Courtesy of

Security Federal
SAVINGS BANK

ESTATE PLANNING **REPORT**®

Issue 3 2021

PLANNING THOUGHTS

Green book notes

When President Biden proposed the American Families Plan, he called for an end to stepped-up basis at death. The White House later clarified that a $1 million exemption would excuse smaller estates from this new tax, but the implementation details were left fuzzy.

The picture became much clearer with the release of the Treasury Department's Green Book on May 28, outlining legislative recommendations for fiscal 2022. Death and gifts would both be treated as realization events for appreciated assets. Dynasty trusts would have to pay tax on capital gains every 90 years. Gain realization would be deferred for family-owned businesses so long as the business remains family owned. For illiquid assets, such as fine art, the tax on the gain could be spread over 15 years.

The Green Book also includes the $1 million exemption for smaller estates, and provides that the exemption would be portable between spouses. Transfers to a spouse or a charity would not be realization events. The exemption is in addition to the exemption from tax of the first $250,000 of gain from the sale of a principal residence ($500,000 for couples). Also, for married couples the residence gain would be portable, so married couples would have $2.5 million to work with. Finally, the exemption would be indexed for inflation.

Importantly, the tax on capital gains at death would be deductible on the decedent's estate tax return, if there is one, reducing double taxation.

However, when an exemption-protected gift is made, the donee will take the donor's tax basis, and so will have to pay tax on the gain if there is a sale. Some have observed that this seems like a waste of the exemption.

This new rule would not go into effect until the first of next year.

Retroactive taxes on long-term gains

Taxpayers with adjusted gross income in excess of $1 million will see the tax rate on their long-term capital gains jump from 23.8% under current law to 40.8%, according to the Green Book. (Others have mentioned a 43.4% tax rate, the sum of the new 39.6% top rate plus the 3.8% tax on net investment income.)

This rule would apply "for gains required to be recognized after the date of announcement," presumably April 28 when the fact sheet was released for the American Families Plan. In other words, the new top rate would be retroactive.

Oddly enough, the retroactive effective date was justified as preventing the wealthy from realizing gains early to avoid the tax rate increase. While it does achieve that goal, it would do so at the expense of revenue. If the wealthy did sell assets to lock in lower tax rates, much more money would flow to the IRS in the near term from their sales. Raising the rate will tend to have the opposite effect, slowing capital gain realizations. This phenomenon was observed when rates were changed in the 1986 Tax Reform Act.

It would appear that those who died with asset appreciation greater than the $1 million exemption could also owe the highest tax rate on their capital gains.

Resistance

The Chairman of the House Agriculture Committee, David Scott (D-Ga.) has written to President Biden on how the elimination of stepped-up basis will affect family farms. "In particular, "step-up in basis" is a critical tool enabling family farming operations to continue from generation to generation," he wrote. All the tax considerations have, over the years, led to more and more consolidation of farmland ownership, making it "more difficult for young, beginning, and socially disadvantaged farmers to get into farming." Rep. Scott was generally supportive of the American Families Plan, and seemed to be calling for additional exemptions for family farms.

Outlook

At this writing there are many uncertainties for these proposals. The likeliest path forward involves another budget reconciliation bill, which is immune to the filibuster. However, bipartisan negotiations over the infrastructure bill seem to have muddied that picture somewhat.

The Green Book does not propose any changes to federal estate or gift taxes, so it seems that there is still time to make use of the larger exemption amounts before their scheduled drop (roughly in half) in 2026.

CASES AND RULINGS

Tax disaster: Transfer of inherited IRA assets to non-IRA account is held irreversible.

Private Letter Ruling 202125007

Parent named an irrevocable trust as the beneficiary of his IRA, designated IRA X in this ruling. His children were the beneficiaries and trustees of the trust.

