BESSEMER
TRUST

Estate Planning Current Developments

March 2022

Steve R. Akers
Senior Fiduciary Counsel
Bessemer Trust
300 Crescent Court
Suite 800
Dallas, TX 75201
214-981-9407
akers@bessemer.com
www.bessemer.com

Ronald D. Aucutt
Senior Fiduciary Counsel
Bessemer Trust
703-408-3996
aucutt@bessemer.com

Kerri G. Nipp
Fiduciary Counsel
Bessemer Trust
300 Crescent Court
Suite 800
Dallas, TX 75201
214-245-1423
nipp@bessemer.com

Table of Contents

Introduction 1

1. Summary of Top Developments in 2021 1
2. Legislative Developments 1
3. Corporate Transparency Act Overview 14
4. Planning for IRA and Retirement Plan Distributions Under the SECURE Act; New Life Expectancy Tables for Calculating Required Minimum Distributions 16
5. Miscellaneous Guidance From IRS; Treasury-IRS Priority Guidance Plan 24
6. Estate Planning for Moderately Wealthy Clients 31
7. Transfer Planning for Clients Who Want to Make Use of the Increased Exclusion Amounts But Do Not Want to Make Large Gifts (or At Least Don't Want to Lose Access to Assets); Flexibility to "Undo" Transfers 32
8. Tax Effects of Settlements and Modifications; Early Termination of Trust; Commutation of Spouse's Interest in QTIP Trust 36
9. Family Limited Partnership and LLC Planning Developments; Planning in Light of *Estate of Powell v. Commissioner* and *Estate of Cahill v. Commissioner* 44
10. FLP Assets Included Under §2036(a)(1); Application of §2043 Consideration Offset; Formula Transfer to Charitable Lead Trust Not Respected; Loans Not Respected; No Deduction for Attorney's Fee, *Estate of Howard V. Moore v. Commissioner*, T.C. Memo. 2020-40, *aff'd*, 124 AFTR 2d 2021-6604, (9th Cir. Nov. 8, 2021) 52
11. Gift and Sale of Partnership Interests Expressed as Dollar Amounts Based on Subsequent Appraisals, Lack of Control and Lack of Marketability Discounts, Multi-Tiered Discounts, *Nelson v. Commissioner*, T.C. Memo. 2020-81, *aff'd*, 128 AFTR 2d 2021-6532 (5th Cir. November 3, 2021) 58
12. John Doe Summons Upheld to Determine Identity of Law Firm's Clients Seeking Advice Regarding Particular Issues, *Taylor Lohmeyer Law Firm P.L.L.C. v. United States* 61
13. Valuation of Majority Interests in LLCs Owning Real Estate; Estate Tax Charitable Deduction Based on Values Passing to Each Separate Charity, *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 63
14. Sale Decisions by Sponsors of Donor Advised Funds Contrary to Expectations of Donors, *Fairbairn, et al. v. Fidelity Investments Charitable Gift Fund*, *Pinkert v. Schwab Charitable Fund* 70
15. Valuation of Publicity Rights, Undervaluation Penalties, *Estate of Michael Jackson v. Commissioner*, T.C. Memo. 2021-48 71
16. Intergenerational Split Dollar Life Insurance, Estate Tax Treatment of Repayment Right, *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60 and *Estate of Levine v. Commissioner*, T.C. No. 2 (February 28, 2022) 76
17. Conservation Easements – Savings Clause Rejected in Conservation Easement Cases, *TOT Property Holdings, LLC v. Commissioner* (And Others); Judicial Extinguishment Proceeds Regulation Invalid Because It Did Not Satisfy Procedural Requirements of the Administrative Procedures Act, *Hewitt v. Commissioner*, 128 AFTR 2d 2021-7033 (11th Cir. December 29, 2021) 86
18. Estate Tax Value of Shares Included Proceeds of Corporate-Owned Life Insurance to Fund Buy-Sell Agreement; Buy-Sell Agreement Did Not Meet §2703(b) Safe Harbor or Other Requirements to Fix Estate Tax Value, *Connelly v. U.S.*, 128 AFTR 2d 2021-5955 (E.D. Mo. September 2, 2021) 90
19. Real Estate Undivided Interests Gifts to Separate Donees In Each of Four Years Valued Separately and Not Aggregated for Valuation Purposes, *Buck v. U.S.*, 128 AFTR 2d 2021-6043 (D. Ct. September 24, 2021) 97
20. Indirect Gifts – Step Transaction, Reducing Value of LLC by Present Value of Guaranteed Payment Obligation to Manager, *Smaldino v. Commissioner*, T.C. Memo. 2021-127 100
21. Application of "Atkinson Rationale" to GRAT and Valuation Issue Regarding Anticipated Merger, CCA 202152018 108

22. Malpractice Action Regarding Advice Involving Creation of FLP and Sale of LP Interests, *Wellin v. Farace*, (4th Cir. November 22, 2021) 111

Copyright © 2022 Bessemer Trust Company, N.A.

All rights reserved.

March 16, 2022

Important Information Regarding This Summary

This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information and disclaims any liability in connection with the use of this information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Introduction

This summary reflects estate planning developments in 2021-2022.

1. Summary of Top Developments in 2021

Ron Aucutt (Lakewood Ranch, Florida) lists the following as his top ten developments in 2021 in his report, "Top Ten" Estate Planning and Estate Tax Developments of 2021 (January 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights:

(1) Continued health challenges;

(2) Proposed increased income tax rates for trusts and estates (see Item 2.g(7) below);

(3) Playing with the basic exclusion amount, including anti-anti-clawback (see Items 5.b(4)(a), and 7.f(2) below);

(4) Bold proposals to coordinate transfer taxes and income taxes (see Item 2.g(3) below);

(5) Splitting gifts and bequests (*Smaldino* [see Item 20 below], *Estate of Warne* [see Item 13 below], *Buck* [see Item 19 below]);

(6) The donor's relinquishment of control over a donor advised fund (*Fairbairn*, *Pinkert*) (see Item 14 below);

(7) The weight to be given to post-death developments (*Estate of Michael J. Jackson*) (see Item 15 below);

(8) John Doe summons to a law firm (*Taylor Lohmeyer*) (see Item 12 below);

(9) Intergenerational split-dollar life insurance (*Estate of Morrissette*) (see Item 16 below); and

(10) Estate tax closing letter for a sixty-seven dollar user fee (Reg. §300-13, CCA 202142010) see Item 5.b(3)(b) below).

2. Legislative Developments

a. **Selected Legislative Enactments in 2020-2021.** Selected legislative enactments in 2020-2021 include the following.

(1) **CARES Act.** The Coronavirus Aid, Relief and Economic Security (CARES) Act (P.L. 116-136, 3/27/2020) provided for direct stimulus payments for certain taxpayers and various tax-related provisions for 2020, including (i) a waiver of RMDs for retirement accounts and IRAs in 2020 and deferring 2019 RMDs, (ii) a $300 above-the-line charitable deduction; (iii) an increased percentage limit from 60% to 100% for cash contributions to public charities (but not donor advised funds); and (iv) an increase of the corporate charitable deduction percentage limitation from 10% to 25%.

(2) **Consolidated Appropriations Act, 2021.** The Consolidated Appropriations Act, 2021, enacted on December 27, 2020, includes various COVID-related relief measures and tax-related measures including (i) an extension (and expansion) of the $300 non-itemizer charitable deduction ($600 for joint returns) for 2021; (ii) an extension of the 100% limit for cash contributions to public charities (for both 2020 and 2021); and (iii) an extension of the 25% limit for corporate charitable contributions in 2021.

For further discussion of the CARES Act and the Consolidated Appropriations Act of 2021, see Items 2.l and 2.m. of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(3) **American Rescue Plan.** The American Rescue Plan is a $1.9 trillion coronavirus rescue package passed under the reconciliation legislative process, signed by the President on March 11, 2021.

(4) **Infrastructure Investment and Jobs Act.** The infrastructure component of the American Jobs Plan is reflected in the Infrastructure Investment and Jobs Act (H.R. 3684), a $550 billion infrastructure

package that was enacted with bipartisan support (not part of a reconciliation package) on November 15, 2021.

b. **The Made in America Tax Plan Proposal.** Alongside the American Jobs Plan (for infrastructure) was The Made in America Tax Plan with proposed changes to the corporate tax code including (i) increases in the top corporate tax rate from 21% to 28%, (ii) various provisions to discourage shifting jobs and profits offshore, and (iii) a minimum tax on large corporations' book income.

c. **The American Families Plan Proposal.** Alongside The American Jobs Plan's proposed investment in infrastructure, The American Families Plan was proposed as a bold investment in the nation's children and families. It included various tax increases (many of which reverse the tax decreases in the 2017 Tax Act).

d. **FY 2022 Greenbook.** Detailed descriptions of the tax proposals in the Made in America Tax Plan (business provisions) and American Families Plan (individual provisions) are included in the Biden administration's "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (popularly called the "Greenbook," released May 28, 2021). The individual tax proposals include: (i) raising the top rate from 37% to 39.6%, (ii) taxing capital gains and qualified dividends as ordinary income (top rate of 39.6% plus the 3.8% "Medicare" tax) for taxpayers having adjusted gross income over $1 million for gains recognized after the date of announcement (presumably April 28, 2021), (iii) providing for deemed realization of gains at the time of gifts and at death for capital gains exceeding $1 million (discussed in more detail in Item 2.e below), (iv) taxing "carried interests" as ordinary income, (v) eliminating real estate like-kind exchanges for gains in excess of $500,000 ($1 million for joint returns), (vi) permanently extending the current limitation that restricts large excess business losses, (vii) applying the 3.8% tax to business income from passthrough entities for taxpayers with adjusted gross income over $400,000 who materially participate in the business, and (viii) adding $80 billion to the IRS for enhanced revenue collections.

When proposed, these measures were expected to be added to and included in a reconciliation package (a $3.5 trillion budget resolution – the first step of the reconciliation process – had already been approved in the Senate and House).

No transfer tax provisions were included. A rather obtuse reference on the Biden campaign website suggested that Presidential candidate Biden supported a return to the 2009 parameters ($3.5 million/$1 million exclusions, not indexed, and 45% rate). Dr. Janet Yellen's written responses to questions in her Senate confirmation process also pointed to a $3.5 million exemption level. A paper previously written by current key Biden administration officials (David Kamin, current deputy director of the National Economic Council, and Professor Lily Batchelder, Assistant Secretary of the Treasury for Tax Policy) makes clear their disdain for various planning alternatives such as GRATs, valuation discounts, and family limited partnerships. Lily Batchelder & David Kamin, *Taxing the Rich: Issues and Options*, at 23 (Sept. 11, 2019) available at https://ssrn.com/abstract=3452274. No transfer tax provisions were included in the FY 2022 Greenbook, but measures to restrict such planning alternatives could be pursued legislatively or by administrative action at some point by the Biden administration.

The FY 2023 Greenbook (which will likely be released in March 2022) may, according to "word on the street," "unveil new provisions that represent the next step in the Administration's broader tax policy," but "revenue pressures may create the need to include prior proposals – whether they be proposals from last year's Greenbook that were not included in the BBBA or even proposals from the last Greenbook released by the Obama Administration." Jorge Castro, Marc Gerson & Loren Ponds, *What's Going On? Upcoming Greenbook Release Expected to Reveal New Revenue Raisers*, MILLER&CHEVALIER TAX TAKE (February 28, 2022).

e. **Deemed Realization Proposals.** The FY 2022 Greenbook (at pages 62-64) clarifies the proposal for the "deemed realization" of capital gains on transfers by gift or at death foreshadowed by the Obama administration's Greenbooks for Fiscal Years 2016 (Feb. 2, 2015, pages 156-57) and 2017 (Feb. 9, 2016, pages 155-56), by President Biden's campaign, and by Representative Bill Pascrell's H.R. 2286 and Senator Van Hollen's "discussion draft" of the Sensible Taxation and Equity Promotion ("STEP")

Act of 2021. The deemed realization proposal was a very bold proposal that would have had major planning implications for estate planning and trust structuring. Details of House and Senate deemed realization proposals by Representative Pascrell and Senator Van Hollen, the FY 2022 Greenbook deemed realization proposal, and planning implications are summarized in Items 2.j – 2.m of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

f. **"For the 99.8 Percent Act" (2019) and "For the 99.5 Percent Act" (2021).** Senator Sanders on January 31, 2019 introduced S. 309, titled "For the 99.8 Percent Act," and on March 25, 2021 introduced S. 994, titled "For the 99.5 Percent Act." The 2019 and 2021 proposals are very similar (identical in most respects). Senator Sanders has introduced similar bills since 2010.

This proposed legislation would make very bold transfer tax changes including (i) reducing the basic **exclusion amount** to $3.5 million (not indexed) for estate tax purposes and to $1.0 million (not indexed) for gift tax purposes, (ii) increasing the transfer tax **rate** from 40% to graduated rates ranging from 45% to 65%, (iii) increasing the potential reduction of the value for family farm and business property under the **§2032A** special use valuation rules, (iv) increasing the potential estate tax deduction for **conservation easements**, (v) disallowing a **step-up in basis** for property held in a grantor trust of which the transferor is considered the owner "if, after the transfer of … property to the trust, such property is not includible in the gross estate of the transferor…," (vi) valuing entities by treating nonbusiness assets and passive assets as owned directly by the owners (and valuing them without **valuation discounts**), with look-through rules for at least 10% subsidiary entities, (vii) eliminating minority discounts and lack of marketability discounts for any entity in which the family either controls or owns a majority ownership (by value) of the entity, (viii) restrictions on **GRATs** (including a 10-year minimum term, a maximum term, and a remainder value at least the greater of 25% of the amount contributed to the GRAT or $500,000 (up to the value of property in the trust), (ix) subjecting assets in **grantor trusts** to gift and estate taxes, (ix) limiting **GST exemptions** to 50 years, and (x) applying additional restrictions to qualify for the **annual exclusion** for transfers to trusts.

This bill is significant; these are far-reaching proposals that have been suggested by others from time to time but now they are in statutory text that can be pulled off the "shelf" to incorporate into whatever other legislation happens to be popular at the time. Indeed, some of the provisions were included in the reconciliation package currently being considered in Congress (H.R. 5376), discussed in Item 2.g(3) below.

For further detail of these proposals see Item 2.n of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights and Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2019 (January 2020), with detailed analysis, found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

g. **Summary of Selected Tax Proposals in H.R. 5376, Build Back Better Act (Using Reconciliation Process).** H.R. 5376, the Build Back Better Act, has undergone a series of revisions (and is still under serious negotiation and no doubt will have additional revisions). Here's a brief summary of the journey so far.

(1) **Reconciliation Process.** The 50-50 split in the Senate makes passing far-reaching legislation (including tax legislation) difficult with the general 60-vote requirement in the Senate. While the budget reconciliation process offers the opportunity of passing certain types of legislation with only a majority vote in the Senate, it has various limitations and can be quite cumbersome.

For a general summary of the reconciliation process including the statutory authority, the two-step process of a budget resolution and reconciliation act, examples of the use of reconciliation, and the Byrd rule (which limits reconciliations measures that would produce additional deficits outside the "budget window" set in the budget resolution), see Item 2.d. of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(2) **Budget Resolution.** On August 24, 2021, the House of Representatives agreed to the Senate-approved Concurrent Resolution on the Budget for Fiscal Year 2022 (S. Con. Res. 14), establishing spending priorities of about $3.5 trillion for the fiscal year beginning October 1, 2021, and ending September 30, 2022. The votes were strictly partisan (with the exception of one Republican senator who did not vote. The resolution left the House Ways and Means Committee and the Senate Finance Committee with flexibility to develop tax changes to pay for the contemplated expenditures.

(3) **H.R. 5376, September 15, 2021; Surprising Inclusion of Sweeping Transfer Tax Proposals Including Early Sunset of Exclusion Amount, Grantor Trusts, and Valuation Discount Provisions.** On September 15, 2021, the House Ways and Means Committee approved the Build Back Better Act (H.R. 5376). That version included estate tax provisions with major planning implications including the decrease in the estate and gift tax exclusion amount, grantor trust changes (§2902 and §1062), valuation of nonbusiness assets in entities, and increased benefit of special use valuation. Ron Aucutt provides this summary of the transfer tax provisions in the September 15, 2021 version of H.R. 5376.

(a) **No Deemed Realization.** The Ways and Means Committee has omitted any deemed realization proposals like those made in the current Congress and in the administration's Fiscal Year 2022 Greenbook (see Item 2.e above).

(b) **Early Sunset for Doubled Basic Exclusion Amount.** The sunset of the 2017 Tax Act's doubling of the $5 million basic exclusion amount (indexed for inflation since 2012) would be accelerated **from January 1, 2026, to January 1, 2022**. Thus, the basic exclusion amount would return to $5 million, indexed for inflation since 2012, which the Joint Committee on Taxation (JCT) staff projects would be $6,020,000 for 2022. This was estimated to raise $54 billion over 10 years (mostly in the first five years before the original 2026 sunset).

(c) **Closer Alignment of Grantor Trust and Transfer Tax Rules.** The bill approved by the Ways and Means Committee would create a new chapter 16, consisting solely of a new section 2901, effectively linking the grantor trust rules and the transfer tax rules so that a trust designed as a grantor trust would continue to be exposed to gift or estate tax with respect to the grantor. Thus, the bill picks up, with some significant changes, the proposals in section 8 of Senator Sanders' "For the 99.5 Percent Act" (discussed in Item 2.f above), which in turn track the Obama administration Greenbooks. With respect to a trust or portion of a trust that is not otherwise includable in the grantor's gross estate and is funded **on or after the date of enactment** (either upon initial formation or by a contribution to an existing trust), section 2901 would

i. include the value of such portion in the grantor's gross estate for estate tax purposes,

ii. subject to gift tax any distribution from such portion during the grantor's life, other than distributions to the grantor or the grantor's spouse or in discharge of an obligation of the grantor, and

iii. treat as a gift by the grantor, subject to gift tax, all of such portion at any time during the grantor's life if the grantor ceases to be treated as the owner of such portion for income tax purposes.

Unlike the "For the 99.5 Percent Act," this proposal would apply only to "any portion of a trust with respect to which **the grantor** is the deemed owner." It omits the additional explicit application in the "For the 99.5 Percent Act" to the extent a deemed owner engages in a leveraged "sale, exchange, or comparable transaction with the trust" that appears to have been aimed at the technique known as a "Beneficiary Defective Inheritor's Trust" ("BDIT"). (Compare Item 2.f above)

The creation of, or addition to, such a grantor trust would not escape gift tax, but, in determining future gift or estate taxes upon one of the events described in paragraphs (a),

(b), and (c) above, "amounts treated previously as taxable gifts" would be "account[ed] for" with a "proper adjustment."

(d) **Certain Sales Between Deemed Owned Trust and Deemed Owner.** Going a step beyond the "For the 99.5 Percent Act," the bill would add a new section 1062 providing:

> In the case of any transfer of property between a trust and a person who is the deemed owner of the trust (or portion thereof), such treatment of the person as the owner of the trust shall be disregarded in determining whether the transfer is a sale or exchange for purposes of this chapter.

The result would be that gain would be recognized by the deemed owner or by the trust, as the case may be, or possibly by both of them (in the case of a substitution of assets or other in-kind exchange, for example). Rev. Rul. 85-13, 1985-1 C.B. 184, the hinge on which almost all grantor trust planning swings, would be nullified. The new rule would not apply to a trust that is fully revocable by the deemed owner.

The bill would also amend section 267 to disallow losses between "[a] grantor trust and the person treated as the owner of the trust (or portion thereof)."

Like the closer alignment of grantor trust and transfer tax rules in section 2901, this rule, as written, would apparently apply only to a trust created, and any portion of an existing trust attributable to a contribution made, **on or after the date of enactment**. The Ways and Means Committee report states that it "is intended to be effective for sales and other dispositions after the date of enactment" – that is, regardless of when the trust was created or funded – but it adds in a footnote (footnote 935) that "[a] technical correction may be necessary to reflect this intent."

This provision and section 2901 together were estimated to raise $8 billion over ten years.

(e) **Valuation of Certain Nonbusiness Assets in Entities.** In a proposal traceable at least to the Reagan and Clinton administrations and virtually identical to section 6 of Senator Sanders' "For the 99.5 Percent Act" (see Item 2.f above), the Ways and Means Committee bill would in effect require the valuation of nonbusiness assets in an entity by **a look-through method**. The proposal would add a new section 2031(d) to the Code, **applicable to transfers (by gift or upon death) after the date of enactment**. Section 2031(d)(1) would read as follows:

> (d) Valuation Rules for Certain Transfers of Nonbusiness Assets—For purposes of this chapter [estate tax] and chapter 12 [gift tax]—
>
> > (1) In General—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092) [see, e.g., Reg. §1.1092(d)-1(a) & (b)]—
> >
> > > (A) the value of any nonbusiness assets held by the entity with respect to such interest shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and
> > >
> > > (B) such nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.

Like the "For the 99.5 Percent Act," the proposal includes a detailed list of what are considered "passive assets," detailed rules about "passive assets" that might be used in a business and "look-thru rules" for entities that are at least 10 percent owned by another entity. The proposal also adds a broad grant of regulatory authority, specifically including the issues of whether a passive asset is used in the active conduct of a trade or business or is held as part of the reasonably required working capital needs of a trade or business.

Unlike the "For the 99.5 Percent Act," however, the proposal does not also include a general prohibition on "minority discounts" in family owned or controlled entities, a prohibition that in the "For the 99.5 Percent Act" (see Item 2.f above) is not limited to "nonbusiness" entities or assets and thus would arguably have a much broader and harsher impact on family businesses.

In addition, new section 2031(d)(2)(A) would provide that "[t]he term 'nonbusiness asset' means any passive asset which (i) is held for the production or collection of income, and (ii) is

not used in the active conduct of a trade or business." That implies that, for example, a vacation home that is not rented would not be valued under the proposed look-through rule, which is a bit surprising.

Also surprising, despite that broad definition of a "nonbusiness asset" (which is repeated in the Ways and Means Committee's report), a summary titled "Tax Changes for Estates and Trusts in the Build Back Better Act (BBBA)," published by the Congressional Research Service on October 22, 2021, limits its description of the proposal to only "cash and readily marketable securities," without explanation.

This proposal was estimated to raise $20 billion over 10 years.

(f) **Increased Benefit of Special Use Valuation.** In contrast to the preceding provisions that would make the estate and gift tax more burdensome, the Ways and Means Committee bill, **effective January 1, 2022**, would increase the limit on the reduction under §2032A in the estate tax value of real property used in a family farm or other family business resulting from valuing the real property in that farm or business use, even if that is not its "highest and best use." Currently the limit on that reduction is $750,000 indexed for inflation since 1998 ($1,190,000 in 2021). Such an increase in the limit has often been offered by lawmakers opposed to across-the-board repeal or reduction of the estate tax as a way to target relief to the family farms and businesses that are often cited as justifications for such repeal or reduction. Unlike section 3 of Senator Sanders' "For the 99.5 Percent Act" (see Item 2.f above), which would increase the limitation to only $3 million, indexed for inflation going forward, the Ways and Means Committee proposal would raise the limit to $11.7 million (which happens to be the current basic exclusion amount), indexed going forward. Even so, the proposal would not really reduce the estate tax on a family farm or business as such; it would merely prevent a tax, for example, on a speculative prospect of development that is faced by such businesses very unevenly. Thus, this proposal should not be expected to be viewed by owners of family farms and businesses as much of a consolation. It was estimated to decrease revenues by $317 million over 10 years.

