Panorama

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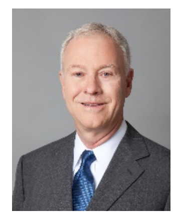

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DO YOU HAVE A LIFE INSURANCE TRUST?

There are many proposals being made in the House of Representatives to raise taxes to pay for the proposed $3.5 trillion infrastructure spending program. Speaker Pelosi has promised to deliver this bill for a House vote by October 31.

Among the revenue raisers in the current draft of the bill is a provision that targets "grantor trusts". This term refers to a trust whose grantor (creator) is deemed to be the owner of the trust for income tax purposes. What does this mean? Generally, an irrevocable trust or its beneficiaries pay its own tax bill, but if the grantor has retained certain powers in this trust, it causes the grantor to become primarily liable for the trust's annual income tax bill. So why intentionally draft your trust this way, you ask? Because it has long been a popular way that advanced estate planners use to transfer more wealth tax free to descendants, by having the grantor (mom or dad) pay the income tax bill for the kids' trust. The reason is that when a grantor pays an income tax bill for which he/she is liable by law, then such payment of tax that ultimately benefits the kids is not deemed to be a taxable gift to the kids. Therefore, the grantor's annual gift exclusions and exemption are preserved and not needed to shelter the "tax payment" transfer from gift tax.

Generally, grantor trusts are irrevocable trusts funded with family business and investment assets whose value is expected to increase substantially by the time of the grantor's death. This shifting of appreciation to the next generation also adds to the estate tax reduction benefit of the trust. Life insurance on the grantor's life is also an asset whose value will one day increase substantially, and many estate planners have the life insurance owned in an irrevocable trust so that the death benefit will not be subjected to estate taxes when the grantor dies. The grantor commits to making annual exclusion gifts to the trust so that the trustee will have sufficient cash to pay the annual life insurance premiums. Since life insurance trusts do not generate taxable income or deductions before the policy matures, they are easily overlooked as being grantor trusts.

The proposed changes could hurt individuals who have created irrevocable life insurance trusts and who continue to fund premium payments on trust-owned policies through annual gifts. If the bill becomes law, such gifts will cause an increasing portion of the policy proceeds (and any other trust assets) to be taxable at the grantor's death–exactly the result that insurance trusts are created to avoid.

So this means that the life insurance trust that was specifically designed to avoid exposure to any transfer taxes may end up causing some portion of the death benefit to be included in your estate. Granted, even if this happens, your estate may not be subject to estate tax bearing in mind that the proposed legislation cuts the federal exemption to roughly $6 million per spouse starting in 2022. So if the includable portion of the life insurance and other assets in the decedent's estate are all under the exemption, no estate taxes will be due, despite this provision.

If you own life insurance in an irrevocable trust that was designed to be part of your estate plan, you should consult with your estate planner before yearend. As with all tax legislation changes, there may still be ways to avoid possible negative tax consequences by adjusting the way you fund the trust with cash to pay the future annual premiums.

BIG BROTHER IS COMING!

Staying with the theme from the first article, Congress is looking for ways to raise income taxes to pay for their infrastructure plan. The obvious changes to raise tax revenue are to increase tax rates, make more types of income subject to tax and reduce deductions. But there is also another way that that has caught a lot of attention and is being considered in the tax bill.

Everyone has heard the cries from Congress that not all Americans "pay their fair share" of the annual tax revenue. But wait a minute – Congress creates the tax rules, and for those who follow those tax rules, how can you say those who pay what is legally owed aren't paying their fair share?

A refresher on the sources of the IRS annual tax collections is in order, and is derived from IRS statistics. Each year, the IRS collects approximately $3.6 trillion in taxes. Individuals account for half of that total. Payroll taxes make up 36%, which is paid by employees, employers and self-employed individuals. Interestingly, corporations only pay 7% of the total annual tab. One would have thought that corporations would be the largest payers rather than individuals! Pulling up the rear, estate taxes paid by individuals account for another 1 – 2%, with the remaining 5.1% attributed to excise taxes, customs duties and other taxes.

Does everyone who is supposed to pay, in fact pay their tax bill? No, the U.S. Treasury Department has for many years studied this issue and refers to those who underpay or pay no income taxes as part of the annual "tax gap". The first and most obvious question is if the IRS collects $3.6 trillion annually, how much is attributed to this tax gap? The answer is an estimated $630 billion as of 2019.

Interestingly, the U.S. Treasury Department estimates of the tax gap has been relatively stable at approximately 83.5% for the voluntary compliance rate over the past 20 years. The average compliance from enforcement activities has also generated approximately another average 2% each year for the last 20 years.

Understand also that we have a voluntary tax assessment and payment system in the U.S. You do not get a bill as you do from the utility company for your taxes. Rather, you file an annual income tax return following directions on how to properly complete it. Then, you voluntarily assess yourself the tax liability that the rules indicate that you owe based on your income and deductions. Of that $3.6 trillion in annual tax collections, only about $3 trillion are paid "voluntarily". The rest comes from IRS annual enforcement activities and penalties from late payments. Sure, there are tax cheats in the world. Some cheat because they are so inclined, some cheat as a protest to wasteful spending by Congress, and some underpay because of mistakes in understanding or simply not having the funds to pay their taxes. Janet Yellen recently gave testimony to Congress that restates the long held belief by the Treasury Department that if we can "improve tax compliance among the wealthiest Americans, we should do so in order to raise revenue due to the Government and reduce the burden for honest taxpayers".

