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ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

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PLANNING THOUGHTS

The lock-in debate continues

On three occasions the Congress has legislated a temporary increase in the amount exempt from federal estate and gift taxes. Such increases were made temporary to reduce the projected loss of revenue from the tax change. In 2009, the exempt amount reached $3.5 million, and 2010 was the year without any federal estate tax at all. Under the prior law, the exempt amount was scheduled to fall to $1.0 million in 2011, but instead, just before the change was to occur, Congress increased the exempt amount to $5.0 million.

However, that new exempt amount was itself temporary, scheduled to expire after only two years. The temporary nature of this change led to many estate planners recommending strategies to "lock in" the larger transfer tax exemption while it remained available. As it turned out, Congress did not allow the exemption to fall after all, but made the $5.0 million transfer tax exemption permanent, and added inflation indexing for good measure.

The third occasion was the doubling of the estate and gift tax exemption in the 2017 Tax Cuts and Jobs Act. The exemption stands at $13.61 million for 2024 decedents, and it seems likely to exceed $14 million in 2025. Then, in 2026, under current law, the exempt amount will be cut roughly in half, to about $7 million.

Is locking in the larger exemption now a good idea? Who should consider exploring that strategy?

Not for the small estates

Those with a projected estate of less than $7 million will remain free of federal estate tax obligations under current law, even if the scheduled reduction in the exemption occurs. Estate planners Beth Shapiro Kaufman and Meghan Muncey Federman argue that those with estates in the $15 million to $20 million range also are not good candidates ["Sunsetting Gift Tax Exemption Is No Reason for a Large Donation," Bloomberg Tax, https://news.bloombergtax.com/daily-tax-report/sunsetting-gift-tax-exemption-is-no-reason-for-a-large-donation]. The reason is that in making lifetime transfers, one first uses any available deceased spousal unused exemption (DSUE), then one's basic exemption, and only then will additional transfers lock-in the "bonus" exempt amount.

As an example, the authors posit a married couple with $15 million in assets. To obtain the desired lock in, they will have to transfer about $14 million worth of their wealth, leaving them with just $1 million. That does not sound reasonable, especially given that even if the sunset of the larger exemption occurs, they will each have a $7 million exemption to work with.

What if the couple has $25 million? At this level the strategy may make better financial sense, but how many couples are willing to part with 60% of their wealth immediately for a speculative future estate tax savings after their deaths?

The widow

The authors also explore the case of a widow, late 80s, with an estate of $20 million, who is willing to make a transfer of $10 million to her heirs. The woman has a DSUE of $6 million from the death of her husband. Should the $10 million transfer go forward, the first $6 million avoids federal gift tax thanks to the DSUE; the next $4 million is protected by the woman's own basic exemption. Nothing has been locked in, and won't be unless she gifts roughly an additional $3 million.

The other tax consideration here is that the gifted assets do not get a basis step-up. If there has been substantial appreciation in value, the heirs will get a hefty capital gains tax exposure along with the gift. The basis step-up occurs only if she holds the asset until death.

Large estate

Now assume that a single person has a $60 million estate, so that a transfer of $14 million to lock in the tax savings is feasible. The potential tax savings is 40% of the locked-in $7 million exemption amount—that is $2.8 million. For some clients, the tax benefits may seem small compared to the assets they are gifting to obtain it.

Prospects

There will be a robust debate about extending the 2017 tax changes

affecting individual taxpayers, scheduled to expire in 2026. Some of these changes helped lower- and middle-income taxpayers, such as the doubled standard deduction, so extension of some elements seems likely. Historically, the amount exempt from federal estate tax has only gone up, never down. At the same time, however, there is agitation in some quarters to increase the tax burden on the wealthiest, and the federal deficit has grown significantly due to higher interest rates for servicing the national debt. Estate taxes are an inefficient means of revenue collection, given the wide variety of strategies available to reduce or eliminate them. Nevertheless, there may be strong support for letting the larger transfer tax exemption sunset, or even reducing it further.

CASES AND RULINGS

When a divorce revokes a will provision to spouse, it also revokes provisions for the spouse's heirs.

Matter of Estate of Tomczik, 992 N.W.2d 691

Mathew and Sara married in 1992 and divorced in 2019. They had no children; neither remarried. Mathew's will left his assets to Sara, but under state law (Minnesota) that provision was revoked by the divorce. That made an alternate residuary clause important. It read: "If any interest is not effectively disposed of by the preceding provisions of this article, one half (½) [sic] to my heirs-at-law and one-half (½) to my wife's heirs-at-law."

After Mathew's death, his personal representative presented his will for probate, listing only Mathew's relatives as heirs. Sara's parents objected. They admitted that Sara was no longer a beneficiary of Mathew's estate, but that as Sara's heirs-at-law they were still entitled to their half.

