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Trusted Insights

WEALTH MANAGEMENT

Consequential proposals

Major tax reform was reported out of the House Ways and Means Committee in September, with a wide range of new rules that will affect many clients of estate planners. In this issue we explore two areas of change: trust and estate planning, and tax-preferred retirement accumulations.

There has been surprisingly little public debate over these tax proposals, perhaps because they have been overshadowed by the significant disagreements over the spending elements of the reconciliation package. It is possible that Congress will not have time before the end of the year to get these proposals enacted—but in that event, the proposed tax increases could return to the legislative docket early next year.

These tax reforms present pitfalls and opportunities for our clients. We look forward to working with you on public information efforts as work on them continues.

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Grantor trusts

THE LEGISLATION REPORTED BY THE HOUSE WAYS AND MEANS COMMITTEE ON SEPTEMBER 15 INCLUDED A VARIETY OF NEW TAX RATES AND RULES FOR TRUSTS:

- a new top tax rate of 39.6%, to apply to retained income above $12,500 (compared to the $450,000 threshold for marrieds filing jointly);
- a new 3% surcharge on modified adjusted gross income in excess of $100,000 (compared to a $5 million threshold for individuals);
- a new cap of $10,000 on the 20% deduction for qualified business income under 199A (compared to a new $400,000 cap for individuals and no cap at all under current law); and
- a potential top federal income tax rate of 46.4%, counting the 3% surcharge and the 3.8% net investment income tax.

However, as severe as these adjustments may appear, changes to the grantor trust rules may have an even more profound effect on estate planning. Grantor trusts have been designed to exploit a discontinuity between the federal estate and gift tax on the one hand, and the income tax on the other hand. An intentionally defective irrevocable grantor trust, for example, will be treated as a completed gift for transfer tax purposes, but will be taxed as if still owned by the grantor for income tax purposes. Taxes paid by the grantor are, in effect, additional tax-free transfers to the trust beneficiaries.

“ **However, as severe as these adjustments may appear,** changes to the grantor trust rules may have an even more profound effect on estate planning. ”

Two changes have been proposed by Ways and Means. First, gift or estate taxes would be imposed when a grantor trust is terminated. This could reduce or eliminate the utility of grantor-retained annuity trusts, spousal lifetime access trusts, intentionally defective grantor trusts, and the like. Second, a sale between a grantor trust and its owner would be treated as a taxable transaction. Until now the IRS has held that such a transaction is a nullity; it is a sale to oneself. The changes have estate planners scrambling.

Effective dates

The proposed legislation would also accelerate the reduction by half of the federal estate and gift tax exemption equivalent. The effective date for that change is the first of next year. The changes to the grantor trust rules would be effective upon the date of enactment of the legislation. Grantor trusts created before that date would be "grandfathered" under the legislative language and would not be affected unless additions were made to the trusts.

However, a clarifying House report was issued on September 26 suggesting that the new rule for sales between deemed owners and grantor trusts would apply to all post-enactment sales, regardless of when the trust was created. A footnote to the report admitted that a technical correction might be needed to put that intent into effect.

This would be a rather shocking result, according to some estate planners. Jonathan Blattmachr was quoted in *Tax Notes* as saying, "It's pretty harsh to say that if you set up something way before the presidential election . . . that you should now be caught by a change in the law." Some of the strategies being recommended earlier this year to "lock in" the larger federal exemption equivalent may no longer be optimal.

The tax legislation is attached to the reconciliation bill, and that legislation appears to be stalled at the moment in Congress. Evidently a compromise may be needed on the spending totals. In addition, the Senate Finance Committee may want to take a turn on drafting any new tax rules. Still, even if the new tax rules for trusts are not enacted this year, they most likely will not simply disappear from the legislative agenda. If they are adopted, tax observers predict a shift to non-grantor irrevocable trusts for managing transfer tax exposure.

Proposed IRA restrictions **for top taxpayers**

A 2014 GOVERNMENT ACCOUNTABILITY OFFICE STUDY (BASED UPON 2011 DATA) FOUND THAT ABOUT 9,000 TAXPAYERS HAD ACCUMULATED MORE THAN $5 MILLION IN THEIR IRAs. Some 314 had more than $25 million. Staffers from the Congressional tax-writing committees asked the Joint Committee on Taxation (JCT) to bring that report up to date. JCT discovered that as of 2019:

- 28,615 taxpayers had IRAs worth $5 million or more;
- 497 had more than $25 million; and
- those 497 taxpayers' IRAs totaled $77 billion (an average of nearly $155 million).

How is that possible, given the fairly low limits on IRA contributions ($6,000 this year, $7,000 for those 50 and older)? Venture capitalists are able to contribute start-up company stock to an IRA, and they do so when the stock has very little value and is not available to the public. They may do this with many different companies, hoping that some will explode in value—and evidently, some have. If the stock was placed in a Roth IRA, those gains will never be taxed.

According to a report in *ProPublica* last June, the co-founder of PayPal, Peter Thiel, did exactly that, and now has a Roth IRA worth some $5 billion. Even if the story is true, Mr. Thiel did nothing illegal. Nevertheless, the story sparked outrage in Congress, and the Build Back Better Act includes some major changes for IRAs that seem responsive to that story.

> "**The change that has received the most publicity** is also the least consequential."

