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ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

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WASHINGTON TALK

A smaller bump for the federal estate tax exemption is coming in 2025, according to Rev. Proc. 2024-40. In 2023 and 2024, the inflation adjustment came to almost $1 million each year, reaching $13.61 million in 2024. For 2025, the exemption will be $13.99 million. At the end of 2025, the exemption will be cut roughly in half under current law.

The annual exclusion will get a $1,000 increase, to $19,000.

Next year is shaping up as a landmark year for tax legislation, as portions of the Tax Cuts and Jobs Act of 2017 (TCJA) expire at the end of the year. Which elements should be made permanent? What are the possible revenue offsets?

The federal estate tax exemption amount, which was doubled in 2017, will certainly be on the table. Many Democrats favor letting the doubling expire, or reducing the exemption even lower. Republicans generally want to keep the current exemption or repeal the estate tax entirely. A few Democrats have signed on to estate tax repeal as well. The Death Tax Repeal Act (H.R. 7035) has 168 Republican cosponsors, and the Senate version of the bill (S. 1108) has 41 Republican cosponsors.

According to the latest IRS data published on estate taxes, in 2021 a total of 6,157 estate tax returns were filed. Only 2,584 of the returns owed estate taxes after allowing for credits and deductions. An unknown number of estate tax returns were filed simply to claim the Deceased Spousal Unused Exclusion (DSUE) amount. This compares to 13,526 estate tax returns filed in 2018 for deaths occurring in 2017, before the TCJA was enacted.

The Urban-Brookings Tax Policy Center reports that most of the collected estate tax revenue comes from the largest estates. Some 89% of the federal estate tax is paid by estates of $20 million and larger. The top 0.1% of wealth holders are estimated to pay 29% of the total estate tax.

An advocate for higher transfer taxes. *The Washing*ton Center for Equitable Growth issued a report in October calling on Congress to let the higher estate and gift tax exemption expire. Their claim is that wealth inequality is getting worse, and that subjecting many more estates to the federal estate tax is the remedy.

The report suggests that the bottom 50% of American families own only 2.5% of U.S. wealth; the next 40% have 30.5%; and the majority of wealth is owned by the top 10% of households. The top 0.1% of households have 13.6% of the wealth.

However, these richest estates are already subjected to the federal estate tax. Dropping the federal exemption down to $5 million or even lower would have little effect on the value of the largest estates, but it would create more work for estate tax specialists.

The report suggests four structural tax reforms that might have a larger impact on wealth inequality.

Replace the estate tax with an inheritance tax. Instead of calculating the death tax based upon the size of an estate, calculate it based upon the value received by each beneficiary after a lifetime exemption. Alternatively, make gifts and bequests subject to income and payroll taxes. Such a change has been projected to raise $1 trillion over ten years.

Repeal stepped-up basis. Eliminating the basis step-up at death has already been proposed by President Biden as a way of raising an estimated $510 billion over ten years. However, carryover basis was tried in the late Carter years, and it proved to be too difficult to administer, and so it was repealed.

Tax capital gains at death. A simpler alternative to carryover basis with a similar effect would be to treat death as a realization event. Payment of the tax on capital gains would reduce the taxable estate but would net an estimated $40 billion per year.

Treat unrealized capital gains as taxable income. This approach is often called a "wealth tax," and is not about taxing asset transfers such as inheritances. There are serious questions about the constitutionality of such a proposal.

For fiscal 2024, the Congressional Budget Office has estimated that the federal deficit came to $1.8 trillion. That was $139 billion larger than the 2023 deficit. Revenue was up 11% on the year, but spending rose 10%.

Estimated tax revenue for the fiscal year was $4.9 trillion, up by $479 billion. Spending was $6.7 trillion, up $617 billion. Individual income taxes raised $2.4 trillion, up 11%, and the payroll tax receipts rose 6%, to $1.7 trillion. Corporate income tax collections shot up 26%, to $529 billion.

Totals of federal estate and gift taxes were too small to merit a line item in the report.

A new analysis from the IRS projected that the "tax gap" in 2022 came to $696 billion. The gap is the amount of federal tax that went unpaid illegally. The largest component of the tax gap, at 77%, was underreporting of income on timely filed returns. Some 14% was tax that reported on time but not paid on time. The remaining 9% was nonfilers.

Although that sounds like a big number, the IRS stated that it is consistent with past measurements of the tax gap. Roughly 85% of taxpayers voluntarily comply with the tax laws, reporting and paying their taxes on time. This measure has remained consistent, but that means that as the economy grows, the tax gap grows as well.

