camp, Chairman  
House Committee on Ways & Means  
1102 Longworth House Office Building  
Washington, DC 20515

The Honorable Orrin G. Hatch  
Ranking Member  
Senate Committee on Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510

The Honorable Sander M. Levin  
Ranking Member  
House Committee on Ways & Means  
1236 Longworth House Office Building  
Washington, DC 20515

RE: Request for Legislation to Subject Estates, Certain Qualified Revocable Trusts, and Qualified Disability Trusts to the Income Tax and Net Investment Income Tax in the Same Manner as Married Persons Filing Separate Returns

Dear Chairmen Wyden and Camp, and Ranking Members Hatch and Levin:

The American Institute of Certified Public Accountants (AICPA) continues to encourage Congress to pass legislation that provides consistent and fair treatment to similarly situated taxpayers. To further this mission, we request that Congress enact legislation that would subject estates and qualified revocable trusts for which the election under Internal Revenue Code (IRC) section<sup>1</sup> 645 is made (collectively referred to as “estates” in this letter) and qualified disability trusts described in section 642(b)(2)(C) to income tax and the net investment income tax in the same manner as a married person filing a separate tax return.

The AICPA is the world’s largest member association representing the accounting profession, with more than 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America’s largest businesses.

### **Proposals**

This proposal highlights the excessive tax burden placed on estates compared with the tax burden that the decedent had during his or her life, as well as provides a solution to these inequalities. As such, we propose taxing estates in the same manner as a married person filing a separate tax return for income tax and net investment income tax purposes. This proposal would restore estates to the federal tax position they were in historically from

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<sup>1</sup> All references herein to “section” or “§” are to the IRC of 1986, as amended, or the Treasury Regulations promulgated thereunder.

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1954-1986. In addition, we believe that Congress should subject qualified disability trusts established for the benefit of disabled individuals to income tax and the net investment income tax in the same manner as a married person filing a separate tax return.

### **Present Law**

Historically, estates and trusts were taxed at the highest income tax rates/brackets applicable to individual taxpayers – those rates/brackets pertaining to married persons filing separate returns. However, the Tax Reform Act of 1986 compressed the income tax rate brackets for trusts and estates. The Revenue Reconciliation Acts of 1990 and 1993 further compressed the rate brackets for these entities.

[The General Explanation of the Tax Reform Act of 1986](#), prepared by the Joint Committee on Taxation (May 4, 1987, at page 1245) explained Congress' reasons for the initial compression of tax rates for trusts and estates. According to the report, "the prior rules ... permit reduction of taxation through the creation of entities that are taxed separately from the beneficiaries or the grantor of the trust or estate. This result arises because any retained income of the trust or estate was taxed to the trust or estate under a separate set of rate brackets ... from those of its grantor and beneficiaries."<sup>2</sup> According to the report, Congress believed that it should eliminate or significantly reduce the benefits that result from the ability to split income between a trust or estate and its beneficiaries, and Congress accomplished this result by reducing the amount of income that a trust or estate must accumulate before it was taxed at the highest bracket.<sup>3</sup>

While the explanation for the change in income tax rates was primarily aimed at trusts, estates were also subjected to the higher rates imposed on trusts. As a result, for the taxable year 2014, the top tax rate of 39.6% would apply to an individual who is married and filing separately only if his or her taxable income exceeds \$228,800. However, if that individual dies in 2014, his or her estate is subject to the top income tax rate of 39.6% on income in excess of \$12,150.

The net investment income tax places an additional burden on estates. Beginning in 2013, section 1411 imposes an excise tax of 3.8% on the lesser of net investment income or the excess of modified adjusted gross income over a threshold amount. For an individual who is married and filing separately, the threshold amount is \$125,000. Therefore, the net investment income tax would apply only if that individual has a modified adjusted gross income in excess of \$125,000. However, if that individual dies in 2014, his or her estate is subject to the 3.8% net investment income tax if the estate's adjusted gross income exceeds \$12,150.

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<sup>2</sup> [The General Explanation of the Tax Reform Act of 1986](#), prepared by the Joint Committee on Taxation (May 4, 1987, at page 1245).

<sup>3</sup> Ibid.