While the U.S. tax system relies on voluntary compliance, there are guardrails in place that help that process. Everyone of tax paying age is well familiar with annual tax information reporting by third party payers of taxable income. For example, employees receive a Form W-2 at the close of each year, where the employer reports the amounts paid and taxes withheld from the employee's annual paycheck. The IRS has an efficient computer matching system where it can quickly find discrepancies between what was reported as being paid by third party payers and the taxpayer. Banks, retirement plans, and investment houses all have tax information reporting requirements each year for the earnings generated or withdrawals taken from retirement plans through 1099 reporting. Selling your house? That's covered too. Not unexpectedly, the voluntary compliance rate by taxpayers is very high when the payers have reported to the IRS what they paid you last year.

Taxes are underpaid for one of three reasons according to the IRS. Either tax returns are never filed, taxes owed are underreported or taxes are accurately reported but underpaid. So where exactly is the compliance and tax payment slippage occurring? Nine percent of the gross tax gap comes from non-filing, eleven percent from underpayment and eighty percent from underreporting. IRS attributes underreporting to several sources – Americans keeping investment accounts in offshore funds, the increase in the new "gig" economy, flow through entities, and cryptocurrency, all of which are not subject to information reporting. Because reporting in these areas is not stringent or is otherwise nonexistent, this is where a lot of underreporting resides.

So that brings us to the new proposal that's all over the airwaves – legislators would like to propose (more) expanded information reporting on banks. Yellen testified that an "information reporting regime that is broad-based will better assist the IRS in targeting enforcement priorities on the high-end who accrue income in opaque ways". The proposal is to require banks to report gross annual inflows and outflows from bank accounts with at least $600 in balance or at least $600 worth of transactions to the IRS. What would this accomplish? Well, if your reported income on your tax return is $50,000 but your total bank deposits for the year are $100,000 that might be cause to expect an IRS audit. Or, if you spent $100,000 from your bank account during the year, but you only reported $50,000 of income, that too might prompt an audit to explain where the money came from that was withdrawn. Certainly, many of these "anomalies" may be entirely explainable. But, the cost of preparing for and defending the audit will increase the taxpayer's cost of compliance. Most people also expect that if an audit is initiated, the IRS auditor can't walk away empty handed and look bad, so expect them to turn over every rock in search for tax revenues.

While this bank "tattling" concept is not new, there is an overwhelming negative reaction by taxpayers from the news reports. Banks already have to report transactions greater than $10,000 under the Bank Secrecy Act of 1970 (to counteract money laundering) and interest or dividends in excess of $10. Chief objectors to the expanded reporting is obviously the banks, on whose shoulders the effort and cost of implementing these disclosure requirements would fall.

Chuck Rettig, the serving IRS Commissioner recently gave Senate testimony stating that for every 1% improvement in voluntary tax compliance, federal annual revenues could increase by about $30 billion per year. Rettig believes that since high-income earners already shoulder a large part of the annual tax burden, they have the greatest incentive to skirt the taxman. Having said that, many of us have had the knock on the front door by the tree trimmer who offers to do the job, but only wants to be paid in cash! While the IRS payday from such information reporting may produce collection results from the 7 figure income earner crowd, it will also sweep in the little guys.

Whether Speaker Pelosi includes or nixes this highly contentious proposal in two weeks is yet to be seen. But there sure is a lot of vehement negative reaction from both parties to this proposal! Stay tuned.

LOOK OUT LARGE IRA'S!

For decades, individual retirement accounts (IRA's) have been an avenue for the average wage earning taxpayer to set aside money in a tax efficient way to help fund his family's retirement. Between self-directed traditional and Roth IRA's, these retirement savings vehicles have become a staple of many taxpayers. The main benefit generally is tax deferred growth and payment of tax during retirement distribution years when income is lower. Roth IRAs added a new element when introduced in 1998, by allowing the contribution and investment of previously taxed dollars, but no tax liability during retirement when distributions begin.

During the summer of 2021, a news story was released regarding PayPal cofounder and Silicon Valley investor Peter Thiel, who reportedly has $5 billion in his tax free Roth IRA. Media sources used leaked IRS taxpayer information (yes, that's against the law), to reveal ways the ultra-rich are able to avoid paying taxes and maximize their wealth.

How on earth did this happen? Forbes reported in 2012 that in 2001 Thiel acquired PayPal shares for his Roth IRA at 30 cents a share and had apparently enjoyed a tax-free gain of $31.5 million when eBay bought out PayPal for $19 a share in 2002. Thiel was reportedly able to build a small Roth IRA into a $5 billion behemoth because he used the money in the account from the sale of eBay shares to buy shares of other startups at low prices.

It all sounds too good to be true — and for most investors, it is. First of all, unlike Mr. Thiel, putting your 12 shares of a private company stock into your IRA is very unlikely to move your needle. You also need an IRA custodian to formalize your IRA holding private investments. Compliance fees and a wide range of potential IRS penalties can make an IRA holding private investments something to steer clear of.

Obviously, the gameplan worked for Mr. Thiel. However, what happens if the private company shares go bust in the IRA? No tax benefits are available for the loss, the account is just worth less (or worthless!). A lot of luck and a large number of private company shares are needed, and then you still have to squeeze those into the account at very low threshold amounts for contributions.

And where there is "too good to be true" tax avoidance smoke, there is usually a Congressional tax-writer trying to douse the flame. Part of the proposed legislation is intended to prevent future Peter Thiel type stories, but it may discourage average taxpayers from using these well intended retirement savings vehicles or alternative investment products in the IRA for the very legitimate purposes for which they were intended.

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