The Heritage Foundation's Project 2025 has received some attention in the presidential campaign. Donald Trump has not endorsed the project, and in fact, his suggestions to eliminate income taxes on tips and overtime hours run counter to the Project's philosophy. Still, it may provide clues to changes that the Republicans will favor. What does Project 2025 advocate for taxes? Some highlights:

- *Estate and gift taxes.* The 2017 doubling of the amount exempt from transfer taxes should be made permanent, and the tax rate lowered to 20%.
- *Individual income taxes.* There should be only two tax rates, 15% and 30%. The top tax rate should begin at the Social Security wage base, so that the tax on wage income is nearly flat above the standard deduction.
- *Corporate taxes.* The corporate income tax rate should be reduced to 18%.
- *Capital gains*. Qualified dividends and realized long-term capital gains should be taxed at 15%.
- *SALT.* The deduction for state and local taxes should be repealed entirely.
- *Repealed taxes.* The Net Investment Income Tax should be repealed, together with the new taxes added to the Tax Code by the Inflation Reduction Act (such as the book minimum tax, the stock buyback excise tax, and the coal excise tax).
- *Supermajorities for raising taxes.* A three-fifths majority in the House and Senate should be required for increasing individual or corporate tax rates.

Moore fallout. An important unresolved question in tax law is whether there is a realization requirement for the imposition of the income tax. A number of politicians have proposed federal wealth taxes, to be applied to the unrealized capital gains of billionaires. Would this pass constitutional muster?

The Supreme Court's decision in *Moore v. U.S.*, No. 22-800, 144 S. Ct. 1680 was expected to address this issue, but it did not. Instead, the majority focused on the attribution of income from a company to its owners, and found an income tax appropriate to the specific circumstances.

In a 33-page dissent, Justices Thomas and Gorsuch suggested that the majority had changed the subject, and that resolution of the realization requirement was ripe for decision. "We granted certiorari in this case to answer whether Congress may 'tax unrealized sums without apportionment among the states.' As the Sixteenth Amendment makes clear, the answer to that question is a resounding 'no.'"

The dissent may provide a roadmap for future arguments and legal analysis of the constitutionality of a wealth tax.

PLANNING THOUGHTS

Final Regs. on basis consistency

In 2015, IRC §1014(f) was added to the tax code to require heirs to use the same tax basis for inherited assets as reported by the estate to the IRS for estate tax purposes. Actually, the requirement was already in place, but the new section added reporting tasks to make the enforcement of the rule easier. Temporary regulations (T.D. 9757) and proposed regulations (Reg-127923-15) were issued in March 2016. They have now been replaced by final regulations (T.D. 9991).

Tweaks

In response to comments, the IRS made several changes and clarifications for a more practical and commonsense approach.

No "zero-basis" rule. The proposed regs. included a rule that any property not reported on the estate tax return would have a tax basis of zero. The lost basis step-up was a fairly draconian penalty, and may have exceeded the scope of the law. The rule was dropped entirely in the final regs. The change does not absolve executors from the duty to find and report all assets in the estate.

Modified timing of reports. The proposed basis rules required basis reporting within 30 days after the filing of the estate tax return. The problem is that assets are often not distributed to beneficiaries that quickly. The final regs. call for the reporting by January 31 of the year following receipt of the property. That gives the beneficiary plenty of time to know their tax basis before their income tax returns must be filed.

Transfer reporting. The proposed regs. required basis reporting for post-death transfers of estate property, an obligation that continued indefinitely. This duty may also have been beyond the scope of the statute. The final regs. drop the requirement, except as to testamentary trusts.

Reactions

The final regs. were met with general approval. *Tax Notes* reported the observation of estate planner Turney Berry: "The reporting will be complex, but that is a result of the statute, so the only way you could make it simple is not to enforce the statute." Attorney Carol Harrington was quoted as saying "there's no widespread problem" that is solved by the new requirements.

The final regs. apply to estate tax returns filed after September 17, 2024.

CASES AND RULINGS

Company-owned life insurance is hit by the estate tax.

Connelly v. U.S., June 6, 2024

Using life insurance to fund a stock redemption by a business when an owner dies has long been a routine estate planning and business succession strategy. That was the approach used by brothers Michael and Thomas Connelly, the co-owners of Crown C Supply. For estate planning purposes, the brothers executed a buy-sell agreement, requiring the company to redeem the shares owned by the first one to die.

Michael died in 2013, when the company was worth about $3.3 million. Pursuant to the buy-sell, $3.0 million of the $3.5 million in life insurance proceeds were paid to redeem Michael's stock, and a federal estate tax was paid. The IRS audited Michael's estate tax return, and it determined an additional $1.0 million was due. Thomas, as the executor, paid the tax and went to the District Court for a refund.

The essential question was whether the $3.5 million of insurance proceeds was included in the value of the family-owned business, doubling its taxable value, and whether the value is reduced by the obligation to redeem the shares from Michael's estate.

In a unanimous June decision, the U.S. Supreme Court held that the insurance proceeds were owned by the company, and so boosted its value for purposes of the federal estate tax. What's more, the obligation to redeem the shares from the estate of the deceased owner did not create an offset, because paying for the redemption did not reduce the value of the company to the surviving shareholder. In short, it was a complete loss for the taxpayer, and a cloud over this estate planning strategy.