Soon after Parent died, the children were advised by the custodian of IRA X that they could not trade stocks in that account, that a transfer to another account would be required for that to happen. The custodian is not identified in the ruling. The children, acting as trustees, moved substantially all the IRA money to a non-IRA account that allowed for trading stocks.

Several months passed, and perhaps someone noticed the looming tax problem. The children asked the IRS for permission to move the money back into an IRA to preserve their tax benefits.

Sorry, no, says the IRS. "The only permitted method of transferring assets from an inherited IRA to another inherited IRA is via a trustee-to-trustee transfer, which requires a direct transfer from one IRA to another IRA. Therefore, once the assets have been distributed from an inherited IRA, there is no permitted method of transferring them back into an IRA."

That conclusion also means the entire transfer of funds to the non-IRA account is taxable to the trust in the year that the transfer occurred. Thus the children have inadvertently accelerated the income tax on substantially all of the inherited IRA assets.

• • •

Foreign marriage is respected for U.S. marital deduction.

Estate of Semone Grossman et al. v. Commissioner; T.C. Memo. 2021-65

Semone Grossman, a German Jew who had survived Nazi concentration camps, immigrated to New York after the war. He had a successful life. At his death in 2014, Grossman left the bulk of his $87 million estate to Ziona, his wife of 27 years, with whom he had had two children. However, the IRS denied the estate's marital deduction, demanded some $35 million in estate taxes and over $7 million in accuracy-related penalties.

Wait, what?

Ziona was Semone's third wife. He married his first wife, Hilda, in 1955, and they had two children. However, they separated in 1965, and Semone made regular payments to Hilda. In 1967, Semone started a new relationship with Katia. Before marrying her, Semone traveled to Mexico to obtain a divorce from Hilda. Although the marriage to Katia also produced two children, it ended by 1974.

That year Hilda filed a lawsuit to have the Mexican divorce declared null and void, a lawsuit that she won following a trial in 1976. The marriage to Katia was nullified, and Hilda was again the legal spouse of Semone. However, the couple never again cohabited, nor filed joint tax returns.

In 1986, then 56 years old, Semone became engaged to Ziona. Both of them had relatives in Israel, and they decided to marry there. Before the ceremony, Semone asked Hilda to cooperate in obtaining a divorce under Jewish religious law. She agreed. They appeared before a rabbi and obtained the necessary paperwork, which Semone brought with him to Israel. The Israeli religious authorities found everything in order, and permitted the wedding to go forward. After the marriage, the couple returned to New York where they lived as a married couple for the rest of Semone's life.

After his estate tax return was filed, the IRS somehow noticed that Semone and Hilda had never formally, legally divorced under New York law. Therefore, the Service reasoned, Hilda was the surviving spouse, not Ziona, even though Semone and Ziona had filed all their tax returns as married filing jointly, even though Hilda had filed all of her tax returns as a single person, and even though Hilda had not attempted to claim her marital share under New York law after Semone's death. Under New York law, the IRS contended, Hilda remained the spouse. Hence, no marital deduction for property passing to Ziona.

The Tax Court concluded that the rule in New York has long been that the validity of a marriage is determined by the place of its celebration. Semone and Ziona had satisfied Israel's fairly strict rules for having a marriage in that country, and public policy generally favors recognition of second marriages.

Semone and Ziona probably could not have legally married in New York. That was in part the basis for the IRS denying the marital deduction. The Tax Court holds that fact was irrelevant to whether they could be legally married elsewhere.

Michael Jackson's estate tax liability is resolved, largely in favor of the estate.

Estate of Michael J. Jackson et al. v. Commissioner, T.C. Memo 2021-48

The Tax Court has rendered its decision on the value of Michael Jackson's estate, nearly 12 years after Jackson's death in 2009.

There were three key assets for which the estate and the IRS could not find an agreement as to value. There is the commercial value of Jackson's image and likeness. The estate valued it at only $2,105 on the estate tax return, because Jackson's reputation was at a low point before he died. The IRS' expert pegged the value at some $161 million! At trial, the estate conceded that the right to use Jackson's image was closer to $3.1 million in value.

