Panorama

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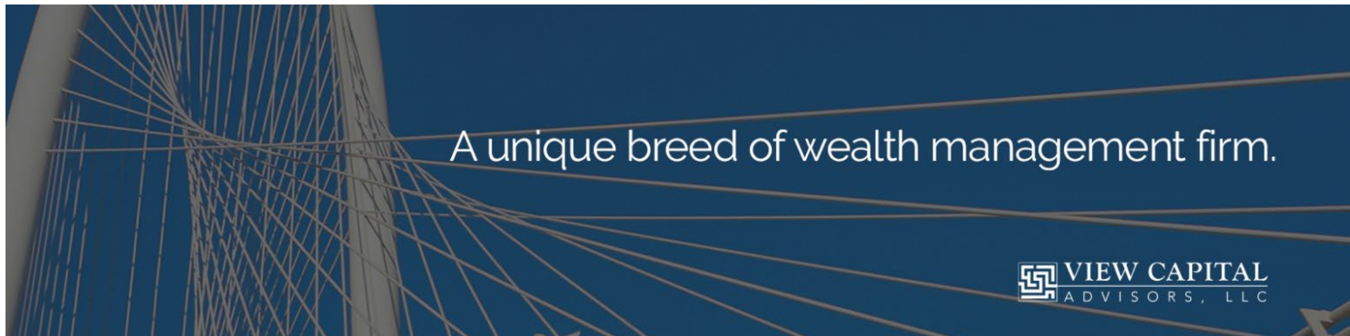


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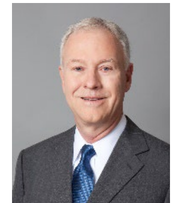

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## SUPREME COURT TO DECIDE UNREALIZED INCOME CASE

The Supreme Court granted certiorari in *Moore v. U.S.* recently, a case which will be decided in 2024. There are significant implications to this ruling that could make fundamental changes to the income tax law as we know it.

In *Moore*, the taxpayers were U.S. shareholders of a controlled foreign corporation (CFC). A CFC is an offshore corporation where more than 50% of shareholders are U.S. citizens or permanent residents. Shareholders of CFCs are subject to special tax rules on their share of the corporation's income, even when the income is not distributed to them. The CFC rules were passed by Congress many years ago to deter some people and businesses who invested "offshore" by keeping their money overseas to avoid or defer U.S. taxes until they brought the offshore income back to the U.S.

Interestingly, this case surfaced from Trump tax changes in 2017. The 2017 Tax Cuts and Jobs Act implemented the Mandatory Repatriation Tax (MRT) which was a one-time revenue raising tax where

all shareholders of CFCs are taxed on its profits after 1986, even if the profits were not distributed to the shareholders. Thus, shareholders had to pay income taxes on their share of undistributed earnings going back over 20 years, even though the CFC rules allowed the deferral.

The point under judicial scrutiny is one of definition and timing, what is "income" and when is it subject to taxation? A commonly accepted approach uses the Haig-Simons definition of income, named after two noted economists. Their view is that an income tax should tax consumption as well as changes in net worth on an annual basis. Under this "mark-to-market" approach, economic gains or losses associated with ownership of an asset would be taxed when they occur during the tax year.

This approach raises many structural questions on how such an approach could ever be effectively administered. For example:

- Valuations – How do you measure the value of private real estate and private businesses?
- Liquidity – Just because an asset has appreciated in value, does not mean a taxpayer has sufficient cash to pay the associated tax.
- Capital Losses – What goes up can go down. How is depreciation in value factored into the tax computation?
- Timing – On what day during the year is the appreciation or depreciation measured?

In view of the administrative difficulties of such a tax, the U.S. tax system has historically taken a "realization" approach, which delays the taxable event until the asset is sold or realized. While realization does not precisely match economic gains or losses, it does provide administrative simplicity regarding the difficulties outlined above.

