Estate Planning Briefs

February/March 2023

Treasury's "Green Book" Explains Tax Hikes Proposed for 2024

President Biden's proposed budget for the 2024 fiscal year includes a wide array of new taxes and tax increases. The budget calls for $6.37 trillion in 2024 federal spending, while projecting that revenue will be just $4.8 trillion. In other words, spending will exceed revenues by $1.846 trillion. Put another way, for every dollar of expected tax revenue, the federal government will spend $1.33.

Although the House Republicans are expected to resist the call for tax increases, the President's proposed budget sets the framework for the debate. Here are some highlights from the 219-page "Green Book" explanation of the tax increases that advisors to affluent taxpayers will want to watch out for.

Retirement plans. Single taxpayers with adjusted gross income over $400,000 ($450,000 for married filing jointly) would be subject to enhanced minimum distribution requirements if the sum of their IRAs and vested qualified retirement plan accounts exceeds $10 million. Half of the amounts over $10 million will have to be taken as a minimum distribution, potentially subject to income taxes. The taxpayer may choose which accounts to tap for the distribution, unless the account totals are $20 million or more. In that event, the enhanced minimum distributions must come first from any Roth IRAs and designated Roth accounts. Note that this rule applies regardless of the taxpayer's age; it is not limited to those 73 and older. The penalty tax on premature distributions will not apply.

Taxpayers at that same income level would have a new limit on rollovers and conversions to Roth IRAs. The object would be to eliminate the "back door Roth IRA" that some higher-income taxpayers have used to get around the income limits. This rule would apply regardless of the account balances.

Montecito Bank & Trust®
Wealth Management
1106-E Coast Village Road
Montecito, CA 93108

Estate taxes. Under current law, the value of a farm for federal estate tax purposes may be reduced if the farm will stay in the family and be actively farmed after the owner's death. The maximum reduction in value was set at $750,000 in 1997, and has since been inflation-adjusted to

$1.31 million. That is not large enough for some farm properties, so the proposal would increase the maximum adjustment to $13 million. Under current law, an annual gift tax exclusion is available for as many donees as a donor wishes. The 2023 exclusion amount is $17,000. For example, a grandfather with three children and seven grandchildren could give each of them $17,000 in one year, a total of $170,000 in gifts, without incurring a federal gift tax, without even having to file a gift tax return. The budget proposal would cap the total benefit at $50,000, while leaving the exclusion amount unchanged.

Grantor-retained annuity trusts (GRATs) have been a popular method for wealthy families to pass substantial value to younger generations at a minimum gift tax cost. The proposal would require GRATs to have a term of at least 10 years, and the gift tax value would have to be the greater of 25% of the value of the assets transferred to the GRAT or $500,000.

A new minimum tax. Perhaps the most radical proposed change would be a new 25% minimum income tax for taxpayers whose wealth is greater than $100 million. Minimum taxes are not new, but they have been triggered by the "overuse" of tax preferences, not by wealth. The radical aspect of the proposal is that it would apply a 25% tax to unrealized capital gains, in addition to the usual income sources.

Determining who has a net worth greater than $100 million could prove problematic. Personal real estate and valuable fine art would have to be included in the calculation, for example. The proposal would not require annual appraisals of illiquid property. Instead, the greater of the adjusted cost basis or the last valuation event would provide a baseline, and that would be increased every year by the five-year Treasury rate plus two percentage points. Taxpayers could offer appraisals to rebut that presumption.

- https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf

COMMENT: The Inflation Reduction Act established a new 1% excise tax on certain repurchases of corporate stock. Although the IRS has yet to issue guidance on this new tax, the budget proposes to quadruple the tax rate, to 4%. The top income tax rate would go to 39.6%; the corporate income tax rate would be increased to 28%.

Attorney-Client Privilege for Estate Planning Advice?

Chaim Lax was a real estate developer and diamond merchant in New York City. In October 2005, the IRS began an examination of Lax's income tax returns for 2002, 2003, and 2004. Lax died in 2008. In 2009, the IRS assessed some $60 million in taxes and penalties due from Lax's estate, primarily income tax deficiencies.

Lax's heirs took steps in 2010 that they believed would help to shield some of the family assets from the IRS. Specifically, there was an assignment for the benefit of creditors transaction, which is a business liquidation proceeding under New York state law that is offered to insolvent debtors as an alternative to bankruptcy.

The IRS won a summary judgment against the estate for some $55 million in March 2022. Next the Service attempted to collect the tax from Lax's adult children, who are the co-executors of his estate. To facilitate that effort, the IRS sought all communications between the executors and their law firm concerning the 2010 corporate reorganization.

The District Court holds that the IRS "demonstrated probable cause that a crime or fraud was attempted or committed and that the communications with the Porzio Firm were in furtherance of that crime or fraud." The attorney-client privilege protects communications about past wrongdoing, but it does not extend such protection to possible future crimes. The law firm was ordered to answer questions put to it by the IRS regarding the transaction.

