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Tax Topics

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Round up

April 15th is just behind us, leaving many taxpayers a little less flush after paying off the balance of their 2014 income tax obligations. In honor of "Tax Day," we wanted to mention a few bills that the House of Representatives passed on April 16th, mostly along party lines: H.R. 622, the "State and Local Sales Tax Deduction Fairness Act of 2015," and H.R. 1105, the "Death Tax Repeal Act of 2015." Although it is unclear if and when the Senate might take up these bills, it matters not: President Obama has promised to veto both of them if they end up on his desk. Here's what the bills would do:

- **H.R. 622, the "State and Local Sales Tax Deduction Fairness Act of 2015."** This bill would make permanent a taxpayer's ability to deduct state and local sales taxes in lieu of state and local income taxes (taxpayers must itemize their deductions to take advantage of this provision, and typically live in states without an income tax). The bill has no offsets to pay for it, and the Joint Committee on Taxation (JCT) projects its cost at about $42 billion over 10 years. The vote was 272 to 152, with 238 Republicans and 34 Democrats in favor of the bill, and 151 Democrats and one Republican against it.

  Comments. Although there is bipartisan support for this provision (it expired – again – at the end of 2014), most Democrats opposed the bill because it had no "pay-fors" and would have added to the long-term deficit. This is the same objection that Democrats have had to other Republican attempts to make permanent certain other popular "extenders" – temporary provisions that Congress regularly renews at one- to two-year intervals, including the now-expired charitable IRA rollover provision. Republicans view the sales tax deduction as a simple question of tax fairness that should be made permanent so that taxpayers know what to expect. (Note that extenders are generally easier to pass than permanent provisions because they are viewed as less costly from a budget perspective: revenue estimators must assume that temporary provisions actually expire, no matter how improbable that is as a matter of tax policy.)

- **H.R. 1105, the "Death Tax Repeal Act of 2015."** This bill would repeal the estate tax and generation-skipping transfer tax (GST) as of the Act's enactment, although distributions from qualified domestic trusts (QDOTs) would still be subject to estate tax for 10 years after the bill's enactment (QDOTs are trusts for non-citizen surviving spouses, and postpone estate tax at the first spouse's death). The gift tax would remain, with a 35% tax rate and a $5 million exclusion, annually indexed for inflation. Lifetime gifts into trusts would be treated as taxable gifts unless the trust was a "grantor trust" (grantors are responsible for paying the income taxes of such trusts). The JCT projects the bill's cost at about $269 billion over 10 years. The vote was 240 to 179, with 233 Republicans and 7 Democrats in favor of the bill, and 176 Democrats and 3 Republicans against it.

  Comments. The Death Tax Repeal Act is essentially the same as the estate tax and GST repeal that took effect in 2010, with one notable exception: it does not have the modified carryover basis regime that also took effect in 2010 and generally passed along a decedent's built-in capital gains to heirs, subject to a limited basis step-up of $1.3 million, plus an additional $3 million for property passing to a surviving spouse. (Repeal was itself retroactively repealed in late 2010; estates of 2010 decedents could opt out of the estate tax in favor of the modified carryover basis regime.) In other words, the Death Tax Repeal Act not only eliminates transfer tax at death, but retains the stepped-up basis rules that eliminate built-in capital gains on a decedent's appreciated property. (Retention of these rules could account for a good deal of the bill's projected cost.)

  Not surprisingly, the Administration has stated that it "strongly opposes" the bill. This position is consistent with various proposals in Mr. Obama's Fiscal Year 2016 Budget, including: 1) reverting to the 2009 transfer tax regime in 2016: $3.5 million estate tax exclusion and GST exemption, $1 million gift tax exclusion, and top estate and gift tax and GST rate of 45%; and 2) treating most transfers of appreciated property – whether by lifetime gift or at death – as deemed sales that trigger capital gains tax.