(g) **Planning Implications of Sweeping Transfer Tax Proposals.** For a detailed discussion of planning implications of these sweeping transfer tax proposals, see Item 4 of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(h) **Other Income Tax Proposals.** Other income tax proposals in H.R. 5376 as approved by the House Ways and Means Committee on September 15, 2021 include –

(i) increasing the individual income tax rates from 37% to 39.6% for taxable incomes over $400,000 ($450,000 for joint returns and surviving spouses) and $12,500 (indexed) for trusts and estates,

(ii) increasing the capital gains rate from 20% to 25% for those same individuals and trusts, effective September 14, 2021 with an exception for gains recognized in 2021 pursuant to written binding contracts entered before that date,

(iii) applying a 3% surcharge for "modified adjusted gross income" over $5 million for individuals and $100,000 for trusts and estates,

(iv) changing the 21% corporate income tax rate to 18% for taxable income up to $400,000, leaving it at 21% for taxable income from $400,000 to $5 million, and increasing it to 26.5% for taxable income over $5 million,

(v) expanding the 3.8% net investment income tax by eliminating the "trade or business" exception in §1411(c)(1)(A) for individuals with "modified adjusted gross income" over $400,000 ($500,000 for joint returns and surviving spouses) and for trusts and estates with AGI over the threshold for the highest income tax bracket, and

(vi) capping the qualified business income deduction under §199A at $400,000 for individuals ($500,000 for joint returns and surviving spouses) and $10,000 for trusts and estates.

(4) Billionaires Income Tax, October 27, 2021. Following Senator Sinema's objection to rate increases for individuals and corporations (which were responsible for much of the revenue raisers in the H.R. 5376) Senator Wyden released his Billionaires Income Tax mark-to-market proposal on October 27, 2021 (described in Item 2.k below).

(5) Administration's Build Back Better Framework, October 28, 2021. In an effort to reach consensus of Democrats in the Senate and House, the administration released a short document titled Build Back Better Framework on October 28, 2021. The document reflected ongoing negotiations and referred to "a new surtax on multi-millionaires and billionaires" but omitted many of the revenue provisions the September 15 version of H.R. 5376 (including the estate planning related provisions discussed in Item 2.g(3) above). The administration's framework did not include any reference to the provisions of Senator Wyden's Billionaires Income Tax, which had met the immediate disapproval of some Democrats.

(6) H.R. 5376, October 28, 2021. That same day, on October 28, The House Rules Committee released a new version of H.R. 5376 reflecting the administration's framework. It omitted the estate tax, grantor trust, and valuation provisions discussed in Item 2.g(3) above. It includes

- the limitations under §1202 for qualified small business stock for high-income taxpayers, and
- the expansion of the 3.8% net investment income tax for active business income from passthrough entities for high-income taxpayers,

but it omits

- increases of the corporate and individual rates (other than the surcharge for high-income individuals discussed below),
- the limitation on the qualified business income deduction under §199A for high-income taxpayers, and
- limitations on ultra-large IRAs and Roth accounts (but some of those limitations were added back in the November 3 version, discussed below).

(7) Surcharge in H.R. 5376, October 28, 2021. Of particular note, the thresholds and surcharge rates on very high-income taxpayers in the September 15 version of H.R. 5376 were increased.

- Threshold. The "modified adjusted gross income" income threshold for individuals is doubled from $5 million to $10 million, including joint returns of married couples (half that amount for married individuals filing separately), and the threshold for trusts and estates is doubled from $100,000 to $200,000. For trusts and estates, "adjusted gross income" is determined under section 67(e), which is calculated after taking into consideration the distribution deduction, but without considering the charitable deduction under §642(c) (but the November 3 version of H.R. 5376, discussed below, does allow consideration of the charitable deduction).
- Rate. The surcharge rate above that threshold is increased from 3% to 5%. In addition, an 8% rate (rather than 5%) applies for income above a threshold of $25 million for individuals (half that amount for married individuals filing separately) and $500,000 for trusts and estates.
- Planning Observation. Structuring trusts with the flexibility to cause capital gains to be included in distributable net income will be very important so that capital gains can be distributed to beneficiaries to decrease the trust's adjusted gross income if staying below the surcharge threshold is important for the trust. For a discussion of structuring alternatives, see Item 18 of Akers, Estate Planning Current Developments and Hot Topics

(December 1, 2015) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(8) **H.R. 5376, November 3, 2021.** An updated version of H.R. 5376, with both technical and substantive additions, was released on November 3, 2021. Revisions in the November 3 version include the following.

- As noted above, the surcharge threshold for trusts and estates is based on income after subtracting the charitable deduction under §642(c).
- Limitations for IRA or Roth accounts are reinstated for high-income taxpayers, including prohibitions of additional contributions after IRA and Roth accounts reach $10 million, requiring certain mandatory distributions from accounts exceeding $10 million, and requiring annual reporting of balances for accounts with at least $2.5 million. The prohibition on IRAs holding certain investments was not added back.
- The 5% and 8% surcharge for electing small business trusts (ESBTs) is determined by combining S corporation income and non-S corporation income to determine if the trust is over the threshold; this will require separate computations of taxable income – one for normal income purposes (treating the S and non-S portions as separate trusts) and a second for surcharge purposes (which coincidentally would appear to allow using S corporation losses to offset taxable income on the non-S portion).
- The $10,000 cap on state and local taxes through 2025 would be increased to $72,500 for 2021 – 2025, and the $72,500 cap would continue for 2026-2031 (as opposed having the cap removed entirely beginning in 2026 under current law).

(9) **H.R. 5376, November 4, 2021 Amendment.** An amendment offered on November 4, 2021 would making various changes including increasing the SALT cap:

- The $72,500 cap on state and local taxes for 2021-2031 (under the November 3 proposal) would be increased to $80,000, except that the $10,000 cap would be reinstituted for 2031 (and the cap would be removed entirely beginning in 2032).

(10) **H.R. 5376, Passed House of Representatives, November 19, 2021; Relevant Tax Provisions Highlights.** The Build Back Better Act (H.R. 5376) passed the House of Representatives on a 220-213 straight party-line vote (except that Representative Jared Golden (Dem. ME) voted against the bill, reportedly because the SALT amendment would largely benefit high-income taxpayers).

(11) **Senate Action, Text From Senate Finance Committee.** The Senate Finance Committee released an unfinished version of the Committee's title (Title XII) of the Build Back Better Act on December 11, 2021, with a summary that "[t]he updated text includes both technical and policy changes, as well as modifications to ensure compliance with Senate budget rules." The tax provisions are very similar to the provisions in H.R. 5376 passed by the House on November 19, 2021. One of the major changes is that the SALT provision is left blank while it is still being negotiated (the Finance Committee text includes Section 127601 as a "placeholder for compromise on deduction for state and local taxes"); a major issue is whether the removal of the $10,000 limitation of the SALT deduction would be restricted to taxpayers with income below a specified threshold, and that income threshold is still being discussed (with the discussions ranging from about $400,000 to about $1 million). *See* Laura Davison, *SALT Talks Continue as Senate Democrats Release Tax Plan*, BLOOMBERG DAILY TAX REPORT (Dec. 11, 2021). The bill is now being negotiated in the Senate, and various changes are still possible. For example, Chairman Ron Wyden is still negotiating to add his Billionaires Income Tax proposal.

(12) **Overview Summary of Current Tax Provisions.** This is a brief overview of relevant tax issues in the Build Back Better Act as it stands now.

Included. The proposed legislation includes the following.

- A 5% income tax surtax applies to modified adjusted gross income for individual taxpayers in excess of $10 million (same as for single and married filing jointly individuals)

and for trusts and estates in excess of $200,000, and an 8% surtax applies for income above a threshold of $25 million and $500,000. The threshold for trusts and estates is determined after taking into consideration the distribution deduction as well as the charitable deduction under §642(c).

- The 3.8% net investment income tax will apply to active business income from passthrough entities for taxpayers with greater than $400,000 in taxable income (single) or $500,000 (joint), and slightly over $13,000 for all non-grantor trusts and estates (under current law the 3.8% tax applies only to passive income).
- The 100% exclusion for qualified small business stock under §1202 is reduced to 50% as of September 14, 2021 for all non-grantor trusts and estates and for individuals with adjusted gross income above $400,000.
- Contribution limitations and minimum distribution requirements will apply to IRAs (including Roth IRAs) above $10 million, but proposed new limitations on accredited investor, qualified purchases, and closely-held investments are not included.
- The House-passed version provides that the $10,000 cap on state and local taxes for 2021-2031 would be increased to $80,000, except that the $10,000 cap would be reinstituted for 2031 (and the cap would be removed entirely beginning in 2032). The text released from the Senate Finance Committee leaves the SALT provision blank (while it is still be negotiated).

Not Included. H.R. 5376, as passed by the House and the text released by the Senate Finance Committee, does not include provisions addressing (among other things)

- increases in the individual rates or capital gains rates (other than the surcharge described above),
- increases of the C corporation rates,
- changes to the carried interest rules,
- the decrease in the estate and gift tax exclusion amount, grantor trust changes (§2902 and §1062), valuation of nonbusiness assets in entities, increased benefit of special use valuation,
- limitations on the §199A deduction for high-income taxpayers,
- the Billionaires Income Tax, or
- any deemed realization/carryover basis provisions.

But negotiations are ongoing, and more changes are possible (negotiations are continuing in the Senate).

(13) Timing. Timing of possible passage of H.R. 5376 is very uncertain at this point. Major negotiations continue in the Senate. Significant differences still exist among the Democrats in Congress on a variety of issues, including the overall cost of the plan, whether to add a work requirement for the expanded child tax credit, whether and how the limitations on SALT deductions will be eliminated or modified, and whether a paid family leave and medical leave, expanded Medicare to cover hearing care, and prescription drug pricing will be included (among other things). So far, Senator Manchin is still expressing concerns about passage of the Build Back Better Act in light of its possible effect on inflation and has objected to including some programs for only several years to reduce the 10-year cost of the bill, although the programs might later be extended indefinitely. Some have quipped that the negotiations to whittle down the Act will result in a "Build Back Something" bill (and, seriously speaking, some have suggested changing the name from something that sounds like infrastructure back to "The American Families Plan"). *See* Doug Sword, *House Dems Envision Whittled-Down 'Build Back Something' Bill*, TAX NOTES (Jan. 12, 2021). Senator Manchin has suggested he might back various climate provisions in the bill, and President Biden on January 19, 2022 endorsed getting

"pieces, big chunks" of the bill passed and specifically noting that "we would be able to get support for the $500 billion plus for energy and the environment." Various Democrats in Congress have rallied round proceeding with the climate change provisions and any other parts of Build Back Better that have the votes as a new package for consideration. *See* Coral Davenport and Lisa Friedman, *'Build Back Better' Hit a Wall, but Climate Action Could Move Forward*, NEW YORK TIMES (January 20, 2022). The Build Back Better Act appears to have dropped in priority at this point in deference to other concerns (such as authorization of government funding).

(14) **Transfer Tax Provisions Omitted but Some Could be Implemented by Administrative Action.** The sweeping transfer tax provisions discussed in Item 2.g(3) above are omitted (and are extremely unlikely to be returned in further negotiations of H.R. 5376), but some of those concepts could be implemented in large part by administrative changes if the Biden administration should want to devote the considerable political will and resources that would be required.

> Legislative changes may be unlikely, but for the Biden administration, which proposed a host of reforms earlier in the year, administrative changes may turn out to be the fallback plan.
>
> The most recent priority guidance plan contains relatively noncontroversial items in the estate and gift tax area. But [Austin Bramwell of Milbank LLP] noted that Treasury has an assistant secretary for tax policy — Lily Batchelder — with an extensive scholarly background in wealth transfer tax issues. "If they want to do administrative changes in our area, Treasury certainly could," he said.
>
> The much-maligned grantor trust reform proposal didn't survive congressional negotiations, but even if the law isn't changed, the rules for grantor trusts could be changed administratively to accomplish essentially the same outcome as the legislative proposal, according to Bramwell. "It's a question of political will and resources, not of administrative law," he said.
>
> However, the amount of political will and resources needed to do something like that is considerable, Bramwell added. The IRS could begin by revoking Rev. Rul. 85-13, 1985-1 C.B. 184, but it may then have to comb through other existing regulations where the position of Rev. Rul. 85-13 is enshrined and go through the notice and comment rulemaking process to correct them.
>
> "It would unsettle so many areas of law that you'd need to get a whole bunch of very good tax lawyers together to figure out how to do it technically," Bramwell said.
>
> Treasury could also bring back a regulatory project limiting valuation discounts. The proposed regs were unpopular at the time, receiving more than 10,000 comments in opposition, and the Trump administration later withdrew them. But both [Justin] Miller and Bramwell said they wouldn't be surprised to see a regulatory crackdown on discounts.

h. **2022 Midterms.** Midterms are historically tough on the president's party.

> Since the end of World War II, the president's party has lost House seats in all by two midterms: 2002 and 1998, when Republicans were seen as overreaching with their impeachment inquiry into President Bill Clinton. In the average midterm election during this time period, the president's party has lost 26 House seats.
>
> ...
>
> [However,] the president's party doesn't always lose Senate seats.... This might sound counterintuitive given how often the president's party loses ground in the House, but House elections are simply more susceptible to the national electoral environment than Senate elections. This is, in part, because all 435 seats are up in each House election, whereas only about one-third of Senate seats (and roughly two-thirds of states) are up. As such, the partisan makeup of those Senate seats can more strongly influence the electoral chances of the two parties. Moreover, Senate elections are statewide contests where incumbents have sometimes had a larger edge than their House counterparts, in part because a distinct personal brand can still somewhat override trends running against the incumbent's party.
>
> ...
>
> Looking ahead to 2022, it's less likely we'll see the Senate and House move in different directions, as Republicans have only two Biden-won Senate seats to defend, Pennsylvania and Wisconsin, which are states Biden won by less than 2 points, meaning Democrats have little in the way of easy pickings. By contrast, the GOP will likely have more opportunities for pickups, as they can expect to challenge Democratic-held Senate seats in battleground states, such as Arizona, Georgia and Nevada, each of which Biden won by fewer than 3 points.
>
> ...

Political science has offered a number of explanations for what's going on under the hood, all of which may contribute at least in part to the presidential party's midterm curse. These can largely be grouped into three categories: a midterm "reversion to the mean" after presidential elections, a "surge and decline" in voter turnout that changes the electorate from presidential years to midterm years and a broader "presidential penalty" where the party in the White House gets punished regardless of how the country is doing.

...

All in all, though, the takeaway from history and political science literature is clear: The president's party is almost always cursed with midterm losses in congressional elections. This reality makes Republicans favorites to win full control of Congress in 2022 pretty much regardless of what happens over the next year — although the extent of the GOP's advantage could grow or shrink depending on how Biden is doing as president. Geoffrey Skelley and Nathaniel Rakich, *Why the President's Party Almost Always Has a Bad Midterm*, FiveThirtyEight by ABC News (Jan. 3, 2022).

Losing just one net Senate seat to Republicans would result in loss of control of the Senate for Democrats. In the 2022 Senate elections, Republicans will be defending 20 of the 34 open Senate seats, including two seats in states (Pennsylvania and Wisconsin) won by President Biden (but by less than two points), while Democrats will not be defending any Senate seat in a state won by President Trump) Three Democratic senators up for re-election in 2022 won their last race by less than 6% (Senators Hassan [NH], Mastro [NV], and Bennett [CO]), and three more Democratic senators up for re-election in 2024 are from states won by President Trump in 2020 (Senators Manchin [WV], Tester [MT], and Brown [OH]). Also, Senators Warnock and Ossof in Georgia won their 2020 races by less than 1% of the vote. Also, Democratic Senate seats in Arizona and Nevada are in states that Biden won by less than three points.

Accordingly, while the evenly split Congress may make sweeping changes harder to achieve, the possibility of a shift of control in the House or Senate (or both) in the 2022 midterms adds urgency for Democrats to do what they can now regarding tax legislation.

i. **Possibility of Retroactive Tax Changes; Constitutionality Issues; Planning Considerations.** Throughout 2020, some planners were concerned that clients should make transfers in 2020 in case legislation in 2021 reducing exclusions or increasing rates would be made retroactive to January 1, 2021. That obviously did not happen. Similarly, in early 2021 there was some concern that the gift exclusion amount might have been reduced retroactively to January 1, 2021. That could have resulted in millions of dollars of gift tax payments being owed by clients who made gifts of their $11.7 million exclusion amount thinking that no gift taxes would be due – an outrageous result. Those clients concerned with the possibility of retroactive tax changes in 2021 could still be concerned in 2022. In light of the fact that the changes have been introduced and debated through the fall of 2021, applying those changes retroactive to January 1, 2022 is very unlikely but **not out of the question**.

The operation of the unified credit for federal gift tax purposes creates the possibility of an inadvertent retroactive gift tax change, as explained in Item 2.q.(2) of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. That is a scary possibility—but transfer tax changes are typically made effective on January 1 of the year following the date of enactment; therefore, the exclusion amount would not be changed as of the date of the gift. In any event, in the very evenly divided Congress, the likelihood of a retroactive reduction of the gift exclusion amount is extremely low, particularly in light of the extreme unfairness of such a change.

If Congress were to enact a retroactive tax change, the legislation likely would be upheld if it were attacked as being unconstitutional. A long history exists of examples of retroactive legislation. Indeed, the Supreme Court has gone so far as to state that Congress "almost without exception" has given general revenue statutes effective dates prior to the dates of actual enactment. *United States v. Darusmont*, 449 U.S. 292, 296 (1981). Retroactive tax legislation is not absolutely barred by the U.S. Constitution, and is almost always upheld by the Supreme Court. For example, "corrective" retroactive estate tax legislation was upheld in *United States v. Carlton*, 512 U.S. 26 (1994). For various examples of and discussions about constitutional issues of retroactive tax legislation see Item 2.q.(3) of Estate Planning Current Developments (December 2021) found here and Item 2.b.(3)

of Estate Planning Current Developments and Hot Topics (May 2021) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights).

For clients who are concerned (or perhaps obsessed) with the very unlikely risk of retroactive gift tax legislation, some planners have examined ways of making gifts that could be limited not to trigger gift tax or that could be "undone" in the event of subsequent legislation making the gift inadvisable. Alternatives include (1) formula gifts up to the available exclusion amount, (2) gifts to QTIPable trusts, (3) gifts to QTIPable trusts with a disclaimer provision that would pass assets to a trust for descendants (or possibly a SLAT although that is not clearly allowed) if the spouse disclaimed, (4) gifts to trusts providing that disclaimed assets would revert to the donor, (5) combinations of the above, (6) selling assets to delay the decision to make a gift by forgiving the note but shifting future appreciation beginning immediately, and (7) attempting to rescind the gift later based on changed circumstances. See Items 12-20 of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights) for a more detailed discussion of these alternative approaches.

j. **Wealth Tax.** The proposed Ultra-Millionaire Tax Act, co-sponsored by Senators Sanders, Warren, and various others, provides a 2% annual tax on the net worth of households and trusts ranging from $50 million to $1 billion and an additional 1% annual tax (for a 3% total tax) on assets above $1 billion. Estimates are that about 100,000 Americans (or fewer than 1 in 1,000 families) would be subject to the wealth tax in 2023, and that it would raise about $3 trillion over a decade, according to an analysis by University of California Berkeley Economics Professors Emmanuel Saez and Gabriel Zucman. Treasury Secretary Janet Yellen has confirmed that President Biden does not favor a wealth tax, and that a wealth tax would have significant implementation problems. *See Yellen Favors Higher Company Tax, Capital Gains Worth a Look*, BLOOMBERG DAILY TAX REPORT (Feb. 22, 2021). For a more detailed discussion of the wealth tax concept, including constitutionality issues and administrative complexities, see Item 2.d. of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

k. **Mark-to-Market Proposals; "Billionaires Income Tax" Proposal.** Senator Wyden (Chair of the Senate Finance Committee) has for some years been pushing a mark-to-market system rather than a wealth tax. Proposals by Senator Wyden in 2019 and 2020 would eliminate the preferential rates for long-term capital gains so that all income would be taxed at applicable ordinary income rates. In addition, new "anti-deferral accounting rules" would apply to high-income taxpayers, providing (i) mark-to-market annual taxation of income from tradable property (such as stocks and bonds), and (ii) lookback taxation of income from nontradable property (a lookback charge [perhaps an interest charge on the deferred tax] would be applied to reduce incentives for the taxpayer to defer the sale of the assets). The anti-deferral accounting rules would apply to taxpayers (including individuals, estates, or trusts) that meet certain income or asset thresholds. A taxpayer would be subject to the rules if she has either $1 million of income OR $10 million of "applicable assets" in each of the prior three years (the income threshold could be satisfied in some years and the asset threshold could be satisfied for other years in the three-year test period). This threshold means that the rules would apply to "only a fraction of the richest 1 percent of Americans." For a detailed description of the proposal, see *Treat Wealth Like Wages*, by Senate Finance Committee Ranking Member Ron Wyden, available at https://www.finance.senate.gov/imo/media/doc/Treat%20Wealth%20Like%20Wages%20RM%20Wyden.pdf.

The Mark-to-Market proposal has arisen again in the consideration of the reconciliation package being considered in 2021 (the Build Back Better Act). After Senator Sinema indicated that she opposed raising corporate and individual income tax rates, Senator Wyden again on October 27, 2021 rolled out his mark-to-market regime in the "Billionaires Income Tax" proposal, as mentioned in Item 2.g(4) above. For a summary of the Billionaires Income Tax proposal, see Item 2.s. of Estate Planning Current Developments (December 2021) found here and Part 2.e of Ronald D. Aucutt, Washington Update: Pending and Potential Administrative and Legislative Changes (January 3, 2022) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

I. **Accelerating Charitable Efforts (ACE) Act Proposal.** Sen. Angus King (I-ME) and Sen Chuck Grassley (R-IA) on June 9, 2021, introduced bipartisan legislation, the Accelerating Charitable Efforts (ACE) Act, to cause philanthropic funds to be made available to working charities within a reasonable time period by tightening restrictions on donor advised funds (DAFs) and private foundations. An essentially identical proposal, H.R. 6595, was introduced in the House on February 3, 2022 by Representative Chellie Pingree (D-ME).

These changes are introduced in response to coalitions of philanthropic and nonprofit leaders and academics urging reforms to unlock hundreds of billions of dollars in DAFs and foundation endowments. A statement from Senator King's office observes that DAFs currently have more than $140 billion set aside for future charitable gifts with no requirement to ever distribute these resources to working charities. However, the proposal is strongly opposed by the Council of Foundations and others in the charitable sector. If the proposal advances to a committee or Senate floor vote, Council on Foundations president and chief executive officer Kathleen Enright has said "we expect a big, pitched battle over it." *Philanthropy Divided Over Legislation to Accelerate DAF Grants*, Philanthropy News Digest website (posted June 11, 2021).

(1) **Additional Restrictions on DAFs.** Four restrictions would apply to contributions to "nonqualified" DAFs in order to receive an income tax charitable deduction: (i) no deduction would be allowed for non-cash contributions unless the fund sells the asset for cash; (ii) no deduction would be allowed until the fund makes a qualifying distribution of the contribution (or the sale proceeds of the contribution); (iii) the deduction would be limited to the qualifying distribution amount; and (iv) contribution must be distributed within 50 years to avoid the imposition of a 50% excise tax on the undistributed portion of the contribution and attributable earnings.