The Tax Court judge criticized the IRS' approach to valuing this asset. "Any projection that finds a torrent of revenue, and not just a trickle, from such a man's image and likeness — especially one who in the last two years of his life was so unpopular he did not even have a Q score — is simply not reasonable," he wrote. The judge decided Jackson's image was worth $4.2 million at death.

Jackson owned a 50% interest in a joint music venture with Sony. The estate reported that asset as worthless, because the venture's liabilities exceeded its assets. IRS asserted it was worth more than $206 million. But the IRS was wrong, the judge ruled, because its expert treated the venture as a music catalog when it was in fact an operating business. The estate was correct, this asset had no value.

Finally, a trust that owned the copyrights to Jackson's music had to be valued. The estate had valued the trust at $2.3 million, while the IRS put it at $114.3 million. The Tax Court judge concluded it was worth $107.3 million.

The IRS had initially asked for a penalty tax on the substantial valuation shortfalls on the estate tax return, which could have run to hundreds of millions of dollars. Even though the Jackson estate won most of its arguments, there remained a huge gulf between what the estate tax return reported and what the Tax Court finally ruled as correct values. Nevertheless, the Court held that no penalty was appropriate. In this incredibly complicated case the estate had relied upon competent experts, was not negligent, and had acted in good faith.

• • •

Attorney may not collect trustee fees on top of legal fees.

Kentucky Bar Association v. Calvert II, 607 S.W.3d 700 (Ky. 2020)

Lawyer Gerry Calvert drafted the R. C. Ford Jr. Trust, and served as attorney for the trust. He arranged for his son (also a lawyer), Gerry Calvert II, to be the trustee of the trust.

The trust accepted a 150-acre parcel of real estate as its primary asset in 1998. In May 2009 a five-acre tract was sold for $400,000, and a bank account was established to hold the sales proceeds. Calvert II sent a letter to the trust beneficiaries in July 2009 promising an accounting of the sale and the management of the trust.

No accounting was ever delivered. Letters from the beneficiaries and their attorneys to Calvert went unanswered. In 2014, a petition to remove Calvert as trustee was granted, and he was ordered by the court to provide an accounting. A partial accounting was eventually supplied, and it showed that Calvert had used some of the trust's cash to pay his personal expenses.

For his misconduct as fiduciary, Calvert received a five-year suspension from the practice of law from the Kentucky Bar Association. His appeal of the suspension as excessive eventually reached the Kentucky Supreme Court. That Court went out of its way to note that it is never allowable for one firm to collect both attorney's fees and trustee's fee from a trust. Based upon the facts presented, the suspension was sustained, and Calvert was ordered to be monitored by the Kentucky Lawyer's Assistance Program at his own expense.

WASHINGTON TALK

Correction issued to Publication 590-B. The initial draft of IRS Publication 590-B to implement provisions to the SECURE Act included an error. An example of the distribution of an IRA over ten years suggested that annual distributions would be required, which is contrary to the legislative language. The revised example says: "*The beneficiary is allowed, but not required, to take distributions prior to that date* [December 31 of the year containing the 10th anniversary of the owner's death].

There was considerable buzz at this year's Heckerling Institute on Estate Planning, held via Zoom conference in early May, about the chances for major changes to federal taxes at death. The two items of greatest concern were Senator Bernie Sanders' (I-Vt.) "For the 99.5% Act" and President Biden's "American Families Plan."

Senator Sander's legislation would cut the federal estate tax exemption from the current $11.7 million to $3.5 million, effective January 1 of 2022. The federal gift tax exemption would be slashed to $1 million on the same date. Tax rates would begin at 45% above the exemption amount, and then rise steadily, reaching 65% for estates larger than $1 billion. A wide range of legal estate planning strategies would be effectively outlawed as of the date of enactment of the legislation. Thus, we have the rerun of "use it or lose it" planning arguments.

