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Trusted Insights

WEALTH MANAGEMENT

A different "death tax" to worry about?

In this issue of *Trusted Insights*, you'll find a review of the Biden administration's proposal to make death a realization moment for the capital gains tax on appreciated property. If enacted, this new tax would affect far more estates than does the federal estate tax, even after the exemption equivalent for the estate tax falls roughly in half in 2026. As such it would require a major rethinking of many estate planning strategies.

Also in this issue, one interesting way to avoid post-mortem valuation debates with the IRS is to sell intellectual property during life. Greater certainty for heirs comes at the price of acceleration of some tax liabilities, but it could be worth it. That might have been the motivation behind Bob Dylan's sale of his royalties last year.

When your clients are in need of fiduciary services, we hope you will keep Webster Private Bank in mind. If you have ideas for our future coverage in *Trusted Insights*, we welcome them.

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Estate planning implications from the Green Book

"Importantly, the tax on capital gains at death would be deductible on the decedent's estate tax return, **if there is one, reducing double taxation.**"

WHEN PRESIDENT BIDEN PROPOSED THE AMERICAN FAMILIES PLAN, HE CALLED FOR AN END TO ADJUSTING THE COST BASIS FOR A DECEDENT'S HOLDINGS AT DEATH. The White House later clarified that a $1 million exemption would excuse smaller estates from this new tax, but the implementation details were left fuzzy.

The picture became much clearer with the release of the Treasury Department's Green Book on May 28, outlining legislative recommendations for fiscal 2022. Death and gifts would both be treated as realization events for appreciated assets. Dynasty trusts would have to pay tax on capital gains every 90 years. Gain realization would be deferred for family-owned businesses so long as the business remains family owned. For illiquid assets, such as fine art, the tax on the gain could be spread over 15 years.

The Green Book also includes the $1 million exemption for smaller estates and provides that the exemption would be portable between spouses. Transfers to a spouse or a charity would not be realization events. The exemption is in addition to the exemption from tax of the first $250,000 of gain from the sale of a principal residence ($500,000 for married filing joint returns). Also, for married couples, the residence gain exclusion would be portable, so married couples would have $2.5 million of nontaxable gain to work with. Finally, the exemption would be indexed for inflation.

Importantly, the tax on capital gains at death would be deductible on the decedent's estate tax return, if there is one, reducing double taxation.

However, when an exemption-protected gift is made, the donee will take the donor's tax basis, and so will have to pay tax on any potential gain if there is a sale. Some have observed that this seems like a waste of the exemption.

This new rule would not go into effect until the first of next year.

Retroactive taxes on long-term gains

Taxpayers with adjusted gross income in excess of $1 million will see the tax rate on their long-term capital gains jump from 23.8% under current law to 40.8%, according to the Green Book. (Others have mentioned a 43.4% tax rate—the sum of the new 39.6% top rate plus the 3.8% tax on net investment income.)

This rule would apply "for gains required to be recognized after the date of announcement," presumably April 28 when the fact sheet was released for the American Families Plan. In other words, the new top rate would be retroactive.

Oddly enough, the retroactive effective date was justified as preventing the wealthy from realizing gains early to avoid the tax rate increase. While it does achieve that goal, it would do so at the expense of revenue. If the wealthy did sell assets to lock in lower tax rates, much more money would flow to the IRS in the near term from their sales. Raising the rate will tend to have the opposite effect, slowing capital gain realizations. This phenomenon was observed when rates were changed in the 1986 Tax Reform Act.

It would appear that those who died with asset appreciation greater than the $1 million exemption could also owe the highest tax rate on their capital gains.

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Resistance

All 50 Republican Senators signed a July 21 letter to the White House in opposition to President Biden's proposal to eliminate basis adjustment at death, except for an exemption for the smallest estates. Such a change would be "a new backdoor death tax" that would cripple the economic viability of family farms and small businesses, according to the letter. The end result would be further consolidation of major agribusinesses.

Outlook

At this writing there are many uncertainties for these proposals. The Green Book does not propose any changes to federal estate or gift taxes, so it seems that there is still time to make use of the larger exemption amounts before their scheduled drop (roughly in half) in 2026.

Why did Bob Dylan sell his royalties?

ONE MAJOR CONUNDRUM WITH THE FEDERAL ESTATE TAX IS DETERMINING EXACTLY THE VALUE TO WHICH THE TAX APPLIES. The estate of musician and songwriter Prince provides an illustration of the sorts of disputes that may arise. Prince apparently died without having made a will or taken any other estate planning steps. What's more, there were tricky questions about who his heirs would be. The estate's executor had to attend to those matters at the same time that an inventory of Prince's assets needed to be compiled and valued.

The executor reported a total value for Prince's estate of some $82 million. The IRS believes that his fortune was nearly double that, $163 million. If the IRS is correct, that would mean additional estate taxes of $32 million and a penalty of $6 million for the substantial understatement of the tax liability on the estate tax return.

