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estate planning briefs®

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The "new" estate tax

The Tax Cuts and Jobs Act, signed by President Trump last December 22, has sent an earthquake through the estate planning community, as demonstrated by the sessions at the Heckerling Institute. The actual changes are remarkably simple:

• The amount exempt from federal estate and gift tax has been doubled. The basic exclusion amount has been increased from $5 million to $10 million, plus an adjustment for inflation since 2011. There is some ambiguity about the application of the new chained inflation measurement, so the 2018 exclusion amount has been variously reported at $11.2 million and $11.18 million.

• The new law does not mention the generation-skipping transfer tax. The exclusion from that tax is the same as the estate and gift tax exclusion, so it also stands at about $11.2 million.

• The larger exclusion will expire as 2026 begins, along with all of the other individual tax provisions of the Tax Cuts and Jobs Act.

Planning for the federal estate tax will become a much smaller niche business in the next few years, as the number of estates that will be affected by it will fall dramatically. But at the same time, 2018 should be a very busy year for estate planners and for families across the wealth spectrum. Existing estate plans will need to be reviewed in light of the new law. There will likely be a greater emphasis on income tax planning and addressing tax basis questions.

We'll have much more on this topic in our April *Estate Planning Study*.

Prospects for 2018 tax legislation

When a tax extenders bill was filed in the Senate in December, House Ways and Means Chair Kevin Brady (R-Texas) said that those issues would be handled after the new year, together with an expected technical corrections bill. Technical corrections have been routine following major tax legislation, as oversights and misdrafting are discovered.

However, some Democrats have indicated that they may not cooperate with technical corrections legislation. What's more, Treasury Secretary Mnuchin said in January that he was not aware of any issues of the tax reform law that required technical correction.

2017 Roth conversions may still be recharacterized and reversed

The Tax Cuts and Jobs Act eliminated the taxpayer opportunity to reverse a conversion of a traditional IRA to a Roth IRA through a recharacterization, beginning January 1, 2018. Under the prior law, such recharacterizations were allowed until the due date for the tax return for the year of the conversion, generally October 15. Why might a taxpayer change his or her mind about the conversion to a Roth? Perhaps the taxpayer's income was greater than anticipated, so the tax cost of the conversion grew beyond expectations. Or perhaps the value of the investments in the Roth IRA fell significantly, and the taxpayer didn't want to pay ordinary income tax on the losses. In any event, the conversion of a traditional IRA to a Roth IRA is now irrevocable.

But what about conversions that happened in 2017, before the law change? Do those taxpayers also lose the right to recharacterize in 2018 as they do their 2017 taxes?

They do not, according to a set of Q&As that the IRS released in January. "A Roth IRA conversion made in 2017 may be recharacterized as a contribution to a traditional IRA if the recharacterization is made by October 15, 2018. A Roth IRA conversion made on or after January 1, 2018, cannot be recharacterized."

The elimination of taxpayer flexibility in conversions to Roth IRAs was projected by the Joint Committee on Taxation to raise less than $50 million per year for the next four years, then about $100 million per year in subsequent years, $500 million during the budget window.

COMMENT: How many recharacterizations of Roth conversions have happened in recent years? How many need to be blocked to increase federal tax revenue by $50 million? Won't the irrevocability of the conversion decision actually slow the rate of conversions to Roth IRAs, which would *lose* net revenue for the government, rather than gain it? It would be interesting to see JCT's methodology on this determination.

Taxes on e-commerce?

In January the U.S. Supreme Court agreed to hear *South Dakota v. Mayfair*, a case built on a statute specifically designed to overturn the Court's 1992 *Quill Corp. v. North Dakota* decision barring states from demanding sales tax collections from remote sellers unless the seller had a physical presence in the state. E-commerce has exploded since those days, and states believe that they are losing too much revenue. South Dakota's law provides some protection for smaller businesses by exempting those with fewer than 200 in-state sales and $100,000 worth of sales revenue. Several Justices have expressed skepticism about the "dormant commerce clause" theory underlying the *Quill* decision.

Attorney fees awarded to trustees

When Anna Smith died in 1991, her estate's main asset was a trust that she had created. The trust held 9,994 shares of stock in State Line Hotel, Inc., a Las Vegas hotel and casino, valued at $11,508,400. The total value of Smith's estate was some $15 million, triggering an estate tax liability of $6.6 million. The liquid assets of the estate were used to pay $4 million of the tax, and the balance was deferred for five years and then was to be paid over ten years when the estate made the IRC §6166 election.