- United States v. Moshe Lax et al.

Special Use Valuation Must be Elected on the First Filed Estate Tax Return

Merle Parks left the bulk of his estate, which included a farm, to his nephew, Ronald. Merle died on September 19, 2003. At that time, the federal estate tax exemption was only $1 million. The estate tax return for Merle was due six months later, but the estate asked for a six-month extension, which is automatically granted. Nevertheless, the estate made a $333,959 prepayment of the expected estate tax liability in June 2004. No estate tax return was filed at that time.

For reasons not explained in the Court's decision, the estate tax return was not filed until February 2010, more than five years after the extension for filing expired. The return reported a gross estate of some $1.7 million, a taxable estate of $1.6 million, and an election for special use valuation of the farm property under IRC §2032A. That tax code provision allows for farm property to be valued for its agricultural use, rather than its fair market value, which is often far higher. The purpose of the provision is to allow farm property to stay within the family, but a number of requirements must be met to prove that the heirs will continue the farm.

Based upon these final values, and allowing for the special use value reduction, the estate asked for a tax refund of $87,838 from the 2004 payment. Two years later, in 2012, the IRS did much more than deny the refund. The Service stated that five years was too long to wait to make the election for special use valuation, that additional taxes of $199,111 were due, as well as a late filing penalty of $27,818.25.

The estate did not pay the additional tax. In 2021, the U.S. brought a civil action to collect the taxes through a judicial seizure and sale of the farm property. The defendants admitted that estate tax return was late, but argued that an election of special use valuation on a late return is still valid, provided that the return is the first estate tax return filed. Both sides asked that the case be dismissed in their favor.

After a long and careful examination of the history of the law and Regulations on valuing farm property for the federal estate tax, the District Court held that the special use election was not invalid for being late, just as the estate had argued. However, it was not a total win for the estate. The IRS continues to have the ability to prove at trial that the estate has not met the other technical requirements for the election, such as qualified uses of the property and material participation in farming by the heirs. With interest, as of the time of the decision, the amount at issue has grown to $433,654.66.

- United States v. Ronald G. Parks et al.; No. 2:21-cv-12676

COMMENT: Thus, more than 19 years after his death, the federal estate tax on Merle Parks' farm property remains unsettled.

The Case of the Innocent Spouse

Sydney Thomas filed joint tax returns with her husband in tax years 2012, 2013, and 2014. Some of the taxes shown on those returns were never paid. Mr. Thomas died in 2016.

After her husband's death, Sydney petitioned for tax relief as an "innocent spouse" under IRC §6015(f). When the IRS denied that relief in 2020, Sydney turned to the Tax Court. Congress amended §6015 in 2019, providing that the Tax Court will review such cases de novo, taking into account the administrative record and any newly discovered evidence.

In the course of preparing for the Tax Court, the IRS discovered a series of Sydney's blog posts about her assets, lifestyle, businesses, and relationship with her husband. In the view of the Service, this evidence tended to undercut her claim for innocent spouse relief. Sydney asked the Tax Court to bar the introduction of the blog posts because they were not part of the administrative record and could have been discovered at any time.

The Court rules for the IRS. There was no need for the IRS to search the internet for information about Sydney before she filed her suit in the Tax Court. Once her filing happened, the Service undertook that investigation, and what they found is "newly discovered."

- Sydney Ann Chaney Thomas v. Commissioner; No. 12982-20; 160 T.C. No. 4

COMMENT: A concurring opinion suggests that the language Congress used creates a one-way benefit for the IRS. The taxpayer couldn't introduce evidence such as the blog posts, because to the taxpayer it would be old news, not "newly discovered." Only the IRS gets the chance to find new evidence for the case.

GSTT Exempt Status Survives a Decanting

An irrevocable trust created before September 25, 1985, is "grandfathered" and is not subject to generation-skipping transfer tax unless it is substantially modified to extend the time for vesting or shifting interests to a lower generation. In this case, pursuant to a court order, the laws governing administration of an irrevocable trust were changed from State 1 to State 2. Consistent with the laws of State 2, the assets will be poured into a new trust with the same beneficiaries and the same termination provisions, but only if a favorable ruling is obtained from the IRS. The features of the new trust include separate trusts for each beneficiary, the appointment of a distribution committee to make discretionary distribution decisions, the creation of an investment committee for investment and administration decisions, and the future appointment of a trust protector. The new trustee must be a corporate trustee, that is, a trust company or national or state banking institution having trust or fiduciary powers. The perpetuities period for the new trust is identical to the original trust.

The ruling is favorable. The IRS concludes that the distribution of principal from Trust A to Trust B will not cause a shift of a beneficial interest to a lower generation beneficiary nor extend the time for vesting of any beneficial interest beyond the period provided for in the original trust. Accordingly, the GSTT exempt status will carry forward to the new trust. Each named beneficiary will have a power of appointment over a portion of the trust, and that will be included in the beneficiary's estate.

- Private Letter Ruling 202301001