For contributions to a "qualified" DAF, no income tax charitable deduction would be allowed for the contribution of a "non-publicly traded" asset until the year the asset is sold, and the deduction would not exceed the gross proceeds received from the sale and credited to the fund. A "qualified" DAF is one that requires the donor's advisory privilege to end before the last day of the 14th taxable year beginning the year after the year in which the contribution is made, and in which the donor identifies at the time of contribution a preferred charitable organization to receive any assets that remain in the fund at the end of the time limit. That limitation does not apply, however, to a "qualified community foundation donor advised fund," meaning that (i) no individual with advisory privileges has advisory privileges with respect to more than $1,000,000 (indexed) in DAFs with that sponsoring organization, (ii) the DAF must make qualifying distributions of at least 5% of the fund value each year, and (iii) the community foundation must serve the needs of a particular geographic community that is no larger than four states and that holds at least 25% of the organization's total assets outside of DAFs.

The new rules would apply to contributions after the date of enactment.

(2) **Changes to Private Foundation Minimum Distribution Requirements.** The following would not count toward the 5% minimum distribution requirement for private foundations: (i) administrative expenses paid to substantial contributors or family members and (ii) distributions to a DAF. These two new rules would apply, respectively, to (i) taxable years beginning after December 31, 2021, and (ii) returns required to be filed after December 31, 2021.

(3) **Exemptions From Investment Income Excise Tax.** The investment income excise tax would not apply to private foundations meeting either of two requirements: (i) the foundation makes qualifying distributions in excess of 7% of the foundation's asset value (other than direct use assets); or (ii) the foundation has a specified duration of not more than 25 years and does not make distributions to other private foundations having a common disqualified person. These provisions would apply to taxable years beginning after the date of enactment.

(4) **Public Support Test Changes.** To determine whether a charity meets the public support test to be classified as a public charity rather than a private foundation, contributions from a DAF to the charity will be treated as coming from the original donor, or if the original donor is not identified,

all contributions from DAFs for which the donor is not identified will be treated as coming from a single donor. This provision would apply to contributions made after the date of enactment.

3. Corporate Transparency Act Overview

a. **Brief Summary.** The Corporate Transparency Act (CTA) was enacted on January 1, 2021 as part of the National Defense Authorization Act. It effectively will create a national beneficial ownership registry. This is an outgrowth of the efforts of the international community, through the Financial Action Task Force (FATF), to combat the use of anonymous entities for money laundering, tax evasion, and the financing of terrorism. Customer due diligence regulations in the U.S., adopted in 2016 and 2018 (the "CDD Regulations"), require financial institutions to obtain identifying information when opening bank accounts for entities and require title insurance companies to provide beneficial ownership information for legal entities used to make high-end cash and wire purchases of real estate in various metropolitan areas. Still, the U.S. has been viewed internationally as being vulnerable to money laundering and tax evasion because of a perceived lack of corporate transparency and reporting of beneficial ownership.

The CTA requires that certain entities must disclose to the Financial Crimes Enforcement Network ("FinCEN") identifying information about individual owners and those who control the entity ("Beneficial Owners") and "Applicants" applying to form an entity. A national registry of entities and their applicants and owners will be created.

At this point, private trusts apparently are not included among the entities that must report, and charitable organizations, including private foundations, are specifically exempt from the reporting requirements.

The publication of the "Pandora Papers" disclosed information about a number of foreigners who have chosen to keep assets held in U.S. trusts. Many of them are connected to people or companies accused of fraud, bribery, or human rights abuses in some of the world's most vulnerable communities. *See* Debbie Cenziper, Will Fitzgibbon & Salwan Georges, *Foreign Money Secretly Floods U.S. Tax Havens. Some of It Is Tainted*, WASHINGTON POST (Oct. 6, 2021). This development may create pressure on the U.S. to agree to more complete disclosure about private trusts and perhaps the beneficial owners of private trusts in the United States.

See generally Kevin L. Shepherd and Edward M. Manigault, *Beneficial Ownership Disclosure and the Corporate Transparency Act: Overdue or Overwrought?*, 35 PROB. & PROP. No. 4 (July/Aug. 2021); Brooke Tansill, *The Corporate Transparency Act: What Practitioners Need to Know*, ABA REAL PROP. TRUST & ESTATE LAW SECTION EREPORT (Summer 2021).

b. **Reporting Companies.** Companies that must report are corporations, LLCs, and other "similar entities" that are created by filing a document with a secretary of state or similar office or foreign entities registered to do business in the U.S. Trusts would seem not to be included as a Reporting Company because they are not created by filing a document with a secretary of state, but some question exists as to whether they might be considered a "similar entity." Future study of partnerships, trusts, and other legal entities is called for under the CTA, so these rules may evolve in time.

Companies that are exempt from reporting include (1) certain specified companies already under close federal regulation (*e.g.*, banks, bank holding companies, SEC registered entities, insurance companies, charitable organizations exempt from tax under §501(c)(3), 501(a), 527(a) or 4947(a), etc.), (2) companies with a physical presence in the U.S. that employ more than 20 people and that have gross receipts exceeding $5 million, and (3) certain entities with no active trade or business (a number of requirements apply to this dormant company exception).

c. **Beneficial Owner.** A "Beneficial Owner" (who must be reported) is any individual who directly or indirectly (i) exercises substantial control over a Reporting Company or (ii) owns or controls at least 25% of the Reporting Company. Certain individuals are excluded as Beneficial Owners: (i) minors (provided the parent or guardian's information is reported); (ii) nominees or agents; (iii) an employee whose control or economic benefits from the Reporting Company come solely from employment; (iv)

an owner solely through a right of inheritance; and (v) a creditor of a Reporting Company (who is not otherwise a Beneficial Owner directly).

For a trust that is a Beneficial Owner of 25% or more of an entity, planners had anticipated that regulations would adopt an approach, like the approach of the CDD Regulations, treating the trustee is the deemed beneficial owner (and not the individual beneficiaries). *See* John A. Terrill & Michael Breslow, *Congress Passes Corporate Transparency Act to Require Disclosure of Beneficial Owners of Entities and the Creation of a National Registry of Entities*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #218 (Jan. 21, 2021). Proposed regulations unfortunately have not adopted that approach, but generally treat as Beneficial Owners (i) trustees, (ii) a trust beneficiary who is the sole permissible recipient of income and principal or who can demand distribution of or withdraw substantially all of the trust assets, and (iii) the trust grantor or settlor who has the right to revoke the trust or otherwise withdraw all of its assets. The preamble to the regulations explains as follows and requests comments.

> Proposed 31 CFR 1010.380(d)(3)(ii)(C) specifies that an individual may directly or indirectly own or control an ownership interest in a reporting company through a trust or similar arrangement. The proposed language aims to make clear that an individual may own or control ownership interests by way of the individual's position as a grantor or settlor, a beneficiary, a trustee, or another individual with authority to dispose of trust assets. In relation to trust beneficiaries in particular, FinCEN believes that it is appropriate to consider an individual as owning or controlling ownership interests held in trust if the individual is the sole permissible recipient of both income and principal from the trust, or has the right to demand a distribution of, or withdraw substantially all of the assets from, the trust. Other individuals with authority to dispose of trust assets, such as trustees, will also be considered as controlling the ownership interests held in trust, as will grantors or settlors that have retained the right to revoke the trust, or to otherwise withdraw the assets of the trust. FinCEN believes that these circumstances comport with the general understanding of ownership and control in the context of trusts and furthers the CTA's objective of identifying true beneficial owners regardless of formalities that may vary across different jurisdictions. However, FinCEN acknowledges that these concepts do not map easily onto every trust or similar arrangement. Accordingly, FinCEN is seeking comment on its general approach to the attribution of ownership interests held in trust to certain individuals, as well as the particular circumstances in which individuals may be considered to own or control ownerships interests held in trust. More broadly, FinCEN seeks comments on whether these and the other proposed examples of how one might own or control ownership interests are clear and useful, and which, if any, require elaboration. FEDERAL REGISTER 69920, at 69935 (Dec. 8, 2021).

d. **Regulations and Effective Date.** The Treasury Secretary has broad regulatory authority and was required to promulgate regulations by January 1, 2022. The CDD Regulations must be conformed with the CTA to eliminate duplicative burdens. The regulations will "use risk-based principles for requiring reports of beneficial ownership information." The reporting requirements take effect on the effective date of the regulations. Proposed regulations promulgated by Treasury's FinCEN were published in the Federal Register on December 8, 2021. Those proposed regulations have been controversial in various respects, including the reporting company, beneficial ownership, and filing due date provisions. ACTEC has filed comments regarding the proposed regulations, available at https://www.actec.org/assets/1/6/22.02.04_Corporate_Transparency_Act_Letter_and_Comments.pdf .

e. **Filing Due Dates.** The statute provides that existing companies when the regulations become effective must file the required information within two years of the effective date of the final regulations, but the proposed regulations change the reporting date to no later than one year after the effective date of final regulations. Proposed 31 CFR §1010.380(a)(1)(iii). The proposed regulations add that any company formed subsequently must file the report within 14 calendar days of the formation of the entity and that a Reporting Company must correct inaccurate information within 14 days of when the company becomes aware or has reason to know that any required information was inaccurate when filed. The proposed regulations also require that every Reporting Company must also file a report within thirty days of certain specified changes of Beneficial Ownership (including any Beneficial Owner exceeding or falling below 25%). (The statute merely requires that changes be reported "in a timely manner, and not later than 1 year after the date on which there is a change.") The short deadlines in the proposed regulations for newly formed entities and for reporting corrections or changes of Beneficial Ownership have been criticized as unrealistic and unduly burdensome for small businesses, "setting the stage for widespread noncompliance." Thomas

Sykes *New FinCEN Reporting Will Challenge Small Companies*, TAX NOTES (Jan. 10, 2022) (recommending that the due dates for filings coincide with federal tax return due dates to substantially reduce compliance burdens and noncompliance; questioning whether regulations that change the precise deadlines found in the very statute that the regulations purport to interpret are lawful under *Chevron* standard for administrative guidance).

f. **Penalties.** Failure to file a timely required report with FinCEN will result in civil and criminal fines (penalties of $500/day the report is outstanding, up to $10,000) and up to two years imprisonment. Any person who willfully provides false ownership information is subject to similar penalties. The preamble to the proposed regulations makes clear that individuals who supply information to Reporting Companies may have liability if that information is false or fraudulent:

> The accuracy of the database may therefore depend on the accuracy of the information supplied by individuals as well as reporting companies, making it essential that such individuals be liable if they willfully provide false or fraudulent information to be filed with FinCEN by a reporting company.

Penalties will also be imposed on anyone who makes an unauthorized disclosure of information about Applicants or Beneficial Owners.

4. Planning for IRA and Retirement Plan Distributions Under the SECURE Act; New Life Expectancy Tables for Calculating Required Minimum Distributions

a. **Overview.** The SECURE Act made various changes regarding retirement benefits including (i) changing the required beginning date for minimum distributions (April 1 of the following year) from age 70½ to 72, (ii) eliminating the prohibition on contributions to an IRA after age 70½ (but if an individual both contributes to an IRA and takes a qualified charitable deduction (QCD) between ages 70½ and 72, the IRA contribution will reduce the portion of the QCD that would otherwise be treated as tax-free), and (most important) (iii) substantially limiting "stretch" planning for distributions from defined contribution plans and IRAs over a "designated beneficiary's"(DB's) lifetime (with several exceptions). The SECURE Act mandates that distributions to a designated beneficiary be made within 10 years following the death of the participant, with exceptions for five categories of "eligible designated beneficiaries" (EDBs).

b. **Eligible Designated Beneficiaries.** The five categories of EDBs are (i) the surviving spouse, (ii) a participant's child who "has not reached majority," (iii) a disabled individual, (iv) a chronically ill individual, and (v) an individual not described above who is not more than 10 years younger than the participant. These beneficiaries qualify for a modified life expectancy payout.

Status as an EDB is determined at the participant's death. A DB who later satisfies one of the five categories of EDBs does not become an EDB for purposes of being able to use an adjusted lifetime payout rather than being subject to the 10-year rule. (Planners had thought that a special rule applied for minors – that if the minor is disabled upon reaching majority, the minor exception continues through the period of disability -- but the proposed regulations say that is not the case, as discussed in Item 4.d(8) below.) A modified life expectancy payout is allowed for EDBs, but the plan must be distributed within 10 years after such EDB's death or cessation as an EDB (even if the next successor beneficiary has become an EDB at that time).

c. **Trust Beneficiaries.** A big change for planners comes into play if the owner wants to use a trust as a beneficiary of a qualified plan or IRA.

(1) **Conduit Trusts Generally Not As Desirable.** A "conduit trust" is a trust that must immediately pay any distribution from a qualified plan or IRA to the trust beneficiary. They were often used because they do not have many complexities that apply to "accumulation trusts" (that permit plan or IRA distributions to be "accumulated" in the trust). They worked fine when plan or IRA distributions were made were distributed over the beneficiary's lifetime, because the distribution each year was relatively small. But when the entire plan must be distributed within 10 years, when the bulk of the plan benefits are distributed to the trust, they would have to be distributed to the beneficiary, and therefore would not serve the purposes for which the owner wanted to

use a trust in the first place. Natalie Choate summarizes, "Almost invariably, conduit trusts will not work the way the client anticipated or wants."

(2) **Conduit Trusts Still Appropriate for Surviving Spouse (and a Beneficiary Not More Than 10 Years Younger).** A distribution to a trust for a surviving spouse (or for a beneficiary not more than 10 years younger than the participant) generally has to be made to a conduit trust, rather than an accumulation trust, to qualify as an EDB (a possible exception is if all other "countable" beneficiaries are EDBs). See Item 4.d(10) below. For example, a standard QTIP trust generally does not qualify as an EDB and the 10-year rule would apply after the participant's death. A QTIP trust that also requires such distributions to the spouse of all plan distributions would constitute a conduit trust that is an EDB and would also qualify for the spousal special treatment (such as recalculating life expectancy each year).

Planners have believed that a trust for a minor would probably have to be a conduit trust in order to qualify for the minor child exception, but the proposed regulations allow using accumulation trusts for minor children. See Item 4.d(7) below.

(3) **Accumulation Trusts Generally Used.** Other than for surviving spouses (and not-more-than-10-years-younger beneficiaries), accumulation trusts will probably be used if the owner wants a trust to receive plan distributions. Accumulation trusts for minor children or for disabled or chronically ill individuals will qualify for the lifetime payout exception under the proposed regulations.

d. **ACTEC Comments; Proposed Regulations.** These provisions of the SECURE Act create many uncertainties, and ACTEC has filed various comments with the IRS with detailed observations and recommendations for guidance. See Item 6.e of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. Those comments are an excellent resource for background information about uncertainties regarding the minimum distribution rules in light of SECURE Act.

The IRS issued proposed regulations to update the minimum distribution rules, including guidance regarding the SECURE Act, on February 23, 2022. REG-105954-20 (published in the Federal Register on February 24, 2022). A few highlights of the proposed regulations are summarized. References in this discussion to the "Preamble" are to the preamble of REG-105954-20.

(1) **Overview.** The proposed regulations reflect statutory amendments since the required minimum distribution regulations were last issued, clarify issues that have been raised in public comments and private ruling requests, and replace the question-and-answer format of the existing regulations. Among other clarifications, the regulations "clarify and simplify" the minimum distribution rules where trusts are beneficiaries.

(2) **Life Expectancy Payments Must be Made During the 10-Year Period for Making Distributions to Designated Beneficiaries If the Owner Dies On or After the Required Beginning Date.** This was a rather shocking change made in the proposed regulations. Planners have believed that if the 10-year rule applied (i.e., for DBs who are not EBDs), no distributions were required until the end of the 10-year period. Indeed, the IRS has taken that position in official IRS publications.

An example on page 12 of the initial 2021 version of IRS Publication 590-B, Distribution from Individual Retirement Arrangements (IRAs) (March 25, 2021), suggested that payments would have to be made each year (based on a life expectancy payout) during the general 10-year period for making distributions from qualified plans and IRAs following the participant's death. Commentators believed the example was simply a mistake and that the only distribution requirement is that the entire account must be distributed by December 31 of the tenth year. *See* Natalie Choate, *IRS Publication 590-B Offers Preview of Treasury Guidance on Post-SECURE RMD Rules … and Some Bloopers*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #757 (April 26, 2021). The IRS issued a statement revising that example on May 13, 2021, and a revised version of Publication 590-B, dated May 13, 2021, making that change was posted. (The 2021 version of that Publication is no longer available for download; the IRS website states that an updated revision of the form is being finalized.) That revised version includes this revised statement:

> The 10-year rule requires the IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31 of the year containing the 10th anniversary of the owner's death. For example, if the owner died in 2020, the beneficiary would have to fully distribute the plan by December 31, 2030. The beneficiary is allowed, but not required, to take distributions prior to that date.

The IRS released a draft of the 2021 Tax Year IRA Publication 590-B on January 7, 2022. (The version of that draft last reviewed by the author says "DRAFT AS OF February 25, 2022.") It has the following statement (on page 11):

> The 10-year rule requires the IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31 of the year containing the 10th anniversary of the owner's death. For example, if the owner died in 2021, the beneficiary would have to fully distribute the IRA by December 31, 2031**. The beneficiary is allowed, but not required, to take distributions prior to that date.** [Emphasis added.]
>
> The 10-year rule applies if . . . the beneficiary is a designated beneficiary who is not an eligible designated beneficiary, regardless of whether the owner died before reaching his or her required beginning date.

The proposed regulations state the general rule that minimum distributions are determined by dividing the account balance by an "applicable denominator." Prop. Reg. §1.401(a)(9)-5(a)(1). If the Participant (generally referred to below as the owner) dies after the required beginning date (age 72) and if the account has a DB, the applicable denominator is the greater of the DB's remaining life expectancy and the owner's remaining life expectancy. Prop. Reg. §1.401(a)(9)-5(d)(1)(ii). The preamble to the proposed regulations gives this example:

> For example, if an employee died after the required beginning date with a designated beneficiary who is not an eligible designated beneficiary, then the designated beneficiary would continue to have required minimum distributions calculated using the beneficiary's life expectancy as under the existing regulations for up to nine calendar years after the employee's death. In the tenth year following the calendar year of the employee's death, a full distribution of the employee's remaining interest would be required. Preamble at 46-47.

The changed position creates uncertainty regarding 2021 required minimum distributions for beneficiaries of plans for which the owner died on or after January 1, 2020 (meaning that the SECURE Act rules apply) and after the owner's required beginning date. The proposed regulations are proposed to apply for calendar years beginning in 2022, and for 2021, "taxpayers must apply the existing regulations, but taking into account a reasonable, good faith interpretation of the amendments made by sections 114 and 401 of the SECURE Act. Compliance with these proposed regulations will satisfy that requirement." Preamble at 77-78. In light of the position taken by the IRS in the May 13, 2021 version of IRS Publication 590-B and the Draft as of February 25, 2022 of Publication 590-B, a reasonable position should be that no distribution was required in 2021, but uncertainty exists until the IRS provides further guidance.

This changed position in the proposed regulation regarding payments required during the 10-year period is very controversial and has been strongly criticized. *See* Austin Ramsey, *IRS Minimum Distribution Proposal Baffles Financial Advisers*, BLOOMBERG DAILY TAX REPORT (February 24, 2021); Mike Jones, *The Proposed Regulations*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER (February 28, 2022.

If the owner dies *before* the required beginning date with a DB, there is no requirement that any payments be made until the end of the 10-year period. Prop. Reg. §54.4974-1(c)(2), §54.4974-1(d)(3)(iii)(C), §54.4974-1(d)(4)(ii).

(3) **Under 10-Year Rule, Payments Required by End of December of Tenth Year.** The proposed regulations confirm, as anticipated, that under the 10-year rule, payments must be made by December 31 of the year in which the 10-year period ends. Prop. Reg. §1.401(a)9)-3(c)(3).

(4) **"Age of Majority" for the Minor EDB Exception Means Age 21**. The statute describing the EDB exception for minor says it applies until the "age of majority" as defined in §401(a)(9)(F) and the regulation for that provision states that a child may be treated as having not reached the age of majority if the child has not completed a specified course of education and is under the age of 25. The IRS determined that applying the "specified course of education" rule would be difficult to

implement for various reasons and takes the position that the age of majority occurs on the child's 21st birthday. Prop. Reg. §1.401(a)()-4(e)(3).

(5) **Can Use Beneficiary's Life Expectancy If Owner Dies On or After Required Beginning Date Despite "At-Least-As-Rapidly" Statutory Requirement.** Section 401(a)()(B)(i) states that if the owner dies after the required beginning date (so that distributions have begun), the account shall be distributed "at least as rapidly as under the method of distributions ... as of the date of his death" – which would generally be over the owner's remaining life expectancy. However, the beneficiary is generally younger (and often a generation younger) than the owner, and the proposed regulations continue the position in existing regulations that the distributions may be made over the longer of the owner's life expectancy or the beneficiary's life expectancy. Prop. Reg. §1.401(a)(9)-5(d)(1)(ii).

If the beneficiary is an EDB (so benefits can be paid over a life expectancy and the 10-year rule does not apply) and is older than the account owner, distributions may be made over the deceased account owner's longer life expectancy, but at the end of the beneficiary's life expectancy (determined at the date of the owner's death) all of the account must be distributed. Prop. Reg. §1.401(a)(9)-5(e)(5).

(6) **Rules for Accumulation Trusts Simplified.** Various complexities have arisen in drafting accumulation trusts as an account beneficiary under the existing regulations. To avoid those complexities, conduit trusts have often been used as plan beneficiaries if a trust is needed, but conduit trusts generally provide no trust protection after the 10-year period for making distributions (unless all trust beneficiaries are EDBs). One of the complexities for accumulation trusts is a requirement that payments may be made over only the *oldest* beneficiary's life expectancy if there are multiple beneficiaries. Another is a requirement that all beneficiaries must be DBs or else there is no DB of the account (and the entire account must be distributed over five years). These requirements have led to gyrations in drafting accumulation trusts to be able to verify with certainty who is the oldest possible beneficiary and to make sure that there is no possible recipient who is not an individual qualifying as a DB. Determining which contingent remainder beneficiaries of trusts and what possible recipients under powers of appointment are counted for this purpose becomes very important, and accumulation trusts have been drafted around those uncertainties.

(a) **Limitations on What Beneficiaries Are Considered.** Determining which beneficiary's life expectancy could be used is not nearly as important under the SECURE Act, because all of the account must be distributed within ten years in any event (unless the beneficiary is an EDB). Accordingly, the proposed regulations simplify the rules significantly and limit the trust beneficiaries who are "countable" as beneficiaries for purposes of applying these rules. **First**, only current beneficiaries and secondary beneficiaries following the death of the initial current beneficiary are counted; beneficiaries following the death of a secondary beneficiary are not counted. For example, following the owner's death, assume the account is paid to the owner's spouse for life, and remaining benefits are paid to the owner's sibling, but if the sibling predeceases the spouse, the account is paid to a charity. The charity is not considered because it receives benefits only following the death of a secondary beneficiary. Prop. Reg. §1.401(a)(9)-4(f)(3)(ii)(A), -4(f)(6)(ii), Ex.2. (Under the existing regulations, the IRS position has been that "mere potential successor beneficiaries" are not considered, but significant uncertainty remains over how far that exception extends. Some uncertainty remains under the proposed regulations, but the clarification that beneficiaries following the death of the secondary beneficiaries are not countable certainly helps.) **Second**, if the trust requires full distribution to a beneficiary by age 31 (who does not have to be a child of the owner), any other recipient who would receive benefits if the beneficiary dies before reaching age 31 is not counted. Prop. Reg. §1.401(a)(9)-4(f)(3)(ii)(B), Preamble at 33 (example).

