ORANGE Bank&Trust COMPANY

ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

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PLANNING THOUGHTS

Sound valuations are critical

Estate planning guru Jonathan Blattmachr observed in a recent webinar that it is rare to see an IRS audit on whether a transaction qualifies for the marital deduction or annual exclusion, because there typically is so little money at stake in such controversies. Instead, IRS attention tends to be focused on valuation issues—closely held businesses, real estate, artwork—because the potential reward for such audits is much greater. A recent IRS memorandum illustrates their line of attack [ILM 202152018].

Factual setting

Donor was the founder of a very successful company, apparently worth billions of dollars. At the end of Year 1, an appraisal of the company was obtained in order to satisfy the reporting requirements for nonqualified deferred compensation plans under IRC §409A. The value was identified as $w per share in the memo.

Also at the end of Year 1, Donor contacted two Investment Advisors to explore the possibility of selling the company. The buyers were expected to purchase a minority interest and a call option for the rest of the company shares at a future date, specified by an agreed formula. Six months later, the Advisors presented five offers to be considered.

Three days after that meeting, Donor created a two-year grantor-retained annuity trust (GRAT), one that presumably zeroed out any gift tax liability. A minority interest in the company was placed in the trust. The appraisal from six months earlier was used to value the shares, because there had been no material change in the fortunes of the business in that interval.

Donor gave the five bidders for his company additional time to increase their offers. Three months later four new offers were received, and one bidder dropped out.

Next Donor gifted shares of the company to a charitable remainder trust. Several weeks after the transfer, Donor accepted an offer from one of the bidders, at $x per share. $x was three times higher than the $w value used in valuing the transfer to the GRAT. Donor used the higher $x figure to calculate his charitable deduction for the transfer to the charitable trust. This was justified by the IRS requirement for substantiation of charitable gifts greater than $5,000.

In Year 4, about six months after the expiration of the two-year GRAT, the buyer purchased the rest of the shares of the company for $z, which was about four times the value of $w used to value the gift to the GRAT. Donor expected all of that appreciation to pass to the remainder beneficiaries free of federal gift taxes.

This was some aggressive tax planning.

The IRS response

The IRS was equally aggressive in its response. The Service concluded in its memo that a willing buyer and seller for the company would have taken into account the possibility of a company sale. Failure to do so spoiled the GRAT entirely. "The operational effect of deliberately using an undervalued appraisal is to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under IRC §2702."

That could mean a very substantial gift tax is due, and there could be tax penalties of up to 40% tacked on. Blattmachr observed, "Getting a good, solid appraisal, where you have not hidden the ball at all from the appraiser . . . it's the best thing you can do to protect your clients."

Some planners have argued that the IRS' aggressive position may not hold up in court—but which clients want to base their wealth management strategies on that possibility?

Resolution of the Prince estate

The estates of celebrities are notoriously difficult to value. Sometimes the death of an entertainer boosts the value of his or her image and likeness, as well as the body of work. Sometimes it doesn't. There's no obvious way to predict the future when any particular celebrity dies.

The executors for pop superstar Prince's estate reported the value of his assets at $82 million. The IRS countered with a taxable value of $163 million. That meant an additional $32.4 million in estate tax was due, and a penalty for understatement of $6.4 million was tacked on for good measure. The executors filed a Tax Court petition to contest the additional taxes, but negotiations with the IRS continued behind the scenes. In June 2021, the parties reported to the Court that they had resolved their differences over the valuation of the real estate, without revealing the details publicly. A final settlement was reached in October 2021.

According to a recent probate filing, the settlement was for an estate value of $156.4 million, with the stipulation that no penalty will be imposed for the understatement. Presumably, the executors had not been negligent in coming up with the lower figure.

That final figure looks like conceding the merits to the IRS, as opposed to finding a compromise figure. However, the probate filing states that Prince's heirs have made it clear that minimizing estate taxes is not one of the primary concerns. "Instead, the members of the Heir Group have uniformly communicated to the Personal Representative their strong desire that the Estate settle with the taxing authorities as quickly as possible to allow the Court to close the Estate and distribute assets to the members of the Heir Group."

CASES AND RULINGS

Property acquired after death passes by intestacy.

Matter of Keough, 196 A.D.3d 160 (2021)

William Keough was among the hostages held captive in Iran between 1979 and 1981. He survived the ordeal, but died in 1985. William's wife, Katherine, died in 2004. Her will left her residuary estate to her stepson, Steven, who was William's son from an earlier marriage.

In 2015, Congress enacted the Justice for United States Victims of State Sponsored Terrorism Act. Under the Act, Katherine was entitled to $600,000 as the spouse of a hostage. If a person entitled to compensation had died when the Act took effect, the money was paid to the estate's personal representative.

