ORANGE Bank&Trust COMPANY

ESTATE PLANNING REPORT

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PLANNING THOUGHTS

A new cloud over estate planning?

With the success of the Democrats in taking over the Senate, expectations for significant tax increases on the wealthy have grown. Among those increases could be a reduction in the amount exempt from the federal estate and gift tax. That could come as a reversal of the doubling of the exemption in 2017, or there could be a move to go all the way back to the 2009 exemption of only $3.5 million.

On the one hand, those possibilities seem to argue for making major wealth moves very soon to "lock in" the higher current exemption. On the other hand, there is a fear that the new Congress might make such changes retroactive to the beginning of this year. Accordingly, some tax observers suggest relying on disclaimers to reserve the opportunity to reverse any major taxable transfers. Another approach could be to use a defined-value gift type of clause that takes into account any legislative action that occurs in 2021.

Whether such strategies will be sufficient to overcome the reluctance of many affluent people to part with any of their assets before the pandemic is fully resolved remains to be seen. Nontax estate planning moves should not be compromised by the new uncertainty.

Retroactivity

The key case on retroactive changes to estate tax law is *U.S. v. Carlton*, 512 U.S. 26 (1994). Congress too hastily added an estate tax break for a sale of shares by an estate to an ESOP. Because the statute did not require the shares to be owned by the decedent at death, one canny executor purchased some $10 million worth of MCI shares with estate assets and sold the shares to MCI's ESOP, generating a $5.3 million deduction for the estate.

That's not what Congress had in mind, and the reforming legislation was made retroactive, invalidating the deduction. The U.S. Supreme Court sustained the retroactivity, saying that the legislation was "curative." Justice Blackmun closed the opinion: "Because we conclude that retroactive application of the 1987 amendment to § 2057 is rationally related to a legitimate legislative purpose, we conclude that the amendment as applied to Carlton's 1986 transactions is consistent with the Due Process Clause."

That decision was unanimous, although Justices O'Connor and Scalia wrote separate concurrences.

The issue of retroactivity was explored thoroughly in 2010, the year that began without an estate tax. It also began without a step-up in basis at death, so that the capital gains tax increase upon the sale of an inherited asset would offset the loss of estate tax revenue. There were complex rules permitting basis step-up for small estates, with the executor charged with making an election for distributing the step-ups among the estate assets.

Eventually the estate tax was restored, and the restoration was retroactive to the first of the year. However, the estates of people who died that year were given a choice of tax regimes. They could submit to the estate tax voluntarily, and so secure a basis step-up (the best result for smaller estates), or they could remain free of estate tax by choosing the law as written at the beginning of the year. George Steinbrenner died in 2010, and reportedly his estate opted out of the estate tax.

With the law written in this way, there could be no due process objection to the retroactive nature of the estate tax change. The remedy was already provided.

Another approach to avoiding a legal challenge would be to have an effective date as of the passage of the legislation. The revenue loss of such a move would be negligible, but the public relations issue could prove more important.

Strategies

Given that the transfer tax exemption could be lowered sooner than 2026, it may make sense to lock in the larger exemption now, but there is a risk. What happens if a client makes a large taxable gift equal to the current exemption amount, but gift tax changes are made retroactive? Estate planning experts Martin Shenkman, Jonathan Blattmachr, and Robert Keebler gave a webinar in January on the strategies that could be used to protect an early 2021 taxable gift from the imposition of additional tax. Possibilities include:

- adding directions for disclaimers to irrevocable trusts, which creates a nine-month window for deciding to change course;
- using a formula to define the value of the transfer, and have the formula recognize the possibility of changes in the tax law and incorporate them, if any; or,
- using spousal lifetime access trusts (SLATs) to effect the transfers and consume the larger exemption.

The handouts for the webinar are posted by attorney Shenkman at https://shenkmanlaw.com/uploads/2021/01/Post-GA-Election-Planning-PowerPoint-Jan-8-2021.pdf.

However, another question may come up when discussing these strategies. Might it be prudent to simply wait and see what Congress comes up with? Is the benefit of locking in the higher exemption worth the cost of the estate planner's fees and the anxiety of wondering whether the plan will actually work if Congress changes the tax law?

CASES AND RULINGS

What should an executor do with a POD pledged as security for a loan?

In re Estate of Treviño, 474 P.3d 223 (Colo. App. 2020)

Jerry had an account with Wells Fargo that was payable on death (POD) to his son Tony. When Jerry and his wife Victoria later borrowed $80,000 from Wells Fargo, he pledged the account as collateral. Jerry and Victoria sold property in Texas to a family member on an installment basis. The installment payments roughly matched the debt service on the loan and were used for that purpose.

Jerry died, and Victoria became his estate's personal representative. She had her lawyer send a letter to Wells Fargo directing them to invade the POD account to pay off the $77,000 balance of the loan. Tony then filed suit alleging that Victoria had breached her fiduciary duties, stating that other estate assets should have been used to pay off the loan before his account was so used.