(b) **Limitations Regarding Powers of Appointment.** If a power of appointment is *exercised* before September 30 of the year after the owner's death, the recipients of the exercise are treated as beneficiaries. If a power of appointment is *restricted* before September 30 of the year

after the owner's death so that it can only be exercised in favor of two or more identifiable beneficiaries, only those permissible recipients are treated as beneficiaries. If a power of appointment is not exercised or restricted by September 30 of the following year, possible recipients under the power of appointment apparently are not considered at all, but the takers in default of the exercise are treated as beneficiaries. Prop. Reg. §1.401(a)(9)-4(f)(5)(ii). An example describes a trust with the owner's spouse (G) as the current beneficiary, the spouse has a power of appointment to name residual beneficiaries (and there are no stated limits as to who are permissible appointees), and in default of exercise of the power of appointment the assets will pass to the owner's two children (K and L) who are not EBDs. If the power is not exercised, G, K, and L are treated as beneficiaries of the plan (and because they are not all EBDs, the 10-year rule applies). Prop. Reg. §1.401(a)(9)-4(f)(6)(v), Ex.5. (The example does not explicitly say that G, K, and L are treated as the *only* beneficiaries of the plan, but concludes that because G, K, and L are not all EBDs, the 10-year rule applies. But the fact that the permissible appointees under the power of appointment are not even listed suggests that permissible appointees are not relevant.)

If a power of appointment is exercised after September 30 of the year after the owner's death, the recipients of the exercise are treated as beneficiaries of the plan beginning in the year in which the exercise occurs. Prop. Reg. §1.401(a)(9)-4(f)(5)(ii)(B).

(7) **Minor Child and Others as Designated Beneficiaries.** As a general rule, if a plan has multiple designated beneficiaries, some of whom are not EBDs, the plan is treated as not having an EBD. An exception applies if there are multiple DBs and one of them is a minor child of the owner; in that case the plan is treated as having an EBD (but this exception does not apply if the remainder beneficiary following the death of the minor is also a current beneficiary of the trust). Accordingly, no payment would have to be made from the plan until the child reaches age 31 if the owner died before the required beginning date. If the owner died after the required beginning date, while there is no specific example in the proposed regulations, payments apparently would be based on the oldest minor beneficiary's life expectancy with no requirement of distributing all of the plan balance until the end of the year in which the child reaches age 31. *See* Prop. Reg. §1.401(a)(9)-4(e)(2)(ii); Preamble at 39.

This means that an **accumulation trust** can be used for a minor child (or minor children). Planners have previously assumed that a conduit trust would be required to qualify a trust for a minor child for the minor child exception. The life expectancy plan distributions for a minor child would be very small, but being able to use an accumulation trust avoids the administrative inconvenience of having to distribute the small amounts distributed from the plan every year to or for the minor child.

If there are multiple minor beneficiaries, planners have wondered whether the final required distribution is 10 years after the oldest minor beneficiary reaches age 21 or 10 years after all minor beneficiaries have reached age 21. The proposed regulation clarifies that the full distribution is required 10 years after the *oldest* minor child reaches age 21 (or, if earlier, the tenth calendar year following the calendar year of that child's death). Prop. Reg. §1.401(a)(9)-5(f)(2)(ii)(A); Preamble at 50. Contrast a somewhat analogous provision for multiple disabled or chronically ill beneficiaries saying that the final required distribution is 10 years after *all* disabled or chronically ill beneficiaries have died. Prop. Reg. §1.401-5(f)(2)(iii)(A), discussed in Item 4.d(9) below.

(8) **Minor Child Becomes Disabled Before Reaching Age of Majority.** Section 401(a)(9)(F) for many years has addressed payments made to a minor child being treated as paid to the surviving spouse for an obscure purpose. The existing regulations provide that for this purpose "a child who is disabled ... when the child reaches the age of majority may be treated as having not reached the age of majority so long as the child continues to be disabled." Reg. §1.401-(a)(9)-6, A-15. Many planners have assumed that a similar exception would apply for purposes of determining whether the child is an EDB if the minor child should become disabled after the owner's death but before reaching the age of majority. The proposed regulations, though, take

the contrary position that the child would cease to be an EBD when the child reaches age 21, even though the child has become disabled by that time. Prop. Reg. §1.401(a)(9)-4(e)(9), Ex. 3; Preamble at 26.

(9) **Trust for Disabled or Chronically Ill Individuals.** The statute, §401(a)(9)(H)(v), describes an "applicable multi-beneficiary trust" (AMBT) as a trust having only DBs as beneficiaries, at least one of which is a disabled or chronically ill individual. The proposed regulations provide two exceptions for AMBTs from the general rule that if a plan has multiple designated beneficiaries, some of whom are not EBDs, the plan is treated as not having an EBD. They are referred to as Type I and Type II trusts. A Type I trust is one that, under the terms of the trust agreement, is to be divided immediately upon the death of the owner into separate trusts for each beneficiary. A Type II trust is one that has one or more beneficiaries who are disabled or chronically ill and for which no other individual has any interest in the plan until the death of the disabled or chronically ill beneficiaries. Prop. Reg. §1.401(a)()-4(g)(2)-(3). Disabled or chronically ill beneficiaries of a Type II trust are treated as EDBs even though there are other beneficiaries who are not EDBs.

The statute is not clear as to whose life is used for the life expectancy payout if there are multiple disabled or chronically ill beneficiaries. The proposed regulations make clear that DBs other than the disabled or chronically ill beneficiaries are not considered and that the life expectancy of the oldest disabled or chronically ill beneficiary is used. Prop. Reg. §1.401(a)()-5(f)(1)(ii). The rule requiring that all plan benefits must be paid in the year in which the oldest beneficiary reaches his or her life expectancy (determined at the death of the owner) does not apply for a Type II trust. Prop. Reg. §1.401-5(f)(2)(iii)(B). The entire plan benefits must be paid within 10 years of the death of the *last to die* of the disabled or chronically ill beneficiaries of the AMBT. Prop. Reg. §1.401-5(f)(2)(iii)(A).

Planners have questioned whether provisions that are often used in supplemental needs trusts could be used in AMBTs, such as (i) backstop provisions (allowing distributions to other beneficiaries of amounts that would cause the disabled beneficiary not to qualify for government assistance programs), (ii) provisions allowing excess assets to be distributed to non-disabled beneficiaries (for tax planning in light of the high rates applied to undistributed trust income or if the special needs beneficiary no longer qualifies for public benefits), and (iii) provisions allowing the payment of travel expenses of a travel companion for a disabled beneficiary. None of those provisions would be allowed under the proposed regulations (the trust would not meet the definition of a Type II trust), but the Preamble invites comments regarding supplemental needs trusts.

> The Treasury Department and the IRS request comments on whether under applicable law a trust for a disabled individual (for example, a supplemental needs trust) could include terms providing that the disabled individual would lose the individual's interest in the trust in the event the interest would disqualify the individual for means-tested government benefits and still satisfy the requirements under the Code to be a type II applicable multi-beneficiary trust. Specifically, comments are requested on whether this type of provision may be included in a trust (thereby allowing a disabled individual to continue to qualify for means-tested government benefits), while not providing for trust payments to any other beneficiary until the death of the disabled individual. Preamble at 38.

Until further guidance is provided, no distributions should be allowed to any beneficiaries other than the disabled or chronically ill beneficiaries.

(10) **No Similar Exception For Spouses or Persons Not More Than Ten Years Younger.** If a trust has as the only current beneficiary(ies) a minor child or children or a disabled or chronically ill person or persons, the plan is treated as having an EDB or EDBs even though other DBs are successor beneficiaries of the trust. See Items 4.d(7) and 4.d(9) above. There is no similar exception for an accumulation trust that has a surviving spouse or persons not more than 10 years younger as the beneficiary. Therefore, if the plan names a trust for a spouse or person not more than 10 years younger as the beneficiary, the plan generally must be a conduit trust in order for the plan to have an EDB.

A possible exception to this general rule is if all of the "countable" beneficiaries of the trust (see Item 2.q(4)(a) above2.q(4)(a) above) are EDBs. Some planners view Prop. Reg. §1.401(a)(9)-4(e)(2) as implying that a plan has EDBs as beneficiaries if the beneficiary is a trust that has only EDBs as countable beneficiaries. (That proposed regulation actually addresses the reverse situation; if a trust-beneficiary has any countable beneficiary who is *not* an EDB – other than the exceptions for trust with minor children, disabled, or chronically ill beneficiaries, or if the plan qualifies for separate account treatment – the plan does *not* have an EDB.) Such a situation would be relatively rare though. For example, a QTIP trust for a spouse that has the owner's sibling who is not more than 10 years younger than the owner as the successor beneficiary at the spouse's death would have only EDBs as countable beneficiaries and would be treated as qualifying for EDB treatment.

This is critically important if someone wants to name a trust for the surviving spouse as beneficiary of a plan or IRA rather than having the spouse as a direct beneficiary. In that situation, a QTIP trust is typically used, but a standard QTIP trust does not qualify as an EDB, and the 10-year rule would apply after the owner's death. A QTIP trust that also requires such distributions to the spouse of all plan distributions would constitute a conduit trust that is an EDB and could be paid over the spouse's life expectancy. Furthermore, a conduit trust having the spouse as the only beneficiary would qualify for the special payment provisions for spouses (for example, the Single Life Table is used, but the life expectancy is recalculated annually). However, in some rare situations the owner may prefer using an accumulation trust for a spouse with a not-more-than-10-years-younger-beneficiary as the successor beneficiary; a conduit trust for the spouse would risk that the life expectancy payments to the spouse (even with annual recalculation of life expectancy) would substantially deplete the trust if the spouse has a long life, leaving little for the successor beneficiary.

(11) Application of SECURE Act to Pre-2020 Deaths. The anti-stretch provisions of the SECURE Act generally apply to owners who die after 2019, EXCEPT that if the initial DB dies after 2019 and before the plan assets have been totally distributed, the remaining benefits must be paid within 10 years of when such DB dies (even though the owner died before 2020). Section 401(b)(5) of the SECURE Act. (Under prior law, when the DB died, the DB's beneficiary could continue to receive benefits over the DB's remaining life expectancy.)

The statutory effective date provisions are unclear about what happens if the participant had multiple DBs. For example, the beneficiary may have been an accumulation trust with various individuals as permissible current or remainder beneficiaries, and each of them is a DB, even though only the oldest DB's life expectancy is used to determine the payout period. The statute is unclear when the 10-year period begins—when the oldest DB has died, when any DB has died, or when all DBs have died. Planners have hoped that the 10-year period would not begin until all DBs had died, but the proposed regulations state that the 10-year period will begin when the oldest DB dies if that beneficiary was still alive on January 1, 2020. Prop. Reg. §1.401(a)(9)-1(b)(2)(iii)(B).

(12) Effective Date of Proposed Regulations. As described above, the proposed regulations regarding required minimum distributions are proposed to apply for calendar years beginning in 2022, and for 2021 "taxpayers must apply the existing regulations, but taking into account a reasonable, good faith interpretation of the amendments made by sections 114 and 401 of the SECURE Act. Compliance with these proposed regulations will satisfy that requirement." Preamble at 77-78.

e. Roth IRAs. The 10-year rule anti-stretch provisions in the SECURE Act apply to Roth IRAs. The accelerated payments from the Roth IRA following the owner's death would not bear a 37% immediate tax, but the opportunity for future tax-free buildup over a long period of time would be lost.

Roth conversions may still make sense for taxpayers who are in considerably lower income tax brackets (because of lower income, NOLs, loss carryovers, etc.) than the beneficiaries. (If an accumulation trust is the beneficiary, the trust reaches the maximum 37% bracket at a mere $13,450 of taxable income in 2022, so the participant might be in a significantly lower bracket. However, the

time period for the tax-free growth would generally be limited to 10 years following the person's death because of the 10-year rule.)

For a discussion of considerations for making Roth conversions, see Bernard Kent, *Roth IRA Conversions in 2020*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #737 (June 9, 2020).

f. **IRA Charitable Rollover; Charitable Planning With Qualified Plans.** The SECURE Act does not eliminate the IRA charitable rollover, but the $100,000 limit on qualified charitable distributions from an IRA that can be excluded from income will be correspondingly reduced by any contributions to IRAs after a person has reached age 72. Changing the age for required minimum distributions from 70½ to 72 will not change the age at which qualified charitable distributions from IRAs will be permitted.

Particularly for nonitemizers, donors over age 70½ should consider making their charitable donations with IRA charitable rollovers at least up to the amount of the minimum required distribution and up to a maximum of $100,000 per year. Even though the nonitemizer donor does not get an income tax deduction, the donor will avoid recognizing income on the distributions. Especially if the donor has reached the RBD (April 1 of the year after reaching age 72 if the person had not reached age 70½ in 2019), the donor will avoid recognizing income on the required distributions from the IRA.

For a discussion of charitable planning considerations with qualified retirement plans (including IRAs) see Item 6.g.-h. of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. For a discussion of other resources about using CRTs to receive plan benefits or of leaving an IRA to charity for a gift annuity, see Item 3.j. of Estate Planning Current Development and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

g. **More Detailed Discussion of Planning Under the SECURE Act.** For a much more detailed discussion of planning issues in light of the SECURE Act, see Item 3 of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

h. **New Life Expectancy Tables for Retirement Plan Required Minimum Distributions.** The Single Life and Uniform Life tables for calculating required minimum distributions are in Reg. §1.401(a)(9)-9(b)-(c).

The Uniform Life table, which is based on the life expectancy of an individual and someone 10 years younger and that recalculates life expectancy each year, may be used only while the account owner is living or for a spousal rollover IRA. Otherwise, the Single Life (or Joint Lives) Table must be used. The Uniform Life Table allows taking withdrawals at a substantially slower rate. For example, using new tables that apply in 2022, the life expectancy of a 72-year-old person under the Single Life Table is 17.2 years, and under the Uniform Life Table is 27.4 years. (The respective life expectancies under the same tables that applied before 2022 were 15.5 and 25.6.)

The tables had not been modified for two decades, but proposed regulations containing revised tables were issued in November 2019, and the revised tables would have applied to distribution calendar years beginning on or after January 1, 2021. Final regulations were issued November 4, 2020 (T.D. 9930, published in the Federal Register on November 12, 2020), and the effective date was moved back to plan years beginning on or after January 1, 2022. The final regulations (which include the new tables) are located at https://www.regulations.gov/document/IRS-2019-0050-0057.

The preamble to the proposed regulations stated that the "life expectancy tables and applicable distribution period tables in the proposed regulations reflect longer life expectancies than the tables in the existing regulations that are generally between one and two years longer than under the existing regulations." Professor Chris Hoyt (Kansas City, Missouri) concludes that "[m]ost individuals will experience reduced RMD amounts of between 0.3% and 0.5% of what they would have had to receive under the prior tables." Christopher Hoyt, *Reduced RMDs From Retirement Accounts*,

TRUSTS & ESTATES at 46 (June 2021). For example, the required minimum distribution for a 72-year-old person decreases from 3.9% (applicable in 2021) to 3.7% under the 2022 tables.

The mechanics of applying the tables are summarized below.

- For RMD distributions during the participant's lifetime after the required beginning date, use the life expectancy factor under the Uniform Life Table for the age that the participant will be in a particular calendar year, and divide the account balance as of December 31 of the prior year by that divisor.
- For a surviving spouse receiving post-death RMD distributions, use the life expectancy factor under the Single Life Table for the age that the spouse will be in a particular calendar year, and divide the account balance as of December 31 of the prior year by that divisor. (This approach reflects that the surviving spouse's life expectancy is recalculated each year.)
- For a non-spouse beneficiary receiving post-death RMD distributions, the life expectancy is not recalculated every year. For the first post-death payment to the beneficiary, which is due in the year following the participant's death, the account balance as of December 31 of the year of death is divided by the beneficiary's life expectancy using the Single Life Table, based on the age the beneficiary will be in the year after the year of the participant's death. In each subsequent year the life expectancy table is no longer used, but the divisor is one less than the divisor for the prior year; the account balance at the end of the prior year is divided by that number.
- For a non-spouse beneficiary who began receiving RMDs before 2022 (and whose life expectancy was determined using the old tables), Reg.§1.401(a)(9)-9(f)(2) describes the following process for distributions in and after 2022:

  (1) Determine the beneficiary's life expectancy using the new Single Life Table, based on the beneficiary's age as of the beneficiary's birthday in the year following the participant's death.

  (2) From that number, subtract the number of years that have passed since the first year RMDs begun.

  Example. Assume the participant died in 2016, and that RMD's began in 2017, and assume the beneficiary's life expectancy divisor in the year following the date of death (2017) using the new Single Life Table is 53.4. In 2022, five years have passed since the year in which RMDs were initially paid to the beneficiary, and the life expectancy divisor for 2022 will be 53.4 – 5, or 48.4.

For an excellent discussion of using the new life expectancy tables in connection with changes made by the SECURE Act, see Vanessa L. Kanga & Natalie B. Choate, *New Life Expectancy Tables – An Opportunity to Provide Value to Clients*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #776 (January 21, 2022).

i. **New Life Expectancy Tables for Pre-Age 59 ½ Distributions.** Notice 2022-6 updates the life expectancy tables used for calculating a series of substantially equal periodic payments ("SESEPP"), a popular method of avoiding the 10% tax on pre-age 50 ½ distributions. Notice 2022-6 replaces Rev. Rul. 2002-62 for any series of payments beginning on or after January 1, 2023 and may be used for a series of payments commencing in 2022. For a discussion of planning considerations for planning SOSEPP distributions using the new tables, see Vanessa L. Kanga & Natalie B. Choate, *New Life Expectancy Tables – An Opportunity to Provide Value to Clients*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #776 (January 21, 2022).

5. Miscellaneous Guidance From IRS; Treasury-IRS Priority Guidance Plan

a. **Administrative Guidance Regarding 2017 Tax Act Changes.** See Item 7 of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights for a summary of some of the administrative guidance that has

been issued regarding the 2017 Tax Act changes including (i) the anti-clawback regulation, (ii) executor or trustee fees and other miscellaneous estate or trust expenses, (iii) regulations regarding excess deductions or losses at the termination of an estate or trust, (iv) the state and local taxes (SALT) deduction guidance, (iv) regulations regarding not reducing the basis of life insurance or annuity contracts by mortality charges, (v) carried interest final regulations, (vi) reportable policy sales and transfer of value issues, (vii) the deduction under §199A for qualified business income, and (viii) qualified opportunity funds. For a detailed discussion of these developments, see Item 5 of Estate Planning Current Developments and Hot Topics (May 2021) found here and Item 5.d.-f. of Estate Planning Current Developments and Hot Topics (December 2020) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

b. **2021-2022 IRS Priority Guidance Plan.** The 2021-2022 IRS Priority Guidance Plan released on September 9, 2021 contains a few changes from the 2020-2021 Plan regarding estate planning related issues. For a general discussion of and commentary about the 2020-2021 Priority Guidance Plan, see Ronald D. Aucutt, *2020-2021 Treasury-IRS Priority Guidance Plan*, ACTEC CAPITAL LETTER NO. 50 (Nov. 25, 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(1) **No Deadline.** The Plan sets the priority for guidance projects during the Plan year (from July 1, 2021 to June 30, 2022). Several years ago, the IRS said that the Priority Guidance Plan had been pared so that only projects anticipated to be completed during the Plan year were included. That statement no longer appears; instead, it states "the plan does not provide any deadline for completing the projects."

(2) **Omission from 2020-2021 Plan – Basis of Assets in Grantor Trust at Death.** The 2021-2022 omits this item from the 2020-2021 Plan: "Guidance on basis of grant trust assets at death under § 1014." IRS representatives informally indicated in 2017 that the intent of this project was to address broadly when grantor trust assets get a step up in basis in a wide variety of situations including under exercises of substitution powers, sales to grantor trusts, sales to grantor trusts for self-cancelling installment notes, and elective community property for residents in other states. For further discussion of this project, see Item 6.c of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(3) **Continuations from 2020-2021 Plan.** Items in the 2020-2021 Plan that carry over into the 2021-2022 Plan include:

> 1. Final regulations establishing a user fee for estate tax closing letters. Proposed regulations were published on December 31, 2020.
>
> 2. Final regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016.
>
> …
>
> 4. Regulations under §2032(a) regarding imposition of restrictions on estate assets during the six-month alternate valuation period. Proposed regulations were published on November 18, 2011.
>
> 5. Regulations under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
>
> …
>
> 7. Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption.
>
> …
>
> 9. Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests.

(a) **Items 2 (Basis Consistency), 4 (Alternate Valuation Date), 5 (§2053), and 7 (§2642(g)).** Numbers 2 and 7 in that list, the basis consistency provision and the §2642(g) GST exemption allocation extension provision, were in "Part 3. Burden Reduction" of the 2020-

2021 Plan and have been moved to the "Gifts and Estates and Trusts" section of the 2021-2022 Plan. For further details about the (i) basis consistency, (ii) alternate valuation date, and (iii) §2053 personal guarantees and present value concepts, see Item 6.c of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

When the basis consistency regulations are finalized, among other things planners hope that the requirement of filing reports for subsequent transfers will be relaxed. Interestingly, the Form 8971 does not specifically address the reporting of subsequent transfers.

(b) Number 1, Estate Tax Closing Letter User Fee. On December 28, 2020 the IRS released a proposed regulation (published in the Federal Register on December 31, 2020) that would impose a new $67 user fee to request an estate tax closing letter (IRS Letter 627). Prop. Reg. §300.13. The regulation was finalized on September 27, 2021, effective October 28, 2021. Reg. §300.13 (T.D. 9957).

At one time, the IRS routinely issued estate closing letters after estate tax examinations had been completed, but for returns filed on or after June 1, 2015, the IRS announced that closing letters would be issued only on request. After receiving many complaints from taxpayers' advisors about long delays in obtaining closing letters, the IRS suggested that estates could obtain an estate tax account "transcript" and that a transcript with code "421" would serve "as the functional equivalent of an estate tax closing letter." That approach was not sufficient, however, because purchasers from estates often wanted the more formal estate tax closing letter for comfort that no estate tax lien was outstanding, and advisors often recommend that executors delay distributing estate assets until a closing letter could be obtained in light of the potential personal liability of executors if assets are distributed before estate taxes are paid. The preamble to the proposed regulation observes, in a classic understatement, that "the IRS received feedback from taxpayers and practitioners that the procedure for requesting an estate tax closing letter can be inconvenient and burdensome," and summarizes the rationale for the new fee and the process that will ultimately be used.