When Katherine died, her sole heir under the intestacy laws was her brother, Fred Schwarz. He died intestate in 2018. In 2019 Fred's cousin, Eleanor, filed a lawsuit claiming the $600,000 should pass to Fred's estate. She was the administrator of his estate. The executrix of Katherine's estate argued that it should pass under the residuary clause of her will.

The Appellate Division of the Supreme Court of New York held for Fred's estate. Will provisions can only control the disposition of property that the decedent owns at death. "We are particularly persuaded by the decision in *Shaw Family Archives Ltd.*, which involved a dispute over ownership interest in Marilyn Monroe's right of publicity after her death. The Court determined that New York law did not permit a testator to dispose by will of property that she did not own at the time of her death," the Court wrote. As Katherine could not have known of the possibility of the future payment, her will is ineffective as to it, and the $600,000 must pass by intestacy to Fred's estate.

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Remaindermen have no standing to sue when an income beneficiary fraudulently obtains principal distributions from a trust.

In re Estate of Calvin, 963 N.W.2d 319 (2021)

Ben Calvin established a trust for his son, John, in 1955. John was to receive all the trust income, payable at least annually. At John's death, the trust assets were to be divided among John's children. The trust also included a provision permitting the trustee to make payments of income or principal to any trust beneficiary.

Two of John's children were co-executors of his estate after he died in 2019. After they looked at the books, they resigned and brought a lawsuit against the estate. It appears that in the ten years before his death, John owned $5 million to $6 million in liquid and marketable assets, yet he persuaded the trustee to make principal distributions to him in addition to the income payments. The principal distributions reduced the value of the trust by some $800,000, and they enlarged the estate by the same amount. The primary beneficiary of the estate was John's second wife, so there could have been an element of undue influence.

The personal representative of John's estate rejected the claims made by his children, noting that the disbursements were authorized by the trust and that the trust did not require a showing of financial need as a prerequisite to any distributions. In the lawsuit that followed for breach of the trust, the personal representative argued that the children had no standing to sue, and the Court agreed. If there was a fraud committed upon the trustee, it is the trustee's responsibility to bring an action against anyone who interferes with the trust.

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Disappointed beneficiaries have no standing to sue for breach of fiduciary duty.

Platt v. Griffith, 858 S.E.2d 413 (2021)

Dr. Griffith had two daughters, a son, and a second wife. His 2008 will placed a 704-acre farm in trust for the wife if she survived him, and to his son if she did not. Dr. Griffith executed a new will in 2010, which provided 20-acre parcels in the farm to each daughter, with the remainder going to the wife and son. However, six months before his death Dr. Griffith executed a deed of gift, granting the entire farm to the son, subject to a life estate held by the wife. The son was named personal representative of the estate.

The disappointed daughters filed a lawsuit alleging that undue influence was used by their brother and the second wife to get Dr. Griffith to make the gift. What's more, they alleged that undue influence was also used to convert $13 million of Dr. Griffith's assets. They asked that the property gift be declared void.

The circuit court dismissed the lawsuit, stating that only the personal representative of the estate could bring a lawsuit to set aside a lifetime transfer. The appellate court agreed, noting that the daughters did not ask to have their brother removed as personal representative.

WASHINGTON TALK

"The most challenging year taxpayers and tax professionals have ever experienced." That is how the National Taxpayer Advocate, Erin Collins, characterized the 2021 tax filing year in the Annual Report released January 12. A few of the troubling details:

- As of the postponed filing deadline of May 17, 2021, the IRS was holding some 35 million tax returns for employee review. Half of those were paper returns awaiting processing, and half were returns that were suspended during processing because of inconsistencies that required review by IRS personnel. Refunds were necessarily delayed.
- Call volumes tripled in 2021, to 282 million telephone inquiries of the IRS. Unfortunately, the Service was only able to get to 32 million of those callers, about 11%. Nearly 90% of callers could not get through to talk to a person.
- There were 13 million math errors made by taxpayers on 2020 returns. Many taxpayers were simply baffled by the IRS notices of their mistakes, and could not determine how to make corrections.
- As of late December 2021, the IRS had a backlog of 6 million unprocessed individual returns, 2.3 million unprocessed amended returns, 2 million unprocessed employer's quarterly tax returns, and about 5 million pieces of taxpayer correspondence. Some taxpayers have been waiting nine months for their refunds.

The Report was not all bad news, of course. The IRS has been doing more with less, as its workforce has shrunk by 17% since fiscal 2010, while the number of individual return filings has grown by 19%. In addition to tax return processing, the IRS issued 478 million stimulus payments totaling $812 billion, and sent Advance Child Tax Credit payments to 36 million families worth some $93 billion.

