Memorandum

To: D.C. Tax Revision Commission
Steven Rosenthal

From: Richard Franklin & Michael Savage[1]

Date: September 24, 2013

Re: DC Estate Tax – Proposed Changes

Summary

The D.C. Tax Revision Commission was established with the purpose of preparing comprehensive recommendations to the Council and the Mayor which (1) provide for fairness in apportionment of taxes; (2) broaden the tax base; (3) make the District's tax policy more competitive with surrounding jurisdictions; (4) encourage business growth and job creation; and (5) modernize, simplify, and increase transparency in the District's tax code.[2]

Part of the Commission's purview is consideration of the D.C. Estate Tax. In our view, the Commission has a continuum of options for ways to handle the existing Estate Tax. Briefly, that continuum is: (1) No Change; (2) Tie the DC Exemption to Federal Exemption; (3) Eliminate DC Estate Tax; and (4) Eliminate DC Estate Tax with something that we'll call a "District Trust," which are Trust Law enhancements to make DC highly competitive with other trust friendly jurisdictions like Nevada, Delaware and South Dakota. We recommend the fourth option, which we believe meets all five of the Commission's goals.

Overview

Nineteen states plus the District have some kind of estate, gift and/or inheritance tax[3] including Maryland and Delaware. Virginia and West Virginia do not impose a state estate tax.

The District has imposed an estate tax since at least 1947[4]. Prior to 2002, the District of Columbia piggybacked on the federal estate tax system, using the federal "state death tax credit" as the starting point for the District's estate tax computation. Under this system, District taxpayers received a dollar-for-dollar credit against their federal estate tax payments for any estate tax due to the District. District

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[1] Both Messrs Savage and Franklin are members of the DC Bar and full time residents of the District of Columbia.

[2] http://www.dctaxrevisioncommission.org/

[3] http://www.forbes.com/sites/ashleaebeling/2013/06/13/where-not-to-die-in-2013-update/

[4] D.C. Code § 47-1809.03

estate taxes, therefore, imposed no additional burden on decedent estates and did not increase the total estate tax payment beyond what would have been paid under federal law. This revenue-sharing approach provided for a system of uniformity across all states and the District in the collection of death taxes. In addition, the system resulted in minimal estate tax administration on the part of the District and minimized the impacts of "death shopping" to reduce estate taxes at death. [5]

The Economic Growth and Tax Relief Reconciliation Act of 2001 changed this arrangement, gradually eliminated the federal estate tax over several years, with full repeal taking effect in 2010. Most importantly, the legislation eliminated the prior system and created an additional tax burden for decedents in states that imposed an estate tax.

After more than a decade of change, the federal estate tax was made permanent by the American Taxpayer Act of 2012 , and set the effective exemption threshold of bequests and gifts at $5.25 million in 2013 (and indexed it for inflation annually thereafter) and set the top tax rate at 40 percent. In addition, the state death tax credit was permanently eliminated. Currently, the District imposes an additional tax starting at $1M, and set the top tax rate at 16 percent.

Collections by imposition of the District Estate Tax by since EGTRRA is a relatively small percentage of total tax revenue collected by the District, as shown here:

Fiscal Year	2009	2010	2011	2012	2013 Est
Total Estate Tax Revenue	74,508	39,341	87,230	102,996	40,000
Total Local Fund Revenue Net of Dedicated Taxes	5,963,337	5,076,407	5,390,851	5,963,337	6,141,007
Percentage of Total Revenue	1.25%	0.77%	1.62%	1.73%	0.65%

Option 1: No Change

District law stipulates that existing District estate tax laws are automatically decoupled from all federal estate tax law changes that stem from ATRA. As stated in the FY 2014 Budget and Financial Plan:

> Thus, while the federal exemption threshold is $5.25 million in 2013, the District threshold was and will remain $1 million. Hence, some District estate tax payers will continue to be required to file and pay District estate taxes although they were not liable for any federal estate taxes. This divergence in exemption thresholds for the District and federal estate taxes has always increased the complexity for applicable District tax payers. Even though estate tax collections were $103 million in FY 2012, collections are expected to be $40 million per year for FYs 2013 to 2017. [6]

[5] FY 2010 Proposed Budget And Financial Plan, Executive Summary

[6] FY 2014 Proposed Budget And Financial Plan, Executive Summary

The benefit of keeping the District Estate Tax at $1M is that it will presumably allow for greater collections of a broader base of tax payers. It isn't far-fetched to argue that, in the near future, any District decedent who owns a home and a retirement account will be obliged to pay some estate tax.[7] This creates meaningful problems for the District tax authorities.

The DC Estate Tax Form D-76 is a complex calculation, difficult to administer and even more challenging to audit. As a result, the specter of large scale District Estate Tax Forms filings, nearly impossible to audit with the existing workforce, will create real problems for the DC Tax authorities. As much has already been acknowledged in the FY 2009 Proposed Budget and Financial Plan:

> From the Government of the District of Columbia's perspective, it is important to note that the current estate tax is primarily a federal tax that is overwhelmingly governed by complex federal regulations. The federal estate tax return takes at least nine months to complete and practically compels affected decedent estates to hire lawyers to ensure compliance. Also, federal estate tax forms must be filled-out completely in order to calculate District estate tax liability, even when no federal estate tax is due but District estate tax is due. Essentially, the District does not have a stand-alone estate tax structure. District estate tax legislation is a diminutive appendage to a complicated set of unwieldy federal rules and regulations.