> In view of the resource constraints and purpose of issuing estate tax closing letters as a convenience to authorized persons, the IRS has identified the provision of estate tax closing letters as an appropriate service for which to establish a user fee to recover the costs that the government incurs in providing such letters. Accordingly, the Treasury Department and the IRS propose establishing a user fee for estate tax closing letter requests …. As currently determined, the user fee is $67….
>
> Guidance on the procedure for requesting an estate tax closing letter and paying the associated user fee is not provided in these proposed regulations. The Treasury Department and the IRS expect to implement a procedure that will improve convenience and reduce burden for authorized persons requesting estate tax closing letters by initiating a one-step, web-based procedure to accomplish the request of the estate tax closing letter as well as the payment of the user fee. As presently contemplated, a Federal payment website, such as *http://www.pay.gov*, will be used and multiple requests will not be necessary. The Treasury Department and the IRS believe implementing such a one-step procedure will reduce the current administrative burden on authorized persons in requesting estate tax closing letters and will limit the burden associated with the establishment of a user fee for providing such service.

In rationalizing the reasonableness of charging a user fee for issuing closing letters, the preamble to the proposed regulation reasoned that the issuance of closing letters "is fundamentally a customer service convenience offered to authorized persons in view of the unique nature of estate tax return filings." The preamble to the final regulation reiterates that a user fee is appropriate because the closing letter is "the provision of a service that confers special benefits, beyond those accruing to the general public," without mentioning that the general public does not face the liens, liabilities, priority over other creditors, and burdens peculiar to the estate tax.

Planners have expressed relief regarding the new system as compared to the existing system characterized by some planners as "horrendous" because "hours are spent on the

phone trying to contact IRS on this at substantial expense to the client" (the IRS replaced the telephone method with a fax method during the pandemic).

> Estate planners might not be thrilled about a newly proposed $67 user fee for estate tax closing letter requests, but they're content to say goodbye to a process that has drawn their ire for years.
>
> …
>
> For Ronald D. Aucutt, Bessemer Trust, the proposed user fee is a means to a better process. The $67 amount "may be a token, but it enables this drama to come to an end," he said. Proposed Estate Tax Closing Letter Fee Earns *Sigh of Relief*, TAX NOTES (Jan. 4, 2021).

Other planners have also been critical of the proposed user fee.

> While the fee amount is not outrageously high, it is always irksome when the government charges members of the public before that government will discharge its duty. In this case, that is particularly so since it is the liability that the government imposes on fiduciaries (both in their fiduciary capacity and their individual capacity) that necessitates a closing letter.
>
> A secondary concern is fee creep. We have all seen modest government fees increase over time to unreasonable amounts. Look no further than the fees charged for private letter rulings – these at one time had no fee, then a small fee, and now bear fees in the many thousands of dollars.
>
> As of now, the fee is only proposed. Chuck Rubin, *IRS Is Proposing a User Fee for Estate Tax Closing Letter*, LEIMBERG ESTATE PLANNING NEWSLETTER #2853 (Jan. 14, 2021).

The regulation does not explain how to request an estate tax closing letter and pay the user fee, but the preamble to the final regulation stated that more detailed specific instructions would be posted within a month. FAQs were posted on October 7, 2021 at https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-estate-taxes. Further information about the process for requesting a closing letter and making the closing letter user fee payment has been posted on pay.gov at https://www.pay.gov/public/form/start/940783687. The frequently asked questions information indicates that the estate should wait nine months after filing an estate tax return to request a closing letter, or 30 days after completion of an estate tax examination. The form for requesting the closing letter and paying the fee is available on that site as of October 28, 2021. *See generally* Patricia McNeal, *The Best $67 an Executor Can Spend – Why You Should Get the Estate Tax Closing Letter*, 46 TAX MGMT. ESTS, GIFTS & TRUSTS. J. No. 6 (Nov. 10, 2021).

A Chief Counsel Advice Memorandum states the IRS position that the procedures for reopening a closed examination described in Rev. Proc. 2005-32, § 5.01 (requiring at least one of three criteria to be met) do not apply when the IRS accepted the return as filed and did not conduct an examination. CCA 202142010 (Oct. 22, 2021). The examination may be begun in that situation notwithstanding the issuance of a closing letter (Letter 627).

(c) **Number 9, New Actuarial Tables.** The actuarial tables project, added in the 2019-2020 Plan, is to update the §7520 actuarial tables based on updated mortality information, which must be done every ten years and was last done effective May 1, 2009. The tables were not updated by May 1, 2019, as was required by §7520, and IRS officials have informally indicated that the IRS has been waiting on data from another agency. That data now appears to be available. On August 7, 2020, the National Center for Health Statistics at the Centers for Disease Control and Prevention issued the decennial life table for 2009-2011, which apparently is the underlying data for the IRS actuarial tables. The new Lx table lists the number of individuals, out of a total of 100,000, who will be alive at each of ages 0-110, based on data from the 2010 census (which obviously is already 10 years old). The new data reflects a somewhat remarkable increase in life expectancies compared to the existing Lx table (based on 2000 census data). For example, at age 84 the number of individuals, out of the 100,000 starting pool, expected to be surviving has increased from 37,837 to 44,809, an 18.4% increase in just 10 years. Larry Katzenstein summarizes:

> The improvements in longevity at older ages is truly remarkable. For example, the probability of survival from age 60 to age 90 went from 21.088% to 26.6021% in just ten years. No wonder the Today show

stopped years ago highlighting viewers who attained age 100. There were just too many of them. Larry Katzenstein, *New Actuarial Tables Are Coming*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #303 (Nov. 30, 2020) (includes the new Lx table, compared to the existing Lx table).

The rather dramatic increase in life expectancy from the 2010 census data compared with the 2000 census data interestingly is contrasted with a CDC report in February 2021 that life expectancy declined about one year from 2019 to the first six months of 2020 (and declined 2.7 years for non-Hispanic Black people and 1.9 years for Hispanic individuals). National Center for Health Statistics Vital Statistics Rapid Release, Rept. No. 10 (February 2021).

The new tables will result in a larger charitable deduction for CLATs for the life of an individual, but a lower deduction for a CRAT (and more difficulty in satisfying the 10% remainder test and 5% exhaustion test for a CRAT) and for the remainder in a personal residence after a retained life estate.

Presumably, proposed regulations with the new tables will be coming soon. Larry Katzenstein points out the following questions that remain.

> Questions remain. Will we be allowed to elect to use the new rates for any transaction after April 30, 2019, the date on which the new tables were mandated by section 7520 to be effective? Will there be an effective date transition period? Will the IRS at some point allow use of exact computer- generated factors rather than the almost-exact published factors—almost exact because of rounding and related issues required to make published tables workable? Will the IRS make minor tweaks to the Lx table …? Larry Katzenstein, *New Actuarial Tables Are Coming*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #303 (Nov. 30, 2020).

Because the mortality tables have not been late before, there is no model for such transitional relief. But even the timely promulgation of the 2009 mortality tables provided what the preamble described as "certain transitional rules intended to alleviate any adverse consequences resulting from the proposed regulatory change." T.D. 9448, 74 Fed. Reg. 21438, 21439 (May 7, 2009). The preamble went on to elaborate:

> For gift tax purposes, if the date of a transfer is on or after May 1, 2009, but before July 1, 2009, the donor may choose to determine the value of the gift (and/or any applicable charitable deduction) under tables based on either [the 1990 or 2000 census data]. Similarly, for estate tax purposes, if the decedent dies on or after May 1, 2009, but before July 1, 2009, the value of any interest (and/or any applicable charitable deduction) may be determined in the discretion of the decedent's executor under tables based on either [the 1990 or 2000 census data]. However, the section 7520 interest rate to be utilized is the appropriate rate for the month in which the valuation date occurs, subject to the … special rule [in section 7520(a)] for certain charitable transfers.

In other words, transitional relief may be provided with respect to the actuarial components of calculations based on mortality (life expectancy) tables, but not with respect to merely financial components such as applicable federal rates and the section 7520 rate, which have been published monthly as usual without interruption. For example, such transitional relief would apply to the calculations since May 1, 2019, of the values of an interest for life, an interest for joint lives, an interest for life or a term whichever is shorter or longer, or a remainder following such an interest. But no transitional relief would be necessary for calculations related to promissory notes or GRATs that involve only fixed terms without mortality components, which the new mortality tables would not affect.

(4) **Additions to 2021-2022 Plan.** The 2021-2022 Plan includes the following new items:

> 3. Regulations under §2010 addressing whether gifts that are includible in the gross estate should be excepted from the special rule of § 20.2010-1(c).
>
> …
>
> 6. Regulations under §2632 providing guidance governing the allocation of generation-skipping transfer (GST) exemption in the event the IRS grants relief under §2642(g), as well as addressing the definition of a GST trust under §2632(c), and providing ordering rules when GST exemption is allocated in excess of the transferor's remaining exemption.
>
> …

8. Final regulations under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates. Proposed regulations were published on September 10, 2015.

(a) **Number 3, Clawback Regulation Exception.** Number 3 addresses the anti-abuse exception to the clawback regulation (discussed in Item 7.f(2) below). Inclusion of this project in the 2021-2022 Plan suggests that the IRS plans to address this issue affirmatively rather than just avoiding the issue and knowing that the chill of the possibility of such an exception keeps clients from employing planning alternatives that might be caught by such an exception.

(b) **Number 8, §2801 Gifts From Expatriates.** This item first appeared in the 2008-2009 Plan, and proposed regulations were issued in 2015. The item was dropped from the 2017-2018 Plan and has not been in the Plan since then. For a discussion of this issue, see Item 27.g(5) of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (June 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(5) **Other Notable Omissions.** Among new items added to the Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015 were the following.

"3. Guidance on basis of grantor trust assets at death under §1014.

…

5. Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872.

…

8. Guidance on the gift tax effect of defined value formula clauses under §§2512 and 2511."

These all address issues that are central to often-used transfer planning alternatives involving gifts and sales to grantor trusts.

Number 3 remained in the Plan until this year. It is discussed in Item 5.b(2) above.

Number 5, addressing the valuation of promissory notes, first appeared in the 2015-2016 Plan and was dropped from the 2019-2020 Plan. (It was moved to the "Financial Institutions and Products" section in 2017-2018 and 2018-2019 Plans).

Number 8, regarding defined value formula clauses, was added in 2015 and was dropped in the 2017-2018 Plan and has not been in the Plan since then.

For a detailed discussion of these important items that previously appeared in Plans, see Item 27.g(2)-(3) of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (June 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

c. **Inflation Adjustments.** Inflation adjustments for 2021 and 2022 were announced in Rev. Proc. 2020-45 and Rev. Proc. 2021-45, respectively. Some of the adjusted amounts are as follows:

- Basic exclusion amount and GST exemption-$12,060,000 in 2022 (the Joint Committee on Taxation had estimated $12,020,000 for 2022), $11,700,000 in 2021 (observe, this $360,000 increase is a larger than typical increase over the prior year's exclusion amount);
- Gift tax annual exclusion-$16,000 in 2022, $15,000 in 2018-2021;
- Estates and trusts taxable income for top (37%) income tax bracket-$13,450 in 2022, $13,050 in 2021;
- Top income tax bracket for individuals-$647,850/$539,900 (married filing jointly/single) in 2022, $628,300/$523,600 in 2021;
- Taxable income threshold for §199A qualified business income-$340,100/$170,050 (married filing jointly/single) in 2022, $329,800/$164,925 in 2021;
- Standard deduction-$25,900/$12,950 (married filing jointly/single) in 2022, $25,100/$12,550 in 2021;
- Non-citizen spouse annual gift tax exclusion-$164,000 in 2022, $159,000 in 2021;

- Section 6166 "two percent amount"-$1,640,000 in 2022, $1,590,000 in 2021; and
- Special use valuation reduction limitation-$1,230,000 in 2022, $1,190,000 in 2021.

d. **No-Rule List, Rev. Proc. 2022-3.**

(1) **ING Trusts.** The no-ruling revenue procedures for the last several years have included various provisions about certain trusts that are typically structured to be non-grantor trusts as an alternative for saving state income taxes (these types of trusts are often referred to as DINGs or NINGs – Delaware incomplete non-grantor trusts or Nevada incomplete non-grantor trusts. Rev. Proc. 2022-3, §5.01(9), (10), (15), & (18); Rev. Proc. 2021-3, §5.01(9), (10), (15), & (17); Rev. Proc. 2020-3, §3.01(93). See Item 8.c of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(2) **Charitable Remainder Trust with Lead Payments to Spouse and Charity**. The 2022 no-rule list adds the following new item in Section 5.01(areas under study for which rulings will not be issued):

> (16) Section 2056.—Bequests, etc., to Surviving Spouse.—Whether an estate is entitled to an estate tax marital deduction for any portion of the annuity or unitrust interest of a charitable remainder trust (as described in § 664) that may be distributed between the decedent's spouse and an organization described in § 170(c) at the discretion of a trustee. Rev. Proc. 2022-3, §5.01(16).

The scope of this new provision is unclear. Perhaps it relates to a situation similar to the facts addressed in PLR 201117005, in which the trustee had the discretion to distribute a portion of the annual unitrust amount either to the surviving spouse or to a charity. Ron Aucutt summarized this ruling in his Top Ten Developments of 2011:

> **Number Nine: A Deductible Whole with Undetermined Marital and Charitable Parts: Letter Ruling 201117005 (Jan. 5, 2011)**
>
> This letter ruling involved, among other things, a proposed testamentary charitable remainder unitrust (CRUT) that was to be distributed under a somewhat unusual formula. While one-fifth of the unitrust amount each year would go to the surviving spouse, four-fifths of the unitrust amount would be distributed either to the spouse or to a private foundation (which was also the charitable remainder beneficiary) in the trustees' discretion. If the surviving spouse remarried, the spouse was to receive only the one-fifth portion of the unitrust amount and any amount of the remaining four-fifths portion of the unitrust amount that was necessary to ensure that the amount received by the spouse was not de minimis.
>
> The Service held that upon the taxpayer's death the entire value of the assets distributed to the CRUT would be deductible in calculating the taxable estate, because all the value of the CRUT would pass to either charity or the surviving spouse, even though the respective values passing to charity and the surviving spouse could not be determined. In looking at the legislative history, the Service concluded that when a taxpayer establishes a testamentary CRUT in which the surviving spouse is the only non-charitable beneficiary, the estate tax marital deduction will completely offset the value of the assets distributed to the CRUT after deducting the value of the remainder interest passing to the charity, so there will be no estate tax attributed to the CRUT.
>
> This common sense result opens up an opportunity for flexibility without creating tax uncertainty.

e. **Using Electronic Signatures on Tax Forms.** On August 28, 2020, the IRS announced that it would temporarily accept the use of digital signatures on certain forms that cannot be filed electronically. Additional forms were added to that list on September 10, including Forms 706, 706-NA, 709, 3520, and 3520-A. IR-2020-206. An IRS memorandum dated December 28, 2020 (Control Number: NHQ-10-1220-006) allows using electronic or digital signatures for those forms (and other listed forms) that are signed and postmarked from January 1, 2021 through June 30, 2021, and a memorandum dated April 15, 2021 (Control Number NGQ-10-0421-0002) extends that permission through December 31, 2021. The memorandum observes in a footnote:

> Electronic and digital signatures appear in many forms when printed and may be created by many different technologies. No specific technology is required for this purpose during this temporary deviation.

An IRS memo dated November 18, 2021, with an expiration date of October 31, 2023, allows taxpayers and representative to use electronic or digital signatures when signing a large number of forms, including the various Form 706s and Forms 709, 3520, 3520-A, 4421, 4768, and 8283.

f. **Private Letter Ruling Fee Increase in 2021; No Further Increase in 2022.** Revenue Procedure 2021-1, 2021-1 I.R.B. 1 (Jan. 4, 2021) covers the procedures for obtaining private letter rulings, including in Appendix A the fee schedule for letter rulings. The fee varies for various types of letter rulings, but the fee for ruling requests not otherwise listed with other specific fees has increased from $30,000 (for requests received prior to February 4, 2021) to $38,000 (for requests received after February 3, 2021), representing a 26.7% increase. The fee for extension requests under §301.9100-3 for those same periods has increased from $10,900 to $12,600. (The user fee is significantly less for taxpayers with gross income under $250,000 [$3,000 after February 3, 2021], and for taxpayers with gross income from $250,000 to $1 million [$8,500 after February 3, 2021].) Those amounts were not changed in the 2022 procedure. Rev. Proc. 2022-1, Appendix A.

g. **Re-Emergence of Section 2704 Proposed Regulations Addressing Valuation?** Proposed regulations released August 2, 2016 changed the valuation for transfer tax purposes of interests in a family-controlled entity that are subject to restrictions on redemption or liquidation and limiting a broad exception in the existing regulations for the lapse of a voting or liquidation right under §2704(a). The proposed regulations were highly controversial, and the Treasury stated that it would withdrew the proposed regulations in a report dated October 2, 2017 acknowledging that the proposed regulations were unworkable (https://www.treasury.gov/press-center/press-releases/Documents/2018-03004_Tax_EO_report.pdf). The proposed regulations were formally withdrawn, 14½ months after their issuance, on October 20, 2017. For a detailed discussion of the history of the proposed regulations, see Item 18 of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (June 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. For a summary of the proposed regulations and concerns raised by them, see Item 5 of Estate Planning Current Developments and Hot Topics (December 2016) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

Will the IRS re-open the §2704 regulation project in an effort to restrict valuation discounts under the Biden administration? The October 2017 report recognized that the regulations' "approach to the problem of artificial valuation discounts is unworkable," but left open the door to a re-working of regulations that might in some way address valuation discounts. *See* Jonathan Curry, *A Look Ahead: Estate Planners Fear Return of 'Ghastly' Dead Regs*, TAX NOTES (Jan. 4, 2021). A regulatory approach that focuses on valuation discounts for passive assets in an entity as opposed to operating businesses would likely draw fewer attacks from the business community. In addition, valuation discounts might be addressed in legislation. The "For the 99.5 Percent Act" sponsored by Senator Sanders includes such a provision (as discussed in Item 2.f above), and a "nonbusiness assets" discount limitation was included in the initially proposed H.R. 5376 (as discussed in Item 2.g(3)(e) above).

The 2021-2022 IRS Priority Guidance Plan (discussed in Item 5.b above) does not add a project dealing with §2704 regulations.

6. Estate Planning for Moderately Wealthy Clients

a. **Small Percentage of Population Subject to Transfer Taxes; Paradigm Shift for Planners.** The $10 million (indexed) gift tax exclusion amount also means that many individuals have no concern with lifetime gifts ever resulting in the payment of federal gift taxes or of having to pay federal estate tax.

For non-resident alien individuals, however, the exclusion amount has not been increased and remains at only $60,000.

Concepts that have been central to the thought processes of estate planning professionals for their entire careers are no longer relevant for most clients – even for "moderately wealthy" clients (with assets of over several million dollars).

b. **Important Planning Issues**

- Do not ignore the GST tax. Without proper allocation (either automatically or manually) of the GST exemption (also $10 million indexed), trusts created by clients generally will be subject to the GST tax (currently 40%) at the death of the beneficiary unless the trust assets are

included in the beneficiary's gross estate. Consider allocating the increased GST exemption to previously created non-exempt trusts.

- Review formula clauses that are based on the available exclusion amount.
- Many moderately wealthy clients will want to rely on portability and leave assets at the first spouse's death either outright to the surviving spouse (and rely on disclaimers if a trust is desirable) or to a QTIP trust with a Clayton provision (which allows the most flexibility). However, a credit shelter trust approach may be appropriate for some moderately wealthy clients.
- Basis adjustment planning will be appropriate for many clients. They and their family members may not have estate tax concerns in light of the higher exclusion amounts even if trust assets are included in their estates so that the assets may qualify for a stepped-up basis at the person's death under §1014 (assuming that §1014 is not repealed).
- Including provisions to provide flexibility to accommodate changing circumstances or changing tax laws can be very helpful.
- For planning in states with state estate taxes (about a third of the states), using multiple QTIP trusts may be helpful if the state recognizes QTIP trusts that are effective for state purposes only.

c. **Further Discussion.** For further discussion of these issues, see Item 7 of Estate Planning Current Development and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

7. Transfer Planning for Clients Who Want to Make Use of the Increased Exclusion Amounts But Do Not Want to Make Large Gifts (or At Least Don't Want to Lose Access to Assets); Flexibility to "Undo" Transfers

a. **Window of Opportunity; Anti-Clawback Regulation.** The $10 million (indexed) gift tax exclusion amount will sunset back to $5 million (inflation adjusted, say about $6.8 million) in 2026 (unless changed by Congress prior to 2026), so gifts making use of the doubled gift tax exclusion amount are available only through 2025. Future legislation may decrease the large exclusion amount even before 2026, though that seems unlikely (Republicans are likely to regain control of either the House or Senate, or both) in the 2022 elections, and the likelihood of Democrats having control of the Presidency, House and Senate following the 2024 elections is historically remote.

The anti-clawback regulation clarifies that the donor can benefit from using the increased gift exclusion amount even if the donor should die after the estate tax exclusion amount has been reduced. The anti-clawback regulation provides a special rule that allows the estate to compute its estate tax credit using the higher of the BEA [basic exclusion amount] applicable to gifts made during life or the BEA applicable on the date of death. Reg. §20.2010-1(c)(1). For a discussion of various issues regarding the anti-clawback regulation, see Item 7.a of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

b. **Cushion Effect.** Perhaps the most important advantage of the increased gift tax exclusion amount for many individuals will be the "cushion" effect – the ability to make gifts in excess of $5 million, but considerably less than $12 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even for assets whose values are very uncertain).

c. **Defined Value Transfers.** Because of the substantial cushion effect of the very large gift tax exclusion amount, clients making transfers significantly less than the full exclusion amount will have much less incentive to add the complexity of defined value transfers to gift transactions. However, clients wanting to use most of the $10 million (indexed) exclusion amount are more likely will plan to consider a defined value transfer to minimize the risk of having to pay gift tax.

One possible defined value alternative is a "two-tiered *Wandry* arrangement." The client would make a traditional *Wandry* transfer of that number of units that is anticipated to be worth the desired transfer amount (which could either be a gift or a sale), but with a provision that if those units are finally determined for federal gift tax purposes to be worth a higher value, a note would be given for the excess amount. That approach was used in *True v. Commissioner* (Tax Court Docket Nos. 21896-16 & No. 21897-16), which cases were settled on a basis that, as reported in Tax Court filings, appears favorable for the taxpayer.

For a more detailed discussion of defined value clauses, see Item 14 of the Current Developments and Hot Topics Summary (October 2017) found here and Item 8.c. of Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts (July 2020) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

d. **Transfers with Possible Continued Benefit for Grantor or Grantor's Spouse; Sales to Grantor Trusts.** Couples making gifts of a large portion of their $10 million (indexed) applicable exclusion amount may want some kind of potential access to or potential cash flow from the transferred funds. Various planning alternatives for providing some potential benefit or continued payments to the grantor and/or the grantor's spouse are discussed in more detail in Items 14-25 of the Current Developments and Hot Topics Summary (December 2013) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. Also, a preferred partnership freeze strategy is discussed in Item 3.q. of the Estate Planning Current Developments Summary (December 2018) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

e. **SLATs.** One spouse may fund an irrevocable discretionary "spousal lifetime access trust" (SLAT) for the other spouse and perhaps descendants. Assets in the trust avoid estate inclusion in the donor's estate if the donor's estate is large enough to have estate tax concerns. Both spouses may create "non-reciprocal" trusts that have sufficient differences to avoid the reciprocal trust doctrine. Assets are available for the settlor-client's spouse (and possibly even for the settlor-client if the spouse predeceases the client) in a manner that is excluded from the estate for federal and state estate tax purposes.