The district court dismissed the parents' plea, but a divided appellate court reversed. Then the Minnesota Supreme Court reversed again, holding that at his death Mathew had no wife, so there could be no class gift to the heirs of someone who did not exist. The court further held that the legislature intended that a divorce would revoke dispositions to an ex-spouse's relatives.

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Picking a mutual fund is not a "marital effort."

Naranjo v. Ochoa, 366 So. 3d 11

Wife received an advance on her inheritance of $830,000 from her mother. She kept this money separate, investing it in a brokerage account. As a "buy and hold" type of investor, she chose four mutual funds to invest in, and did nothing more with the portfolio. The strategy was a good one, because the value of the account grew by some $892,000.

Unfortunately, the marriage did not work out. In the divorce proceedings, Husband laid claim to half of the increase in the account value, as it came about as the result of efforts by either party during the marriage. The divorce court agreed, holding that only the $830,000 was nonmarital property, and Husband should share half the growth.

The Florida District Court of Appeal reversed, holding that passive growth in an investment account is not the result of efforts by either marital partner, but is attributable to the conduct of the managers of the mutual fund. Wife will get to keep her entire brokerage account.

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To be valid, a trust must have a purpose other than tax avoidance.

Saccato v. Comm'r, T.C. Memo 2023-96

Lawrence Saccato was in the storage business. Over the years, he created a variety of legal entities, and he managed them with his long-term girlfriend. What he failed to do was file a tax return, a failure that recurred for 14 straight years.

When the IRS attempted to audit Mr. Saccato, he was not cooperative. He claimed that he was neither the trustee nor the beneficiary of the various trusts he had set up in connection with his business. The IRS therefore used his bank account records to reconstruct Saccato's income.

Before the Tax Court, Saccato continued to maintain that he did not own the business propertyand that he was not the trustee of the trusts (although he had so described himself to a bank and the state authorities). Saccato also made a number of assertions similar to those made by tax protesters, which the Tax Court characterized as "gibberish."

The Court held that "We find that these 'trusts' do not exist and that, if they did exist, they would be shams. The sole purpose of these fictitious entities was to obscure petitioner's true ownership of the assets they purportedly held." The IRS determinations recreating Saccato's income from bank records were sustained. What's more, Saccato persisted in making nonsense arguments after he was warned to desist. The Court added a $10,000 penalty to the overdue taxes for wasting its time.

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The IRS offers advice on income taxes and digital assets.

IR-2024-18

In January, the IRS reminded taxpayers that they will again see a question regarding digital assets on their tax returns this year. It's a yes-or-no question, and the answer goes to whether there are tax consequences for digital asset ownership. What is a digital asset? Virtual currencies, such as bitcoin, as well as non-fungible tokens (NFTs) are included.

If one does not own any digital assets, the question should be

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answered "No." A "No" answer is also appropriate for taxpayers who:

- Simply held digital assets in a wallet or account;
- Transferred digital assets from one wallet or account they own or control to another wallet or account they own or control; or
- Purchased digital assets using U.S. or other real currency, including through electronic platforms.

The "Yes" answer is required if there has been a sale or other transaction with a digital asset. Examples include:

- Receiving digital assets as payment for property or services provided;
- Receiving digital assets resulting from a reward or award;
- Receiving new digital assets resulting from mining, staking and similar activities;
- Disposing of digital assets in exchange for property or services;
- Disposing of a digital asset in exchange or trade for another digital asset;
- Selling a digital asset; or
- Otherwise disposing of any other financial interest in a digital asset.

The IRS views digital assets as property, which has a tax basis. If cryptocurrency is used to make a purchase, gain or loss must be recognized on the change in the value of currency. If wages are paid in cryptocurrency, they are taxable as ordinary income.

Additional details on the tax ramifications of owning digital assets may be found at https://www.irs.gov/businesses/small-businesses-self-employed/digital-assets.

WASHINGTON TALK

Modernization is coming to the IRS' estate and gift tax operations. Electronic filing of income tax returns has been around a long time, but not so for filing estate or gift tax returns. Those must be filed on paper. What's more, such filings may require substantiation of values, and so may balloon to fill banker's boxes. As a result, the IRS has mountains of paper to store, and retrieval of documents must be done by hand.

That may change in the coming years. Caitlin Dale, an IRS estate tax specialist, told the attendees at the November Tax Division meeting of the AICPA that electronic versions of Form 706 for estate and generation-skipping taxes and Form 709 for gift taxes are in the works. However, it won't be ready for the public "as soon as we'd all like," she warned.

