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ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

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PLANNING THOUGHTS

What is income?

Under the U.S. Constitution, direct taxes must be apportioned among the states. An income tax is a direct tax, and the early attempts to create a federal income tax were declared unconstitutional as they were not apportioned, making a constitutional amendment necessary to create today's income tax regime. Indirect taxes, such as tariffs, which are passed along to consumers, do not need to be apportioned.

A case is working through the courts that will address the limits of the federal taxing power. 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, a mandatory repatriation tax (MRT). The Moores received a tax bill for $15,000 on the accumulated but undistributed earnings from their investment.

The couple paid the bill and sued for a refund. They argued 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 MRT 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. What's more, the MRT was a retroactive tax, a violate of due process.

The district court granted the Government's motion to dismiss for failure to state a claim and denied the Moores' cross-motion for summary judgment. It held that the MRT taxed income and, although it was retroactive, did not violate the Fifth Amendment's due process clause [*Moore v. United States,* No. 20-36122]. The couple appealed.

The Ninth Circuit speaks

Taxpayers had no better luck with the Ninth Circuit Court of Appeals. That Court held that the apportionment clause applies only to capitations or land taxes. There is "no set definition of income under the Sixteenth Amendment." Taxpayers do not have to realize income for the income to be taxable, according to the Court. Realization is not a constitutional requirement. What's more, Congress in the past has disregarded the corporate form to facilitate taxing shareholder income.

Similarly, the Court held that there is no constitutional bar to retroactive taxes, though there may be a presumtion against retroactivity. Here, the retroactive nature of the MRT served a legitimate purpose, as without it, the pre-2018 foreign income would escape tax forever.

Rejoinder from an SEC Chairman

Writing in *The Wall Street Journal*, former SEC Chairman Christopher Cox and accounting professor Hank Adler took issue with the Ninth Circuit's reasoning ["The Ninth Circuit Upholds a Wealth Tax," January 25, 2023]. "The ruling upends a bedrock principle of taxation, which is that to create taxable income, there must be a transaction, or 'realization.' That's what distinguishes an income tax from a tax on property or wealth."

There is much more at stake in this case than the mandatory repatriation tax, the two conclude. "If Moore is allowed to stand, Congress would have a green light to tax every U.S. investor in a domestic corporation in the same way. There would be no constitutional bar to requiring that shareholders pay income tax on their proportionate share of accumulated and undistributed earnings of every corporation in which they, or even their 401(k) plan, hold stock."

This case appears to be headed to the U.S. Supreme Court for final resolution. The reply brief concludes: "The Government's pinched reading of the Apportionment and Direct Tax Clauses reduces this meaningful structural limitation on federal power into an arbitrary and pointless near-nullity. It is wrong, has already been rejected, and should continue to be rejected."

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.

A late election of special use valuation is valid provided it is made on the first estate tax return that is filed.

United States v. Ronald G. Parks et al.; No. 2:21-cv-12676

Merle Parks left the bulk of his estate, which included a farm, to his nephew, Ronald. Merle died on September 19, 2003. At that time, the federal estate tax exemption was only $1 million. The estate tax return for Merle was due six months later, but the estate asked for a six-month extension, which is automatically granted. Nevertheless, the estate made a $333,959 prepayment of the expected estate tax liability in June 2004. No estate tax return was filed at that time.

For reasons not explained in the Court's decision, the estate tax return was not filed until February 2010, more than five years after the extension for filing expired. The return reported a gross estate of some $1.7 million, a taxable estate of $1.6 million, and an election for special use valuation of the farm property under IRC §2032A. That tax code provision allows for farm property to be valued for its agricultural use, rather than its fair market value, which is often far higher. The purpose of the provision is to allow farm property to stay within the family, but a number of requirements must be met to prove that the heirs will continue the farm.

Based upon these final values, and allowing for the special use value reduction, the estate asked for a tax refund of $87,838 from the 2004 payment. Two years later, in 2012, the IRS did much more than deny the refund. The Service stated that five years was too long to wait to make the election for special use valuation, that additional taxes of $199,111 were due, as well as a late filing penalty of $27,818.25.

The estate did not pay the additional tax. In 2021, the U.S. brought a civil action to collect the taxes through a judicial seizure and sale of the farm property. The defendants admitted that estate tax return was late, but argued that an election of special use valuation on a late return is still valid, provided that the return is the first estate tax return filed. Both sides asked that the case be dismissed in their favor.

After a long and careful examination of the history of the law and Regulations on valuing farm property for the federal estate tax, the District Court held that the special use election was not invalid for being late, just as the estate had argued. However, it was not a total win for the estate. The IRS continues to have the ability to prove at trial that the estate has not met the other technical requirements for the election, such as qualified uses of the property and material participation in farming by the heirs. With interest, as of the time of the decision, the amount at issue has grown to $433,654.66.