For a detailed discussion of SLATs and "non-reciprocal" SLATs, including a discussion of the §§2036 and 2038 issues and creditor issues, see Items 78 and 80 of the ACTEC 2020 Annual Meeting Musings (March 2020) found here, Item 10.i. of Estate Planning Current Developments and Hot Topics (December 2019) found here, and Item 16 of the Current Developments and Hot Topics Summary (December 2013) found here, all available at www.bessemertrust.com/for-professional-partners/advisor-insights. For a discussion of potential conflicts of interest between spouses and creditor concerns with SLATs, see Item 10.e of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

f. **Gifts to "Lock In" Use of Increased Gift Exclusion.**

(1) **Planning Alternatives.** Alternatives that might allow an individual to take advantage of the "window of opportunity" with the large exclusion amount but minimize the current impact on the client's access to assets include using: (i) an "enhanced grantor retained income trust;" (ii) a promise to make a gift or a gift of a legally enforceable note; (iii) a transaction that does not satisfy §2701; (iv) a §2519 deemed transfer; or (v) a retained income trust. For a brief summary of these alternatives, see Item 10.f.(1)-(5) of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

Exercise caution before using any of those alternatives. The IRS is considering whether to adopt an anti-abuse exception to the anti-clawback regulation that would remove the effectiveness of these planning alternatives, as discussed in subparagraph (2) immediately below (and that project has been added to the 2021-2022 Priority Guidance Plan).

(2) **Possible Anti-Abuse Exception to Anti-Clawback Regulation; New York State Bar Association Tax Section Recommendation to IRS.** Planners should be cautious in using the planning approaches

described in subparagraph (1) above as a way of making use of the increased gift exclusion amount until we know whether the IRS adopts the recommendation not to extend the anti-clawback adjustment to gifts that are included in the gross estate or to situations in which assets have been valued under Chapter 14 (reserved in the November 2019 final regulation).

The preamble to the anti-clawback final regulation notes that a commenter recommended that the anti-clawback rule be revised so that it would not apply to gifts that are included in the gross estate, such as gifts with retained life estates or with retained powers or interests or certain gifts "within the purview of chapter 14" (not identified in the preamble as gifts valued at a higher amount under §§2701 or 2702). The preamble concludes that although "such a provision is within the scope of the regulatory authority granted in section 2001(g)(2), such an anti-abuse provision would benefit from prior notice and comment. Accordingly, this issue will be reserved to allow further consideration of this comment." The commenter referred to in the preamble was not identified in the preamble but was the New York State Bar Tax Section (cited below).

For example, the enhanced grantor income trust would result in making use of the large current BEA even though the grantor would be able to receive all the trust income; this is clearly the result under the existing anti-clawback regulations. The preamble to the proposed regulations made clear that the increased BEA was applied for prior gifts "whether or not included in the gross estate." (That approach has some support in the statutory language of §2001(b)(2) which, in the estate tax calculation process, provides for a subtraction of the hypothetical gift tax on all "gifts made by the decedent after December 31, 1976" not just on "adjusted taxable gifts," which would exclude gifts that are includible in the gross estate (§2001 last sentence).) Other possible planning alternatives are listed in subparagraph (1) above. Will that change?

The New York State Bar Association Tax Section's comments to the IRS regarding the anti-clawback regulation "brings to the attention" of the IRS that the approach of increasing the estate tax unified credit amount by exclusions applied against gifts that are later included in the gross estate (if those exclusions exceed the BEA available at death) "permit individuals to make relatively painless taxable gifts that lock in the increased exclusion amount, even though they retain beneficial access to the transferred property." The comments point out that the same benefit may result from making a gift that is subject to treating a retained interest as being worth zero for gift tax purposes under §2702. The comments recommend that the estate tax unified credit amount not be increased by exclusions applied against gifts that are included in the gross estate.

> We recommend that Treasury and the Service consider proposing rules that would create exceptions to the favorable rule of the Proposed Regulations in the case of gifts that are included in the gross estate. Under this approach, if a decedent made a gift of property before 2026 and the gift is included in the gross estate, any increased basic exclusion amount used by the gift is not preserved at death. As the gift would be purged from the estate tax computation base under Section 2001(b), there is no concern about claw back of tax. Further, the property would be subject to the estate tax lien and the decedent's executor would normally have a right to recover the share of estate taxes attributable to the property.

In addition, the comments point out a similar effect might result under §2701 from a gift of common stock while retaining preferred stock in the entity, which could leave the donor with "the right to earnings and income of the entity through the retention of preferred interests." If the Service wishes "to limit the benefits of locking in temporarily increased exclusion amount," the Section recommends "that the Treasury and Service study the problem further." The NYSBA Tax Section comments are available at http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2019/1410_Report.html.

The 2021-2022 IRS Priority Guidance Plan adds the following project: "Regulations under §2010 addressing whether gifts that are includible in the gross estate should be excepted from the special rule of § 20.2010-1(c)." The addition of the project indicates that the IRS is actively considering the adoption of an anti-abuse rule (and suggests that it likely will adopt some kind of exception). Planners should be cautious in using these approaches as a way of making use of the increased gift exclusion amount until the IRS issues further guidance (or a proposed regulation).

For an excellent discussion of planning alternatives that might be impacted by the anti-abuse rule, and planning considerations in light of the possibility of a future anti-abuse proposed regulation, see Katie Lynagh, *Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion*, BNA ESTATES, GIFTS & TRUSTS J. (May 14, 2020). For example, to guard against the possible issuance of such an anti-abuse rule, a possible planning alternative with a retained §2036 interest is to give a protector the ability to remove the grantor's retained income interest (which arguably would not be subject to the three-year rule of §2035 because the donor would not be voluntarily releasing the retained interest, *see* PLRs 9032002 & 9109033, although a regulatory anti-abuse rule could conceivably address deathbed planning).

(3) **Locking in Use of GST Exemption.** Clients might also lock in use of the "bonus GST exemption" before the GST exemption sunsets to $5 million (indexed) by making a transfer to a grantor retained income trust. The estate tax inclusion period (ETIP) during the period of the retained interest prevents the inclusion ratio from being determined during the ETIP but does not appear to prevent GST exemption from being allocated. The GST tax regulations address the effect of allocating GST exemption prior to the end of the ETIP. Reg. §26.2632-1(c)(5), Exs. 1-2; §26.2642-1(b)(2)(i). However, the regulations do not specifically address the effect of a decline of the GST exemption during the ETIP. Also, if an anti-abuse rule is adopted regarding clawback of the estate and gift exclusion amount, will it also address similar alternatives making use of the GST exemption?

g. **Transfer Planning During a Period of Legislative Uncertainty and in Low-Interest Rate Environment; Adding Flexibility.** A great deal of uncertainty exists regarding whether gift/estate exclusion amounts will be reduced, whether rates will be increased, or whether other transfer tax reforms might be implemented (for example, attacking valuation discounts, GRATs, and future transfers to grantor trusts). For a terrific resource addressing a wide variety of planning alternatives during times of such uncertainty, see Carlyn McCaffrey & Jonathan Blattmachr, *The Estate Planning Tsunami of 2020*, ESTATE PLANNING (Nov. 2020).

Adding flexibility to irrevocable trusts can be very helpful considering the existing substantial legislative uncertainty. Some of the ways of adding considerable flexibility are:

- using nontaxable powers of appointment;
- providing broad standards for distributions by independent trustees;
- granting substitution powers to the settlor;
- authorizing trust decanting (which may be available under state statutes); and
- providing special modification powers to trust protectors.

h. **Transfers With Flexibility to "Undo" the Transfer.** At the time of making a transfer the possibility exists of future tax legislation that would make the transfer inadvisable for some reason. Some planners have examined ways of making gifts that could be limited not to trigger gift tax or that could be "undone" in the event of subsequent legislation making the gift inadvisable. Alternatives are discussed in considerable detail in Items 12-20 of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

i. **Lifetime Gifts of Low Basis Assets; "Appreciation Hurdle."** The estate tax savings of gifts are offset by the loss of a basis step-up if the client dies no longer owning the donated property (unless §1014 should be repealed by future legislation). Be wary of making gifts of low-basis assets, particularly if the donor is in old age or near death. For a discussion of David Handler's "appreciation hurdle" chart, see Item 10.k. of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

j. **Report Transactions on Gift Tax Returns with Adequate Disclosure.** Many planners encourage clients to file gift tax returns to report gift or non-gift transactions to start the statute of limitations. Otherwise, the possibility of owing gift tax on an old transaction is always present. In order to start

the statute of limitations, the return must meet the adequate disclosure requirements of Reg. §301.6501(c)-1(f).

k. **Further Discussion.** For further discussion of each of these alternatives, see Item 8 of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

8. Tax Effects of Settlements and Modifications; Early Termination of Trust; Commutation of Spouse's Interest in QTIP Trust

The tax effects of court modifications, other trust modifications, decanting, and settlements are summarized in Items 42-51 of the ACTEC 2015 Annual Meeting Musings (April 2015) summary found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. This Item includes several brief miscellaneous comments.

a. **Background; *Bosch and Ahmanson*.** In *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), the Supreme Court observed that legislative history regarding the marital deduction directed that "proper regard" be given to state court construction of wills. Because the Senate Finance Committee used "proper regard" rather than "final effect," the opinion concluded that state court decisions should not be binding on the issue, and that federal courts in tax cases will be bound only by the state's highest court in the matter before it.

   The *Bosch* approach is applied to settlements in *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). A four-part test is used to determine if the results of a settlement will govern the tax consequences.

   The courts and national office of the IRS typically realize that the four-part analysis applies, but individual examiners are extremely suspicious of collusion in settlements.

b. **Revenue Ruling 73-142—Pre-Transaction Actions Can Avoid *Bosch* Analysis.** In Rev. Rul. 73-142, a settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The settlor obtained a local court construction that the settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the settlor removed the trustee and appointed another, so the settlor no longer had the removal power.

   In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred before the taxing event, which would have been the settlor's death. The IRS agreed that it was bound by the court's ruling as well, **"regardless of how erroneous the court's application of the state law may have been."**

   The court order must be obtained *prior* to the event that would otherwise have been a taxable event in order for the IRS to be bound under the analysis in Revenue Ruling 73-142.

c. **Construction vs. Reformation/Modification Proceedings.** A construction proceeding interprets a document as signed. It often involves an ambiguous document. The IRS is essentially bound regarding the availability of a marital or charitable deduction because the interpretation relates back to the date of execution of the instrument (assuming the four-part analysis of settlement agreements can be satisfied).

   A reformation modifies a document, and the IRS position is that the reformation generally applies prospectively only. Accordingly, a post-death reformation may not result in an action causing assets to have passed to a surviving spouse or charity as of the date of death to qualify for an estate tax marital or charitable deduction. Some rulings have given reformations retroactive effect, however, in "unique circumstances."

d. **Income Tax Consequences of Early Termination of Trusts.** Letter Rulings 201932001-201932010 ruled that the early termination of a trust (under a nonjudicial settlement agreement with court approval), with all of the beneficiaries being paid the actuarial value of their interests in the trust, had very significant income tax consequences. That is contrasted with the fact that trust distributions,

even at the normal termination of a trust, are not typically treated as sale or exchange events. The remainder beneficiaries in the 2019 PLRs were treated as having purchased the interests of the life beneficiary and the contingent remainder beneficiaries (and the life beneficiary had a zero basis in his interest under the uniform basis rules of §1001(e) so the total amount paid to the life beneficiary was capital gain). The remainder beneficiaries, as the deemed purchasers, do not pay tax on amounts **received** in the commutation (as the fictional purchasers, they are just receiving what is left in the trust after they have bought out everyone else), but they "realize gain or loss on the property exchanged." So, they recognize gain on the assets **paid out** to others less the amount of their uniform basis attributable to those assets. Massive income taxation can result, which could be totally avoided by not terminating the trust early.

Various commutation PLRs have reached similar results, and some case law supports the rationale, including *Cottage Savings Association v. Commissioner*, 499 U.S. 554, 559 (1991) (exchange of participation interests in a group of mortgages for participation interests in another group of mortgages constituted an exchange of property for other property differing materially either in kind or in extent and therefore loss on the exchange could be recognized). *Cf.* Letter Ruling 202047005 (gift of annuity interest in charitable remainder trust to the private foundation remainder beneficiary resulted in termination of the trust but was treated as a charitable gift rather than as a sale or exchange of a capital asset that would have resulted in taxable income to the taxpayer).

For a detailed discussion of planning implications of these rulings, see Item 16 of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

e. **Section 2519 Brief Overview.** Transfers to QTIP trusts qualify for the gift and estate tax marital deduction. The QTIP trust is subject to transfer taxes at the earlier of (1) the date on which the surviving spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest (under §2519), or (2) upon the surviving spouse's death (under §2044).

Section 2519(a) provides that for estate and gift tax purposes,

> any disposition of all or part of a qualifying income interest for life in any property to which this section applies [i.e., property for which a QTIP election was made and a marital deduction was allowed under §2056(b)(7) or §2523(f)] shall be treated as a transfer of all interests in such property other than the qualifying income interest.

Reg. §25.2519-1(c)(1) clarifies what is deemed transferred when §2519 is triggered:

> (c) *Amount treated as a transfer.*—(1) *In general.*—The amount treated as a transfer under the section upon a disposition of all or part of a qualifying income interest for life in qualified terminable interest property is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under section 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. The gift tax consequences of the disposition of the qualifying income interest are determined separately under §25.2511-2.

If the surviving spouse disposes of all or part of a qualifying income interest for life, §2519 treats the disposition as a transfer of all interests in the QTIP other than the qualifying income interest (i.e., as a transfer of the remainder interest).

The effect is that if the spouse disposes of any portion of the qualifying income interest in a QTIP trust, the spouse is treated as having *transferred* the remainder interest in the trust. Whether the amount of the *gift* resulting from the deemed transfer of the remainder interest is offset by any consideration received by the spouse-beneficiary in the transaction the resulted in triggering §2519 is unclear but is addressed in *Kite II* and in CCA 202118008 (both discussed below).

The transfer of the income interest itself can be a gift under §2511 if the spouse receives less than full value in return for the income interest.

The conversion of QTIP assets into other property in which the surviving spouse continues to have a qualifying income interest for life is not a disposition for purposes of §2519. Reg. §25.2519-1(f)(sale and reinvestment of assets of a QTIP trust is not a disposition under §2519 provided that the

surviving spouse continues to have a qualifying income interest for life in the trust after the sale and reinvestment).

A spouse-beneficiary of a QTIP trust may purposefully dispose of a small part of the income interest as a way of making a substantial gift without relinquishing significant retained economic rights. See Item 21.i(4) of Estate Planning Current Developments (December 2021) found here and Item 3.j.(8) of Estate Planning Current Developments (December 2018) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

f. ***Kite v. Commissioner*** **Brief Summary.** Mrs. Kite ("Wife") created a QTIP trust for Mr. Kite ("Husband") who died a week later. Under the terms of the trust the assets remained in the QTIP trust for Wife's benefit, and Husband's estate made the QTIP election to qualify for the estate tax marital deduction.

The court's initial decision, *Kite v. Commissioner*, T.C. Memo. 2013-43 (decision by Judge Paris) (referred to as "*Kite I*"), held among other things:

1. The transfer of assets from the QTIP Trusts to a limited partnership in return for limited partnership interests, the subsequent reorganization of the partnership as a Texas partnership (to save state income taxes), and the trusts' sale of the interests in the limited partnership in return for 15-year secured notes did not constitute a disposition triggering §2519.

2. The distribution of all the QTIP trusts to Wife and her sale of the interests in the general partnership for the private annuities were part of an integrated transaction that was deemed to be a disposition of her qualifying income interest for life, that triggered §2519 and in turn caused a deemed transfer of the remainder interests in the QTIP trusts.

Kite II is the court's Order and Decision regarding the Rule 155 computations of the gift tax as a result of the decision in *Kite I*. (Cause No. 6772-08, unpublished op. Oct. 25, 2013).

Despite countervailing indications in the statute, regulations, and legislative history, the court in *Kite II* interpreted §2519 to mean that the full amount of the deemed transfer of the QTIP trust remainder interest is a gift, regardless of any consideration received by the surviving spouse. "[A] deemed transfer of a remainder interest under section 2519 cannot be made for adequate and full consideration or for any consideration."

For a summary of Kite I and Kite II, see Item 21.f of Estate Planning Current Developments (December 2021) found here and for a more detailed discussion of *Kite I* and *Kite II*, see Akers, *Kite v. Commissioner*, Rule 155 Order and Decisions (Cause No. 6772-08, unpublished opinion October 25, 2013) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights).

g. **Commutation of Spouse's Interest in QTIP Trusts With Charitable Trust as Remainder Beneficiary, PLR 202016002.** The commutation of a spouse's qualifying income interest in a QTIP trust in return for the actuarial value of the income interest not only has potential income tax effects, as discussed in Item 8.d above, but also is treated as a transfer under §2519 of all interests in the trust other than the qualifying income interest. Letter Ruling 202016002 addresses the tax effects of a settlement agreement terminating QTIP trusts. A specified amount was paid from one QTIP trust to the spouse-beneficiary in consideration of her resignation as trustee and in resolution of her demands for principal invasion and various disputes; that amount was paid under the trustee's authority to make principal distributions for the health, education, support, and maintenance of the spouse. In addition, the QTIP trusts were terminated by paying to the spouse-beneficiary the actuarial value of her income interest and distributing the remaining assets to the charitable trust that is the remainder beneficiary of the QTIP trusts.

- The payment to the spouse of the actuarial value of the income interest in exchange for her lifetime income interest is a disposition of her income interest for purposes of §2519, resulting in a deemed transfer of all interests in the trust other than the qualifying income interest (i.e., the remainder interest).

- The transfer of the qualifying income interest itself is subject to potential treatment as a gift under §2511, but the transfer is not a gift because the spouse receives the present value of the qualifying income interest.
- The deemed transfer of the remaining assets to the remainderman is a gift by the spouse under §2519, but the spouse is entitled to a gift tax charitable deduction where the assets pass to a charitable trust.

h. **Commutation of Spouse's Interest in QTIP Trusts With Individuals as Remaindermen, CCA 202118008.** Chief Counsel Advice 202118008 also involves the commutation of a QTIP trust, but with individuals as remaindermen rather than a charitable trust (so the deemed gift of the remainder interest under §2519 could not be offset by the gift tax charitable deduction). The CCA is an excellent illustration of the difficulty and complexity of planning with QTIP interests. The spouse-beneficiary ("Spouse") held a testamentary limited power of appointment. The Spouse, and the children as remaindermen ("Children") and a virtual representative of the contingent remaindermen entered into an agreement to have all the trust property distributed to the Spouse. On the same day, the Spouse transferred the trust assets to trusts for the Children and their descendants, partly as a gift and partly as a sale in return for a promissory note (the "Gift/Sale Transactions"). The CCA addressed various issues.

(1) **Transaction Viewed as Commutation.** The transaction is viewed as a commutation (though the CCA acknowledged that a commutation is typically the distribution of trust assets to all holders of beneficial interests equal to the actuarial value of their interests). The commutation "constitutes a disposition by Spouse of Spouse's qualifying income interest within the meaning of §2519" and therefore as a "gift of all interests in Trust 1 other than the qualifying income interest."

(2) **Children Treated as Making Gifts to Spouse of Remainder Interest.** The Children were also treated as making gifts to the Spouse of their interests as remaindermen. The Children argued that they should not be treated as making a gift but that the transaction was a reciprocal exchange for consideration. The IRS disagreed, reasoning that the Spouse was treated as not receiving any consideration for the deemed transfer to the Children, because transferring all of the QTIP assets to the Spouse did not augment the Spouse's estate beyond the amount that would be included in the gross estate under §2044 if the transaction had not occurred. But the fact that the Spouse was treated as receiving no consideration did not nullify the Children's transfers of their remainder interests. The IRS viewed the transaction as a two-step process. First, "the remainder interest vested outright, equally, in Children, the then remaindermen." Second, "Children then transferred their valuable property interest to Spouse and received nothing in exchange." (Thus, the Children were treated as making a gift of their remainder interests even though the Spouse held a testamentary power of appointment and the Children were not assured of receiving anything. Apparently, the IRS got around that hurdle by reasoning that the transaction was viewed as first "vesting" the remainder interest in the Children.) The IRS looked to Revenue Ruling 98-8 and *Kite II* as supporting its position that the deemed transfer of the remainder interest by Spouse to the Children and the deemed transfer of trust property from the Children to the Spouse do not offset each other.

(a) **Revenue Ruling 98-8 Analysis.** The CCA's conclusion that Rev. Rul. 98-8 supports its conclusion that the two deemed transfers do not offset each other is off base. Rev. Rul. 98-8 merely addresses an indirect commutation of a QTIP trust. (The factual scenario considered in Rev. Rul. 98-8 was (i) the purchase of the remainder interest by the spouse for a note, (ii) the distribution of all trust assets to the surviving spouse, followed by (iii) the spouse paying off the note with a portion of the trust assets. The net result was that the spouse ended up with assets equal to the value of the income interest.) The key result of the transaction considered in Rev. Rul. 98-8 was that the value of the remainder interest was not owned by the spouse and was no longer in a QTIP trust subject to taxation at the spouse's subsequent death under §2044. Therefore, the remainder value would escape gift and estate taxation. That is not the case under the facts of the CCA – the Spouse utilized unified credit and received a promissory note that will be included in the Spouse's gross estate.

(b) **IRS Reasoning That *Kite II* Supported Its Conclusion.** The IRS also argued that the *Kite* case supported its conclusion. The Rule 155 order in *Kite* (sometimes referred to as *Kite II*) concluded that the spouse in that case was treated as making a gift of the entire remainder interest value even though the spouse received an annuity interest having an actuarial value equal to the value of the remainder interest. No. 6772-08 (T.C. Oct. 25, 2013) (order and decision under Tax Court Rule 155). (The *Kite* decision on which the Rule 155 Order was based is T.C. Memo. 2013-43, sometimes referred to as *Kite I*.) The CCA reasoned that under the *Kite* analysis, the QTIP statutory scheme and legislative history support the view that

> the separate transfers by Spouse and Children cannot be offset by consideration for gift tax purposes.
>
> …
>
> Eliminating the taxable transfer by Spouse based on a deemed reciprocal gift transfer by the remaindermen would allow the value of the remainder of Trust 1 to escape transfer tax under both §§ 2519 and 2044, which would be contrary to the **QTIP statutory scheme** and **legislative history**. (emphasis added; emphasized words are addressed below)

(c) **Strong Criticism of *Kite II* Reasoning.** The conclusion in *Kite II* that the amount of the *gift* resulting from the deemed *transfer* of the remainder interest was not offset by any payments made to the spouse has been strongly criticized. *See Recent Developments*, 48th ANN. HECKERLING INST. ON EST. PL. (2014) (Ronald Aucutt ed.). Most planners and commentators had believed following *Kite I* that a zero gift would result from the deemed transfer of the remainder interest in light of the court's determination that the wife received full value (an annuity) when she transferred the assets of the QTIP trust. *See e.g.,* Jeffrey Pennell, *Jeff Pennell on Estate of Kite: Will It Fly?* LEIMBERG EST. PL. EMAIL NEWSLETTER, Archive Message #2062 (February 11, 2013).

