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INVESTMENT & TRUST SERVICES

Estate Planning REPORT

March/April 2019

PLANNING THOUGHTS

Perspectives on federal transfer taxes

In March the Congressional Joint Committee on Taxation released a summary of the current state of federal taxation [JCX 9-19]. The sources of federal revenue were identified and ranked. As has been true for many years, the federal estate, gift, and generation-skipping transfer taxes were bringing up the rear. One of the arguments for repealing federal estate taxes entirely is that they are inefficient, in that the compliance and enforcement costs are large for a relatively small amount of federal revenue.

The report included appendices that put the various revenue sources into historical context.

The income tax has long been the primary driver, at 45% to 50% of total collections over the years. Despite the tax reductions for many taxpayers in the Tax Cuts and Jobs Act of 2017, 2018 proved to have record personal income tax collections, at $1.683 trillion, an increase of nearly $100 billion over 2017. The increase is attributable to the growing economy. The trillion-dollar mark was first breached in 2000, and again in 2006–2008. The recession contracted income tax collections below $1 trillion for the next two years.

2018 was the first year that personal income taxes provided more than 50% of federal revenue. The share touched 43% in 2004, and it has never been below that figure since 1969, the first year of the report.

Social insurance taxes come next, with a record $1.170 trillion paid in 2018. Social insurance taxes have provided roughly 30% to 35% of total federal revenue. The highest share was 40.0% in 2010, the lowest 20.9% in 1969. In 2018 the share was 35.2%

The share of each of these has been fairly consistent despite the many tax law changes that have occurred over the years. Corporate tax collections have been more volatile, as they are more sensitive to the economy generally. In 2006, for example, corporations paid 14.7% of total federal taxes. This fell by roughly a third, to 9.0% by 2017, the year before the reforms of the Tax Cuts and Jobs Act of 2017. The estimate for 2018 is 6.2%—the same as it was in 1983.

Below is a table of the contribution share of these three taxes to federal revenue for selected years.

Federal receipts by source, as a percentage of total revenues

Year	Personal income tax	Social insurance taxes	Corporate income tax
1969	46.7%	20.9%	19.6%
1979	47.0%	30.0%	14.2%
1989	45.0%	36.3%	10.4%
1999	48.1%	33.5%	10.1%
2009	43.5%	42.3%	6.6%
2018	50.6%	35.2%	6.2%

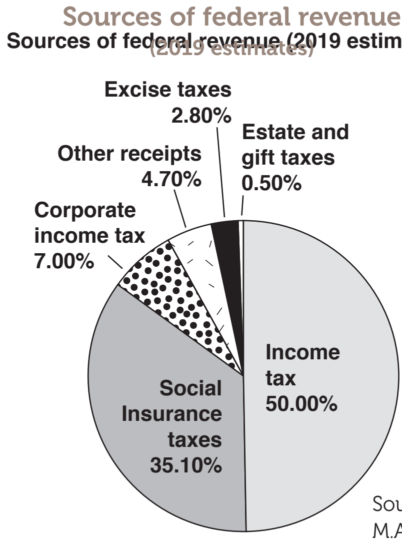
Source: JCX 9-19; M.A. Co.

Transfer taxes

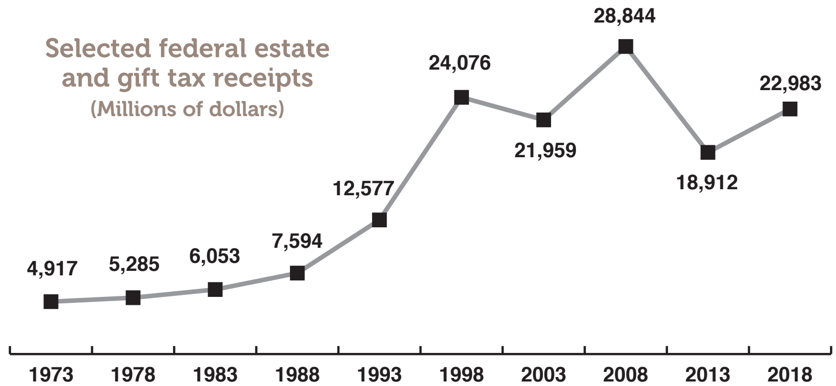
In contrast, federal estate and gift taxes provide a scant 0.7% of total federal revenue. Their share was over 2% in 1971-1973, and that has hovered near 1% since 1990. The relative insignificance of estate and gift taxes will likely worsen, as this report covers periods before the doubling of the amount exempt from such taxes.

