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Tax reform update

The legislative process for tax reform this year is as unique as many other aspects of the Trump administration.

On July 27 the Trump administration released a joint statement on tax reform, signed by Treasury Secretary Steven T. Mnuchin, Speaker of the House Paul Ryan, Senate Majority Leader Mitch McConnell, Senate Finance Committee Chairman Orrin Hatch, House Ways and Means Committee Chairman Kevin Brady, and National Economic Council Director Gary Cohn. Key goals include:

• tax relief for families;

• lower tax rates for small business;

• simplification; and

• "a system that encourages American companies to bring back jobs and profits trapped overseas."

The most important news in the statement was that the border-adjustable tax has been dropped. The statement made no mention of federal estate taxes.

The emerging consensus of tax observers seems to be that there is a good chance for some rate reductions—possibly temporary—for individual taxpayers this year, as well as changes to taxation of multinationals. The GOP needs a win after the failure of health insurance overhaul. Tax reform of the scope achieved in1986 no longer appears likely.

The administration is passing the tax relief torch to Congress, so hearings are expected in September, a House vote in October, and a Senate vote in November.

COMMENT: That timeline could prove deeply problematic for the IRS if the legislation includes any retroactive elements affecting the 2017 tax year.

Farmers against taxation

Representatives of the agricultural industry met with Treasury Secretary Mnuchin in late July to explain their needs from tax reform. On their wish list:

- repeal of the federal estate tax;
- retention of basis step-up at death;
- preserving the tax treatment of like-kind exchanges;
- maintaining the deduction for interest expense; and
- continued allowance of cash accounting.

COMMENT: In past debates over estate tax repeal, the lost revenue from abandoning the estate tax has been offset by the gains from eliminating basis step-up at death. That was the trade made in 2010, the year that initially was without a federal estate tax. Hoping for both tax breaks after tax reform is a bit like having your cake while also eating it, and seems unlikely.

Adoptee's inheritance from biological parent

Marrion's will left her residuary estate to "my children," Russell and Marcia. The will was executed in 2006. In 2007 Russell was adopted as an adult by his paternal aunt for the express purpose of avoiding Iowa's inheritance tax. Unlike an estate tax, which only has deductions for surviving spouses and charities, an inheritance tax may include exemptions and special tax rates depending upon the relationship of the heir to the deceased.

After Marrion died in 2014, Marcia challenged her brother's right to inherit under their mother's will. As a result of the adoption, Marcia argued, he was now Marrion's nephew, not her child in the eyes of the law. It was uncertain whether Marrion ever learned of the adoption. Barring Russell's inheritance would be consistent with Iowa's public policy of severing the relationship of an adopted-out child with his or her biological parents for purposes of intestate succession and inheritance tax.

The Iowa probate court disagreed, and the Iowa Supreme Court has affirmed that decision. Russell was identified by name in his mother's will; he received his inheritance based upon that fact, not by being a member of a class of persons ("my children"). Allowing a testamentary gift to a child who has been adopted by another does not violate any public policy.

—Roll v. Newhall, 888 NW2d 422 (2016)

Trustee removal denied

Edward Taylor created a trust in 1928 for his daughter Anna and her descendants. The trust has always had a corporate trustee and co-trustees. Anna became a co-trustee when Edward died in 1939, for example. The trust is irrevocable, and it will terminate in 2028. In 2009 four subtrusts were created, one for each of Anna's four grandchildren.

In 2013 three of the grandchildren asked that the trust be amended, to permit them to change the corporate trustee without cause. The trustee resisted, even though there was then no plan of removal, because the trust did not permit it.

The Orphans' Court denied the grandchildren's request; the intermediate appellate court approved it; and the Pennsylvania Supreme Court has reversed. The situation is governed by sections 7740.1 and 7766 of Pennsylvania's Uniform Trust Act. Those sections were found to be ambiguous by the Court, making a tour through the legislative history necessary. The Court concluded that under the statute the trust could not be amended to grant the removal power.

COMMENT: Modern trusts typically address the question of trustee removal explicitly. This was not the case when the Taylor trust was drafted in 1928. The beneficiaries were asking only that their trust conform to modern practice, but the Court was unpersuaded.

—Trust Under Agreement of Edward Winslow Taylor, Supreme Court of Pennsylvania Eastern District, No. 15 EAP 2016

Social media fair game for the IRS?

Two law professors at Washington State University have warned that the IRS has turned to data mining of social media in its enforcement efforts [Houser and Sanders, "The Use of Big Data Analytics by the IRS: Efficient Solutions or the End of Privacy as We Know It?"]. The demise of the Taxpayer Compliance Measurement Program left a data gap that needs to be filled, and social media may provide part of the solution.

The professors warn of the dangers of abuse of secret data collection systems. Taxpayers may have an expectation of privacy when they are online, but this is an error. Anything that may be seen by the public may be seen by the IRS. The Service then pairs this information with its own databases in a process of data analytics. "For the IRS, data analytics is not trying to predict the future behavior of taxpayers, but predicting data that it does not have; that is, predicting whether tax returns are compliant with the tax law." Given the data breaches that the IRS itself has experienced, as well as questionable IRS targeting practices of recent years, the concerns raised by the professors seem warranted.

19 Vand. J. Ent. & Tech. L. 817 (2017), http://www.jetlaw.org/wp-content/uploads/2017/04/Houser-Sanders_Final.pdf

Bankruptcy and life insurance

Richard Sharif declared bankruptcy. Among his listed financial assets were a life insurance policy on the life of Soad Wattar, who had died earlier that year, and the Soad Wattar revocable trust, of which Sharif was a beneficiary. The bankruptcy court ordered the insurance company, which held the $500,000 of insurance proceeds, and the trustee of the $1.6 million trust to turn those assets over to it. They complied.

Ragdah Sharifeh and the estate of Soad Wattar then sued the insurance company and the trustee, claiming that the property rightfully belonged to them. The lawsuit was dismissed for lack of standing. The insurance policy clearly stated that Richard was its owner, not Ragdah. The estate of Soad Wattar had no claim to the trust assets, as a primary purpose of creating a revocable trust is to avoid having assets pass through the probate estate. Claims of a breach of fiduciary duty were dismissed as well.

—The Estate of Soad Wattar v. Hartford Life and Annuity Insurance Company, USDC IL No. 16 cv 4397

No GST tax upon trust reformation

Decedent's trust, which became irrevocable before September 25, 1985, provided discretionary income for Son and his heirs. At Son's death, the trust was to be divided into shares for Son's children, with one-half distributed to the child at age 30 and the balance at age 35. Should any child die before attaining that age, his or her share would pass in equal shares to that child's own children (Son's grandchildren).

However, the trust instrument failed to address the situation in which one of Son's children dies before he does. That is what has happened, Son's daughter has died, and her children will potentially be disinherited. That is an oversight that the family has asked the local court to correct.

However, there are potential tax consequences to this change in the trust instrument. It could lose the grandfathering protection from the generation-skipping transfer tax; there could be an imputed gift to the otherwise disinherited heirs; there could be estate inclusion issues.

Happily, the IRS concludes that this was a bone fide scrivener's error, and that the reformation would be consistent with the intention of the trust's creator. There is a state statute authorizing just such a reformation in this sort of situation. Accordingly, none of the feared tax consequences will materialize.

—Private Letter Ruling 201732029

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