(d) **QTIP Statutory Scheme.** The CCA's reasoning that the "QTIP statutory scheme" supports its conclusion is quite ironic. The CCA correctly observes that the purpose of the marital deduction is merely to defer the transfer tax until a subsequent lifetime transfer or the death of the donee-spouse. But in this case the Spouse received back assets (the promissory note), directly owned by the Spouse, and made use of the Spouse's unified credit amount with a combined value equal to the full value of assets that had been in the QTIP trust. Those assets would later be subject to gift or estate tax (or already made use of unified credit amount). The policy and intent of the marital deduction seems to support (indeed to require) that replenishment of the value to the surviving spouse must be considered in determining the amount of gift that is made under §2519. Otherwise, as discussed immediately below, there is a double inclusion of assets subject to the gift and estate tax.

(e) **Double Inclusion.** The CCA does not address the distinct possibility of taxing the same value twice as a result of its conclusion—once as a gift equal to the value of the deemed transfer of the remainder interest under §2519 and the second time at the spouse's death when the assets that the spouse received as consideration are subject to estate tax and the spouse had made use of unified credit in making a gift of assets to trusts for descendants in the combined Gift/Sale Transaction. The CCA interprets §2519 as resulting in a taxable gift of the full actuarial value of the remainder interest, even though that value is replenished in the wife's direct ownership of assets (or utilization of unified credit).

Would the double inclusion be avoided by the provision in §2001(b) that any gifts that are also included in the decedent's gross estate will not be added back into the estate tax calculation as adjusted taxable gifts. Apparently not under the CCA's reasoning that the Spouse did not merely make a deemed gift and retain an interest in the trust, but the Spouse received back assets as the result of an independent gift from the Children.

(f) **Legislative History.** The CCA reasons that the legislative history to §2519 makes clear that an unlimited deduction is allowed under §2056(b)(7) for QTIP property and

> §§ 2044 and 2519 were added to ensure that the transfer tax deferred by § 2056(b)(7) becomes subject to tax, either on the surviving spouse's death or after a lifetime disposition of spouse's qualifying income interest. *See* H. REP. NO. 97-201, at 161-62.

That legislative history would be satisfied by the inclusion of the promissory note in Spouse's estate and the utilization of Spouse's unified credit, both resulting from the Gift/Sale Transaction. The estate tax on the value in the original decedent's estate was deferred at the decedent's death and will be subject to the transfer tax by the Spouse.

(g) **Comparison to Outright Transfer to Spouse.** Observe the dramatically different result under this reasoning than if the original transfer had been made outright to the Spouse instead of into a QTIP trust for the Spouse. For an outright transfer to the Spouse, the estate tax otherwise payable at the first spouse's death would still have been deferred, but the Spouse could have made the gifts and sales of those interests to trusts for the descendants without any interim deemed gift from the Spouse to Children and an immediate return gift from Children to Spouse. What is the policy reason behind treating outright transfers to spouses and QTIP transfers so radically differently? In any event, this difference illustrates the wisdom of including liberal distribution standards in QTIP trusts for future planning flexibility. If the trustee simply transfers all the assets to the spouse, that is merely a distribution from the QTIP and is not a deemed transfer of the remainder interest under §2519, at least if the spouse does not make an immediate transfer of those assets in an integrated transaction. *Cf.* Reg. §25.2519-1(e) (the exercise of a power to appoint QTIP property "to the donee spouse is not treated as a disposition under section 2519, even though the donee spouse subsequently disposes of the appointed property").

(3) **Value of Spouse's Gift Is Full Actuarial Value of Remainder Interest.** The value of the Spouse's gift of the remainder interest under §2519 is the full actuarial value of the remainder interest, because [without citing any authority] possible "[d]iscretionary principal distributions and the testamentary limited power of appointment are not taken into account."

In its discussion of the value of the Spouse's gift, the CCA does not directly address why the gift amount is not reduced by the value of the promissory notes received and the use of the Spouse's unified credit amount in the Gift/Sale Transaction when the Spouse gave and sold assets to the trusts for descendants. But in its "reciprocal exchange" analysis, the CCA quoted *Kite II* for its conclusion that the gift by the spouse is the full value of the remainder interest, not reduced by the consideration received when the spouse transferred the remainder interest. In *Kite I*, the court treated the distribution of assets to the spouse (not authorized in the trust instrument) and the sale of the remainder interest in return for an annuity as an integrated transaction that triggered §2519. As discussed above, the result of not allowing a reduction in the amount of the deemed gift under §2519 is that the value of the remainder interest is subject to transfer tax **twice** – first in the §2519 deemed gift of the remainder interest and second in the use of unified credit and transfer tax that will ultimately be applied on the promissory notes resulting from the Gift/Sale Transaction. For a detailed criticism of the reasoning and effect of the *Kite II* analysis see Akers, Kite v. Commissioner, Rule 155 Order and Decisions (Cause No. 6772-08, unpublished opinion October 25, 2013) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights).

(4) **Value of Gift by Children Is Full Actuarial Value of Remainder Interest.** The value of the gift by the children of the remainder interest to the Spouse (following the deemed transfer of the remainder interest from the Spouse to the Children) does take into account restrictions on the beneficial interests, but the CCA reasons that the possibility of principal invasion for the Spouse was negligible given that the annual income from the QTIP trust would have been sufficient for the Spouse's support needs. The CCA also concludes that "the testamentary limited power of appointment would be appropriately treated as having no measurable effect on the value of these interests." Why not? The CCA merely says that conclusion is "based on all the facts and circumstances" – even though the Spouse *in fact on the same day* made a transfer other than outright to the Children who were the remaindermen.

i. **Planning For Surviving Spouses' Interests in QTIP Trusts.** Planning for surviving spouses who are beneficiaries of substantial QTIP trusts is complicated. This CCA is an example of clients entering

into complicated transactions in planning with QTIP trusts – with bad tax results in the eyes of the IRS.

(1) **Moore, Kawashima & Miyasaki Paper.** For an outstanding detailed discussion of planning alternatives for a surviving spouse who is the beneficiary of a QTIP trust, see Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 1202.3 (2010).

(2) **Distributions.** One of the primary planning options is for the QTIP trust to make a distribution of substantial assets to the spouse-beneficiary, who could then engage in traditional transfer planning alternatives. The biggest hurdle to this planning option is that the trust agreement may have a restrictive standard for principal distributions, and the trustee may not be able to justify a large principal distribution under that standard. Commentators have pointed to possible gift implications of unauthorized distributions (or the failure to object to unauthorized distributions) from trusts:

> If a trustee makes a principal distribution to the surviving spouse to allow him or her to make gifts but the trust instrument does not permit the distribution, the remainder beneficiaries may be deemed to have made taxable gifts by not objecting to the distributions. There is clear authority stating that the release of a right or acquiescence to termination of rights for less than adequate consideration will constitute a gift for gift tax purposes. The seminal case of *Dickman v. Commissioner* [citation omitted] established that a gift need not be in the form of an actual transfer of property. Rather, foregoing a valuable right or property interest (in the case of *Dickman*, interest) also constitutes a gift. IRS § 2501 imposes a gift tax on a broad category of transfers, described in IRS § 2511. The broad nature of gift transfers is discussed in Treas. Reg. § 25.2511-1. In addition, the IRS has confirmed in a number of rulings that acquiescence by a property owner to a transaction that will reduce the value of the property owner's interests is effectively the release of a general power of appointment that will be treated as a gift under IRS § 2501 [citing Rev. Ruls. 84-105 & 86-39].
>
> …
>
> The strategies discussed above in many cases will require the cooperation of formal agreement of multiple parties. The gift tax implications of any such strategy should be considered prior to such an agreement.
>
> Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 ¶ 1201.5 (2010).

(a) **Possible Collapsed Transactions Argument by IRS.** Note, however, that the IRS may claim that a distribution followed by a gift should be collapsed and deemed to be a prearranged and simultaneous transaction, resulting in a distribution from the nonexempt trust to the end recipient. *Cf. Estate of Kite v. Commissioner*, T.C. Memo. 2013-43 (QTIP context; surviving spouse's children as trustees distributed all principal to spouse and she sold the assets to her children two days later in deferred private annuity arrangements; transactions were treated as a disposition by the spouse of her income interests in the QTIP, triggering §2519; suggesting that the combination of a trust distribution to a beneficiary followed by transfers by the beneficiary might be treated as if the subsequent transfers were made by the trust).

(b) **Effect of Unauthorized Distributions.** To the extent distributions are made that are not authorized in the trust agreement, the IRS might argue that it should ignore the distributions. *See Estate of Lillian Halpern v. Commissioner*, T.C. Memo. 1995-352 (distributions from general power of appointment marital trust to descendants; spouse consented but the distributions were not authorized; court recognized the distributions that were made when the spouse was competent but did not recognize distributions made after the spouse had become incompetent because a guardian could have set aside the distributions, so those distributions were included in the spouse's estate under §2041); *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278 (beneficiary-trustee made distribution to self, contrary to standards in trust, and sold those assets for private annuity; trust assets included in decedent's gross estate under §2036 and the distributed assets were not excluded from the decedent's gross estate merely because of ascertainable standards in the trust); *Estate of Hartzell v. Commissioner*, T.C. Memo. 1994-576 (court rejected IRS argument that assets distributed from marital trust to decedent during her lifetime and given to family were includable in her gross estate because the distributions were improper transfers from the

trust; Ohio court would have approved the transfers because distribution standard of "comfort, maintenance, support, and general well being" would include distributions to assist her desire to continue giving gifts to family members to ensure family control of family businesses); *Estate of Council v. Commissioner*, 65 T.C. 594 (1975) (IRS argued that trustee did not have the authority to distribute trust assets to spouse for gifting purposes; court stated that the issue was not whether a state court would have approved the distributions beforehand but whether a state court would rescind the distributions after made; conclusion that trustees acted within the bounds of reasonable judgment).

Several cases have concluded that the failure to follow restraints on distributions caused trusts to be treated as grantor trusts for non-tax purposes. *United Food & Commercial Workers Unions v. Magruder Holdings, Inc.*, Case No. GJH-16-2903 (S.D. Md. March 27, 2019) (failure to comply with fiduciary constraints regarding trust distributions caused a trust to be treated as a grantor trust for non-tax purposes); *SEC v. Wyly,* 2014 WL 4792229 (S.D.N.Y. September 25, 2014) (SEC recoupment case; court reasoned that a failure to comply with fiduciary constraints regarding trust distributions caused a trust to be treated as a grantor trust for non-tax purposes) (case summary is in Item 17 of Current Developments and Hot Topics Summary (December 2015) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(c) **Issue Not Addressed in *Kite*.** In *Kite v. Commissioner*, discussed in Item 8.f above, the Wife substituted her children as trustees of QTIP trusts and the same day they transferred all of the QTIP trust assets to the Wife. The case did not address whether the principal invasion standard in the trust instruments authorized such distributions and whether the children made gifts as a result of making unauthorized distributions. Despite the IRS's failure to raise the beneficiary gift issue in *Kite*, planners structuring planning opportunities with QTIP trusts cannot ignore the potential gift issues by beneficiaries if the beneficiaries either make distributions as trustees or fail to object to distributions made by others as trustees that are not authorized under the trust agreement (*see Dickman v. Commissioner*, 465 U.S. 330 (1984); Rev. Rul. 84-105; Rev. Rul. 86-39).

(3) **Spousal Power of Withdrawal.** A power by the spouse to withdraw assets does not disqualify the trust for the marital deduction as long as the spouse is not legally bound to transfer the withdrawn assets without full consideration. Reg. §20.2056(b)-7(d)(6). (A withdrawal power might be structured to arise only after a year so the trust clearly would not qualify for the marital deduction under §2056(b)(5), which would avoid a possible argument by the IRS that the QTIP election could not be made for that trust, which would cause a loss of some of the flexibilities afforded under the QTIP rules, such as using partial QTIP elections and reverse QTIP elections.)

(4) **Triggering Section 2519 Deemed Disposition.** A type of transfer that offers the ability to take advantage of the increased $10 million (indexed) gift exclusion amount in the event that the exclusion amount later sunsets back to $5 million (indexed) while still leaving cash flow for a surviving spouse who is the beneficiary of a QTIP trust is to make a §2519 transfer. This planning alternative is described in Item 21.i(4) of Estate Planning Current Developments (December 2021) found here and Item 3.j(8) of the Estate Planning Current Developments (December 2018) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights. However, BEWARE that the IRS is considering amending the anti-clawback regulation to remove this type of planning alternative (see Item 7.f(2) above).

(5) **Freezing Transactions.** The QTIP trust might engage in freezing transactions (for example, by selling trust assets for a long-term note or contributing trust assets to a partnership in return for preferred interests).

(6) **Additional Resources.** Some of the planning alternatives for planning with QTIP trusts are summarized in Item 8 of the Observations in Akers, Kite v. Commissioner, Rule 155 Order and Decisions (Cause No. 6772-08, unpublished opinion October 25, 2013) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights). Transfer planning utilizing a §2519 deemed transfer is discussed in Item 3.j.(8) of the Estate Planning Current

Developments (December 2018) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. *See also* Richard S. Franklin, *Lifetime QTIPs—Why They Should Be Ubiquitous in Estate Planning*, 50th HECKERLING INST. ON EST. PL. ch. 16 (2016); Richard S. Franklin & George Karibjanian, *The Lifetime QTIP Trust – the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exemption*, 44 BLOOMBERG TAX MGMT. ESTATES, GIFTS & TR. J. 1 (March 14, 2019).

j. **Early Termination of Trust Not Approved by Court, *McGregor v. McGregor*, 308 Neb. 405 (February 12, 2021).** Do not assume that a court will approve the beneficiaries' desire to terminate a trust early. The Nebraska Supreme court upheld the probate court's refusal to approval a nonjudicial settlement agreement that would have terminated a trust early. The settlor of the trust had died and obviously could not consent to the early termination. The trust agreement created a Family Trust for the surviving spouse, and after the spouse's death, the remaining assets would be distributed to trusts for the lifetimes of the settlor's two children. The surviving spouse and the two children entered into an agreement that the assets would be distributed outright to the children at the surviving spouse's subsequent death, but the spouse later attempted to revoke the agreement. The trust contained a spendthrift clause, and the trust stated the settlor's intent to create "a non-support discretionary spendthrift trust that may not be reached by the beneficiaries['] creditors for any reason." The court determined that the spendthrift provision constitutes a material purpose of the trust that the settlement agreement would violate by terminating the trust early. *McGregor v. McGregor*, 308 Neb. 405 (February 12, 2021).

9. Family Limited Partnership and LLC Planning Developments; Planning in Light of *Estate of Powell v. Commissioner* and *Estate of Cahill v. Commissioner*

a. **Overview of Section 2036 Issues.** The most litigated transfer tax issue is whether assets contributed to an FLP/LLC should be included in the estate under §2036 (without a discount for restrictions applicable to the limited partnership interest). About 39 reported cases have arisen. The cases seem to be decided largely on a "smell test" basis.

(1) **Bona Fide Sale for Full Consideration Defense.** The bona fide sale for full consideration defense is the key for defending both §2036(a)(1) and §2036(a)(2) cases. Almost every one of these cases that the taxpayer has won was based on the bona fide sale for full consideration exception to §2036. The three exceptions are *Kelly, Mirowski,* and *Kimbell* (at least as to some assets). See Item 9.f below.

(a) **Bona Fide Sale Test – Legitimate and Significant Nontax Reason.** The key is whether "legitimate and significant nontax reasons" existed for using the entity, as announced in *Bongard v. Commissioner*, 124 T.C. 95 (2005). Having tax reasons for creating entities is fine; the test is whether "**a**" legitimate and significant nontax reason applied as well. The tax purposes are not weighed against the nontax purposes. For a listing (with case citations) of factors that have been recognized in particular situations as constituting such a legitimate nontax reason, see Item 8.g. of the Current Developments and Hot Topics Summary (December 2016) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

Also, make sure that other planning is consistent with the purposes of the partnership. Consider documenting the nontax reasons. Contemporaneous evidence really helps satisfy the court. The estate planning attorney's files can significantly help (or hurt) at trial.

(b) **Full Consideration Test.** To satisfy the full consideration requirement, as described in *Bongard*, the interest received by the parties making contribution to the entity should be proportionate to their contributions, and the value of contributed property should be credited to capital accounts. This must be done when the entity is created. On liquidation the owners will receive their proportionate interest in the partnership based on the capital accounts.

(2) **Section 2036(a)(1).** The IRS typically argues that assets should be included under §2036(a)(1) as a transfer to the FLP/LLC with an implied agreement of retained enjoyment. The latest of those

reported cases is *Estate of Moore v. Commissioner*, briefly summarized in Item 10 below. The government wins about 2/3 of those cases. (In some of those cases, the FLP/LLC assets have been included in the estate under §2036 even though the decedent had transferred the partnership interests during life (*Harper, Korby*).)

Agreement of Retained Enjoyment. If the bona fide sale for full consideration exception does not apply, the IRS must still establish an implied agreement of retained enjoyment in the assets that were transferred to the partnership or LLC. For a summary list (with case citations) of factors that suggest an implied agreement retained enjoyment, see Item 8.g. of the Current Developments and Hot Topics Summary (December 2016) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(3) Section 2036(a)(2). In a few cases, the IRS has also made a §2036(a)(2) argument, that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the income or property contributed to the entity. Two cases have applied §2036(a)(2) where the decedent had some interest as a general partner (*Strangi* and *Turner*), and one case applied §2036(a)(2) when the decedent held merely a limited partnership interest (*Powell*, as discussed in Item 9.c.(1) below).

(a) Possible Defenses Even as General Partner. The Tax Court in *Cohen* (79 T.C. 1015 (1982)) said that being co-trustee of a Massachusetts business trust does not necessarily require inclusion under §2036(a)(2) if cognizable limits on making distributions apply rather than a situation in which trustees could arbitrarily and capriciously withhold or make distributions. Traditionally, planners have relied on the *Byrum* Supreme Court case for the proposition that investment powers are not subject to §2036(a)(2).

As discussed in *Strangi*, §2036(a)(2) applies even if the decedent is just a co-general partner or manager, but as a practical matter, the IRS does not view co-manager situations as critically as if the decedent was the sole manager. Having co-managers also typically helps support the nontax reasons for the partnership or LLC.

(b) *Powell*, *Cahill*, and *Morrissette*. The *Powell*, *Cahill*, and *Morrissette* cases applied §2036(a)(2), as discussed in Item 9.c below. *Levine* refused to apply §2036(a)(2) because the decedent could not participate at all in the decision to cause the cash surrender value of intergenerational split dollar life insurance policies to be paid early. See Item 16.b below.

(c) IRS Agents Are Making the *Powell* Argument. John Porter tried *Estate of Wittingham v. Commissioner* in February 2018. The case was ultimately settled, but the IRS made the *Powell* argument with respect to an LLC created by the decedent, in which the decedent and her two sons were the managing members and held the Class A units with voting rights. The case involved the sale of units in return for a private annuity even though the decedent had just found out that she had pancreatic cancer. The case ultimately settled with the taxpayer conceding that some prior purported loans were gifts and conceding about 20% of the private annuity issue because of uncertainty about some medical issues.

Planners report anecdotally that the IRS is continuing to raise the §2036(a)(2)/*Powell* arguments in audits.

(4) Some Relatively Recent §2036 Cases. For a detailed summary of some §2036 cases (other than *Powell*) over the last six years (*Purdue, Holliday*, and *Beyer* cases), and a planning checklist for structuring the proper formalities for FLPs and LLCs, see Items 10 and 29 of the Current Developments and Hot Topics Summary (December 2016) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

b. Overview of Other Issues – §2703 and Indirect Gift. Other issues that the IRS sometimes raises in audits regarding FLP/LLCs are (1) whether specific restrictions in partnership agreements should be ignored for tax purposes under §2703 (*see Holman*, *Fisher II*, and *Kress*, and §2703 is discussed in the context of intergenerational split dollar situations in *Cahill*, *Morrissette*, and *Levine*)) and (2) whether contributions to an FLP/LLC immediately followed by gifts of interests in the entity should

be treated as indirect gifts of the underlying assets of the entity (*see Holman, Gross, Linton,* and *Heckerman*).

c. FLP Assets Includable under §2036(a)(2) – *Powell, Cahill,* and *Morrissette* – But Not *Levine.*

(1) ***Estate of Powell*** **Synopsis.** *Estate of Powell v. Commissioner*, 148 T.C. 392, is a "reviewed" Tax Court decision that may be the most important Tax Court case addressing FLPs and LLCs since the *Bongard* case 15 years ago. The Tax Court breaks new ground (1) in extending the application of §2036(a)(2) to decedents owning only limited partnership interests, and (2) in raising the risk of double inclusion of assets under §2036 *and* a partnership interest under §2033, which may (in the court's own words) result in "duplicative transfer tax." (The case was decided on cross motions for summary judgment and is not an opinion following a trial.)

For a brief overview summary of *Powell,* see Item 26.c.(1) of Estate Planning Current Developments (December 2021) found here and for a more detailed discussion of the facts and court analysis in and planning implications of *Powell*, see Item 15.g. of the Current Developments and Hot Topics Summary (December 2017) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(2) **Synopsis of** ***Estate of Cahill*** **and Settlement.** In *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (Judge Thornton), the decedent's revocable trust had advanced $10 million to an irrevocable trust under a split dollar agreement for the trust to purchase life insurance policies on the lives of the decedent's son and his wife; the estate valued its reimbursement at only $183,700, because of the long period of time before the policies would mature at the insureds' deaths. The IRS argued, among other things, that the reimbursement right should have a value equal to the full cash surrender value of the policies (about $9.6 million) in part because of §§2036, 2038, and 2703. The court rejected the estate's motion for a partial summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) did not apply and that Reg. §1.61-22 applied in valuing the decedent's reimbursement rights. The estate tax audit was settled on August 16, 2018, with the estate conceding all the issues regarding the intergenerational split dollar arrangement (agreeing that the value of the decedent's reimbursement right was the $9.6 million cash surrender value of the policies) and the imposition of a 20% accuracy-related penalty under §6662; the IRS conceded regarding the value of certain notes from family members unrelated to the split dollar transaction. For a more detailed summary of the *Cahill* case (including ramifications of its §2703 analysis) see Item 13 of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(3) **Tax Court Follows Same Position in** ***Estate of Morrissette v. Commissioner*****.** The initial case in *Estate of Morrissette v. Commissioner,* 146 T.C. 171 (2016), determined that the economic-benefit regime applies to the split dollar arrangement in that case. The IRS made arguments under §§2036, 2038, and 2703, similar to its arguments in *Cahill*. The court entered an Order dated February 19, 2019 denying the taxpayer's motions for summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) do not apply, reasoning merely that *Estate of Cahill* "is directly on point" regarding §§2036(a)(2) and 2038(a)(1).

