ORANGE Bank&Trust COMPANY

ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

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PLANNING THOUGHTS

Elements of tax reform?

The House Ways and Means Committee in September released proposed tax increases totaling $2.18 trillion over the next ten years. Key components of "Responsibly Funding Our Priorities" include:

- increasing the corporate income tax rate from 21% to 26.5%, raising $540 billion;
- applying the 3.8% net investment income tax to certain business income of those earning more than $400,000 per year, raising $252 billion;
- lifting the top marginal income tax rate to 39.6%, raising $170 billion;
- applying a new 3% surcharge on incomes greater than $5 million, raising $127 billion;
- boosting the tax on long-term capital gains from 20% to 25%, raising $123 billion;
- increases in tobacco taxes yielding $97 billion; and
- cutting the unified credit for estate and gift taxes roughly in half, which raises only $54 billion, in large part because that change was already scheduled for 2026.

The reduced unified transfer tax credit would not take effect until next January 1. With the net investment income tax and the new 3% surtax, the top rate for long-term capital gains would become 31.8%.

Missing from the initial release of the bill was any change to the $10,000 cap on the deduction for state and local taxes. However, Democrats reportedly were continuing to negotiate for this tax break. The President's proposal to make death a moment for the recognition and taxation of long-term capital gains also did not appear in the initial draft. In a September 16 statement from the White House, the President expressed the hope that his proposed changes to the capital gains tax would make it into the final bill. He did not mention the changes to the SALT deduction.

The tax changes were attached the reconciliation bill, which became bogged down over disagreements about spending priorities. Additionally, Kyrsten Sinema (D-Ariz.) reportedly is opposed to lifting the corporate tax rate at all. It is possible that some provisions will be scrapped as the bill works through the legislative process. On the other hand, tax-raising ideas not enacted this year seem likely to reappear next year.

Trust-specific changes

"Responsibly Funding Our Priorities" took special aim at trust taxation:

- a new top tax rate of 39.6%, to apply to retained income above $12,500 (compared to the $450,000 threshold for marrieds filing jointly);
- a new 3% surcharge on modified adjusted gross income in excess of $100,000 (compared to a $5 million threshold for individuals);
- a new cap of $10,000 on the 20% deduction for qualified business income under 199A (compared to a new $400,000 cap for individuals and no cap at all under current law);
- a potential top federal income tax rate of 46.4%, counting the 3% surcharge and the 3.8% net investment income tax.

What's more, the legislation would shoot two arrows directly into the heart of a very popular estate planning strategy, the grantor trust. Arrow one, gift or estate taxes would be imposed when a grantor trust is terminated, so it would lose its transfer tax avoidance utility. Arrow two, a sale between a grantor trust and its owner would be treated as a taxable transaction. Until now the IRS has held that such a transaction is a nullity, it is a sale to oneself. The proposals have unnerved estate planners.

When IRAs get "too big"

A 2014 Government Accountability Office study (based upon 2011 data) found that about 9.000 taxpayers had accumulated

more than $5 million in their IRAs. Some 314 had more than $25 million. Staffers from the Congressional tax-writing committees asked the Joint Committee on Taxation (JCT) to bring that report up to date earlier this year. JCT reported that as of 2019:

- 28,615 taxpayers had IRAs worth $5 million or more;
- 497 had more than $25 million;
- those 497 taxpayers' IRAs totaled $77 billion (an average of nearly $155 million).

Taxwriters were unhappy with the news, and "Responsibly Funding Our Priorities" addresses this concern. Taxpayers who have aggregate vested accounts in defined contribution plans, including IRAs, 401(k)s, and 403(b)s, of $10 million or more would be prohibited from making a contribution to an IRA or a Roth IRA in years in which the taxpayer's income exceeds $400,000 (for married filing jointly, $450,000). Rollovers, inherited IRAs, and transfers incident to divorce would not be considered contributions for this purpose. Note that the taxpayer would still be allowed to contribute to a 401(k) plan if available.

Changes to permitted IRA investments are also included. Under current law, an IRA may not invest in a company in which the IRA owner has a 50% or greater ownership interest. This threshold would be lowered to 10%. The IRA also could not invest in securities available only to "qualified investors" who have a specified minimum income or assets—in other words, securities not available to the general public. Such investments were the basis of those IRAs growing so large.

Not satisfied with preventing new supersized IRAs, the taxwriters also chose to force the current owners to disgorge their tax-preferred savings. There is an expansion of the required minimum distribution calculation for large IRAs and Roth IRAs. The general rule would be that half the account value in excess of $10 million would have to be distributed. A special rule would apply to Roth IRAs, for which 100% of the amounts greater than $20 million would have to be disgorged. The interaction of the two rules will be complicated. The 10% penalty for early withdrawals would not apply, but if the account owner is not yet 59½ the income tax could apply to the distribution of earnings from a Roth IRA.

