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Will 2024 be a pivotal year for estate planning?

The U.S. Supreme Court very rarely decides cases concerning estate planning or wealth management, so 2024 could be remarkable. The Court accepted two important cases with potentially far-reaching implications. Arguments for one case have been heard already. Decisions are not expected until the spring.

What is a closely held business worth?

Crown C Supply was a family business owned by Michael and Thomas Connelly. Michael owned 77.18% of the stock, Thomas the remaining 22.82%. For estate planning purposes, the brothers executed a buy-sell agreement, requiring the company to redeem the shares owned by the first one to die. The company was not cash rich, so life insurance was purchased to be able to meet the obligation. However, the company was not required to use the life insurance proceeds for that purpose. This is a fairly routine estate planning strategy for small businesses.

Michael died in 2013, when the company was worth about $3.3 million. Pursuant to the buy-sell, $3.0 million of the $3.5 million in life insurance proceeds were paid to redeem Michael's stock, and a federal estate tax was paid. The IRS audited Michael's estate tax return, and it determined an additional $1.0 million was due. Thomas, as the executor, paid the tax and went to the District Court for a refund.

The essential question is whether the $3.5 million of insurance proceeds affects the value of the family-owned business and whether it is offset by the obligation to redeem the shares.

In the Courts. Unfortunately, the brothers had not fully complied with their buy-sell agreement, in that they had not updated the company valuation, nor had they conducted an independent appraisal of the company. As a result of those failures, the District Court held that the agreement did not set the price for the value of the shares. The Court reasoned that without a clearly determined share price, the enterprise value of the company

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must be increased by the value of the insurance proceeds it received, sustaining the IRS' higher valuation and increased estate tax due.

The Court of Appeals unanimously affirmed the receipt of the proceeds increased the shareholders' equity in the company. The Court also held that "an obligation to redeem shares is not a liability in the ordinary business sense." When the corporation purchases its own stock, there is a corresponding increase in the value of shares still outstanding.

The estate appealed the ruling to the U.S. Supreme Court, alleging that there is a split in the circuits sufficient to warrant the Court's attention. The question is presented as: "Whether the proceeds of a life insurance policy taken out by a closely held corporation on a shareholder in order to facilitate the redemption of the shareholder's stock should be considered a corporate asset when calculating the value of the shareholder's shares for purposes of the federal estate tax." In December, the U.S. Supreme Court agreed to hear the case.

Comment. Using life insurance to fund a stock redemption agreement has long been a routine estate planning and business succession strategy. The Connelly decision casts a cloud over it. The broad language and economic analysis used by the court could potentially threaten legitimate shareholder agreements, even if they are followed to the letter. Small business owners need to keep an eye on this one.

If the insurance purchased by a company effectively also becomes subject to the estate tax, much more insurance must be purchased to obtain liquidity for both the redemption and the tax payments. An alternative to consider that reduces the problem could be cross-purchase agreements, but for businesses with more than three owners, this approach becomes unwieldy. Guidance on this subject from the U.S. Supreme Court will be much appreciated.

What is income?

Under the U.S. Constitution, direct taxes must be apportioned among the states. An income tax is a direct tax, and the early attempts to create a federal income tax were declared unconstitutional, as they were not apportioned, making a constitutional amendment necessary to create today's income tax regime. Indirect taxes, such as tariffs, which are passed along to consumers, do not need to be apportioned.

Charles and Kathleen Moore invested $40,000 in a start-up company that provided better tools to subsistence farmers in India. The company was a huge success, but it reinvested all of its profits in expanding its market. The firm grew to hundreds of employees, thousands of dealers, and millions of customers. The Moores never received a financial return from their investment but were more than pleased with the success of the company that they helped to fund. The growing success of the Indian farmers was their reward.

In the 2017 Tax Cuts and Jobs Act, the taxation of multinational firms was reformed. One element of that change was the imposition of a one-time tax on accumulated foreign earnings, a mandatory repatriation tax (MRT). The Moores received a tax bill for $15,000 on the accumulated but undistributed earnings from their investment.

The couple paid the bill and sued for a refund. They argued that they have received no financial reward from their investment, no "income" as that term is used in the tax law, and therefore that $15,000 MRT was effectively a property tax, not an income tax. As such, it would have to be apportioned, and as it was not, the tax itself is unconstitutional. What's more, the MRT was a retroactive tax, a violation of due process.

In the Courts. The district court granted the government's motion to dismiss for failure to state a claim and denied the Moores' cross-motion for summary judgment. It held that the MRT taxed income and, although it was retroactive, it did not violate the Fifth Amendment's due process clause. The couple appealed.

