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ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

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PLANNING THOUGHTS

The lay of the land

At the annual conference of the ABA's Real Property, Probate and Trust Section, held in late April, estate planners Benjamin Cohen Kurzrock and Andrew Comiter were joined by Kathryn Meyer of the IRS Office of Chief Counsel to discuss "Estate Planning in an Era of Enhanced Enforcement."

Ms. Meyer reported that the IRS is still recovering from the backlogs created during the pandemic, including the delays for closing letters for estate tax filings. On the other hand, the IRS is hiring, including estate and gift tax attorneys, examiners, and support personnel. Training programs are underway to bring everyone up to speed. Estate and gift attorneys have also joined the IRS Appeals division in recent years. Even though transfer taxes generate a very small share of federal revenue, the IRS is ramping up for more activity in this area.

One area that has become markedly more efficient is the Tax Court, with the advent of eFiling of petitions and remote proceedings through Zoomgov. The remote proceedings were made necessary by the pandemic, but apparently they will continue to be used indefinitely for most cases.

Fiscal 2023 "Greenbook"

Attorney Kurzrock reviewed key priorities in the Biden administration's 2023 budget proposal, as outlined in the "Greenbook" [https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf]. On the income tax side, the administration hopes to:

- restore the top 39.6% tax rate beginning in 2023;
- tax long-term capital gains and dividends as ordinary income for those with taxable income greater than $1 million;
- treat transfers of appreciated property by gift or at death as realization events, triggering capital gains taxes; and
- impose a new minimum tax of 20% for those with wealth of $100 million or more, to be applied to total income *and unrealized capital gains.* Such gains would only be taxed once.

Proposed changes in the estate and gift tax arena are likely of greater concern to estate planners.

GRATs. Grantor Retained Annuity Trusts would be required to have a term of at least ten years, and the minimum value for gift tax purposes would be the greater of 25% of the value of the assets or $500,000 (but not more than the value of the assets transferred). If the grantor acquired a trust asset in an exchange, gain or loss would have to be recognized for income tax purposes.

Grantor trusts. One of the useful tax benefits of a grantor trust is that the payment of the trust's income tax obligations by the grantor is not a taxable gift, even though the trust beneficiaries enjoy an economic benefit (and the grantor's taxable estate is reduced). This rule would be reversed, and such payments of income tax would be taxable gifts unless reimbursed by the trust.

Promissory notes. The administration is concerned that taxpayers may rely upon IRS-provided interest rates on promissory notes for gift tax purposes, but then look to market rates for valuing the same note after a death. A new consistency requirement would head off such strategies.

GST trusts. When the generation-skipping transfer tax was adopted, all the states had rules against perpetuities. That has changed, creating the possibility of a private trust that is shielded from the estate and gift tax for many generations, perhaps permanently in some cases. To combat such forward-looking tax planning, the proposal would limit the availability of the GST exemption to "direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the creation of the trust" and to taxable terminations for such beneficiaries. Significantly, there is no "grandfathering" protection for older trusts. For purposes of this rule, trusts created before enactment of the new rule would be deemed to have been created on the date of enactment.

Noteworthy issues

Attorney Comiter reviewed some of the issues that have been coming up frequently in transfer tax litigation. Among them:

- whether an advance in an intrafamily loan is a bon afide debt or a gift;
- the value of such debt for transfer tax purposes;
- complying with the statutory rules for grantor retained annuity trusts;
- split-dollar life insurance; and
- formula clauses used to create certainty for gift taxation, such as defined-value clauses.

Attorney Meyer volunteered that the IRS is putting considerable resource and focus on split-dollar life insurance cases. All three attorneys noted the importance of rigorously complying with the terms of a chosen estate planning strategy, in particular by keeping very good records. For example, in a GRAT the annuity must actually be paid, and the payments documented.

Other concerns

Executive Order 13771 during the Trump administration mandated the removal of two regulations before the addition of one new one. This was revoked early in the Biden administration, so greater regulatory activity may be expected.

The sunset of the Tax Cuts and Jobs Act is fast approaching. Unless Congress acts, the amount exempt from federal estate and gift tax drops roughly in half on January 1, 2026. Thousands of families who need not be concerned today about federal transfer taxes could suddenly have some major new tax issues to confront.

All in all, estate planners should have plenty of work for the next several years.

CASES AND RULINGS

Recitation of governing law does not establish a trust's situs.

Silver v. Horneck, No. 1-20-1044, 2021 WL 4931871

Robert and Corinne Silver, residents of Illinois, created trusts to manage their wealth. They had two children, Elizabeth and Geoffrey, who were the remainder beneficiaries. After Robert died, Corinne became the trustee of both trusts. In 2012 she amended the trusts to name a grandnephew, Peter Horneck, as successor trustee (as well as the executor of her estate). Corinne also added a trust provision providing that, in the event trust distributions were delayed, the trustee was to pay certain of Elizabeth's expenses, and that these payments were not to count against her one-half share.