More importantly, we believe that keeping a low exemption will not guarantee greater tax revenue, and in our view will actually reduce total tax collections for the District. Rather, the benefits of a growing tax base eases the pressure to raise revenues and, conversely, a shrinking tax base often leads to a troublesome tax-and-spend downward spiral as actual revenues fail to meet estimates.

As professionals in this community, we can confirm that our colleagues spends significant time assisting clients reduce and evade District Estate tax through jurisdictional (Virginia, Florida, others) and other tax and wealth transfer planning strategies. We believe that keeping the exemption at $1,000,000 will only increase relocation and tax planning. We further believe that such a low exemption will cost us significantly more through lost income tax revenue, reduced charitable giving and decreased involvement in the cultural and civic life of our most productive citizens.

Option 2: Tie the DC Exemption to the Federal Exemption

Some states with state estate taxes have elected to tie their exemption to the Federal exemption (currently $5.25M), including Delaware and Hawaii, while others have increased the exemption without tying to the Federal exemption. Those states include Connecticut, Maine and Washington ($2M), Vermont ($2.75M) and Illinois ($4M).

Increasing the DC Exemption would achieve two important goals: the first would be to ease estate tax administration burdens and the second would be to be a more competitive jurisdiction than neighboring Maryland.

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[7] According to Real Estate Business Intelligence, the average detached home sales price in August 2013 in the District was $850,829.

Option 3: Eliminate DC Estate Tax

As currently structured, the estate tax causes people to change their behavior and encourages them to move outside the District, thereby reducing overall tax paid and reducing our economic vitality.

We believe that, as a result, the DC Estate Tax is not (and will never be) a meaningful revenue raiser. It is complex and difficult to administer. Eliminating it makes us more a more competitive tax jurisdiction than Maryland and a bit more like Virginia. The District does not live in a bubble, and it competes directly with surrounding jurisdictions. It's no accident that through sensible tax planning Virginia is consistently ranked as one of the best places to do business and is considerably higher on the rankings than Maryland and has a much higher growth rate.[8]

Indeed, between 2007 and 2010, almost 40,000 Marylanders moved to Virginia, taking $2.17 billion with them, according to the Internal Revenue Service data used in the study conducted by Change Maryland.[9]

Elimination of the DC estate tax is not without precedent. In fact four states have recently done just that: Ohio, North Carolina, Indiana and Tennessee.

Option 4: Eliminate DC Estate Tax and create the "District Trust"

While we propose repeal of the DC estate tax, we further suggest that the District take the steps, outlined below, to stimulate business and tax revenues from increased activity in trust and investment services in the District. We believe that this shift in focus would more than make up for any lost revenue from repealing the District's estate tax.

Essentially, these suggestions would be designed to position the District as the premier domestic US jurisdiction in which to situs trusts. Trust administration in the United States is big business, with trillions of dollars held in trust, and management thereof generating billions of dollars in management fees to business to banks, trust companies, etc.

The District is well positioned economically, politically, financially and geographically. All of the major banks and trust companies already have substantial presences here (unlike jurisdictions like Alaska, South Dakota or Nevada).

We believe that a Trust sitused in the District will not attract the District's income tax if the trust was not created by a District resident. So someone from New York, Maryland or Illinois (all high tax jurisdictions) could situs their trust in the District and use a bank or trust company in the District to be the Trustee without triggering District taxes.

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[8] Legislative Exchange Council's "Rich States, Poor States," ranks Virginia #3, Maryland #20; CNBC, "America's Top States for Business 2013" ranks Virginia #5, Marlyland #40

[9] http://www.washingtontimes.com/news/2012/jul/3/marylanders-move-in-droves-to-virginia/?page=all

While the trust itself would not be subject to District Tax, the trustee located in the District, however, performing the trust management and investment services and collecting trustee's fees and will be subject to the District's income tax. Therefore, the income tax in the District is not an impediment to families from other states and jurisdictions to situsing trusts here in the District. The benefit to the District is the increased business to the banks, trust companies, investment firms performing trust services in the District.

The suggestions are briefly stated as a means to present the outline of the idea. We would be pleased to illustrate these suggestions by providing copies of representative statues from other states that have enacted such laws. Of course, these are just examples and the District is not limited to these ideas or to the path other states have followed.

