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ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

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PLANNING THOUGHTS

Tax increases in the 2025 budget

President Biden's budget proposal for 2025 includes an ambitious array of tax increases aimed at affluent taxpayers. Although these ideas are not expected to move through the Congress this year, they provide a road map for where the Democrats hope to take the tax code in the coming years. Below is a sample of the provisions of importance to wealthy families.

Increase top tax rates. The highest income tax bracket, with a rate of 37%, begins at income of $609,350 for singles, $731,200 for joint returns. The proposal restores the old 39.7% rate, but imposes it at a much lower income level; $400,000 for singles and $450,000 for joint returns.

New rates for capital gains and qualified dividends. To the extent a taxpayer's income exceeds $1 million, long-term capital gains and qualified dividends would be taxed at the top income tax rate of 39.7%.

Income tax on transfers of appreciated property. Under current law, a gift of appreciated property has a carryover basis, and a transfer of appreciated property at death gets a stepped-up basis. The proposal calls for such transfers to be realization events, with the potential for taxes on capital gains in addition to the estate or gift tax. However, every taxpayer would have a $5 million exclusion from the application of this income tax.

Minimum tax on unrealized appreciation. For taxpayers with wealth over $100 million, the administration wants a 25% minimum tax on income plus unrealized capital gains, beginning in 2025. This is popularly known as a "wealth tax." There is some doubt over the constitutionality of this idea.

Grantor-Retained Annuity Trusts. A ten-year term would be required, and the remainder interest would have to be at least 25% of the value of the amount contributed to the GRAT.

Grantor trusts. Sales between a grantor and a trust that is not fully revocable would be taxable, effective for sales after enactment. The grantor's payment of the income tax on the trust's income and gains would be treated as a taxable gift, effective for trusts created after the date of enactment.

Limits on valuation discounts. When a family collectively owns at least 25% of a property, there will be no discount for transfers of partial interests within the family.

New limit for Crummey trusts. The total tax-free transfer to a Crummey trust in a single year would be limited to $50,000.

Limits to the GSTT exemption duration. The generation-skipping transfer tax exemption would apply only to transfers no more than two generations below the transferor, and to younger generation members alive at the creation of a GSTT trust.

Narrow the 1031 like-kind exchange deferral. In general, the deferral of gain on the like-kind exchange of real property would be limited to $500,000 per taxpayer.

Cap on retirement account accumulations. Taxpayers with vested retirement account balances greater than $10 million would be required to withdraw at least 50% of the excess. If the account is greater than $20 million, the withdrawals must come from Roth IRAs or designated Roth accounts. However, this rule only applies to "high-income" taxpayers, that is, singles with income over $400,000 and couples filing jointly with over $450,000 in income.

Certain conversions to Roth IRAs denied. Those same "high-income" taxpayers would no longer be permitted to convert a traditional IRA to a Roth IRA.

Expected revenue impacts

According to the Green Book explanation of the revenue proposals, the total revenue increase over ten years from the changes in estate and gift taxes would come to just $97.221 billion. The proposed wealth tax alone is projected to reap five times that amount, $502 billion. Changes for retirement plans for high-income taxpayers would yield $23.6 billion. All of the income tax increases for high-income taxpayers, including the wealth tax, would increase the tax burden by $1.834 trillion.

Various proposals to support workers and families, such as expansion of the child credit, would cost the Treasury $764 billion over ten years.

Prospects

Major tax legislation is not expected to be enacted this year, given the divided Congress. The immediate focus for tax writers is what to do about the 2026 expiration of the individual tax provisions of the Tax Cuts and Jobs Act of 2017. Democrats have long characterized that legislation as primarily benefiting the wealthy. On the other hand, the Republican Chair of the House Ways and Means Committee, Jason Smith, recently stated that "Congress must act soon to prevent what would be the largest tax hike in history on workers, families, farmers, and small businesses."

According to the Congressional Budget Office, a straight extension of TCJA's provisions would "cost" $3.5 trillion over 10 years. At the time it was enacted, the CBO scored TCJA as costing $1.5 trillion.

CASES AND RULINGS

Penalties for failing to take an RMD from certain inherited IRAs are waived again.

IRS Notice 2024-35

Once upon a time, distributions from an inherited IRA could be spread over the beneficiary's lifetime. For young beneficiaries, the RMDs might be small enough that the inherited IRA would continue to grow handsomely. This changed with passage of the SECURE Act. In general, subject to important exceptions, the assets of an inherited IRA must be distributed to the beneficiary over ten years.

Estate planners debated how to handle those distributions. Should they be deferred until the tenth year, for maximum tax-deferred buildup? Or should a program of taking 10% each year for ten years be better, as it avoids pushing the beneficiary into a higher tax bracket?

When the IRS proposed regulations to implement the new rules, the Service pointed out that most everyone had overlooked another rule. If the account owner was already taking required minimum distributions (RMDs), the beneficiary also had to take distributions at least that fast. Failure to take an RMD results in a substantial excise tax.