Corrine moved to Florida in 2014, and resigned as trustee in 2015. Mr. Horneck, a Colorado resident, took over the trust administration, in consultation with the family lawyers who were still in Illinois. Corrine died in 2017.

In July 2017, Elizabeth asked for the reimbursement of some $14,000 in expenses. Horneck sent her a check for $50,000, but when she learned that $50,000 had also been sent to her brother, Elizabeth did not cash the check. She thought her predistribution payments should be coming "off the top" of the trust. After two years of correspondence and fruitless negotiations, Elizabeth filed suit in Illinois for an accounting and an enforcement of the trust provisions.

The problem is that Elizabeth herself is a resident of Florida, the trustee lives in Colorado, and brother Geoffrey lives in Oregon. The trust document recited that it was to be governed by Illinois law, but went on to say that "The *situs* of any trust created hereunder may, however, be transferred at any time." The trust situs became Florida when Corinne moved there, and Colorado when she resigned the trusteeship. The Illinois court held that it did not have jurisdiction over the case, under these circumstances.

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Sham trust is ignored for federal tax purposes. Attorney is sanctioned for frivolous arguments.

Samuel Wegbreit et al. v. Commissioner; No. 20-1306; 21 F.4th 959

Wegbreit founded Oak Ridge LLC, a financial services company. The firm prospered, and in 2003 Wegbreit met with a tax planning attorney to reduce his tax liabilities. The attorney persuaded Wegbreit to create a trust for his wife and children, to transfer the business to it, and to have the trust acquire life insurance from an off-shore company. From 2004 to 2008, the Wegbreits took out over $3 million in policy loans, none of which was reported as income. In 2005 Oak Ridge was sold for $11.3 million. The Wegbreits did not report that sale as income, and neither did the trust. IRS conducted an audit in 2008, and found some $15 million in unreported income.

The Wegbreits contested the deficiency in Tax Court. Unfortunately, the paperwork was a mess. There were three different trust agreements, and no one was certain which one controlled. One of the trusts was dated the year before Wegbreit met with his attorney. The records for the insurance policies were equally confused.

The Tax Court ruled that the trust was a sham, that Wegbreit had never given up control of Oak Ridge, and that he treated the trust assets as his own. The deficiency was sustained [Samuel Wegbreit et ux. et al. v. Commissioner, T.C. Memo. 2019-82].

An appeal was filed with the Seventh Circuit Court of Appeals. Unfortunately, the appellate argument was as incoherent and con-

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fused as the trust paperwork. The Court stated: "The Wegbreits raise a bevy of legal topics wholly irrelevant to the Tax Court's decision, from statutory diversification rules for life insurance portfolios to the grantor trust doctrine. When they do address germane issues, their brief flagrantly violates Rule 28's requirement to support each argument 'with citations to the authorities and parts of the record on which [they rely].'" The only relevant arguments the Court could discern were matters that had been waived in the earlier proceedings.

The Court was so unhappy with the waste of its time that the appellate attorney was sanctioned with a $5,000 fine for bringing a frivolous appeal.

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Stepdaughter disinherited by divorce.

In re Joseph and Sally Grablick Trust, Nos. 353951 & 353955, 2021 WL 5976582

When Joseph and Sally were married in 1993, Sally had an eight-year-old daughter, Katelyn. Joseph treated his stepdaughter as his own child, but he never adopted her. When Joseph executed his will in 2005, he identified Katelyn as his stepchild. His assets were to pass to a family trust for Sally, remainder to Katelyn. However, there was also a default provision in favor of Joseph's mother and sister.

Joseph and Sally divorced on April 3, 2019. He died three months later, on July 2, 2019. The reasons for the divorce after 26 years of marriage were not explained. However, by operation of local law [Michigan], an inheritance for a spouse is revoked by divorce. Katelyn was named personal representative of the estate, and she filed the will and the trust with the probate court, asking for an order determining heirs. The probate court held that the divorce revoked both Sally and Katelyn's status as trust beneficiaries. Thus, the takers in default, Joseph's mother and sister, will inherit the entire trust.

Katelyn appealed the decision, but the Michigan intermediate appellate court affirmed. The statute is clear that, in the absence of specific contrary language in the will or trust, inheritances for an ex-spouse and any relatives of the ex-spouse are revoked by divorce.

WASHINGTON TALK

Individual income tax collections are on track to reach a record $2.6 trillion in the current fiscal year ending September 30, according to a Congressional Budget Office projection reported in *The Wall Street Journal.* The income tax will represent a record 10.6% of the economy, up sharply from 9.1% in 2021 and well above long-term averages.

The boom is unexpected and unexplained so far, and may be a mixed blessing. Much of the surge is outside of paycheck withholding, suggesting that it represents realizations of capital gains. There is some thought that many wealthy taxpayers sold appreciated property in 2021 to avoid the tax increases threatened in the now-stalled Build Back Better legislation. As such, those revenues are advance payments that, in the normal course, would have been received in the future, and now may not be.