The taxpayers had no better luck with the Ninth Circuit Court of Appeals. That Court held that the apportionment clause applies only to capitations or land taxes. There is "no set definition of income under the Sixteenth Amendment." Taxpayers do not have to realize income for the income to be taxable, according to the Court. Realization is not a constitutional requirement. What's more, Congress in the past has disregarded the corporate form to facilitate taxing shareholder income.

Similarly, the Court held that there is no constitutional bar to retroactive taxes, though there may be a presumption against retroactivity. Here, the retroactive nature of the MRT served a legitimate purpose, as without it the pre-2018 foreign income would escape tax forever.

The U.S. Supreme Court accepted the taxpayers' appeal and heard oral arguments in December. It appeared to some observers that the Court was looking for a narrow decision to resolve the case.

Comment. There is potentially much more at stake in this case than the mandatory repatriation tax. A bedrock principle of taxation has long been the requirement of a transaction for income to be taxable—payment of wages, for example, or a sale of an asset. But against this, there is also a well-developed body of tax law on taxing pass-through income to partners, whether they receive it or not.

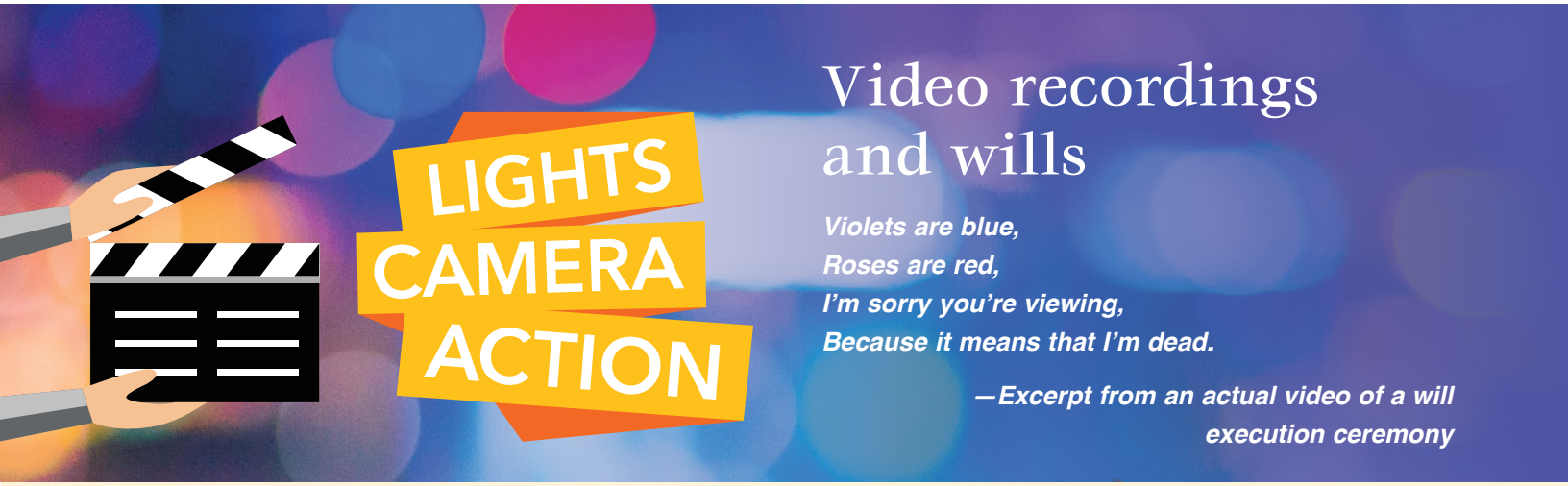
If realization of income is not a prerequisite to taxation, could Congress impose a tax on asset appreciation even without a sale of the asset? In fact, some politicians have already proposed doing just that, calling it a "wealth tax." Washington state is considering just such a wealth tax at the state level, which, if enacted, would cost Amazon's Jeff Bezos well over $1 billion every year. By coincidence, Mr. Bezos has already announced he is moving to Florida for personal reasons.

A sweeping decision by the Supreme Court could open the door to wealth taxes at the federal level, or it could slam the door closed, barring another Constitutional amendment. On the other hand, the Court may be able to craft a narrow decision that leaves the issues attending a wealth tax for another day.

Summing up

The most difficult aspect of estate planning is not knowing what the future may bring, how the tax laws may change, what may happen in the economy and financial markets, and in the path of family dynamics and circumstances. That's why estate plans should be reviewed periodically for their adequacy.

