ORANGE Bank&Trust COMPANY

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ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

ISSUE 3 2022

PLANNING THOUGHTS

Late allocations of GSTT exemptions

The allocation of the exemption from the generation- skipping transfer tax (GSTT) happens with the gift or estate tax return reporting the transfer. Sometimes this step is overlooked, in which case default allocation rules come into play. It may be possible to revisit the allocation with a late filing. When markets move dramatically after the transfer and before the tax return filing, a rethinking of the allocation may be appropriate.

Recent estate tax ruling

At Donor's death, her revocable trust was divided into three charitable remainder annuity trusts (CRATs)—one each for Son, Daughter, and Grandson. The CRATs are not skip persons, but they have potential exposure to the generation-skipping transfer tax because there are contingent annuitants who are skip persons.

The executor of Donor's estate relied on an attorney to file a timely estate tax return and claim a charitable deduction for the remainder interests of the trusts. However, the attorney did not affirmatively allocate Donor's GSTT exemption, which means that there is a deemed allocation equally among the three trusts.

This is not optimal, and now that the oversight has been discovered, the estate would like an extension of time for allocating the exemption. Specifically, the exemption will be allocated to cause Grandson's CRAT to have an inclusion ratio of zero, and any remaining exemption to be divided equally between the remaining two trusts. The change will cause Grandson's CRAT, presumably the one with the longest expected term, to be exempt from the GSTT.

In private advice, the IRS concludes that everyone acted in good faith, and grants an additional 120 days to allocate the exemption [Private Letter Ruling 202233002].

Bear markets

Estate planners Edwin Morrow and Daniel Griffith wrote "Using 20/20 Hindsight for Allocating GST Exemption to 2021 Gifts to Trust" [LISI Estate Planning Newsletter #2982 (September 19, 2022) at http://www.leimbergservices.com]. They observed that when a major taxable gift to a trust is followed by a substantial decline in value, the donor is likely to regret making the gift. There is no "do-over" for the transfer; the taxable value is set, but there could be some solace taken by adjusting the GSTT allocation.

The authors posit a basket of investments (stocks, ETFs, bond funds) worth $10 million on December 1, 2021, when it was transferred to an irrevocable trust. The assets fell in value to $9.5 million by April 1, 2022, and $8.18 million by July 1, 2022. If the taxpayer chose a six-month extension for tax filings for 2021, he should consider allocating only $8.18 million of the GSTT exemption to the trust, leaving $1.82 million to shield a future generation-skipping transfer.

What might be the ultimate value of that extra exemption? There is no short-term gain, but according to the author's calculations, a $1.8 million trust will grow to some $9.7 million in 30 years if it grows pre-tax at 7%. If the estate tax avoided by the trust at that time is still 40%, that represents a transfer tax savings of nearly $3.9 million!

The benefits of this strategy are particularly dramatic given 2022's financial market gyrations, but it's a good idea to remember whenever the issue of GSTT allocation comes up.

IRS extends automatic portability election to five years.

Rev. Proc. 2022-32, 2022-30 IRB 101, superseding Rev. Proc. 2017-34

As welcome as the portability of the federal estate tax exemption may be (the Deceased Spouse's Unused Exemption, or DSUE), there is a catch—one has to ask for the DSUE to receive it; it's not automatic. There's only one way to claim the DSUE, and that is by filing an estate tax return for the first spouse to die, even though no tax will be due.

When the filing requirement has been overlooked, some estates have asked the IRS via a private letter ruling for permission to file a very late estate tax return, so as to claim the DSUE. For estates smaller than the filing threshold, the Service has granted the extension of time. With larger estates, the tax code does not give the IRS the same flexibility.

So many people were filing these private ruling requests that in 2017, the IRS announced that smaller estates that asked for the extension within two years of death would automatically get a favorable response, and did not need to go to the expense of a private ruling. However, that change did not make a big enough dent in the flood of requests. In July the IRS extended the deadline to five years following the death of the spouse. The estate tax return must say on page 1 "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)."

Why have so many estates realized belatedly that they have this issue? The fact that stock prices were, until this year, appreciating very nicely may have grown some estates into taxable territory, triggering the need for a DSUE. Also, the amount exempt from federal estate tax is scheduled to fall roughly in half in 2026 under current law. That change will not affect a DSUE secured in an earlier year.

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Property settlement agreement trumps beneficiary designation in a 401(k) account.

Morgan v. Bicknell, 268 A.3d 1180 (2022)

After 21 years of marriage, Richard and Lisa Bicknell divorced. In the property settlement agreement, Richard waived "any and all interest" in Lisa's 401(k) account, worth some $102,000 at that time. However, Richard had been named as the surviving beneficiary of the account during the marriage, as required by ERISA. After the divorce, Lisa never changed the beneficiary designation.