Another possibility is that the hot stock market in 2021 encouraged more trading, resulting in a greater share of short-term capital gains taxed at a top rate of 40.8%, as opposed to the long-term rate of 23.8%.

Corporate tax receipts are also beating expectations, though not by as much as the income tax. The CBO had projected corporate taxes to be about 1.3% of GDP after the Tax Cuts and Jobs Act, but in 2021 they came in at 1.7%, and are projected to hit 1.8% in 2024. CBO calls this outcome "unexplained" as well. Kevin Hassett and Tyler Goodspeed, former Council of Economic Advisers chairs in the Trump administration, credited TCJA with the increase, but others have argued that the strong economy is chiefly responsible.

Spending story. Although the burst of federal tax revenue may be welcome, it will not be enough to keep up with spending, the CBO reports. Over the last 50 years, total federal tax revenue has averaged 17.3% of GDP. CBO projects that figure will reach 18.1% over the next ten years, and possibly markedly more if the TCJA personal tax provisions are allowed to expire on time in 2026. But that will not be nearly enough, says CBO, to cover the projected 23.2% of GDP that the federal government plans to spend during the same period (up from the 50-year average of 20.8%).

These projections do not take into account interest rate hikes that may be needed to combat inflation. Such rate increases could sharply increase the cost of servicing the national debt.

SECURE Proposed Regs. released. The IRS released some 300 pages of Proposed Regulations on 2019's SECURE Act in February. With one exception, the proposals were well-received by estate planners.

The exception concerns a bifurcation of the 10-year rule for beneficiary payouts. Planners generally had assumed that no payouts would be required until the end of the 10 years (though beneficiaries would be free to take some, if desired). Instead, that approach only is available if the account owner dies before Required Minimum Distributions (RMDs) have begun at age 72. If the account owner has begun a program of RMDs, the beneficiary of the inherited account must take annual distributions, and then empty the account by the end of the tenth year.

An ambiguous SECURE exception concerned an heir who is a minor child. The law states that the ten-year rule for minors only kicks in when they reach the "age of majority." But states have different laws as to when the age of majority happens. What's

more, in some states the status of "minor" may be extended for full-time college students, until age 26.

The IRS put the ambiguity to rest. For purposes of inherited IRA distributions, the age of majority will be 21, and there are no exceptions for students. For example, if the ten-year-old child of the IRA owner inherits the account, there will be small RMDs for 11 years, and then the account will have to be distributed over the next ten years. The IRA must be terminated when the child reaches age 31.

The Securing a Strong Retirement Act of 2022 (H.R. 2954) passed the House in March on a vote of 414 to 5. The bill would provide for automatic enrollment in employer retirement plans, as well as mandating that employers with ten or more employees be required to offer them a retirement plan, such as a 401(k) plan.

One snag that has developed concerns the savers credit, which is intended to encourage lower-income taxpayers to set aside money for retirement. The credit is 50% of the amount saved up to $2,000 (providing a maximum tax credit of $1,000). Tax credit availability phases out after income of $20,500, or $41,000 for married filing jointly. One problem has been that the large majority of taxpayers at that level of income have no federal income tax liability at all, so the credit does them no good.

The House bill boosts the phase-out level for marrieds filing jointly to $68,000, which is apparently is not controversial. But to address the issue that so many eligible taxpayers have no tax liability, the Democrats want to make the credit refundable, and that is where resistance has been encountered in the Senate.

Last year the IRS was swamped by some 185 million attempted calls by taxpayers for tax information. This year there were only 39.5 million such calls to customer service lines, of which 2.7 million got through. These dispiriting figures are from a preliminary report of the Treasury Inspector General for Tax Administration (TIGTA).

On a more positive note, the Service identified 76,814 fraudulent tax returns in 2022, compared with just 2,325 in 2021. Some $808 million in false tax refund claims were blocked.

No leads yet. In June 2021, internet publisher ProPublica released "The Secret IRS Files" based upon 15 years of tax returns of the top 0.001% of taxpayers. After reviewing data from an anonymous leaker, the report purported to show that wealthy Americans are undertaxed.

There was an immediate uproar over the violation of taxpayers' confidential information, and a full investigation was promised. After nearly a year, we are no closer to understanding how the IRS data was compromised or stolen. Hackers might have been responsible, or perhaps an unscrupulous IRS employee did the deed. Treasury Secretary Janet Yellen, testifying before the Senate Committee on Banking, Housing and Urban Affairs in May, said the leak was "very damaging" and the department is doing "everything in our power to make sure there is not inappropriate access to such data."

Failure to resolve questions concerning the data leak has led to political opposition to proposals to expand information reporting to the IRS, and has been cited as a reason to oppose the IRS' hiring of more enforcement personnel.

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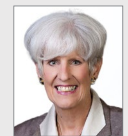

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