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Overvaluation of conservation easement triggers major penalties.

Brooks v. Comm'r, CA-4, July 15, 2024

A Virginia couple purchased 85 acres in Georgia for $1.35 million. They subdivided the property into two parcels, 44 and 41 acres. Next they donated a conservation easement over the 41-acre parcel to Liberty County, Georgia.

On their 2007 partnership tax return, the couple claimed a charitable deduction of $5.1 million for the conservation easement donation. Only $748,702 could be claimed in that tax year; the rest was carried forward.

The IRS audited the couple in 2015, and disallowed the carry-forwards for tax years 2010 and later (the statute of limitations had expired for earlier years). The couple took the matter to the Tax Court and lost [TC Memo 2022-122].

The couple appealed to the Fourth Circuit with no better luck. The Court identified a variety of errors in their legal arguments. "But more remarkable was their attempt to claim a $5.1 million deduction for a limited easement estate on property that they had purchased in fee simple for $652,000 only a year earlier. Such a claim simply does not pass any reasonable smell test, much less the tax law's requirements."

The Court sustained a 40% gross valuation misstatement penalty.

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Extension allowed for GSTT election

Private Letter Ruling 202428002

Taxpayer created irrevocable trusts for two children- trusts that potentially had exposure to the generation-skipping transfer tax. Taxpayer employed an accountant to report the funding of the trusts to the IRS on Form 709. Evidently the accountant did not discuss the issue of allocating the GST exemption to the trusts, because the Form did not elect out of the automatic allocation.

In a later year, new accountants hired by Taxpayer noticed the oversight, and suggested that Taxpayer ask for an extension of time to correct the filing. In private advice, the IRS granted the extension.

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Estate plan implemented under power of attorney a month before decedent's death fails to secure estate tax benefits.

Estate of Fields v. Comm'r, T.C. Memo 2024-90

Anne Milner Fields was born in Winnsboro Texas. She moved to Dallas after graduating from high school. Following a stint as a secretary, Anne met and married Bert Fields, Sr., an oil businessman. He died in 1963; the couple had no children.

Anne inherited the family business, for which she had no preparation. She enrolled in accounting and business classes at Southern Methodist University, and she enlisted business partners and advisers to bring her up to speed on the oil business. According to the Tax Court, "Her schooling, charisma, drive, and curiosity yielded good business decisions, which over time compounded into considerable personal wealth."

Anne never remarried, never had any children. She took a special interest in a great-nephew, Bryan Milner. She paid for his undergraduate and graduate education, as well as providing mentoring in his career as a banker.

In 2010 Anne signed her last will and testament, a statutory durable power of attorney for financial affairs, and a medical power of attorney. Bryan was named the executor of her estate as well as the holder of the powers of attorney. In 2011 Anne was diagnosed with Alzheimer's dementia. After questions were raised about Bryan's authority to buy a house for Anne, he had her examined by two doctors in 2012. They provided the medical opinion that Anne had been competent to sign the powers of attorney in 2010, but that by 2012 she was no longer competent. This gave Bryan the needed authority to act under the power of attorney.

During the week of May 2, 2016, Anne fell in the presence of one of her caregivers. On or about May 11, 2016, Bryan made contact with an estate planner. On May 13, Anne fainted and was sent to the hospital, where it was discovered that she had had a heart attack and had a spine fracture. On May 25, Bryan formed AM Fields Management, of which he was a 100% owner. On the same day he created a limited partnership, AM Fields. His management company contributed $1,000 to the partnership for a 0.0059% general partnership interest. As Anne's agent, Bryan contributed $17 million of her assets to the partnership in exchange for a 99.9941% limited partnership interest. The doctors sent Anne to hospice on June 15, and she died eight days later.

Bryan obtained an appraisal of the value of Anne's interest in the limited liability company for her federal estate tax return. The appraiser applied a 15% discount for lack of control over the partnership, and a 25% discount for the lack of marketability. The reported value for the partnership interest was $10.8 million, which, combined with other assets, triggered an estate tax liability of $4,617,800.

The IRS audited the estate tax return and concluded that the planning steps taken in the weeks before Anne's death had no meaningful effect; the entire value of the partnership must be included in her estate under IRC §2036. The Tax Court agreed.

What's more, an accuracy-related penalty was imposed upon the estate, even though the executor relied upon an appraiser for the value. Said the Tax Court: "Moreover, a reduction of approximately $6.2 million in the Estate's reportable assets thanks to the seemingly inconsequential interposition of a limited partner interest between Ms. Fields and her assets on the eve of her death would strike a reasonable person in Mr. Milner's position as very possibly too good to be true."

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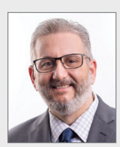

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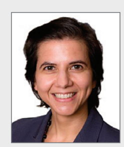

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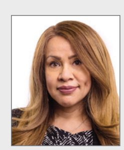

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