Thus, more than 19 years after his death, the federal estate tax on Merle Parks' farm property remains unsettled.

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Estate planning advice is denied the attorney-client privilege.

United States v. Moshe Lax et al.

Chaim Lax was a real estate developer and diamond merchant in New York City. In October 2005, the IRS began an examination of Lax's income tax returns for 2002, 2003, and 2004. Lax died in 2008. In 2009, the IRS assessed some $60 million in taxes and penalties due from Lax's estate, primarily income tax deficiencies.

Lax's heirs took steps in 2010 that they believed would help to shield some of the family assets from the IRS. Specifically, there was an assignment for the benefit of creditors transaction, which is a business liquidation proceeding under New York state law that is offered to insolvent debtors as an alternative to bankruptcy.

The IRS won a summary judgment against the estate for some $55 million in March 2022. Next the Service attempted to collect the tax from Lax's adult children, who are the co-executors of his estate. To facilitate that effort, the IRS sought all communications between the executors and their law firm concerning the 2010 corporate reorganization.

The District Court holds that the IRS "demonstrated probable cause that a crime or fraud was attempted or committed and that the communications with the Porzio Firm were in furtherance of that crime or fraud." The attorney-client privilege protects communications about past wrongdoing, but it does not extend such protection to possible future crimes. The law firm was ordered to answer questions put to it by the IRS regarding the transaction.

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Blog posts are admissible evidence in an "innocent spouse" case.

Sydney Ann Chaney Thomas v. Commissioner; No. 12982-20; 160 T.C. No. 4

Sydney Thomas filed joint tax returns with her husband in tax years 2012, 2013, and 2014. Some of the taxes shown on those returns were never paid. Mr. Thomas died in 2016.

After her husband's death, Sydney petitioned for tax relief as an "innocent spouse" under IRC §6015(f). When the IRS denied that relief in 2020, Sydney turned to the Tax Court. Congress amended §6015 in 2019, providing that the Tax Court will review such cases de novo, taking into account the administrative record and any newly discovered evidence.

In the course of preparing for the Tax Court, the IRS discovered a series of Sydney's blog posts about her assets, lifestyle, businesses, and relationship with her husband. In the view of the Service, this evidence tended to undercut her claim for innocent spouse relief. Sydney asked the Tax Court to bar the introduction of the blog posts because they were not part of the administrative record and could have been discovered at any time.

The Court rules for the IRS. There was no need for the IRS to search the internet for information about Sydney before she filed her suit in the Tax Court. Once her filing happened, the Service undertook that investigation, and what they found is "newly discovered."

A concurring opinion suggests that the language Congress used creates a one-way benefit for the IRS. The taxpayer couldn't introduce evidence such as the blog posts, because to the taxpayer it would be old news, not "newly discovered." Only the IRS gets

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the chance to find new evidence for the case.

Transfer to a successor trust does not void GSTT exempt status.

Private Letter Ruling 202301001

An irrevocable trust created before September 25, 1985, is "grandfathered" and is not subject to generation-skipping transfer tax unless it is substantially modified to extend the time for vesting or shifting interests to a lower generation. In this case, pursuant to a court order, the laws governing administration of an irrevocable trust were changed from State 1 to State 2. Consistent with the laws of State 2, the assets will be poured into a new trust with the same beneficiaries and the same termination provisions, but only if a favorable ruling is obtained from the IRS. The features of the new trust include separate trusts for each beneficiary, the appointment of a distribution committee to make discretionary distribution decisions, the creation of an investment committee for investment and administration decisions, and the future appointment of a trust protector. The new trustee must be a corporate trustee, that is, a trust company or national or state banking institution having trust or fiduciary powers. The perpetuities period for the new trust is identical to the original trust.

The ruling is favorable. The IRS concludes that the distribution of principal from Trust A to Trust B will not cause a shift of a beneficial interest to a lower generation beneficiary nor extend the time for vesting of any beneficial interest beyond the period provided for in the original trust. Accordingly, the GSTT exempt status will carry forward to the new trust. Each named beneficiary will have a power of appointment over a portion of the trust, and that will be included in the beneficiary's estate.

WASHINGTON TALK

In a surprise move, the Republican leadership selected Missouri Republican Jason Smith as the new Chair of the House Ways and Means Committee. Smith was fourth in seniority among Republicans on Ways and Means. He has been in the House only since 2012. In contrast, the previous Chair, Richard Neal of Massachusetts, was a 30-year veteran in the House before receiving the assignment.

Smith has pledged greater scrutiny and oversight of the IRS, "by investigating politically motivated leaks of taxpayer information by the IRS and rolling back efforts by the Biden Administration to use the agency to target the middle class."