When taxpayers become thoroughly frustrated with their dealings with the IRS, they sometimes turn to their Congressional representatives for help. In the three years before the pandemic hit, members of Congress received 10,000 to 11,000 such inquiries per year, which are then typically referred to the Taxpayer Advocate. In 2020, that figure more than tripled, to 35,000. Then in 2021, it nearly doubled again, to 66,453.

One idea put forward by Taxpayer Advocate Collins is to freeze automated Notices from the IRS for a six-month period. Staff shortages at both the Taxpayer Advocate Service (TAS) and the IRS have harmed communication and made it difficult to resolve cases. The TAS is so far behind, they are only now accepting cases of amended returns for tax year 2019, and have announced that cases based solely on processing delays are not being accepted at all.

Because so many in Congress have heard from so many exasperated taxpayers, there is strong Congressional interest in Collins' proposal of a freeze on automated Notices.

Dynasty trusts came under attack from Americans for Tax Fairness in a February report. According to the study, in 1990 there were 66 American billionaires, and they were worth an aggregate $240 billion. Before the pandemic started, the now 745 billionaires were worth $2.9 trillion—and during the pandemic that figure blossomed by 70%, to $5 trillion!

The study identifies the following elements of legal tax strategies that may have the effect of concentrating dynastic wealth:

- the generation-skipping transfer tax exemption;
- valuation discounts for family-controlled entities;
- intentionally defective grantor trusts;
- zeroed-out grantor-retained annuity trusts;
- irrevocable life insurance trusts;
- stepped-up tax basis for inherited assets; and
- calculation of gift taxes on a tax-exclusive basis, reducing the effective gift tax rate from 40% to 28.57%.

Interestingly, the study includes an important observation that cuts against its arguments that dynasty trusts should be blamed for any increase in wealth disparities. "Newer fortunes—held by Elon Musk, Jeff Bezos, Mark Zuckerberg and others—destined to evolve into dynastic wealth in future generations, have been growing at a rate that dwarfs the dramatic experience of existing dynastic wealth." The eight wealthiest Americans as of October 2021, each with a net worth over $100 billion, are all first-generation wealth holders—they created their fortunes, they did not inherit them.

New rules for donor-advised funds are included in the Accelerating Charitable Efforts Act [Ace Act], introduced by Rep. Chellie Pingree (D-Maine) and Rep. Tom Reed (R-N.Y.). Proponents are upset that the regulations for donor-advised funds do not prescribe a payout rate. The money contributed to such funds generates a full charitable deduction for the donor in the year of the donation, but the charity may have to wait many years to receive anything. The legislation is intended to shorten the wait.

Opponents counter that donor-advised funds already distribute their funds at a higher rate than the 5% payouts required of private foundations. They argue that any legislation to disincentivize donor-advised funds at this difficult time would be tone deaf at best.

Bipartisan support for modernizing the IRS computers was expressed at a February 17 Senate Finance Committee hearing on this year's filing season challenges. However, no one seemed to know what that might cost, nor whether the IRS has the necessary expertise to manage such an upgrade. Reportedly the IRS presently employs 60 different computer systems, and those systems are unable to communicate with each other!

In fiscal 2021, the IRS received an additional $1 billion earmarked for technology upgrades. Only 16% of that money has been spent to date. National Taxpayer Advocate Erin Collins testified that a significant portion of the IRS operating budget goes to putting "Band Aids" on those 60 systems just to keep them going. To build the foundation for a new system would require a multi-year commitment for increased funding from the Congress, which Collins suggested the IRS is not confident to be forthcoming. She did not have a cost estimate for such a program.

Social Security and Medicare are good deals for most taxpayers. A February research report from the Urban Institute compared the total career FICA taxes paid to the discounted present value of Social Security and Medicare benefits to be paid during an average retirement for someone who retired at age 65 in 2020. For example, a male who has earned an average wage throughout his career, $59,100 in 2021 dollars, will have paid $319,000 in total Social Security taxes (adjusted for inflation). His first year Social Security benefit will be $21,700, and the total retirement benefit for an average retiree comes to $335,000. Medicare is another story entirely. His lifetime Medicare taxes came to $86,000, while the actuarial value of his Medicare benefits net of premiums was $238,000.

For the highest income taxpayers, the picture is not quite so rosy. Someone who had maximum taxable earnings throughout a career would have paid, according to the report, $756,000 in taxes for a total retirement benefit worth $540,000. The first year benefit would have been $34,900. He would have paid over double the taxes for a roughly 50% increase in benefits. His Medicare net benefit is the same $238,000, but he paid $204,000 in lifetime Medicare taxes.

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