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Certain trusts established for the benefit of disabled individuals have received special tax treatment since 2001. Section 642(b)(2)(C)(i) provides that qualified disability trusts may claim a personal exemption in the amount that is based on the personal exemption for individuals under section 151(d) (\$3,950 for 2014), rather than the \$300 or \$100 personal exemption allowed for regular trusts. This provision applies to taxable disability trusts described in 42 U.S.C. section 1396p(c)(2)(B)(iv) (relating to the treatment, for purposes of determining eligibility for medical assistance under the Social Security Act, of assets transferred to a trust established solely for the benefit of a disabled individual under 65 years of age). The Commissioner of Social Security must determine that all the beneficiaries of the trust are considered disabled for some portion of the year. A trust does not fail to meet this requirement merely because the corpus of the trust may revert to a person who is not disabled after the trust ceases to have any beneficiary who is disabled. While qualified disability trusts are entitled to the same personal exemption allowed to an individual rather than a regular trust, qualified disability trusts are subject to income tax and the tax on net investment income at the same rates as regular trusts.

### **Analysis**

The AICPA believes, as a matter of fairness and equity, Congress should adjust the income tax and net investment income tax rates/brackets applicable to estates. In order for an individual (taxed at the highest level as married filing separately) to reach the highest income tax rate of 39.6% in 2014, he or she would need to report taxable income in excess of \$228,800. As a result of this \$228,800 threshold, so-called lower to middle class individuals may never pay tax on any of their taxable income at that rate. However, once an individual dies, the individual's estate is subject to the income tax rate of 39.6% on its annual taxable income in excess of \$12,150. An individual with taxable income of \$12,150 in 2014 would have a top income tax rate of 15%. Similarly, with respect to the section 1411 net investment income tax, no excise tax would apply on the individual's net investment income unless (in the case of a married individual filing a separate return) his or her modified adjusted gross income exceeds \$125,000. Therefore, many individuals will never reach the \$200,000 single, \$250,000 married filing jointly, and \$125,000 married filing separately thresholds and never pay the net investment income tax during their lifetimes, but because of the tax inequalities applicable to estates, this net investment income tax will almost certainly apply to their estates after their deaths. For purposes of these income and excise tax rates, Congress should treat estates as if they were a continuation of the deceased individual and tax them at the highest applicable individual rate.

An estate serves a unique role as being the successor to an individual for a limited period of time during which it winds up the affairs of the individual and then distributes the assets to the individual's heirs. The fiduciary of the estate is responsible for collecting all the assets

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of the decedent, paying off the decedent's creditors, filing federal and state estate tax returns, if necessary, and finally distributing the remaining assets to the beneficiaries. Unlike trusts, a person has to die in order to create the estate, and one individual cannot create multiple estates.

Unlike trusts that now can exist in perpetuity in some states, an estate is in existence for only a limited period of time. Most probate courts strive to expedite the collection and disposition of assets, frequently requiring explanations for any delay in distributing the assets and closing the estate. In addition, the Internal Revenue Service (IRS) will not continue to consider an estate that is unnecessarily kept open as an estate for purposes of the IRC. Treasury Reg. §1.641(b)-3 provides that the executor cannot unduly prolong the period of administration of an estate. If the administration of the estate is unreasonably prolonged, the estate is considered terminated for federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. For qualified revocable trusts that the trustee elects to treat and tax as part of the estate under section 645, the statute itself provides a termination date for such treatment. Under section 645(b), the trustee can treat the qualified revocable trust as part of the estate for no longer than two years after the date of the decedent's death if the filing of a federal estate tax return is not required. If the filing of a federal estate tax return is required, the trustee can no longer consider the qualified revocable trust as part of the estate after six months after the date of the final determination of the estate tax liability.

The only way an estate could eliminate exposing the estate's income to the high income tax rates of section 1(e) and to the net investment income tax is by making distributions of current income to the estate's beneficiaries in order for the lower individual tax rates to apply. There are, however, numerous non-tax reasons that can serve to limit or prohibit the estate's fiduciary from making current distributions to beneficiaries. For example, an executor of an estate may not have the ability to make distributions to beneficiaries because of the following reasons: (1) in some situations, the executor faces challenges in probating the will quickly; (2) the executor needs to retain the assets to pay specific bequests and debts (including income and estate taxes); (3) state law prohibits the executor from making distributions until after the claims period for debts expires (imposing personal liability on the executor) and some states require court approval prior to making any distributions; (4) executors of smaller estates frequently do not understand their fiduciary income tax filing responsibility and the income tax consequences of not distributing income before the end of the tax year or within the 65 day period following the close of the tax year; and (5) pending litigation or will contests delay the estate's closing. In addition to needing court approval for distributions, estates often cannot pay some necessary expenses (such as for the executor and attorney) until there is court approval. This additional judicial hurdle pushes most of the estate's income tax deductions into the final fiduciary return. Estates generally pay expenses and distribute assets to beneficiaries as soon as possible because all parties are anxious for the process to be completed and for the estate to close. We believe that the

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federal tax laws should not penalize the estate and its beneficiaries by imposing very low thresholds before the highest income tax rate and the net investment income tax apply to the estate's temporarily retained income.