Under Nevada law the trust could not continue as the owner of the hotel beyond 1993 without going through additional regulatory hoops. Therefore, the trust was dissolved, and the shares were divided among Anna's four children.

In 1995 the IRS decided that the estate had lowballed the value of the shares in the hotel, and it assessed additional estate taxes of $2.4 million. The estate contested the deficiency, and eventually it settled for an increase in the estate tax due of $240,381.

In 1997, about a week before the first installment of the deferred tax was due, an IRS agent contacted the executors of the estate to suggest "an alternative to your continued personal liability for the unpaid estate tax." The alternative was to execute a special lien for the estate tax, using the shares in the hotel as security. The four beneficiaries agreed to the

arrangement. Shares worth some $6 million (based upon the 1995 settlement) secured the tax debt of some $1.8 million.

However, after the IRS agent submitted the agreement to the District Counsel, she was advised that the IRS would not accept closely held stock as collateral because of potential problems with securities laws. The executors responded, through their lawyers, that any securities laws issues were the IRS' problem, not theirs.

To cut to the chase, the hotel went bankrupt in 2002, rendering the shares owned by the children worthless—in fact, they took deductions of over $1 million for their losses. That also rendered worthless the collateral that the IRS held for the tax debt.

Next, the IRS filed suit against Anna's four children to collect the balance of the estate tax due, under trustee, transferee, and beneficiary liability theories. By the time that the lawsuit commenced, two of the children had died. Their estates could have been substituted as parties to the action, but the IRS never made the necessary motions, so the suit against them was dismissed. Ultimately, the beneficiaries prevailed on most of the issues before the Court.

Now the beneficiaries have asked the IRS to pay half of their attorney's fees, specifically fees related to the discharge of fiduciary duties, to the liability of the trustees, and to the attempt to foreclose the tax lien. The District Court concluded that the government's position on these issues was not substantially justified, and it awarded the estate fees totaling $316,206.

— Johnson, Mary Carol S. et al. v. United States; No. 2:11-cv-00087

"Tea Party" settlement announced

The Justice Department has settled the last of the lawsuits over the IRS' conduct in reviewing groups for tax exempt status. "But it is now clear that during the last Administration, the IRS began using inappropriate criteria to screen applications for 501(c) status," said Attorney General Jeff Sessions. "The IRS's use of these criteria as a basis for heightened scrutiny was wrong and should never have occurred. It is improper for the IRS to single out groups for different treatment based on their names or ideological positions."

The IRS has issued an apology to the affected groups, which had their applications delayed for years.

Taxes and penalties when inherited IRA used to settle claim against an estate

After Thomas Ozimkoski died, a will contest broke out between his surviving spouse, Suzanne, and a son from an earlier marriage. In the settlement, the son received his father's 1967 Harley-Davidson motorcycle and $110,000 cash, "free of income taxes."

The only liquid asset in the estate was an IRA worth $235,495. After the money was rolled into an IRA for Suzanne, she withdrew $110,000 to make the payment to the son. During that year she also withdrew about $64,600 for herself, which left about $60,000 in the IRA.

Suzanne's income was only about $15,000. She filed her tax return in May, 24 days late. Suzanne did not report the IRA withdrawals on her Form 1040, apparently believing that the son would have to pay the income tax on his $110,000 payment. She was mistaken.

The IRS assessed the following taxes on Suzanne: $3,100 for failing to file a timely return; $21,988 of income tax; $17,460 penalty for the premature distribution (Suzanne was not yet 59½); and $12,437 penalty for the substantial underpayment of tax. The total came to $62,185.

Suzanne lost her case in the Tax Court, as there is no provision in the tax code that allows for the payment of estate settlements from an IRA. The penalty tax was partially abated, as the Court held it was reasonable (though mistaken) for Suzanne to have expected the son to pay income taxes on his share. The Court noted that Suzanne had not received very good tax counseling.

—Ozimkoski v. Comm'r, T.C. Memo. 2016-228

COMMENT: Should Suzanne withdraw the $60,000 balance of the IRA to pay the IRS bill, she will owe additional income tax on that withdrawal.

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