An even larger project is the digitizing of all past gift tax returns, to enable electronic access to them. All such returns are required for accurately determining the remaining estate tax exemption available to a decedent's estate. The IRS is starting the digitizing with current exam cases, then proceeding to open years, and eventually will get to everything else.

During the pandemic, the IRS temporarily accepted PDFs of estate tax returns uploaded to a secure online portal, but that fix has expired. The Service does not have confidence that its hardware is sufficient to support today's security requirements for an online portal, so PDFs are no longer accepted.

Dragging the estate and gift tax division into the 21st century is made possible by the additional funding that the IRS received from the Inflation Reduction Act. However, no time frame or project deadlines were announced.

Out of every 10,000 deaths in 2019, only 8 estates owed federal estate taxes, according to the most recent IRS data. The Institute on Taxation and Economic Policy published "The Estate Tax is Irrelevant to 99% of Americans" in December 2023, summarizing the IRS report [itep.org/federal-estate-tax-historic-lows-2023/]. From 1997 to 2001, over 2% of estates paid were affected by the federal estate tax, a high-water mark, and the share fell below 1% in 2004. It continued to sink, breaking the 0.10% level in 2018.

The reason fewer and fewer estates owe the tax is that the growing exemption amount works to target the tax to the very wealthiest estates. The inflation adjustment to the exemption for 2024, an increase of $690,000, is larger than the entire exemption was in 2001 and earlier years. As a result, the majority of estate tax revenue in recent years comes from estates of $50 million and up.

Although the statutory estate tax rate is 40%, according to the report the average taxable estate in 2019 paid 19.7% of its assets to the IRS, after taking into account the exempt amount, charitable legacies (averaging 10.7% of the estate) and state death taxes (2.5%). That left 67.0% of the estate for the heirs.

The report complains that estate planners have been doing their jobs too well, finding legal means to reduce the transfer tax exposures of their clients. The use of grantor trusts and grantor retained annuity trusts are specifically identified as "loopholes" in need of closing.

Bloomberg reports that although the over-70 cohort is 11% of the population, this group now owns 30% of the wealth in the country. Increases in home values and stock prices since 2019 have added an estimated $14 trillion to this group's net worth. What's more, the labor force participation rate for this group has nearly doubled from the low point of 10% in the mid-1990s.

According to the Federal Reserve data cited by Bloomberg, people over 65 have an average of $1.8 million in equity holdings. However, averages can be deceiving, pulled higher by the exceptional wealth at the top of the scale. An estimated 10% of those over 65 are living in poverty.

So far, five members of the House Ways and Means Committee have announced that they won't seek reelection next year. They are Republicans Brad Wenstrup of Ohio and Drew Ferguson of Georgia, and Democrats Earl Blumenauer of Oregon, Daniel Kildee

of Michigan, and Brian Higgins of New York. They are among the 30 members of the House who have announced their coming retirements.

Taxing endowments. Senator J. D. Vance of Ohio, Republican, has introduced S. 3514, the College Endowment Accountability Act. The bill would boost the excise tax on the net investment income from endowments from the current 1.4% to 35%, but only for those endowments at nonreligious schools larger than $10 billion. Endowments subject to the tax held an estimated $270 billion in 2022.

On the Senate floor, Senator Vance questioned the wisdom of tax subsidies for such large funds, saying, "Many of our Ivy League institutions . . . are little more than hedge funds with universities attached to them as pretend."

The bill was blocked by Senate Democrats in mid-December, but could reappear in the spring, given the controversies that have developed on some college campuses.

Terry Kahn's parents fled Nazi Germany, bringing him and his sister to settle in Tucson. He attended the University of Southern California, and later enlisted in the army, serving three years in Vietnam. After his discharge, Mr. Kahn moved to Indianapolis and began working for the Veterans' Administration. His career there lasted 30 years.

In the mid-1990s, Mr. Kahn became acquainted with attorney Dwayne Isaacs. The pair shared a monthly lunch for about 10 years, during which time the attorney learned of Mr. Kahn's circumstances. He had never married or had children; his sister had died; and he had no close relatives. Mr. Kahn asked the attorney to draft a simple will that would pass his entire fortune to charity, and left the choice of beneficiary up to the attorney, with a single stipulation. No money would go USC, his alma mater, because they already had enough money.

Mr. Kahn had been exceedingly frugal, and was a careful and successful investor. At his death, his estate was worth $13 million!

Mr. Isaacs then had the chore of contacting local charities, asking them, "What would you do with $1 million?" Several charities refused to take the call, thinking it must be a scam. But for 12 local nonprofits, according to an item in the Daily Mail, it was an unexpected gift from out of the blue. Said Mr. Isaacs of Mr. Kahn: "He's smiling someplace, there's no doubt about it. He would be getting a kick out of this."

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