Shares are one thing; dollars are another. The amount of estate tax revenue collected has been growing, despite the substantial increase in the exemption amount. Some $22.9 billion in federal estate and gift taxes was estimated to have been collected in 2018. That sounds like a lot. But to put it into perspective, the federal excise tax on gasoline raised $22.5 billion that year; the excise tax on tobacco brought in $13.0 billion; and the excise tax on alcohol was worth $10.6 billion.

The high water mark for transfer tax collections was 2000, at some $29 billion. The lowest amount in this



Source: JCX 9-19; M.A. Co.



Source: JCX 9-19; M.A. Co.

report was $3.4 billion in 1969. Collections fell to $7.3 billion in 2011, as 2010 was the year when the federal estate tax was optional.

Another way to look at the various taxes is as a percentage of gross domestic product. On this basis, estate taxes were highest in the early 1970s, at 0.3% to 0.4% of GDP. They have not been higher than 0.2% of GDP since 1978, and were 0.1% in 2018.

Personal income taxes have ranged from 7.1% in 2011 to 9.3% in 1998. Social insurance tax averaged 4.9% of GDP through the period, and corporate tax averaged 2.6%. The largest total federal tax burden occurred in 1981, at 19.1% of GDP. The lowest, 14.6%, happened in 2009 and 2010, following the recession.

Below is a table of impact on GDP of the various taxes for selected years.

Federal receipts by source, as a percentage of GDP

Year	Personal income tax	Social insurance taxes	Corporate income tax
1969	8.9%	4.0%	3.7%
1979	8.5%	5.4%	2.6%
1989	8.0%	6.5%	1.9%
1999	9.2%	6.4%	1.9%
2009	6.3%	6.2%	1.0%
2018	8.3%	5.8%	1.0%

Source: JCX 9-19; M.A. Co.

CASES AND RULINGS

When S corporation stock is valued, the economic environment must be taken into account. Significance of family transfer restrictions is held unproven.

James F. Kress et ux. v. United States; No. 1:16-cv-00795

Green Bay Packaging Inc. was founded in 1933 by George Kress. The firm manufactures corrugated packaging, folding cartons, coated labels, and related products. It remains privately held, though it employs about 3,400 people in 14 states. The Kress family owns 90% of the stock, and the remaining shares are owned by employees and directors of the company.

In order to keep the family business in the family, members of the Kress family have engaged in systematic intrafamily gifts of stock. In 2007, 2008, and 2009 James and Julie Kress made substantial taxable gifts to their children and grandchildren, and they paid federal gift taxes of over $1.2 million each.

The IRS audited those gift tax returns and concluded that the shares were undervalued. For example, where the couple had reported a value of $28.00 per share in 2007, the IRS believed that $45.97 was closer to the true value. The couple paid the deficiency and sued for refund.

At trial the IRS did not provide a rationale for the $45.97 figure. Their expert concluded that $38.04 was the appropriate per share price. The Wisconsin Federal District Court picked apart the analysis, and rejected it. The appraiser had failed to take into account the worsening economy in the years that the gifts were made, and at least one of his "comparables" was not truly comparable at all.

However, the taxpayer's expert was not accepted in full either. The expert had applied a marketability discount of 30% to reflect the lack of liquidity in the holdings and the restrictions in place to keep the family holdings in the family. The Court believed that the appraiser failed to demonstrate the impact of the specific family transfer restrictions on value, and reduced the discount to 27% The bottom line was that the share value in each of the three years went up by about $1.

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An extension is granted to elect special use valuation.

Private Letter Ruling 201908018

The date of D's death is not given in this ruling, but he owned farmland when he died. His wife was named the executor of his estate, but her attorney did not tell her about the election under IRC §2032A to value the farm property for its agricultural use rather than its fair market value. When the wife timely filed Form 706, the election was not made. Wife was later removed as executor by the probate court, and an Administrator Ad Litem was appointed. He hired an accounting firm to review the tax filings, and that firm also overlooked the §2032A election. A supplemental Form 706 was filed to make corrections to the first filing, and still the election was not made.