Senator Sanders' press release on the proposal may be found here: https://www.sanders.senate.gov/press-releases/sanders-and-colleagues-introduce-legislation-to-end-rigged-tax-code-as-inequality-increases/.

The proposal may not be as radical as it first appears. Many elements were actually first proposed during the Obama administration, and so enjoy considerable support from Democrats. Also, the estate tax exemption already will be cut roughly in half under current law in 2026.

On the other hand, President Biden has not indicated any support for modifying transfer taxes this year. Instead, his proposed "American Families Plan" included the recommendation that stepped-up basis at death be eliminated. The administration later clarified that $1 million worth of basis step-up would still be allowed to excuse smaller estates from the new rule.

Should all of these proposals be enacted, it has been pointed out that death taxes could reach or exceed 100%, unless deductions were allowed for taxes paid.

Pushback on estate tax hikes. On still another hand, there is support among some in Congress to reduce or eliminate the federal estate tax.

Senators Tom Cotton (R-Ark.), John Boozman (R-Ark.), and Joni Ernst (R-Iowa) introduced the Estate Tax Reduction Act, which would lower the estate tax rate to 20%. The legislation was also supported by Representatives Jodey Arrington (R-Texas) and Henry Cuellar (D-Texas) in the House of Representatives. The current tax rate is so high that only 30% of family-owned businesses make it to the second generation, and just 12% survive to a third generation.

House Ways and Means Committee member Jason Smith, (R-Mo.) introduced H.R. 1712, the Death Tax Repeal Act. It would eliminate the federal estate and generation-skipping transfer tax as of the date of enactment.

Income Group (Percentile)	Amount ($ Billions)	Share (Percent)	Average rate of all federal taxes (Percent)
Bottom 50	4,252	20.7	6.2
50-90	8,889	43.4	14.1
90-95	2,106	10.3	17.6
95-99	2,709	13.2	18.6
99-99.5	617	3.0	22.6
99.5-99.9	874	4.3	26.0
99.9-99.99	610	3.0	30.8
Top 0.01	447	2.2	32.9

Source: JCX 24-21, May 10, 2021

Given the deliberations in Congress over how to boost tax revenue from the top 1% of Americans, the bipartisan Joint Committee on Taxation has issued a detailed summary of the current tax system for wealth and high incomes. The report includes many interesting observations, as in the table above.

The progressivity of the current tax system is clear from this data, though it may not be as progressive as some might wish.

The income group of $1 million and up pays 63.3% of total federal estate taxes collected, over $12 billion in 2016, according to the report. While the top 1% have 12.5% of the national income, they own 30.8% of national wealth. Some very wealthy people live on relatively low incomes.

The heirs of the chairman of Korea's Samsung group have agreed to pay an inheritance tax of $10.8 billion on his fortune. The obligation will be paid in six installments. The estate will also donate some 23,000 works of art by western and Korean artists to a national organization for preservation. South Korea's top inheritance tax rate is 50%, second only to Japan's 55%.

HEATHER WINTERS
VICE PRESIDENT, TRUST
heather.winters@secfedbank.com

BARBARA ROADS
OPERATIONS MANAGER
barb@secfedbank.com

Logansport – Main	574-722-6261	314 Fourth Street, Logansport, IN 46947
Logansport – Mall	574-722-3826	300 Mall Road, Logansport, IN 46947
Delphi	765-564-3000	1260 S. Washington, Delphi, IN 46923
Kokomo – Markland	765-457-1161	519 E. Markland Avenue, Kokomo, IN 46901
Kokomo – Boulevard	765-471-3521	1600 E. Boulevard, Kokomo, IN 46902
Lafayette	765-250-3916	3920 McCarty Lane, Lafayette, IN 47905
West Lafayette	765-471-3510	2827 US 52 W, Ste. E., West Lafayette, IN 47906