Recently the IRS and the executors of the Prince estate compromised on the taxable value of the late singer's real estate. They seemed to have split the difference—where the estate reported a value of $15.7 million for nine real estate parcels, and the IRS countered with $21.4 million, both sides settled for $17.7 million. The more difficult valuation questions still lie ahead, concerning the value of music royalties and Prince's likeness.

Bob Dylan's alternative?

In early December 2020, the music world was startled to learn that Bob Dylan had sold the copyrights to virtually all of his music to Universal Music Publishing Group. Terms of

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the sale were not disclosed, but the price was estimated at $300 million in news reports. Fans protested that songs such as "Blowin' in the Wind" were priceless.

Was Dylan "selling out" with this transaction? He did not comment on the matter, but observers suggested that selling a hard-to-value asset before death is rather a demonstration of responsible financial stewardship. Here are the estate management problems that Dylan solved with this move:

- *No arguments over values.* When you have an actual willing buyer and seller for an asset, there is no need to employ experts to rationalize a hypothetical value.
- *Liquidity for the estate.* One of the problems for the Prince beneficiaries if they lose their Tax Court case will be coming up with the cash to pay the tax—the IRS does not accept future royalty interests in payment of current obligations. Dylan's estate should have access to ready cash if major tax payments are due.
- *Flexibility for implementing lifetime wealth-management strategies*. Dylan may want to make transfers to his children or to trusts on their behalf. He may want to engage in philanthropy. With cash such strategies are simpler to implement.

> "The downside to making a sale of an appreciated asset during life **is that an income tax will have to be paid.**"

The downside to making a sale of an appreciated asset during life is that an income tax will have to be paid. If the asset is held until death, the tax basis is stepped up to fair market value, and so the tax on the capital gain may be largely eliminated.

Under the Songwriters Capital Gains Tax Equity Act enacted in 2006, Dylan's sale of his copyrights will be treated as a long-term gain, eligible for the preferential 20% tax rate. During the campaign, President-elect Biden suggested eliminating that tax preference for higher-income taxpayers. He also suggested scrapping the basis adjustment rule at death. So those tax factors may also have motivated Bob Dylan to make the sale sooner rather than later.

Short takes

Rates for top taxpayers

Given the deliberations in Congress over how to boost tax revenue from the top 1% of Americans, the bipartisan Joint Committee on Taxation has issued a detailed summary of the current tax system for wealth and high incomes. The report includes many interesting observations, as in the table below.

Income Group (Percentile)	Amount ($ Billions)	Share (Percent)	Average rate of all federal taxes (Percent)
Bottom 50	4,252	20.7	6.2
50-90	8,889	43.4	14.1
90-95	2,106	10.3	17.6
95-99	2,709	13.2	18.6
99-99.5	617	3.0	22.6
99.5-99.9	874	4.3	26.0
99.9-99.99	610	3.0	30.8
Top 0.01	447	2.2	32.9

Source: JCX 24-21, May 10, 2021

The progressivity of the current tax system is clear from this data, though it may not be as progressive as some might wish.

The income group of $1 million and up pays 63.3% of total federal estate taxes collected, over $12 billion in 2016, according to the report. While the top 1% have 12.5% of the national income, they own 30.8% of national wealth. Some very wealthy people live on relatively low incomes.

Transfer of inherited IRA assets to non-IRA account is held irreversible.

> **“Once the assets have been distributed from an inherited IRA,** there is no permitted method of transferring them back into an IRA.”

Parent named an irrevocable trust as the beneficiary of his IRA, designated ‘IRA X’ in this ruling. His children were the beneficiaries and trustees of the trust.

Soon after Parent died, the children were advised by the custodian of IRA X that they could not trade stocks in that account and that a transfer to another account would be required for it to happen. The custodian is not identified in the ruling. The children, acting as trustees, moved substantially all the IRA money to a non-IRA account that allowed for trading stocks.

Several months passed, and perhaps someone noticed the looming tax problem. The children asked the IRS for permission to move the money back into an IRA to preserve their tax benefits.

Sorry, no, says the IRS. “The only permitted method of transferring assets from an inherited IRA to another inherited IRA is via a trustee-to-trustee transfer, which requires a direct transfer from one IRA to another IRA. Therefore, once the assets have been distributed from an inherited IRA, there is no permitted method of transferring them back into an IRA.”

That conclusion also means the entire transfer of funds to the non-IRA account is taxable to the trust in the year that the transfer occurred. Thus, the children have inadvertently accelerated the income tax on substantially all of the inherited IRA assets. *[Private Letter Ruling 202125007]*

When making major financial decisions, it is prudent to work with a professional advisor/fiduciary to ensure that you are making the appropriate decision and avoiding any unforeseen pitfalls.