1. Increase Trust Privacy Laws. The idea is to permit a settlor (i.e., the creator of a trust) in the District to create a trust that allows the trustee leeway in the amount and timing of information that must be provided to each trust beneficiary. For example, a settlor may create a trust for multiple beneficiaries and may not wish each beneficiary to know about the other beneficiaries. The District's trust privacy laws could be written such that each respective beneficiary's right to information is limited to the relevant information needed to protect his or her interests in the trust. Many states allow a trust to provide for privacy to some degree, even the current District laws, but some states have gone beyond norm. Nevada recently enacted groundbreaking trust privacy statutes.[10] [Importantly, the focus of this privacy idea is among the parties to the trust (settlor, fiduciaries, and beneficiaries), not privacy from governmental authorities, such as the taxing authorities.]

2. Decanting. This idea is a means of creating greater flexibility for trusts in the District to change and evolve over time. Trusts can last for multiple generations and over time circumstances change. "Decanting" is the term used to describe the process of a trustee distributing the assets from one trust to another trust. Therefore, if the terms of an existing trust become outdated and if the trustee has the requisite authority, the trustee could distribute the existing trust to a new trust with terms more consistent with and beneficial under the current circumstances. Decanting is usually accomplished without any court proceeding. Twenty-one states permit decanting, including Delaware, Florida, New York, and Virginia.

3. Directed Trusts. Today's trusts may own interests in closely held businesses, real estate and hedge funds and private equity. A financial institution, for example, may be hesitant to act as trustee when the trust owns such assets. Directed trust statutes allow the traditional trustee role to be bifurcated. Multiple trustees can be appointed with different areas of expertise and

[10] Pursuant to this new Nevada law, the terms of the trust may restrict providing a full copy of the trust and information about the trust. A review process has been established that is designed to enable a beneficiary just to receive sufficient information to protect his or her interest. "A trustee is not required to provide to a beneficiary information that does not affect the beneficiary's interest in the trust…" The Trustee could be instructed by the trust instrument to provide each beneficiary information regarding his or her interests and sufficient information to protect his or her interests (e.g., information sufficient to determine the funding of his or her share; the asset, expense and liability information regarding his or her separate trust; and the applicable administrative provisions). Information regarding other beneficiaries could be withheld.

responsibility without each trustee having a duty to review or be responsible for actions outside its responsibility. Alaska, Delaware, Florida, and South Dakota are among the states having directed trust statutes.

4. *Inter Vivos* QTIP Protection. A *inter vivos* QTIP trust is particular type of marital trust in which one spouse (the Donor spouse) gives a life interest in the trust to the other spouse (the Donee spouse) and the gift qualifies for the federal gift tax unlimited marital deduction. These trusts are powerful estate tax planning tools. Under current DC trust law, assets contributed to an *inter vivos* QTIP trust by the Donor spouse that continue in trust for the benefit of the Donor spouse upon the death of the Donee spouse (i.e., if the Donor spouse actually survives the Donee spouse) would likely be subject to the claims of the Donor spouse's creditors, and, therefore, includible in the Donor spouse's estate for federal estate tax purposes. Some states, such as Arizona, Florida, Maryland and Florida have abrogated this creditor rule.

5. Domestic Asset Protection. Generally, trust use "spendthrift" clauses to prevent trust beneficiaries from transferring their beneficial interests to creditors or from creditors being able to reach the trust assets. Courts have generally enforced spendthrift clauses as against trust beneficiaries and their creditors, which would allow a parent to create a spendthrift trust for a child, but have not allowed settlors to create spendthrift trusts for themselves – i.e., preventing the parent from creating a spendthrift trust for the parent himself to protect the parent's assets from his own creditors (the rule against self-settled spendthrift trusts). Some states, such as Alaska, Delaware, Nevada, Ohio, South Dakota and Virginia have abrogated the rule against self-settled spendthrift trusts. Generally, these laws allow a settlor by compliance with certain rules to create a discretionary trust for himself without his creditors being able to reach the trust assets, but a fraudulent transfer to the trust would not qualify for this protection.

6. Elective Community Property Trusts. The idea of this type of law is permit a married couple to create a revocable trust that enables the couple (residents of District or non- residents of the District that reside in a non-community property state) to obtain the benefits available to married couples living in community property states. Achieving a double step up in income tax basis on the death of the first spouse to die is a primary benefit of this arrangement. Alaskan law permits this planning.

7. Pre-Death Will and Trust Contest Laws. A few states allows pre-death will and revocable trust contests. This allows the testator or settlor to determine claims against his or her estate during lifetime. The beneficiaries and disinherited heirs are notified of the process and have an opportunity to bring their claims to the court. If they do not participate or if their claims are unsuccessful they are generally barred following the testator's or settlor's death from bring such claims. Alaska, Arkansas, Delaware, Nevada, North Dakota and Ohio have pre-death contest laws.

Conclusion

The District has a unique opportunity to eliminate its estate tax to make us a more competitive tax jurisdiction and, therefore, ultimately lead to greater income, sales and property tax revenue. This, in concert with progressive trust legislation could lead to a boom in trust administration business, all subject to tax, and allow us to become a trust destination of choice.

Thank you for allowing us to weigh in on this important topic. We are available at your convenience to discuss further or present testimony. Michael can be reached at 202.442.7477 or at michael.r.savage@ustrust.com. Richard can be reached at 202.857.3434 or at rfranklin@mcarthurlaw.com.