Prospects for passage

The Senate Finance Committee has not yet spoken on these tax changes, and there is not much time left in this year's legislative calendar for the usual legislative compromising. On the other hand, history suggests that the Congress can work more quickly as a deadline approaches. The Tax Cuts and Jobs Act passed the Senate on December 20, 2017, and was signed by President Trump on December 22, 2017. The American Taxpayer Relief Act of 2012 was passed by the Congress on January 2, 2013 and signed the next day by President Obama. Anything is possible.

CASES AND RULINGS

The terms of a lost will may be proved by the testimony of the witnesses to the will.

In the matter of the estate of Theodore Ernest Scheide, Jr. St. Jude Children's Research Hospital, Appellant, v. Theodore E. Scheide, III, Respondent, 478 P.3d 851 (2020)

Theodore's June 2012 will left his multi-million dollar estate to his life partner, Velma, if she survived him, or to the St. Jude research hospital if she predeceased him, which she did. The estate planning attorney kept the original of that will. An October 2012 will was executed changing only the nominee for executor of the estate. Theodore kept this original himself, as well as a copy of it.

Both wills explicitly disinherited Chip, Theodore's long-estranged son. He specifically asked his estate planner to not get in touch with Chip.

As Theodore's health declined, he was eventually moved into a nursing home and a guardian was appointed for him. His papers were boxed up and followed him. After Theodore died, the guardian was unable to locate the original October 2012 will. She speculated that Theodore had destroyed it, and recommended to the probate court that the estate pass to Chip. When the estate planning attorney learned of this development, she contacted the probate court and St. Jude's to inform them of the existence of the earlier wills. The probate and appellate courts held that the statutory requirements for proving a lost will had not been met.

The Supreme Court of Nevada reversed. Although the original October 2012 will could not be found, it continued to have legal existence until there was proof of its destruction by the testator, which was not here provided. The statute requires that two witnesses have knowledge of the terms of the will, and in this case one witness only could confirm the testator's signature, not the terms. But the terms of the will were uncontested, and failing to probate the lost will in this situation "would create an absurd result of putting an unnecessary and onerous burden on the second witness."

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An irrevocable trust for a child and his descendants may not be terminated before the child's death by an agreement among all the trust beneficiaries.

Ackers v. Comerica Bank & Tr. , No. 11-18-00352-CV (Tex. App. Dec. 31, 2020)

Dale Ackers' 1993 will left half of his estate to his son, Gary, outright, and the balance to a trust for the benefit of his son Larry. Larry was the sole lifetime trust beneficiary, and at his death the corpus would pass to Larry's then-living descendants per stirpes, and not per capita.

Although this may sound like a routine trust provision, Larry's life circumstances turned out to be anything but routine. He had three children, but he gave up his parental rights as to two of them, and they were adopted into other families. One of those has since had two children of her own.

Larry would like to enter into negotiations with the trust remaindermen with an eye toward terminating the trust. The problem is, who are the remainder beneficiaries? Larry wanted to exclude the children adopted by other families and any of their descendants.

Larry filed a petition for declaratory relief to determine the remaindermen, and the trustee resisted. The question is not ripe for review, the lower court held, and the appellate court affirmed. Members of the class gift cannot be determined until Larry's death. The Court also noted that a spendthrift provision in the trust would bar any attempt by beneficiaries to terminate the trust prematurely.

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A controversy over a transition rule in TCJA 2017 could be a precursor to testing the constitutionality of a federal wealth tax.

Moore v. United States, No. 20-36122

A new case is going to address the limits of the federal taxing power. According to *The Wall Street Journal,* Charles and Kathleen Moore invested $40,000 in a start-up company that provided better tools to subsistence farmers in India. The company was a huge success, but it reinvested all of its profits in expanding its market. The firm grew to hundreds of employees, thousands of dealers, and millions of customers. The Moores never received a financial return from their investment, but were more than pleased with the success of the company that they helped to fund. The growing success of the Indian farmers was their reward.

In the 2017 Tax Cuts and Jobs Act the taxation of multinational firms was reformed. One element of that change was the imposition of a one-time tax on accumulated foreign earnings. The Moores received a tax bill for $15,000 on the accumulated but undistributed earnings from their investment.

The couple paid the bill and is suing for a refund. They argue that they have received no financial reward from their investment, no "income" as that term is used in the tax law, and therefore that $15,000 was effectively a property tax, not an income tax. As such, it would have to be apportioned, and as it was not, the tax itself is unconstitutional.

In the most recent briefing, according to a *Tax Notes* report, the government contends that a "deemed repatriation" is taxable income even though no money changes hands. As a backup position, the government has also argued that the apportionment requirement of the constitution may not apply to a direct tax on personal property (as opposed to real estate). That will be difficult to square with Supreme Court precedents in *Eisner v. Macomber,* 252 U.S. 189 (1920), and *Pollock v. Farmers' Loan & Trust Co.,* 158 U.S. 601 (1895).