The trial court ruled that Victoria had acted reasonably and that Jerry's estate was worth only some $69,000, of which only $2,425.61 was in liquid assets. The Colorado Court of Appeals now reverses that portion of the trial court judgment, holding that the executor should have used those liquid assets first, before going to the POD account. Tony had further argued that the installment payments should have continued to be used for the debt service, so that no invasion of the POD was warranted at all. The appellate court rejected that argument, as the trial court did, because doing so would have unduly delayed the settlement of Jerry's estate.

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Executor in Massachusetts is permitted to represent an estate pro se.

Wilbur v. Tunnell, 151 N.E.3d 908 (Mass. App. Ct. 2020)

Arthur Tunnell died in 2016, leaving a will that named his sister, Margaret, as the executor of his estate. She was not a lawyer. Arthur's landlord, Ralph Wilbur, brought an action against the estate for damage to rental property and missed rent payments. Margaret appeared in court pro se, asking that the lawsuit be dismissed. The court denied her request and ordered Margaret to get a lawyer to represent the estate.

She got the lawyer, who filed a motion for reconsideration of the prior orders, including a request that Margaret be allowed to continue to represent the estate herself. When that was denied, her lawyer filed an appeal.

Nonlawyers are permitted to represent themselves when there are no third parties involved. Usually this means that they are not allowed to represent trusts or estates in court. However, in this case Margaret was the sole beneficiary of the estate, and no third-party interests were at stake. In these limited circumstances, the appellate court rules, Margaret can fire her attorney and once again appear in court pro se to defend the interests of the estate.

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Change of IRA beneficiary ordered nullified.

Carmack v. Carmack, 603 S.W.3d 900 (Mo. Ct. App. 2020)

Under ERISA, spouses acquire rights in their partner's employer-sponsored retirement plans. Nonspouse beneficiaries may not be named without the written consent of the spouse. If an individual joins a retirement plan when single and later marries, the spouse gains those rights regardless of what the old beneficiary designation says.

This rule does not generally apply to IRAs, however.

Terry Carmack opened his IRA in 2002, naming his wife, Marilyn, as its beneficiary. That status continued until 2016, when Marilyn's health deteriorated and she began to develop dementia. In August 2016 Marilyn was relocated to a long-term care facility. In September, Terry named his siblings as the beneficiaries of his IRA. He then asked Marilyn's daughter to file an application for Medicaid for Marilyn to help with the nursing home expenses. The decision does not reveal what became of that application, but Marilyn returned home to live with Terry.

Terry died in 2018, and Marilyn survived him. His estate then consisted of $94,450 worth of housing, vehicles, and bank accounts, and $386,031 in the IRA.

Marilyn filed suit, alleging that the change of IRA beneficiary was a gift in fraud of her marital rights, which reduced her intestate share of Terry's estate. The trial court agreed, and the intermediate court of appeals now confirms that judgment.

Although the state law appears to apply to lifetime transfers, the court held that the fact that the transfer did not happen until death, and that the IRA is a nonprobate asset not part of the estate, is immaterial. Had there been no beneficiary designation at all, the IRA would have been part of Terry's estate, subject to Marilyn's marital rights.

The trial court held Terry's "intent was to render [Wife] destitute in an ill-conceived effort to make the state and federal governments pay for his wife's care instead of him or his children." The appellate court agreed, and cited this as further evidence that Terry's change of beneficiary was intended to defeat Marilyn's marital rights.

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WASHINGTON TALK

Elizabeth Warren has joined the Senate Finance Committee. She gave up her seat on the Health, Education, Labor, and Pensions Committee and remains a member of the Senate Banking, Housing, and Urban Affairs Committee. Warren has promised to work toward implementation of a national wealth tax, and she also supports lifting the estate tax rate back up to 55%, with a lower exemption threshold.

During the campaign Warren advocated an annual 2% wealth tax on holdings in excess of $50 million, and a 6% annual tax on those with over $1 billion. The defect in the estate tax, apparently, is that the IRS has to wait for the rich to die before collecting it. An annual wealth tax promises to be a bonanza for appraisers and tax attorneys, given the administrative difficulties inherent in accurately measuring an individual's total wealth at a moment in time, including real estate and fine art.

There is considerable support among wealthy Democrats for higher taxes on "the rich," and Warren has proved to have significant political clout. A robust debate on the merits of a wealth tax should be expected this year.

According to an item at the TaxProfBlog [https://taxprof.typepad.com/taxprof_blog/2021/02/ny-times-college-dropout-jeffrey-epstein-earned-hundreds-of-millions-as-his-cut-of-billions-of-taxes.html], Jeffrey Epstein earned hundreds of millions of dollars by advising billionaires to create GRATs to lower their federal transfer taxes. Reportedly his fee was determined as a percentage of the tax savings achieved by the GRAT, and he outsourced much of the drafting to law firms.