The ruling does not make clear what event caused the realization that this overlooked election could have saved the estate considerable tax dollars, but now an extension has been requested to make the election. The IRS concludes that everyone acted reasonably and in good faith relied upon tax professionals, so an additional 120 days is granted to file another Form 706 making the special use valuation election.

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Government's collection action is held to be timely; award of attorney's fees is reversed.

United States v. Mary Carol S. Johnson et al.; CA-10, No. 17-4083; No. 17-4093; No. 18-4036

Here is an estate tax case that causes one to think of Dickens' *Jarndyce and Jarndyce*.

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 District Court.

Next, the beneficiaries 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.

The Tenth Circuit Court of Appeals now reverses that judgment. The taxpayers had relied upon the six-year state law statute of limitations, when the federal ten-year limitation is what should apply in this case.

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If her proposal for an annual wealth tax fails to gain traction, Senator Elizabeth Warren (D-Mass.) has an alternative to consider, an increase in the federal estate and gift tax. Her bill, the American Housing and Economic Mobility Act of 2019 (S. 787), would:

- nearly double transfer tax rates, with a 55% basic tax rate, 60% for estates larger than $13 million, 65% for those over $93 million, and 75% for those above $1 billion;
- slash the basic exclusion from transfer taxes by two-thirds, to $3.5 million;
- cut the gift tax annual exclusion by 33%, to $10,000, and limit donors to two such exclusions per year;
- mandate a minimum 10-year term for grantor annuity trusts;
- kill the exemption from the generation-skipping transfer tax for certain trusts; and
- amend the grantor trust rules.

The bill has not yet been scored by the Joint Committee on Taxation.

A bipartisan investigation of conservation easements is under way in the Senate Finance Committee, with letters having been sent to 14 people asking for testimony. The concern is that the deduction for a contribution of a conservation easement has been abused when partnerships use high appraisals to inflate deductions. Committee Chair Chuck Grassley (R-Iowa) is concerned "when a handful of individuals cook up a scheme to cash in at the expense of federal revenue and in violation of Congress's intent."

Several groups that are active promoting conservation easements, including the Land Trust Alliance and Partnership for Conservation, came out in support of the investigation.

Stretch IRAs are under fire. Bipartisan bills are working their way through the House and Senate, intended to expand access to tax-preferred retirement accounts. In the House there is the SECURE ACT (Setting Every Community Up for Retirement Enhancement Act, H.R. 1994), and the companion in the Senate is the Retirement Enhancement and Savings Act of 2019 (S. 972). Each bill targets stretch IRAs to find offsetting revenue for the new taxpayer incentives. The acceptable beneficiaries for stretch IRAs would be limited, and distribution of the inherited IRA would be required within ten years in the House bill and five years in the Senate bill.

The ranking Democratic member of the Senate Finance Committee, Senator Ron Wyden of Oregon, has a new idea for wringing more tax dollars from the wealthy. He proposes that investments be marked to market annually, and ordinary income tax rates be applied to the unrealized gains. Reportedly, Wyden is preparing a white paper on the strategy. A similar proposal was scored by the Joint Committee on Taxation in 2016 as raising $16.5 billion over ten years.

Welcome SALT guidance. The IRS will apply the tax benefit rule to taxpayers who receive state tax refunds and who exceeded the $10,000 cap on deductions for such taxes, according to *Revenue Ruling 2019-11* (2019-17 IRB 1). Four examples are included. The holding is: "If a taxpayer received a tax benefit from deducting state or local taxes in a prior taxable year and the taxpayer recovers all or a portion of those taxes in the current taxable year, the taxpayer must include in gross income the lesser of (1) the difference between the taxpayer's total itemized deductions taken in the prior year and the amount of itemized deductions the taxpayer would have taken in the prior year had the taxpayer paid the proper amount of state and local tax or (2) the difference between the taxpayer's itemized deductions taken in the prior year and the standard deduction amount for the prior year, if the taxpayer was not precluded from taking the standard deduction in the prior year."

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