  It goes without saying that the estate tax – or "death tax," as the bill refers to it – is a true hot-button item that engenders fierce debate: on one side, are those who feel passionately that death should not be a "taxable event" and that it is wrong to tax the family farm or business, or a lifetime of savings; on the other side, are those who feel just as passionately that eliminating the estate tax would create a monied aristocracy, exacerbate wealth inequality and deficits, and be a boon to the wealthiest of the wealthy. However one comes out on the issue, it is a fact that the nearly 100 year-old federal estate tax now affects fewer and fewer people: the inflation-indexed $5 million exclusion means that in 2015, an individual can protect $5.43 million from gift and estate tax ($10.86 million per married couple); according to the Center on Budget and Policy Priorities, this means that the federal estate tax only affects about 2 out of every 1,000 decedents (0.20%). This exclusion, along with the current basis step-up rules, mean that many estates pass free of both federal estate tax and any built-in income tax liability (note that *state* estate tax/inheritantance tax might still apply, and that the basis step-up rules don't apply to assets such as retirement accounts).

  One way of looking at Mr. Obama's proposals (more robust transfer taxes and what amounts to a capital gains tax at death) and the Death Tax Repeal Act is that they represent two extremes: the possibility of property being taxed twice at death, or not at all. Does either approach have a chance of currently being enacted? No. But after the 2016 elections? That's a different question.

  Right now, both parties are basically at a stalemate – at least as to anything remotely ideological – and are trying to score political points while setting the stage for the 2016 elections. The most obvious change these elections will bring is a new occupant of the White House. As to Congress, the current House of Representatives has 244 Republicans, 188 Democrats and 3 vacancies; the current Senate has 54 Republicans, 44 Democrats and 2 Independents, both of whom caucus with the Democrats. In

2016, the entire House is up for re-election, of course, as is one-third of the Senate. Of that one-third, 10 are Democrats, three of whom are retiring (Barbara Boxer (CA), Barbara Mikulski (MD) and Harry Reid (NV)); the other 24 seats are currently held by Republicans (note that Marco Rubio (FL) is running for President and is not running for re-election). Although the gap between the number of Republicans and Democrats in the Senate is much narrower than the gap in the House, Democrats have their work cut out for them if they hope to retake control of both houses of Congress.

What the looming 2016 elections presumably mean for tax legislation is that while the current Congress will need to address certain provisions – such as the 50+ extenders that expired at the end of 2014, including the sales tax deduction – *major* legislation that requires bipartisan cooperation seems unlikely until at least 2017, assuming it happens.

Nightmare on Elm Street

Imagine the following scenario: Dad is a very successful insurance broker. He has deferred compensation arrangements with Company, pension benefits and a 401(k); he also has life insurance, and an IRA. He marries Wife in 1990, and names her as sole beneficiary of some of these assets, and as co-beneficiary of others. (We'll assume that Son, presumably from a prior marriage, is the other co-beneficiary). Dad divorces Wife in 2006. Pursuant to his divorce decree, Dad agrees to keep $1 million of insurance on his life for Ex-Wife's benefit. Dad dies in 2009, never having changed any of his beneficiary designations.

Son, Dad's executor, and Ex-Wife both present claims to Company regarding the deferred compensation and pension benefits payable at Dad's death. Son says that under the divorce settlement agreement, Ex-Wife waived any rights or expectancy interests in these assets; Ex-Wife insists that she didn't. Company files an interpleader action, and asks the local district court to decide who gets the property: Dad's estate or Ex-Wife? The District Court finds for Ex-Wife, who "*never had any claims against her former husband to waive"* [italics in original]; her claims didn't arise – against Company – until Dad's death, since Dad could have changed the beneficiary designations at any time after his divorce, but didn't. *New York Life Insurance Company v. Smoot and Smoot*, Southern District Court of Georgia, CV 209-047, 11/30/09.