If you have questions about estates and wealth management, we would be pleased to share our knowledge with you. Call for an appointment at your earliest convenience. ☐



Video recordings and wills

Violets are blue,
Roses are red,
I'm sorry you're viewing,
Because it means that I'm dead.

—Excerpt from an actual video of a will execution ceremony

As video recording has become ubiquitous in recent years, more and more people have considered adding a video element to their estate plans. Such a video could simply be a final farewell, or an exhortation to heirs to use their inheritance wisely.

Or the video could have legal consequences.

If heirs don't get along, or if there is a chance that the will might be contested, a video of the will execution ceremony can prove indispensable in fulfilling the wishes of the testator.

Visual impact

A video that is created at the time that a will is executed, under the supervision of an attorney, might be used for any or all of the following purposes in subsequent litigation:

- ***To show testamentary capacity.*** The will maker can be questioned, and the answers can be recorded, proving that he or she understands the effect of making a will, comprehends the nature and extent of the property being passed by the will, realizes that a will is being executed, and demonstrates an appreciation of the family situation sufficient to form a coherent plan for the distribution of the estate. When the will maker is elderly, a video proving these points could be especially useful.
- ***To show due execution of the will.*** The video may show the testator declaring the document to be his or her will and signing it, along with the witnesses' signatures to the will.
- ***To show testamentary intent.*** The testator may discuss the reasoning behind elements of the estate plan, to prove that they are fully understood.
- ***To show the lack of undue influence or fraud.*** The will maker can explain on the video that the will is being made voluntarily. If there is an unexpected provision, such as a disinheritance, the reasons may be articulated.
- ***To assist in will interpretation.*** Statements made by the testator contemporaneously with the will execution could prove helpful if any will provisions subsequently appear to be ambiguous. By explaining what he or she means by certain words and phrases, the testator can preserve evidence of his or her intent, which could be invaluable if a dispute later arises.

To learn more

If you want to create a video memorial to be shown at your funeral, a talented family member can be a great resource. To add an element of certainty to an estate plan with a video, consult with your estate planning advisors at your earliest convenience. A variety of formalities will need to be followed to be confident that the video will have the desired legal effect. ☐

Fewer estates owe federal estate tax

Out of every 10,000 deaths in 2019, only 8 estates owed federal estate taxes, according to the most recent IRS data. The Institute on Taxation and Economic Policy published "The Estate Tax is Irrelevant to 99% of Americans" in December 2023, summarizing the IRS report [itep.org/federal-estate-tax-historic-lows-2023/]. From 1997 to 2001, over 2% of estates paid were affected by the federal estate tax, a high-water mark, and the share fell below 1% in 2004. It continued to sink, breaking the 0.10% level in 2018.

The reason fewer and fewer estates owe the tax is that the growing exemption amount works to target the tax to the very wealthiest estates. The inflation adjustment to the exemption for 2024, an increase of $690,000, is larger than the entire exemption was in 2001 and earlier years. As a result, the majority of estate tax revenue in recent years comes from estates of $50 million and up.

Although the statutory estate tax rate is 40%, according to the report the average taxable estate in 2019 paid 19.7% of its assets to the IRS, after taking into account the exempt amount, charitable legacies (averaging 10.7% of the estate) and state death taxes (2.5%), that left 67.0% of the estate for the heirs.

The IRS' estate and gift tax operations will move into the 21st century

Electronic filing of income tax returns has been around for a long time, but not so for filing estate or gift tax returns. Those must be filed on paper. What's more, such filings may require substantiation of values, and so may balloon to fill banker's boxes. As a result, the IRS has mountains of paper to store, and retrieval of documents must be done by hand.

That may change in the coming years. Caitlin Dale, an IRS estate tax specialist, told the attendees at the November Tax Division meeting of accountants that electronic versions of Form 706 for estate and generation-skipping taxes and Form 709 for gift taxes are in the works. However, it won't be ready for the public "as soon as we'd all like," she warned.

An even larger project is the digitizing of all past gift tax returns, to enable electronic access to them. All such returns are required for accurately determining the remaining estate tax exemption available to a decedent's estate. The IRS is starting the digitizing with current exam cases, then proceeding to open years, and eventually will get to everything else.

During the pandemic, the IRS temporarily accepted PDFs of estate tax returns uploaded to a secure online portal, but that fix has expired. The Service does not have confidence that its hardware is sufficient to support today's security requirements for an online portal, so PDFs are no longer accepted. ☐