The proposal caught planners by surprise, and the IRS responded by waiving penalties for failure to take an RMD from certain inherited IRAs in 2021, 2022, and 2023. In the above Notice, the penalties are again waived for 2024. The Notice suggests that the Reg. is now expected to take effect in 2025.

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Electronic signature on a will denied in Pennsylvania.

In re Estate of Kittler, 303 A.3d 463 (Pa. Super. Ct. 2023)

After Susan Kittler was hospitalized for a fall in October 2020, her son consulted an estate planner to have her will drafted. Susan was removed to a nursing home, and visitors were prohibited during the height of the COVID-19 pandemic. The attorney was able to contact Susan remotely for an initial discussion on November 12. By November 18, Susan had learned that she had bone cancer, so the next telephone conference involved her financial planner as well. Her testamentary intentions were made clear at that time, and a will was drafted to reflect them.

On November 24, 2020, a video conference took place that included the services of a notary employed by the York County Bar Association. The notary utilized DocVerify, an online software vendor that met the Pennsylvania Department of State's requirements to serve as a secure electronic method for affixing a digital signature. The procedural requirements were followed to the letter, for the two witnesses, as well as for the testator. In short, every possible step was taken to create a valid will, in circumstances in which the state had forbidden face-to-face contact.

Nevertheless, after Susan died a year later, the registrar of wills refused the probate of her will—not because anyone raised an objection to it, or that there was any doubt that it reflected Susan's testamentary wishes, but because the electronic method for signing a will had not been approved. The Orphan's Court agreed.

The appellate court noted that electronic signatures have been explicitly approved for guardianships, but no similar rule has been created by the legislature or the Pennsylvania Supreme Court for the execution of wills. Until that happens, a will must be signed in ink on paper by the testator to be valid.

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Children are included in "all relatives."

Matter of Estate of Shepherd, 534 P.3d 1061 (Okla. Civ. App. 2023)

In Oklahoma, children who are not mentioned in a will are entitled to receive an intestate share of the estate unless it appears that the omission was intentional. Priscilla Shepherd signed a holographic will that left her house to a named granddaughter, and it did not specifically leave anything to her three children. The final line of the will was, "All moneys owed by anyone is forgiven. This is my desire and will to be for all relatives."

Two daughters objected to the will and applied for their intestate share, arguing that there was no clear intent in the will to disinherit them. The district court held that although they were not named, they were among the "all relatives" identified in the final line of the will. A divided intermediate appellate court agreed that the statute for pretermitted children did not apply.

A dissenter pointed out that the will was ambiguous at best, and it failed to provide evidence of intentional omission as required by state law.

A pet trust requires a specific remainder beneficiary.

Matter of Estate of Jablonski, 214 N.E. 3rd 1051 (Mass 2023)

Teresa Jablonski executed a will in August 2013. The will left her entire estate to a testamentary pet trust for Teresa's cocker spaniel, Licorice. Any other pets owned by Teresa at her death were also to be beneficiaries of the pet trust. At the death of the last surviving pet, the trust assets were to pass to a charity, to be chosen by the trustee. Teresa's niece, Ann, was named executor of the will, but the trustees were not specified.

Unfortunately, Licorice died before Teresa did, and she acquired no other pets before her death. When Ann presented Teresa's will for probate, her other nieces and nephews objected. They argued that because there were no pets to be beneficiaries, the pet trust had lapsed, and so Teresa's estate should be divided among themselves under the laws of intestacy. Ann countered that the correct result was acceleration of the charitable interest in the trust remainder. The probate court ruled in Ann's favor, without holding a trial.

On appeal, this ruling was voided, because there is an issue of fact that requires a trial for determination. Whoever drafted Teresa's will did not do a very good job of it. When the pet trust failed, its assets passed to the residuary estate. But the residuary clause of the will then sent all remaining estate assets back to the pet trust, which no longer existed!

The appellate court held that Teresa's will failed to demonstrate a clear intent for the disposition of estate assets in the event all of Teresa's pets died before she did. The fact that no specific charity, or even type of charity, was mentioned in the will troubled the court. Additional fact-finding will be required to determine Teresa's intent. Unless it can be shown clearly at trial that Teresa really wanted her estate to go to a charity at her death, the estate will pass to her relatives under the law of intestacy.

Had Teresa met with her lawyer after Licorice died, all ambiguities could have been resolved, and years of litigation would have been avoided.

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Loans without expectation of repayment are gifts.

Estate of Mary P. Bolles v. Comm'r, No. 22-70192, (9th Cir. 2024)

Mary was in the habit of advancing funds to her children as loans, then forgiving a portion of such loans each year in the amount of the gift tax annual exclusion. However, her advancements to her oldest son, Peter, were substantially larger, in order to help him establish his architecture practice. After some initial successes, Peter suffered some financial reverses and was not able to pay the interest on his loans.