This case appears to be headed to the U.S. Supreme Court for final resolution.

This may seem like a minor transitory tax problem, as the 2017 imposition was a one-time event. However, should the Moores succeed, it could be the death knell for such proposals as Senator Elizabeth Warren's "wealth tax." A tax on wealth is very different from a tax on income, and many observers have questioned the constitutionality of wealth taxes, as they are property taxes. The Moore litigation may resolve that larger question.

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WASHINGTON TALK

Who pays zero taxes? In 1969 Treasury Secretary Joseph Barr reported that 155 high-income households had legally not paid any income tax. Thus began the public outrage over a fair sharing of the tax burden. Unfortunately, the public has less appreciation for the many ways that the tax code is used to reward those who act as Congress wishes.

The Democratic tax proposals this year fall within this tradition. Much has been made of the increase in corporate tax rates, but as *The Wall Street Journal* pointed out, "Some Profitable Companies Would Still Pay No Taxes Under Democrats' Plan," [https://www.wsj.com/articles/some-profitable-companies-would-still-pay-no-taxes-under-democrats-plan-11632481202]. If enacted, the legislation would not affect accelerated depreciation or most tax credits, and it does not include a corporate minimum tax (except for foreign income).

On the contrary, the bill would expand the tax credits for "clean energy" and low-income housing. It is possible that the number of profitable companies paying no corporate income tax will go up, not down, if the legislation passes.

Tax rates of the rich and famous. According to a White House report released on September 23, the 400 wealthiest American families paid an income tax rate of only 8.2% for the period from 2010 to 2018. The report suggested that the low rate was attributable to the preferential tax rates for capital gains combined with the zero tax imposed upon appreciated assets that are held until death, which benefit from a basis step-up. No mention was made in the report of the contribution of tax-free municipal bond income by the wealthiest as a means to bring down their income tax obligations.

Still, a tax rate of 8.2% seems rather remarkably low for any taxpayer, let alone billionaires. A look at the fine print of the report yields the real factor, one that is far more important than nominal tax rates. "An important feature of our analysis that is less common in existing estimates of tax rates is that we include untaxed ("unrealized") capital gains income in our more comprehensive income measure as they accrue."

Characterizing unrealized capital gains as income would be a radical departure in income accounting, one that might be lost on the ordinary reader. The report justified the approach by reference to the "Haig-Simmons" income definition, which includes changes in wealth plus taxes and consumption. Although Haig-Simmons may be helpful in economic analysis and forecasting, it is questionable as a basis for imposing taxes, or for calculating true tax rates.

The "working rich," not the billionaires, appear to the real target of tax writers, according to Clifford Asness writing in *The Wall Street Journal* [October 19, 2021]. Current proposals do not include a wealth tax, repeal of basis step-up at death, or a serious change to the carried interest rules. The larger burden will fall upon families with two-earner professional couples who live in high tax states, who already may have marginal income tax rates above 50%. Billionaires tend to not have much ordinary income to be taxed at ordinary rates.

Asness concludes: "All of this lets the bill's proponents talk a good game while continuing to kowtow to some of their biggest donors. A more charitable—but still cynical—explanation is that those writing policy know that going after the easy-to-tax ordinary income of the working rich will be relatively easy and the working rich outnumber the superwealthy by a large margin, leading to far more revenue."

Some 150 industry associations joined forces to lobby against any changes to stepping up the basis of inherited capital assets. The Family Business Estate Tax Coalition wrote in a September 9 letter: "Stepped-up basis prevents family-owned businesses and farms from being hit with two significant and damaging tax bills when a family member passes away—the capital gains tax on any appreciated assets and the estate tax on whatever is left."

The group includes the American Bankers Association, the Real Estate Roundtable, and the U.S. Chamber of Commerce. Given the uncertain effect of the legislation on family farms, a number of farm-state Democrats have indicated a lack of enthusiasm for the proposal.

An alternative to taxing gains at death. Senate Finance Committee Chair Ron Wyden, D-Ore., has proposed a novel "mark to market" tax regime for billionaires as an alternative to the President's idea of taxing gains at death. At a September 24 news conference, President Biden indicated that he would support the Wyden alternative.

The upside for the Wyden approach is that the IRS would not have to wait for a death to collect the increased tax revenue. The downside is that the idea may be unconstitutional, as it could be considered a "direct tax" on the ownership of property that is not apportioned among the states. Three prominent tax attorneys laid out the arguments in "The Constitutional Uncertainty of a Broad Mark-to-Market Rule for Derivatives" *[Tax Notes,* September 27, 2021].

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