H. R. 25, the Fair Tax Act of 2023, was introduced in the House by Rep. Earl Carter, R-Ga. The bill would repeal the federal income tax and payroll taxes, as well as the federal estate and gift taxes, replacing them with a national sales tax. The new tax regime would begin in 2025 with an initial sales tax rate of 23%. As such, it would be similar to the value-added taxes used throughout Europe. The bill starts with 11 co-sponsors.

Versions of the Fair Tax have been introduced in every Congress since 1999, but none were reported out of Committee. That likely will change this year. In the fight over the speakership, one of the promises demanded by the conservative holdouts was a floor vote on the Fair Tax.

Passage of so radical a change to a tax system that rewards savings instead of consumption seems unlikely this year. Perhaps a robust debate of the concepts will get the public accustomed to the possibilities.

Defund the IRS? Republicans on the Ways and Means Committee have introduced the Family and Small Business Taxpayer Protection Act to rescind the $80 billion budget increase for the IRS included in the Inflation Reduction Act. The $7.9 billion earmarked for technology upgrades and taxpayer services would not be touched, but the funding for expanded audit efforts and thousands more IRS agents would be canceled.

An amendment to the Inflation Reduction Act to bar increased audit rates for those who earn less than $400,000 was defeated. A new analysis suggests that if the IRS returns to the audit rates of 2010, there will be an additional 700,000 audits of taxpayers with income less than $75,000. Republicans are still smarting from the IRS targeting of conservative groups during the Obama administration, and are angry that the massive leak of taxpayer information to ProPublica has not been resolved, and the perpetrators have not been identified.

The Congressional Budget Office scored the measure as reducing tax collections by $185.8 billion over ten years, which would be offset by the spending reduction of $72 billion. Passage of the bill in the House is uncertain, and the Senate is unlikely to go along with the plan.

During its first fiscal quarter, the federal government collected $1.026 trillion in taxes, the Congressional Budget Office reported on January 10. That was down by $26 billion, compared to the first fiscal quarter of 2022. Unfortunately, federal spending during that period increased by $76 billion, reaching a total of $1.444 trillion.

Hence, the federal deficit for that quarter was $418 billion. In percentage terms, the federal government spent roughly 40% more than it took in.

Payroll taxes were up for the quarter, thanks to the strong labor market, as were corporate taxes. Individual income taxes were down, perhaps related to losses in the financial markets. The remittance from the Federal Reserve banks fell from $26 billion to less than $1 billion, as higher interest rates affected profits. The higher interest rates also boosted the interest cost of the national debt by $45 billion (or 44%) during the quarter.

Who gets audited? A new report from the Transactional Records Access Clearinghouse (TRAC) makes some provocative observations about IRS auditing in recent years. The odds of a millionaire being audited in person by an IRS agent in fiscal year 2022 was just 1.1%, according to the report.

The IRS says that the audit rate was 2.8% for millionaires, but that depends upon what is meant by the term "audit." The Service includes "correspondence audits" in its figures—letters that ask a

taxpayer for more information. Such letters are easily and efficiently generated, but TRAC discounts those inquiries as not providing meaningful oversight of tax returns.

That the rate of auditing has dropped is not in dispute. In 2012, there were 40,965 audits of taxpayers with $1 million or more of income, and those were all by revenue agents. In 2022, the revenue agents audited 7,210 millionaire tax returns, and roughly an equal number of correspondence audits, despite the fact that there are more millionaire tax filers than ever these days. The report fails to discuss what the audits turned up. Most millionaires use professional tax preparers who are unlikely to risk their livelihoods with fraudulent returns, who are diligent in being accurate in their work. How much additional tax revenue was obtained per audit? How much time was needed for the audit, compared to added taxes and penalties? Does this turn out to be a good use for scarce resources, at a time when the IRS is being tasked with other responsibilities?

At the other end of the income spectrum, the report observes a relatively high audit rate of those who claim the earned income tax credit, running at 12.7%. Nearly all of these (97%) are correspondence audits asking for information to verify the claim of the tax credit. According to the report, such audits have a fairly good chance of increasing tax revenue, because the taxpayer loses the credit entirely if the request for information goes unanswered. Unfortunately, the earned income tax credit can be complicated to compute and document, and the lower income taxpayers may not have access to the necessary resources. The IRS is not much help, because so few callers have been able to get through in recent years.

Any thoughts on the disclaimer Regs.? In T.D. 8095, the IRS requested comments on the Regulations applicable to qualified disclaimers under IRC §2518. No changes to the Regs. have been proposed, so the question seems to be whether practitioners are satisfied with the Regs. as they are. The IRS expects that 2,000 taxpayers will take half an hour each to respond to the request for comments, according to the Federal Register. Comments must be received by March 13, 2023.

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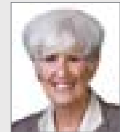
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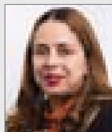
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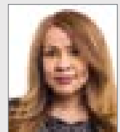
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