"Given where we are in the economy, it is unlikely that we will see Congress enact revenue raisers in the short run," reported Mark Mazur, Treasury deputy assistant secretary for tax policy, to a January 26 virtual meeting of the ABA's Section of Taxation. The early focus of the Biden administration is expected to be on responding to the pandemic and providing financial relief to those affected.

Mazur also suggested that although retroactive tax increases can be problematic for taxpayers, the possibility cannot be ruled out.

An end to stepped-up basis? President Biden has proposed something similar to the existing Canadian plan, in which the tax on capital gain is applied to unrealized gains at death or upon a gift of an appreciated asset. The tax is paid by the donor or the estate. In the Canadian system a price is paid for the basis step-up, rather than it being free.

However, when the Canadians adopted capital gains taxation at death they dropped their estate tax entirely; it was a trade and a simplification. Biden's plan does not include that element. However, should elimination of the federal estate tax be added there is a chance for bipartisan support, according to some observers. After all, candidate Trump in 2016 proposed eliminating the estate tax as well as stepped-up basis at death.

Unresolved questions include exclusions for charitable or spousal transfers, as well as the level of a de minimis exemption.

Projected estate tax revenue. The Urban-Brookings Tax Policy Center released projections in December of the impact of estate taxes in the coming years. For 2021, only 2,700 taxable federal estate tax returns are expected. That number stays roughly constant until 2026, when the 2017 estate tax changes expire. At that point taxable returns more than triple, to 9,000.

Current federal estate tax revenue collected comes to $16 billion annually. When the exemption is cut in half in 2026, tripling the number of filers, the revenue only doubles. That's because the additional returns will all be at the lower end of the wealth spectrum.

Returning to the 2009 exemption of $3.5 million would boost the number of taxable estate tax returns to over 16,000 per year and raise about $46 billion each year in revenue. Even that larger amount is not much more than a rounding error in the federal budget.

The IRS proposes a new fee for estate tax closing letters. One side effect of the creation of the portable estate tax exemption for married couples (the Deceased Spouse's Unused Exemption, or DSUE) was an explosion in the number of estate tax returns being filed. The portable exemption must be claimed on an estate tax return. In the Brookings study above, each year there are as many or more nontaxable estate tax returns as taxable ones. Usually an estate escapes federal estate tax through the charitable or marital deduction, but now many smaller estates are filing what amounts to protective returns for the surviving spouse.

These returns generate no money for the IRS, which in 2015 responded to the flood of protective returns by ending the routine provision of an estate tax closing letter to the executor of an estate. Such letters then had to be specifically requested, and practitioners reported that the process was clumsy and protracted.

On December 29 the IRS issued proposed regulations *(REG-114615-16)* suggesting that there will be a better process for closing letters, and that there will be a fee of $67 for such letters. The immediate reaction of many practitioners was a sigh of relief.

Near the end of the Obama administration, the IRS issued regulations under IRC §2704 that affected estate planning for family-owned businesses in a potentially drastic way, curtailing discounts for minority interests of family members. There was considerable pushback at the time from the estate planning community, with over 10,000 comments on the proposal (a record). Those regulations were an early casualty of President Trump's deregulation initiatives.

Now some planners are worried that the IRS might return to that regulatory project, which has never been formally abandoned. The concern at the IRS is that interests in family-owned businesses have been designed to artificially push down values for transfer tax purposes. The concern of advisors is that some of those techniques have been well established for many years, and the original IRS proposals presented major compliance burdens. Perhaps there is a middle ground.

IRS reorganization coming. In 2019's Taxpayer First Act, the Congress invited the IRS to assess the ways in which it could improve the taxpayer experience. The invitation was answered in a 253-page report delivered to Congress on January 11. Key points:

- A taxpayer experience strategy that focuses on creating a proactive, convenient, seamless, personalized, and effective interaction with taxpayers and the tax professional community;
- A comprehensive training strategy, a multi-faceted approach to empowering the workforce and equipping them with the skills and tools they need to advance their careers, provide high-quality service to taxpayers and enhance the taxpayer experience; and,
- A recommended organizational design that will increase collaboration, coordinate strategic implementation of large-scale initiatives, enhance innovation, strengthen communications and prioritize taxpayer rights, all with the aim of improving the taxpayer experience.

Implementation of the new plans is expected to begin this year.

BROOKSIDE AVENUE
Frank Skuthan, SVP & Trust Services Director
t. 845-341-5041
e. fskuthan@orangebanktrust.com
91 Brookside Avenue • Chester, NY 10918

MOUNT VERNON BRANCH
Sinead Fitzsimons, VP & Senior Trust Officer
t. 914-298-9374
e. SFitzsimons@orangebanktrust.com
510 South Columbus Avenue • Mount Vernon, NY 10550