Seven years later, Lisa died intestate. It appears that the 401(k) plan administrator delivered the funds to Richard, as directed by the paperwork. The administrator of Lisa's estate filed a lawsuit to recover the money, arguing that Richard had irrevocably waived his interest in the account in the property settlement agreement, and that the agreement further provided it could not be amended except in writing. Richard countered that he and Lisa had remained friendly and in contact after the divorce, and furthermore Lisa had told him that she would never change her 401(k) beneficiary (the couple had no children).

The court held that the case is a question of contract law, and that the contract—the property settlement agreement—will be enforced by its terms. Richard must send the retirement plan money to the estate for distribution. The appellate court confirmed the judgment.

Stock sale adeems a bequest.

In re Estate of Cone, 2022 WL 587448 (Tenn. Ct. App. Feb. 28, 2022)

Cone Solvents, Inc., was a family-owned chemical distribution company. Tom Cone owned 12.5% of the shares, his father and sister, Susan, owned the balance. In his will, Tom left his sister a bequest of "any interest I may own at the time of my death in Cone Solvents, Inc."

In 2006, Tom started a new business venture, a trucking business, Frontier Logistical Services, LLC. Tom had an 85% membership interest and a 100% governance interest in the new company. Four years later, the new company agreed to buy all the tangible and intangible assets of Cone Solvents, Inc. Frontier assumed the most of Cone's liabilities, including a $475,000 debt to Cone Sr.; it hired Cone Sr. as a consultant; and it kept Cone Solvents' employees on staff. Thereafter Frontier added chemical distribution to its trucking business under the Cone Solvents', Inc. name and logo.

Cone Solvents, Inc. was liquidated, and Tom gave Susan a 12.5% interest in Frontier. However, he never amended his will.

When Tom died in 2015, still owning 72.5% of Frontier, his widow asked the probate court to rule that the bequest to Susan had been adeemed by extinction. There were no shares of Cone Solvents, Inc., in Tom's estate, the court held. The sale of the firm's assets had been to an existing company, so there was no argument that it was a mere change in form. The Court of Appeals in Tennessee affirmed. "Cone Solvents, Inc. did not merely change name or form. Its assets were sold to another—already existing—business. Frontier had been a viable trucking business for almost four years before the asset purchase. More importantly, Frontier was the buyer, not the decedent."

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A no-contest clause in a trust is enforceable, even if a contest fails on jurisdiction grounds.

Matter of Phyllis V. McDill Revocable Trust, 506 P.3d 753 (2022), 2022 WY 40

Phyllis McDill, resident of Wyoming, created a revocable trust naming her three children—Thomas, Michael, and Teresa—as beneficiaries, as well as her grandchildren. Phyllis named herself as trustee, with Michael and Teresa as successor cotrustees. At her death, her real property was to be sold and the proceeds added to the trust.

The trust was amended four times. In May 2014, she made herself and Michael cotrustees. In June 2016, she added Thomas as a third cotrustee, and further gave Thomas certain real property after her death. That amendment was revoked in September 2016 by a third amendment.

The final amendment, made in December 2016, added a no-contest provision to the trust. Anyone who attacked the trust or any beneficial interest would be disinherited, together with their descendants. However, before the sanction could be enforced, the person contesting the trust would have to be warned about the possibility of disinheritance, and would have 30 days within which to abandon the contest. In that event, the inheritance would be restored.

Two years later, Phyllis died. Michael informed his siblings that they had 120 days to challenge the validity of the trust. Within that time frame, Thomas filed a lawsuit in Texas, alleging that the third and fourth amendments to the trust were invalid, procured by Michael's undue influence. He also sought an order giving him the real property.

Two months later, Michael sent the notice to Thomas that his Texas lawsuit violated the trust's no-contest clause, and that Thomas must abandon the lawsuit within 30 business days or he would be disinherited. When Thomas did not abandon the lawsuit, Michael turned to the Wyoming courts for confirmation that the no-contest provision was triggered.

Next, the Texas court dismissed Thomas' lawsuit for lack of personal jurisdiction over the parties. Thomas then tried to bring his complaint to the Wyoming court, but that court ruled that the Texas lawsuit had indeed been an "unsuccessful contest" of the trust terms sufficient to trigger the no-contest clause. Now Thomas had no standing to sue in Wyoming, because he was not a trust beneficiary.

On appeal, Thomas argued that an "unsuccessful contest" had to be one that failed on the merits, not one dismissed on jurisdictional grounds. The Supreme Court of Wyoming was not impressed by his logic. "The plain meaning of 'unsuccessful' is 'not successful: not meeting with or producing success,'" the Court observed. Whether the contest failed on procedural grounds or on the merits is not relevant.

WASHINGTON TALK

Queen Elizabeth II's net worth was estimated to be $500 million in 2019, and the Crown's real estate (including Buckingham Palace) was worth some $25 billion. In the United Kingdom, a 40% inheritance tax generally applies to amounts over about $375,000. However, no death duties will be due from the royal family, under an arrangement worked out with Prime Minister John Major in 1993.