Because of their unique role as successor to an individual, estates are treated differently and more favorably than trusts in several important areas of the IRC. Estates are permitted to adopt a fiscal year, while trusts are required to use the calendar year under section 644(a). All estates are permitted as shareholders of an S corporation under section 1361(b)(1)(B), while only certain trusts described in section 1361(c)(2) are permitted S corporation shareholders. Estates are permitted a charitable deduction for amounts of gross income that pursuant to the terms of the governing instrument are permanently set aside for charitable purposes under section 642(c)(2). Since 1969, the IRC has not permitted this set-aside deduction for trusts. Rather, trusts are allowed a charitable deduction only if gross income is paid for a charitable purpose during the taxable year. Section 469(i) allows an individual to deduct up to \$25,000 of losses from rental real estate activities in which the individual actively participates. Under section 469(i)(4), this deduction is also permitted to the individual's estate for taxable years ending less than 2 years after the date of the individual's death. The throwback rules (sections 665-668, which taxed beneficiaries of trusts on distributions of accumulated income) were applicable only to trusts and not estates even before they were repealed for domestic trusts in 1997. Because trusts and estates are not always treated the same for federal income tax purposes, there is no policy reason that requires Congress to treat them the same for purposes of the income tax rate schedule and the net investment income tax. Just as estates receive more favorable treatment than trusts in the cited situations above, allowing estates more favorable tax rates than trusts is justified because of the unique nature of estates.

Qualified disability trusts are frequently established by a parent or grandparent for the benefit of a disabled child. Often these trusts are funded at the death of the parent or grandparent. The assets are placed in trust because the child is not capable of handling the set aside funds personally. Congress concluded in 2001 that these trusts deserved the same treatment as individuals for purposes of the amount of the personal exemption. We believe Congress should similarly treat these qualified disability trusts as individuals for purposes of the federal income tax rates and the net investment income tax. If all the income from the trust were distributed to the disabled individual, the individual – not the trust – would pay the income tax on the trust's income. It is very likely that the individual, who is taxed at the lower individual rates, would pay substantially less income tax on the trust's income than the trust would pay if no distributions were made. It is also very likely that the individual will owe no section 1411 tax on the net investment income because the individual's adjusted gross income will be below the threshold amount. However, trustees make discretionary distributions from these trusts based on the needs of the disabled individuals and not to lower taxes. Because these trusts serve to manage funds for beneficiaries who are not capable of managing funds for themselves, Congress should treat these qualified disability

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trusts as if they were married individuals filing separately for purposes of the income tax rates and the section 1411 tax on net investment income.

### **Conclusion/Recommendations**

Congress should restore the income tax rate/bracket schedule for estates to the pre-1986 approach, in which estates have the same income tax rate/bracket schedule as that applicable to the highest income tax rate/bracket schedule for individuals (i.e., the married filing separate income tax rate/bracket schedule). In addition, Congress should make the estate's threshold for imposition of the section 1411 net investment income tax the same as for married individuals filing separately (i.e., \$125,000). Congress also should treat qualified disability trusts described in section 642(b)(2)(C) as subject to income tax and the tax on net investment income as if the qualified disability trust were a married individual filing a separate return.

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We thank you for the opportunity to present this legislative proposal for your consideration. Please feel free to contact me at (304) 522-2553, or [jporter@portercpa.com](mailto:jporter@portercpa.com); Eric Johnson, Chair of the AICPA Trust, Estate, and Gift Tax Technical Resource Panel, at [Ericljohnson@deloitte.com](mailto:Ericljohnson@deloitte.com), or (312) 486-4442; or Eileen R. Sherr, AICPA Senior Technical Manager, at (202) 434-9256, or [esherr@aicpa.org](mailto:esherr@aicpa.org), to discuss the above comments or if you require any additional information.

Sincerely,



Jeffrey A. Porter, CPA  
Chair, AICPA Tax Executive Committee