In 1995, Mary had a legal document drafted which acknowledged that Peter owed her $771,628, that he would not be able to repay it, and that this amount would be considered an advancement of his inheritance. Peter signed the document.

After Mary died in 2010, that transaction became an estate-tax issue. At first, the IRS contended that the document was effectively a note whose value must be included in the estate. That issue was conceded, and the Service argued in the alternative that it was a taxable gift to be taken into consideration when calculating the estate tax.

The Tax Court agreed with the IRS that a gift occurred, but in looking at the entire record, the Court concludes that the gifts really began in 1990. That was when Peter's financial difficulties became severe enough that Mary must have realized his loans would never be repaid [Estate of Mary P. Bolles et. al. v. Comm'r, T.C. Memo 2020-71].

In a per curiam opinion, the Ninth Circuit Court of Appeals affirms the Tax Court decision. The Court also affirmed the denial of a deduction for litigation costs associated with the case, because the IRS substantially prevailed.

WASHINGTON TALK

The House Republican Study Committee released a counterproposal for the 2025 federal budget. The section on taxation does not recommend tax increases. Key elements include:

- End the 2026 sunset for the individual provisions of 2017's Tax Cuts and Jobs Act.
- Promote economic growth with full and immediate expensing of investments in equipment, as well as research and development.
- Create a new Universal Savings Account with new tax benefits.
- Index capital gains for inflation.
- End the federal estate tax (but not, apparently, the federal gift tax).
- Restore the $20,000 threshold for requiring a 1099-K return.
- End marriage penalties in the tax code.
- Protect donor-advised funds.

In March, Senate Finance Committee Chairman Ron Wyden and Maine Senator Angus King introduced the Getting Rid of Abusive Trusts Act. The act would not necessarily get rid of any trusts at all, but it would severely affect the tax benefits of Grantor-Retained Annuity Trusts (GRATs).

Under the bill, a GRAT would be required to have a term of at least 15 years, and a maximum term of the life of the annuitant plus 10 years. Reducing the annuity during the term of the trust would be prohibited. Finally, the remainder interest of a GRAT for gift purposes would have to be at least 25% of the amount transferred to the trust.

Under current law, a trust grantor who is the owner of the trust for income tax purposes may reserve the right to substitute assets of equal value in the trust. The proposal would treat any such transfer as a taxable sale for income tax purposes.

Finally, the payment of the income taxes of a GRAT would be treated as a taxable gift to the remainder trust beneficiaries.

These provisions parallel those in the President's budget proposal.

The IRS spending increase is well underway. The Inflation Reduction Act provided nearly $80 billion in supplemental funding for the IRS through September 30, 2031. Some $20.2 billion of that was clawed back in the final fiscal funding bill for 2024, passed in late March. But that will have an effect on the future years, as the IRS has already dipped into the added funding to the tune of $4.4 billion. About $1.8 billion went for labor costs in the fiscal first quarter. Another $1.5 billion was spent on contractors and advisory services, including:

- $800 million for business systems modernization;
- $536 million for operations support;
- $84 million for taxpayer support;
- $50 million for enforcement; and
- $8.6 million for direct file, the IRS program for allowing taxpayers to avoid the commercial tax preparation software.

Potential DNA search complications. Carmen Thomas turned to *23andMe* in search of information about her birth father. She learned that Kali Brown was likely her half sister, as well as Abigail Brown. Their father, Joseph Brown, had recently died. For one month, the three women corresponded, getting to know each other, but then Kali said that a break was needed.

As it turned out, the reason for the break was that the Brown sisters had filed a medical malpractice claim for their father's death. At trial, the jury awarded the estate $1 million and the sisters $9.5 million each. The case was later settled for an undisclosed amount.

Upon learning of the settlement, Carmen Thomas felt that she was entitled to share in it, as a biological heir, even though she never met or knew her father. A lawsuit has been filed alleging "unjust enrichment, conversion, interference with inheritance expectancy, and breach of fiduciary duty." The case is pending.

A bump in charitable giving? The Indiana University Lilly Family School of Philanthropy projects a 4.2% increase in charitable giving in the U.S. for this year, followed by a 3.9% increase in 2025. The increase is attributed to the strong stock market and higher net worths. These averages are higher than the long-term growth in charitable giving. Foundations are expected to see the largest increases, according to the study.

The Department of Labor released a final version of its fiduciary rule for retirement advisors in April. Roughly $1 trillion is rolled from 401(k) and other employer retirement plans to IRAs every year. There has been concern that retirees have not been getting the best advice on how to handle the money. "This rule protects the retirement investors from improper investment recommendations and harmful conflicts of interest," said Acting Labor Secretary Julie Su.

The rule takes effect on September 23, unless it is delayed by court action. Earlier attempts to extend fiduciary obligations to retirement advisors were struck down or narrowed through litigation.

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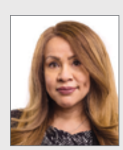
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