Major tax elements of the recently enacted Inflation Reduction Act include:

- extending through 2028 the limitation on pass-through business losses;
- a 15% minimum tax on book income for corporations with profits over $1 billion;
- a 1% excise tax on stock repurchases;
- modification and extension of green energy tax credits; and
- expanding funding for the IRS by $80 billion over the next ten years.

The much-discussed increase in the cap on the deduction for state and local taxes did not make it into the bill. Neither did any of the proposals for limiting wealthy taxpayers'access to tax-deferred retirement accounts or enhanced Required Minimum Distributions from exceptionally large IRAs.

The excise tax on stock repurchases does not apply to stock contributed to retirement accounts or ESOPs. It is effective beginning the first of next year. Corporate stock repurchases are generally thought to boost share prices by reducing the number of shares available to be owned. Some companies may opt to accelerate their repurchase plans into this year, which could add to some year-end volatility in the stock market.

Investor's Business Daily projects that this year stock buybacks for the S&P 500 as a whole will hit $1 trillion, which would translate into $10 billion of excise tax revenue. Goldman Sachs reportedly estimated that the excise tax will reduce S&P 500 earnings per share by 0.5%.

To allay the concerns that arose in some quarters about a dramatic increase in IRS audit rates, Treasury Secretary Janet Yellen wrote to IRS Commissioner Charles Rettig on August 10. In keeping with President Biden's promise not to raise taxes on anyone earning less than $400,000, Yellen directed that the new money be directed toward enforcement efforts of higher income taxpayers.

However, her language was very carefully chosen. "Specifically, I direct that any additional resources— including any new personnel or auditors that are hired—shall not be used *to increase the share* of small business or households below the $400,000 threshold that are audited relative to historical levels (emphasis added)." In other words, the actual number of audits of lower income taxpayers will go up, but only in proportion to the increase for all taxpayers.

The Congressional Budget Office has calculated that increased scrutiny on filers earning less than $400,000 will account for $20 billion over 10 years, out of a total of about $204 billion that has been projected to be raised.

Senator Mike Crapo, R-Idaho, has introduced S. 4817, which would prohibit the use of any of the new IRS funding for auditing any taxpayer with taxable income below $400,000. The bill is not expected to get *any* traction.

The IRS confessed to another inadvertent disclosure of taxpayer information in September. An estimated 120,000 taxpayers were affected. The information was a subset of non-Section 501(c)(3) organizations, which are not subject to the disclosure rules of 501(c)(3) organizations. No Social Security numbers or Forms 1040 were revealed, but individual names and business contact information were. The Service will be contacting affected taxpayers.

Prince's estate is finally settled. Pop star Prince died without having made a will or taken any other estate planning steps. What's more, there were tricky questions about who his heirs would be, as he died without children or a surviving spouse. The estate's executor had to attend to those matters at the same time that an inventory of Prince's assets needed to be compiled and valued. Eventually six heirs were identified. Three of them sold substantially all of their expected inheritance to music company Primary Wave.

The executor reported a total value for Prince's estate of some $82 million. The IRS believed that his fortune was worth nearly double that, $163 million, which would have meant additional estate taxes of $32 million and a penalty of $6 million for the substantial understatement of the tax liability on the estate tax return.

After a series of negotiations, the estate and the IRS reached a compromise, valuing Prince's estate at $156 million, some six years after his death. Now that the tax issues are taken care of, the heirs can begin promotions of Prince's music and likeness. Reportedly there are plans for music exhibitions, films, even Broadway shows. Primary Wave's statement: "When we announced our acquisition of the additional expectancy interests in the estate last year, bringing our ownership interest to 50%, our goal was to protect and grow Prince's incomparable legacy. With the distribution of estate assets, we look forward to a strong and productive working relationship."

Cryptocurrency as an estate asset. Matthew Mellon II became a brand ambassador for Ripple XRP, a cryptocurrency token. He purchased $1 million worth of the tokens in 2015, and another $1 million in 2016. The tokens exploded in value. Mellon terminated his relationship with the company, but in doing so accepted substantial limitations on his ability to transfer his tokens. Specifically, his sales could not exceed 0.5% of the average daily trading volume of the prior week. In accordance with the agreement, he sold 5.7% of his holdings for some $13 million over a period of many months.

Mellon died unexpectedly at age 53 in 2018. At his death, his remaining tokens had a nominal value of $242 million. An appraisal was conducted, taking into account the restrictions on sale and the volatility of the cryptocurrency markets. The appraiser concluded a 40% discount was appropriate, and so the tokens were valued at $151 million and reported on a timely filed federal estate tax return.

The IRS rejected the discount entirely, and called for an increase in the estate's taxable value of some $90 million, triggering an estate tax deficiency of $36 million. The estate is resisting the demand, and has filed a petition in the Tax Court [Estate of Matthew T. Mellon II et al. v. Commissioner; No. 18446-22].

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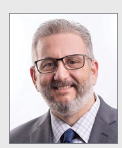
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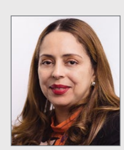
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