Act II begins with Son going back to the same District Court to get reimbursed from Ex-Wife for the estate tax dollars attributable to the $5.4 million worth of property she received (Son received $2.2 million from Dad's estate and Dad's former business partner received about $100,000). Son argues that Ex-Wife owes nearly $1 million of the nearly $1.5 million in estate taxes that Son has already paid to the IRS from Dad's estate. (In the meantime, Ex-Wife pointed out that because Dad was required to maintain $1 million worth of life insurance coverage for her benefit, part of what she received was a legitimate claim on the estate, and therefore deductible; the IRS agreed and reduced the estate tax bill.)

Back in the District Court, Son makes two arguments for why Ex-Wife should pay her share of tax: 1) the tax law allows the executor to recover tax from beneficiaries of life insurance policies (IRC Sec. 2206, for tax mavens); and 2) the tax apportionment clause in Dad's will says that "[a]ll transfer, estate, inheritance, succession and other death taxes which shall become payable by reason of my death…shall be charged against and paid by the recipient of such property or from the property to be received."

Ex-Wife argues that she is not liable for the $350,000+ of tax attributable to the non-life insurance assets she received (i.e., the deferred compensation, the IRA, the 401(k) and the annuity, none of which are covered under IRC Sec. 2206) for two reasons: 1) Georgia (where this all took place) does not provide for a right of contribution for taxes; and 2) even if there were such a right, her divorce from Dad makes the terms of his will inapplicable to her.

The District Court again agrees with Ex-Wife. It says that it doesn't even need to consider Ex-Wife's first argument, since Georgia law is quite clear in stating that "[a]ll provisions of a will made prior to a testator's final divorce…in which no provision is made in contemplation of such event shall take effect as if the former spouse had predeceased the testator." Because the tax apportionment clause is a "provision" like any other, it doesn't apply to Ex-Wife: she and Dad divorced after he executed his will, and his will didn't contemplate divorce; Ex-Wife is therefore treated as having predeceased Dad. While this may be an unintended outcome of Georgia's probate code, that statute is unambiguous, and also applies to the tax apportionment clause. Son appears to be caught "in a gap between the two systems" – having to pay the taxes on his father's estate and being precluded from collecting tax because of Georgia's probate code; this outcome, the court says, is "inescapable." *Smoot v. Smoot*, Southern District Court of Georgia, No. 2:13-cv-0040, 3/31/15.

Comments. Wow. Not only does Ex-Wife get the property that still names her as beneficiary, she also doesn't have to pay any estate tax on it! So what might have been done differently to prevent this outcome? Although it is true that Georgia law does not have a default provision that allocates estate taxes to beneficiaries, that would not have mattered if Dad had simply updated his beneficiary designations after his divorce to name someone other than Ex-Wife.

As a practical matter, many states have laws that would at least have mitigated this result: an ex-spouse may be barred from taking property via a "stale" beneficiary designation, and default tax apportionment laws may require beneficiaries to pay their pro rata share of estate tax, subject to a contrary provision in the decedent's will (or revocable trust). Yet while state law may come to the rescue and preclude a now ex-spouse from taking, say, life insurance or an annuity, it will not necessarily work with respect to retirement accounts, which are typically governed by federal law (ERISA).

But rather than having to litigate a matter or hope that state law is on the decedent's side, wouldn't it be better to regularly check planning documents – including beneficiay designations – to make sure that they still accomplish their desired purpose? This is especially true if there has been a major life event, such as marriage, divorce, death, or the birth of a child. Judging by the number of cases dealing with ex-spouses and "stale" beneficiary designations, however, such periodic planning checks don't happen nearly enough.

May 7520 rate

The IRS has issued the May 2015 applicable federal rates: the May 7520 rate is 1.8%, a 0.20% (20 basis points) decrease from April's 2.0% 7520 rate. The May mid-term rates are: 1.53% (annual) and 1.52% (semiannual, quarterly and monthly). The April mid-term rates were: 1.70% (annual), 1.69% (semiannual and quarterly), and 1.68% (monthly).

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