New rules

The change that has received the most publicity is also the least consequential. Taxpayers who have aggregate vested accounts in defined contribution plans, including IRAs, 401(k)s, and 403(b)s, of $10 million or more would be prohibited from making a contribution to an IRA or a Roth IRA in years in which the taxpayer's income exceeds $400,000 (for married filing jointly, $450,000). Rollovers, inherited IRAs, and transfers incident to divorce would not be considered contributions for this purpose. Note that the taxpayer would still be allowed to contribute to a 401(k) plan if available.

Changes to permitted IRA investments are much more important. Under current law, an IRA may not invest in a company in which the IRA owner has a 50% or greater ownership interest. This threshold would be lowered to 10%. The IRA also could not invest in securities available only to "qualified investors" who have a specified minimum income or assets—in other words, securities not available to the general public, such as those Mr. Thiel invested in.

New RMDs

A new provision that seems specifically to target Mr. Thiel is an expansion of the required minimum distribution calculation for large IRAs and Roth IRAs. The general rule would be that half the account value in excess of $10 million would have to be distributed. A special rule would apply to Roth IRAs, for which 100% of the amounts greater than $20 million would have to be disgorged. The interaction of the two rules will be complicated. The 10% penalty for early withdrawals would not apply, but if the account owner is not yet 59 ½ the income tax would apply to the distribution of earnings from a Roth IRA.

> "**The retirement plan changes contemplated by Congress have high thresholds today,** accounts aggregating $10 million or more, but that could change in the future."

Why it matters

Some may remember that one of the promises made by Bill Clinton when he campaigned for President was a 10% surtax on the incomes of millionaires. The tax was adopted after his election. Because the top tax rate was then 36%, the 10% surtax came to 3.6%, yielding a new top tax rate of 39.6% (a rate that would be restored by the Build Back Better Act). Interestingly, the definition of "millionaire" was brought down to those with an income of $250,000 or more.

The retirement plan changes contemplated by Congress have high thresholds today, accounts aggregating $10 million or more, but that could change in the future. The Joint Committee on Taxation scored the proposed changes to retirement plans as raising only some $4.3 billion over the ten-year budget window. Those high thresholds could be easily lowered should there be a need for more tax revenue in future years. According to the Investment Company Institute's 2021 Fact Book, IRAs and defined contribution plans hold some *$22 trillion* in assets.

Short takes

No gift tax due when "gift" was made to create a contract.

Businessman Ronald Pratte hired Jeffrey Bardwell in 2001 to manage a Phoenix lumberyard. During the next four years the two became close friends. Ronald sold his construction business. He then met with Jeffrey and four other men at the Las Vegas airport. At that meeting he gave each man a check for $2 million, and expressed the wish that each would start a home construction business. Ronald reported the transfers as taxable gifts and paid the gift taxes on them. No, it's not the setup for a Hollywood movie—this really happened.

Ronald claims that, in exchange for the check, Jeffrey had promised to work for him for the rest of Ronald's life. Jeffrey counters that he made no such promise, that he understood the transfer to be an unrestricted gift. Ronald filed a lawsuit for breach of contract, and among the damages he claimed was his payment of gift taxes. Both sides moved for summary judgment.

The trial court held that the pleadings were sufficient to allow a jury to conclude that there had been an enforceable contract. However, if there was a contract, then there was no gift, and no need to pay the gift tax. Ronald apparently thought he had paid the gift tax for Jeffrey, but the obligation to pay the tax falls on the donor, not the donee. The court dismissed any damage claim based upon the erroneous gift tax payment [*Ronald H. Pratte v. Jeffrey Bardwell et al.;* No. 2:19-cv-00239].

Executor's assertion of ignorance as a defense to a failure to file an estate tax return survives a motion to dismiss.

David Leighton's sons, Frank and David Jr., were nominated as co-executors after David Sr.'s death in 2017. David Jr. refused the nomination to serve, leaving Frank as the sole executor. Frank diligently sought out professional advice for administering the estate, which he expected to be worth $1 million to $2 million. He properly filed the decedent's final income tax return and was advised that no estate tax return would be needed if the estate did not exceed $5.49 million. Accordingly, he let the time for filing an estate tax return expire without filing a return.

> "When the IRS failed to respond to his request for abatement, **he took the matter to the Court of Federal Claims.**"

About two years after David Sr.'s death, David Jr. revealed that a substantial trust had been created and funded with more than $5 million in assets, and a gift tax return had been filed reporting the transfer in 2012. Frank promptly arranged for the preparation of an estate tax return and paid estimated taxes, penalties, and interest on the overdue filing. He paid too much, and the IRS refunded an overpayment of roughly $50,000.

The IRS calculation included a late-filing penalty of $85,000. Frank objected that the penalty was improper, as he had acted reasonably with all the information that he had been given about his father's assets and giving history. When the IRS failed to respond to his request for abatement, he took the matter to the Court of Federal Claims.

The IRS moved to dismiss, arguing essentially that executors have no defense against failing to file a return. The Court rejected the motion, holding that the key question to be settled by a trial is "should the Executor or his tax advisors have known about the Decedent's funded trusts prior to their unveiling in 2019?" [*Frank T. Leighton et al. v. United States;* No. 1:21-cv-00840].

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