The Supreme Court has previously opined on realization and taxable income. The most recognized rule was stated in *Commissioner v. Glenshaw Glass* where the Court stated that income is defined as an accession to wealth, clearly realized, under the taxpayer's control. While simple on its face, determining when a realization event occurs can still be subject to interpretation.

The leading case on realization was *Eisner v. McComber* where it ruled that a realization event occurs when there is gain from capital, labor, or both. The most accepted view of when income is "realized" is when the appreciated asset is liquidated for cash. This comports with the long held "wherewithal to pay" concept, that tax fairness favors taxation of gains at the point where there is cash available to pay the tax.

The Supreme Court will decide whether the 16th Amendment allows the taxation of unrealized income. The 16th Amendment to the U.S. Constitution was ratified in 1913 and allows Congress to levy a tax on income from any source. The goal of the realization rule has been to ensure that people have the money to pay the income taxes due. However, prudent and legal tax planning strategies involve deferring taxes, paying at a lower tax rate in the future, or avoiding taxes altogether. Where to draw the line on realization has been debated by both the legislature and the courts.

Progressive Liberals (notably, Senators Warren and Sanders) have long advocated for a "wealth tax" in the U.S. to force wealthy individuals to pay their fair share of income taxes. While the *Moore* case does not directly address the "wealth tax," a ruling in favor of taxing unrealized income could open the door to more aggressive modes of taxing increases in wealth in the future, including wealth taxes.

## IRS BASIS STEP-UP RULE CHANGE

In March, the IRS issued Revenue Ruling 2023-2, which will make a substantial impact on estate planning, particularly where an irrevocable trust is involved. In the last decade or so, more families have begun utilizing irrevocable trusts for estate tax reduction as well as to protect family assets from beneficiary mismanagement and third-party liabilities. But this ruling is directed at a specific type of irrevocable trust. In particular, the irrevocable trust in this ruling was termed an "intentionally defective grantor trust" causing the grantor to be liable for federal income tax on the trust's income. This structure results in wealth transfers (to pay the trust's income taxes) without inclusion of the trust's assets in the grantor's estate. Therefore, the grantor is treated as owner of the trust for income tax purposes but not for estate tax purposes. Under this ruling, property held in an irrevocable trust that is not included in the trust grantor's taxable estate at death (i.e., the grantor must be the owner of the trust assets for estate tax purposes) will no longer receive a step-up in basis.

A statutory exception to the obligation of capital gains taxes applies to assets passing at the death of the owner to their beneficiaries. The death of the owner bestows upon the beneficiaries a step-up in basis, so they inherit the asset with a new adjusted cost basis as if the beneficiaries purchased those assets at the current fair market value as of date of death, not the value at the time the asset was purchased. This eliminates most or all post purchase date capital gains and related taxes, depending on the timing of the sale by the beneficiaries.

Prior to the issuance of this ruling, there was much debate as to whether assets passing to beneficiaries through an irrevocable trust would receive a step-up in basis when the grantor died. Historically, assets that are disposed of during an individual's lifetime are subject to capital gains taxes on the increase in value of that asset over time. The amount of capital gains owed is determined largely by the difference between the value at the time of purchase and the value at the time of transfer.

How will this ruling affect assets going forward in an irrevocable grantor trust where the decedent grantor was the income tax owner of the trust assets at the time of death? Internal Revenue Code Section 1014 (the basis step up statute) requires that the property pass from the decedent by bequest, devise, or inheritance. Beneficial ownership of the trust assets is transferred by gift during the grantor's life. Prior to the March 2023 ruling, such transfers from the trust at death have been generally receiving

the step-up in basis. So is there still a planning benefit to anyone would do irrevocable trust planning in the future? I believe so, irrevocable trust planning still arbitrages the potential estate tax cost of 40% of the full value of the trust assets against the capital gains income tax cost of 23.8% of the gain on purchase cost.

Most families will not find themselves subject to estate tax under current rules because the current federal estate tax is only applicable to estates valued at $12.92 million or more, or $25.84 million for married couples. It will be more likely to impact families when the estate exemption sunsets (reverts to 2017 exemption levels) in 2026 to about half of that exemption amount.

## COMPARING JOINT ACCOUNT OPTIONS

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Here we will compare two common ways for two individuals to jointly own an investment account. Those methods are joint tenants with right of survivorship (JTWROS) and transfer on death accounts (TOD).

Joint tenants with right of survivorship is a legal form of joint ownership, where two or more parties have equal rights and ownership of an account. If one joint owner dies, the surviving owner automatically gets full ownership of the asset.

On the other hand, a TOD for investment accounts is an arrangement between a financial institution and an account owner under which the account owner designates specific beneficiaries to receive the account's assets when the account owner dies.

Here's the difference. A JTWROS account designation gives both account owners equal rights and access to the assets in the account and automatically transfers ownership to the surviving account owner at the death of one of the joint account owners. TOD account assets on the other hand, transfers ownership to a named beneficiary upon the account owner's death, much like a life insurance policy or retirement plan. Unlike the JTWROS account, the beneficiary doesn't have access to the assets in a TOD account while the owner is alive.

Both types of accounts avoid probate at the death of an account owner as account assets go directly to your designated beneficiary or survivor without going through probate, which can be costly and time-consuming. TOD accounts override a last will and testament. The named beneficiary on a TOD account will receive the assets no matter whom they're designated to in the will.

Regarding both arrangements, when a joint account owner death occurs the survivor or beneficiary must present a valid death certificate to the financial institution to validate the transfer. If the survivor desires to keep the investment account at the same financial institution, they must open a new account in the name of the survivor, using the survivor's tax reporting ID. The survivor could also make this new account a joint account with a new joint owner.

If the primary account owner is concerned about another individual having immediate and unrestricted access to all assets in the account, a TOD account would be the better choice. After a joint owner dies, the remaining owner is free to make changes, including who inherits the assets after the remaining joint owner dies. The same is also true of TOD accounts.

Tax implications may apply to either account. For income tax purposes, the primary joint owner's social security number will be used for tax reporting, therefore all income on the account will need to be reported on that primary joint owner's federal income tax return. This is probably not an issue where the joint owners are married but could be an issue where non-spouses are joint owners.

Assets in JTWROS accounts may get a step-up in cost basis when either spouse passes away. This can help reduce capital gains taxes when the survivor sells assets, but you can only step-up half of the full value of the asset. A TOD account will also get a step-up in cost basis, but on the full value of the account assets.

Gift tax can also apply to either arrangement where the account transfers to the survivor at death. If the surviving joint owner is a non-spouse, that transfer is a taxable gift on the value transferred to the joint owner. Annual gift exclusions or the lifetime exemption may negate any gift tax, but a gift tax return may nevertheless be required to be filed.

Here are a few more items to take note of. If the account holder lives in a community property state, their spouse typically has a legal claim to half of the assets in the account unless the assets were inherited or acquired before marriage. Because a TOD account is revocable, the owner can close the account, withdraw all the money in it or change the beneficiary at any time. You can't name alternate or backup beneficiaries to a TOD account, meaning the account will remain part of your probate estate if the designated beneficiary dies before the account owner.

There could be a situation where a joint account is not appropriate. If the primary account owner wishes to leave the account in trust for the benefit of the survivor, you would use an individual account or a revocable trust account. But in these cases, the account owner would provide the trust account instructions in his will or living trust for the inheriting survivors. Then whatever limits on access to the account assets the account owner desires can be laid out in the trust agreement or will.

# Panorama

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**We seek to bring wealth planning best practices and a wide range of non-proprietary solutions to our clients. We also conduct our own research and diligence on world markets and investment alternatives.**

**For further information, please contact your investment representative or one of our wealth planning specialists:**

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