The court ultimately held that the bona fide sale for full consideration exception to §2036 and §2038 and the §2703(b) safe harbor applied, and the court valued the estate's reimbursement right, T.C. Memo. 2021-60 (May 13, 2021), as discussed in Item 16.c-16.f below. For a much more detailed discussion of the *Morrissette* developments before the 2021 opinion, see Item 13 of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(4) **Section 2036(a)(2) Not Applicable in** ***Levine*****.** The Tax Court held that §2036(a)(2) and §2038 did not apply in *Estate of Levine v. Commissioner*, T.C. No 2 (February 28, 2022). A big distinction from *Morrissette* is that in *Levine* the life insurance trust that owned the policies had the sole right to decide whether to terminate the split dollar agreement or surrender the polices prior to the deaths of the insureds. The court reasoned that the decedent did not any right, whether by

herself or in conjunction with anyone else, to terminate the policies and therefore to designate who could possess or enjoy the property or to alter, amend, revoke or terminate the transfer. See Item 16.b below.

d. **What to Do? Planning in Light of Powell.**

(1) **Overview of Planning Alternatives.** Planning alternatives for avoiding inclusion under §2036 (and in particular, §2036(a)(2)) in light of *Powell* and *Cahill* include the following:

- No revocable transfers;
- Avoid transfers under a power of attorney;
- Satisfy the bona fide sale for full consideration exception;
- Transfer all voting rights, including power to amend or revoke the agreement;
- Eliminate unanimous partner approval requirement for dissolution (which was present in *Powell*);
- Avoid having the decedent or decedent's agent as general partner of an FLP;
- Provide for slicing and dicing of voting rights and manager powers (discussed in more detail below);
- No participation in removal of managers unless replacement must be not related or subordinate to the donor;
- Use trusts as owners of entity interests with an independent trustee;
- Transfer all interests during life; and
- "Claim victory" and dissolve the FLP/LLC following prior successful transfers.

For a more detailed discussion of these and other planning steps in light of *Powell*, see Item 19.d. of Estate Planning Current Developments and Hot Topics (December 2020) found here and Item 15.g. of the Current Developments and Hot Topics Summary (December 2017) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(2) **Slicing and Dicing of Voting Rights.** If the donor retains any voting rights, create classes of voting rights. For example, Class A limited partners and members would possess full voting rights normally provided to limited partners or members, and Class B limited partners or members (including the donor) could vote on all matters other than (a) the liquidation or dissolution of the entity, (b) distributions from the entity, (c) the right to approve a proposed transfer of an interest in the entity, or (d) the amendment of the entity agreement in a way that would alter any of those restrictions.

(3) **Limiting Donor's Powers as Manager of LLC or as General Partner of Limited Partnership.**

(a) **Distribution Decisions.** If the donor will continue to be a general partner or hold an interest in a general partner or will be the manager of an LLC, limit the donor from having the right to participate in any distribution decisions. For example, use a separate "distribution general partner" or "distribution manager" who has exclusive authority over decisions about when the entity would make distributions to its owners.

If the donor insists on participating in distribution decisions, §2036 and §2038 should not apply if distributions decisions are subject to a definite standard that is specific enough that it can be enforced by a court (based on old cases under §2036 and §2038). Consider providing that Class A limited partners or a "special general partner" or "special manager" (other than the donor) must consent to establishing reasonable reserves (at least for more than a baseline established in a budget that is approved from time to time by all the partners).

(b) **Investment and Management Decisions.** There are strong arguments that investment and administrative powers held by the donor as a general partner (or manager of an LLC) should not trigger estate inclusion under §2036 or §2038. *See, e.g.*, *Estate of Ford v. Commissioner*, 53 T.C. 114 (1969), *nonacq.* 1978-2 C.B. 3, *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971) ("the

power to invest in 'nonlegals' (i.e., investments not classified under a particular State law or ruling of the pertinent court as legal investments for trust funds) and the power to sell or exchange the trust property do not amount to a right to designate who shall enjoy the trust property or a right to alter, amend, or revoke the terms of the trust"); *United States v. Powell*, 307 F.2d 821 (10th Cir. 1962) (trustee-grantor had power to invest assets as he deemed "most advisable for the benefit of the trust estate"; held that trustee's acts were subject to review by a court of equity and did not invoke the predecessor to §2038); *Estate of Graves v. Commissioner*, 92 T.C. 1294, 1302-03 (1989) ("Even if the decedent had the power to direct the investment of the trust property, this power would not constitute a power to alter, amend or revoke because she would have effectively been a trustee. As a trustee, she would have had to act in good faith, in accordance with her fiduciary responsibility, and safeguard and conserve the trust principal."); *Estate of King v. Commissioner*, 37 T.C. 973 (1962), *nonacq*. 1963-1 C.B. 5 (grantor had the right to direct the trustee regarding investment of trust assets, but the court reasoned that "the grantor had in effect made himself a fiduciary" and held that there was "no retained right or power in the decedent to divert any of the corpus to the income beneficiaries or to divert any income to the remaindermen"). The key under these cases is the existence of a fiduciary duty that a court can supervise and ensure that the fiduciary will act impartially. *See Estate of Bowgren v. Commissioner*, 105 F.3d 1156 (7th Cir. 1997) (absence of fiduciary duty by donor to donee who received an assignment of an interest in a land trust caused §§2036(a)(2) and 2038 to apply).

Despite this strong authority, some planners are reluctant, considering the *Powell* and *Cahill* broad "in conjunction with" reasoning, to allow a donor to serve as manager of an LLC with management authority regarding investment decisions. Conceivably, the IRS might argue that the donor could make investments in non-income-producing assets that would deprive the entity of any cash flow to make distributions to the owners, and therefore retain the ability to designate who shall possess or enjoy the property or the income therefrom (§2036(a)(2)) or alter, amend, revoke, or terminate enjoyment of the property (§2038(a)(1)). Bear in mind that §2038 is triggered by the mere ability to affect the timing of enjoyment of the property even though the identity of the beneficiary is not affected, Reg. §20.2038-1(a), and §2038 is based on powers that exist at death rather than powers that are retained at the time of the transfer.

Even if the transfer is to a trust with an independent trustee that is a member of the entity, if the donor serves as a manager of or in some other management position with the entity, the IRS could possibly argue under *Powell* that the donor's authorities "in conjunction with others" could impact beneficial enjoyment of the transferred assets.

Because of these concerns, if the donor makes a gift of an interest in the entity, some respected planners structure the entity to avoid having the donor as a general partner or manager or limit the donor's authority as manager or other management position to participate in "tax-sensitive" activities. Diana Zeydel (Miami, Florida) has noted the possibility of limiting the donor's authority as manager with respect to decisions, approvals, or consents relating to various potentially tax sensitive activities such as distributions, allocations to reserves, determining the fair market value of interests, making loans to or guarantees of loans of any entity owner, withdrawal or resignation of any owner, dissolution or liquidation of the entity, any incident of ownership in any life insurance policy on the life of any entity owner, voting the stock of any "controlled corporation" as described in §2036(b), or an amendment of the governing instruments with respect to any of those matters.

If the donor merely makes a sale of an interest in an entity (and does not make a gift), planners may still encourage the appointment of a distribution officer and a liquidation officer to be safe and just let the donor manage the assets.

Other respected planners are not as concerned with the donor serving as the manager of an LLC with authority over LLC investments, especially if the owners of the entity are family trusts with independent trustees. They believe that only the independent trustee of the trust can control the beneficiary's enjoyment of the gifted asset, and the LLC manager has a

fiduciary duty to the LLC members a la the Supreme Court's fiduciary duty analysis in *United States v. Byrum*; therefore, it is the trustee of the trust and not the grantor as manager who controls the income and distribution spigot to the recipients of the gifted property.

e. **Prior Cases That Have Limited the Broad Application of the "in Conjunction with" Phrase in §§2036 and 2038.** Section 2036(a)(2) was enacted with almost identical "in conjunction with" statutory language as in §2038. Several cases have limited the application of the "in conjunction with" provision in determining whether §2038 applied. The *Helmholz*, *Tully*, and *Bowgren* cases are cited and briefly summarized in Item 19.e. of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

f. **Summary of §2036 FLP/LLC Cases (14-23, with 2 on Both Sides).** Of the various FLP/LLC cases that the IRS has chosen to litigate, 14 have held that at least most of the transfers to an FLP/LLC qualified for the bona fide sale exception —

(1) *Church v. United States,* 2000-1 USTC ¶60,369 (W.D. Tex. 2000) (preserve family ranching enterprise, consolidate undivided ranch interests);

(2) *Estate of Eugene Stone v. Commissioner*, T.C. Memo. 2003-309 (partnerships to settle family hostilities);

(3) *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), *vacating and rem'g* 244 F. Supp. 2d 700 (N.D. Tex. 2003) ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests);

(4) *Bongard v. Commissioner*, 124 T.C. 95 (2005) (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts);

(5) *Estate of Schutt v. Commissioner*, T.C. Memo. 2005-126 (maintaining buy and hold investment philosophy for family du Pont stock);

(6) *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74 (joint management and keeping a single pool of assets for investment opportunities);

(7) *Estate of Miller v. Commissioner*, T.C. Memo. 2009-119 (continue investment philosophy and special stock charting methodology);

(8) *Keller v. United States*, 2009-2 USTC ¶60,579 (S.D. Tex. 2009) (protect family assets from depletion in divorces);

(9) *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 BL 223971 (W.D. Ark. Oct. 2, 2009) (centralized management and prevent dissipation of family "legacy assets");

(10) *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) (maintaining buy and hold investment philosophy for closely held stock);

(11) *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21 (asset protection and management of timberland following gifts of undivided interests);

(12) *Estate of Joanne Stone v. Commissioner*, T.C. Memo. 2012-48 (desire to have woodland parcels held and managed as a family asset and various other factors mentioned);

(13) *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73 (ensuring equal estate distribution, avoiding potential litigation, and achieving effective asset management); and

(14) *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249 (centralized management and other factors).

(In the context of intergenerational split dollar life insurance scenario rather than an FLP/LLC, situation, *Estate of Morrissette* held that the bona fide sale for full consideration exception applied, and *Estate of Cahill* held that it did not apply on the facts of those cases. *Estate of*

Levine held that §2036 and §2038 did not apply without relying on the bona fide sale for full consideration exception.)

Three cases (*Kelly*, *Mirowski*, and *Kimbell*) held that §2036 did not apply (at least for some assets) without relying on the bona fide sale for full consideration exception. All the FLP cases resulting in taxpayer successes against a §2036 attack have relied on the bona fide sale exception to §2036 except *Kelly*, *Mirowski*, and *Kimbell*. *Kelly* relied on the bona fide sale exception to avoid treating the contributions to partnerships as transfers triggering §2036 but reasoned that no retained enjoyment existed under §2036(a)(1) regarding gifts of limited partnership interests [that obviously did not qualify for the bona fide sale for full consideration exception]. *Mirowski* similarly relied on the bona fide sale exception with respect to contributions to the partnership, but not as to gifts of partnership interests. *Kimbell* relied on the bona fide sale for full consideration exception for transfers to a partnership, but for other transfers to an LLC, the Fifth Circuit refused to apply §2036 (the particular issue was about §2036(a)(2)) without addressing whether the bona fide sale for full consideration exception applied to those transfers.

Interestingly, six of those 14 cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the *Miller*, *Joanne Stone*, and *Purdue* cases and authored the Tax Court's opinion in *Bongard*. Judge Chiechi decided both *Stone* and *Mirowski*. (Judge Wherry decided *Schutt*, Judge Halpern decided *Black*, Judge Jacobs decided *Shurtz*, Judge Foley decided *Kelly*, and *Church* and *Kimbell* were federal district court opinions ultimately resolved by the Fifth Circuit. *Keller* and *Murphy* are federal district court cases.)

Including the partial inclusion of FLP/LLC assets in *Miller* and *Bongard*, 23 cases have applied §2036 to FLP or LLC situations: *Estate of Schauerhamer v. Commissioner*, T.C. Memo. 1997-242, *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000), *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, *Thompson v. Commissioner*, T.C. Memo. 2002-246, *aff'd*, 382 F.3d 367 (3d Cir. 2004), *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd,* 417 F.3d 468 (5th Cir. 2005), *Estate of Abraham v. Commissioner*, T.C. Memo. 2004-39, *Estate of Hillgren v. Commissioner*, T.C. Memo. 2004-46, Estate of *Bongard v. Commissioner*, 124 T.C. 95 (2005) (as to an LLC but not as to a separate FLP), *Estate of Bigelow v. Commissioner*, T.C. Memo. 2005-65, *aff'd*, 503 F.3d 955 (9th Cir. 2007), *Estate of Edna Korby v. Commissioner*, T.C. Memo. 2005-102, *aff'd*, 471 F.3d 848 (8th Cir. 2006), *Estate of Austin Korby v. Commissioner*, T.C. Memo. 2005-103, *aff'd*, 471 F.3d 848 (8th Cir. 2006), *Estate of Rosen v. Commissioner*, T.C. Memo. 2006-115, *Estate of Erickson v. Commissioner*, T.C. Memo. 2007-107, *Estate of Gore v. Commissioner*, T.C. Memo. 2007-169, *Estate of Rector v. Commissioner*, T.C. Memo. 2007-367, *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278, *Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66, *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011), *Estate of Mille*r *v. Commissioner*, T.C. Memo. 2009-119 (as to transfers made 13 days before death but not as to prior transfers), *Estate of Malkin v. Commissioner*, T.C. Memo. 2009-212, *Estate of Holliday v. Commissioner*, T.C. Memo. 2016-51, *Estate of Beyer v. Commissioner*, T.C. Memo. 2016-183, *Estate of Powell v. Commissioner,* 148 T.C. 392 (2017), and *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40. In addition, the district court applied §2036 in *Kimbell v. United States* but the Fifth Circuit reversed.

g. Review of Court Cases Valuing Partnership/LLC Interests. Despite the many cases that have addressed the applicability of §2036 to limited partnership or LLC interests, fewer cases have actually reached the point of valuing partnership interests. Observe that some cases have allowed discounts even for controlling interests in FLPs or LLCs. *E.g.*, *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (4% lack of control discount for controlling majority interests in LLCs); *Estate of Streightoff v. Commissioner*, T.C. Memo. 2018-178, aff'd 954 F.3d 713 (5th Cir. 2020) (18% lack of marketability discounts for estate's de facto controlling interest in LLC holding cash and marketable securities). John Porter, an attorney in Houston, Texas who has litigated many of the family limited partnership cases, summarizes discounts that have been allowed by the courts in FLP/LLC cases as follows (the *Streightoff*, *Estate of Jones*, *Grieve*, *Nelson, Warne,* and *Smaldino* case results have been added to the table):

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Strangi I	Securities	Tax	31%
Knight	Securities/real estate	Tax	15%
Jones	Real estate	Tax	8%; 44%
Dailey	Securities	Tax	40%
Adams	Securities/real estate/minerals	Fed. Dist.	54%
Church	Securities/real estate	Fed. Dist.	63%
McCord	Securities/real estate	Tax	32%
Lappo	Securities/real estate	Tax	35.4%
Peracchio	Securities	Tax	29.5%
Deputy	Boat company	Tax	30%
Green	Bank stock	Tax	46%
Thompson	Publishing company	Tax	40.5%
Kelley	Cash	Tax	32%
Temple	Marketable securities	Fed. Dist.	21.25%
Temple	Ranch	Fed. Dist.	38%
Temple	Winery	Fed. Dist.	60%
Astleford	Real estate	Tax	30% (GP); 36% (LP)
Holman	Dell stock	Tax	22.5%
Keller	Securities	Fed. Dist.	47.5%
Murphy	Securities/real estate	Fed. Dist.	41%
Pierre II	Securities	Tax	35.6%
Levy	Undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Giustina	Timberland; forestry	Tax	25% with respect to cash flow valuation (75% weighting to cash flow factor and 25% weighting to asset method); BUT reversed by 9th Circuit and remanded to reconsider without giving 25% weight to asset value
Koons	Securities	Tax	7.5%; Estate owned 70.42% of voting interests and could remove limitation on distributions
Gallagher	Publishing company	Tax	47%
Streightoff	Securities	Tax	0% lack of control discount because the 88.99% LP interest could remove the general partner and terminate the partnership; 18% lack of marketability discount
Kress	Manufacturing	Tax	Lack of marketability discounts of 25% for 2007-2008 gifts & 27% for 2009 gifts (those numbers included 3% downward adjustment because family transfer restriction was not taken into account); adjustment also made for minority interest in evaluating non-operating assets
Jones	Sawmill & timber	Tax	35% lack of marketability discount from noncontrolling interest value
Grieve	Securities	Tax	35% for one LLC and 34.5% for another LLC (98.8% non-voting LLC interest)
Nelson	FLP owned 27% of holding company that owned various subsidiaries with operating businesses	Tax	FLP's interest in holding company valued with 15% lack of control discount and 30% lack of marketability discount; transferred limited partner interest in FLP valued with 5% lack of control discount and 28% lack of marketability discount

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Warne	Majority interests (all over 70%) in five LLCs owning real estate	Tax	2% lack of control discount (court might have found no LOC discount but parties agreed some LOC discount was proper) and 5% lack of marketability discount; for charitable deduction of a 100% LLC interest passing to two charities, parties stipulated a 4% discount for a 75% LLC interest and 27.385% discount for a 75% LLC interest
Smaldino	Ten rental real estate properties	Tax	36% combined lack of control and marketability discount (accepting view of IRS expert) for transfers of minority nonvoting interests

John Porter, *The 30,000 Foot View from the Trenches: A Potpourri of Issues on the IRS's Radar Screen*, 49th ANN. HECKERLING INST. ON EST. PL. ¶ 511 (2015).

10. FLP Assets Included Under §2036(a)(1); Application of §2043 Consideration Offset; Formula Transfer to Charitable Lead Trust Not Respected; Loans Not Respected; No Deduction for Attorney's Fee, *Estate of Howard V. Moore v. Commissioner*, T.C. Memo. 2020-40, *aff'd*, 124 AFTR 2d 2021-6604, (9th Cir. Nov. 8, 2021)

a. **Synopsis.** In a pre-death planning context beginning in late 2004, after contracting to sell a farm for about $16.5 million the decedent transferred a 4/5ths interest in the farm to an FLP in return for a 95% limited partnership interest. A Management Trust (with two children as co-trustees) was the 1% general partner, but the decedent exercised practical control over the FLP and caused transfers of $2 million of the sale proceeds to himself, $2 million to his children (who gave notes for their transfers), and $500,000 to a grandson as a gift.

The decedent subsequently gave $500,000 to an Irrevocable Trust (for his children) and several weeks later transferred his 95% limited partnership interest to the Irrevocable Trust for a $500,000 cash down payment and a $4.8 million note (the gift and sale amount represented a discount of just over 50% for the FLP interest).

The decedent's revocable trust provided a formula bequest to a charitable lead trust in an amount to "result in the least possible federal estate tax." In addition, the Irrevocable Trust provided that the trustee would distribute to the revocable trust "the value of any asset of this trust which is includible in my gross estate."

Following the decedent's death at the end of March 2005, the charitable lead trust apparently was funded with a substantial amount under the revocable trust's formula transfer. An IRS examination resulted in this case alleging additional gift and estate taxes.

Not surprisingly, the court determined that the farm was included in the gross estate under §2036(a)(1). The bona fide sale for full consideration exception in §2036(a) did not apply because no businesses required active management, the children did not actually manage sale proceeds in the FLP, no legitimate creditor concerns existed, and the "whole plan" involving the FLP had a "testamentary essence." The decedent retained enjoyment or possession of the assets transferred to the FLP under §2036(a)(1) (at least by implied agreement) because, although he kept sufficient assets for personal needs, he instead "scooped into FLP assets to pay personal expenses," and his relationship to the assets remained unchanged after the transfer to the FLP.

The court followed up on the discussion of §2043 in *Estate of Powell v. Commissioner* with its own lengthy analysis, but on the facts of the case the application of §2043 had little practical impact.

The court refused to allow any additional charitable deduction under the formula transfer provision in the Irrevocable Trust as a result of the inclusion of the farm in the gross estate because (1) specific wording in the formula limits any transfer, and (2) the charitable amount was not ascertainable at the decedent's death but depended on subsequent events (the IRS audit and tax litigation). The *Christiansen* and *Petter* cases were distinguished because they merely involved valuation issues to

determine what passed to charity, but in this case the charity did not know it "would get any additional assets at all."

The court also determined that (1) the $2 million transfers to the children in return for notes were actually gifts (with a detailed review of factors considered in determining whether bona fide debt exists), (2) additional gift taxes resulting from those gifts must be included in the gross estate under §2035(b) because the gifts were made within three years of death, and (3) a flat fee of $475,000 for attorney's fees was not deductible because the evidence did not establish what services were performed for the fee and that it was necessarily incurred in the administration of the estate.

The estate appealed only the denial of the charitable deductions to the Court of Appeals for the Ninth Circuit. In a short unpublished opinion, the Ninth Circuit affirmed on the narrow ground that the specific wording in the formula, which the court found unambiguous, limits any transfer to charity, without addressing the Tax Court's additional more general rationale denying the charitable deduction because the formula charitable transfer depended on subsequent events (the tax litigation). *Estate of Howard V. Moore v. Commissioner,* T.C. Memo. 2020-40 (April 7, 2020, Judge Holmes), *aff'd*, 128 AFTR 2d 2021-6604, Docket No. 20-73013 (9th Cir. Nov. 8, 2021).

For a detailed discussion of *Estate of Moore*, see Item 20 of Estate Planning Current Developments and Hot Topics (March 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

b. **Estate Inclusion Under §2036(a).** Not surprisingly based on the facts, the court determined (after a lengthy analysis) that the farm was included in the gross estate under §2036(a)(1).

c. **Section 2043 Consideration Offset Discussion.**

(1) **Court Analysis.** The court followed up on the discussion of §2043 in *Estate of Powell v. Commissioner* with its own lengthy analysis. The court proceeded with an extended discussion of §2043, fortunately avoiding *Powell*'s doughnut and doughnut hole analogies, but applying a formula approach. The court's analysis ended up with the following formula:

> Value in Gross Estate = Value of farm at date of death – money that left the estate between the time of the sale and date of death.

The court discussed five examples of how §2043 would apply in different circumstances, but on the facts in the *Moore* case the application of §2043 had little practical impact.

(2) **Section 2043 Background.** The §2043 analysis was not actually "discovered" in *Powell*. The plurality opinion's summary of how §2043 applies in the context of §2036 FLP cases is similar to what Professor Jeffrey Pennell has been telling planners for decades. *See*, *e.g.,* Pennell, *Recent Wealth Transfer Developments*, ABA REAL PROP., PROB. & TR. LAW SECTION 14TH ANN. EST. PL. SYMPOSIUM, at 21-23 (2003).

(3) **Double Inclusion Approach Is Often Not Applied in Other Contexts.** In other contexts, the IRS has not used the double inclusion approach where doing so would result in unfair results. The IRS has previously ruled that life insurance proceeds received by a partnership should not be includible in the gross estate *both* under §2042 and under §2033 as to the decedent's partnership interest. For example, in Revenue Ruling 83-147, 1983-2 C.B. 158, the IRS refused to include life insurance proceeds payable to a partnership both as part of a partner's interest in the partnership and under §2042 as a result of incidents of ownership attributed to the decedent as partner of the partnership, because doing so would result in "unwarranted double taxation":

> In *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff'd on another issue* 244 F.2d 436 (4th Cir. Cir), *cert denied*, 355 U.S. 827 (1957), a partnership held 10 policies on the decedent's partner's life, at his death…. The court found that the decedent, in his individual capacity, had no incidents of ownership in the policies, and held that the insurance proceeds were not includible in the gross estate under the predecessor to section 2042(2) of the Code. The Service acquiesces in the result of *Estate of Knipp* on the basis that in that case the insurance proceeds were paid to the partnership and inclusion of the proceeds under the predecessor of section 2042 would have resulted in the **unwarranted double taxation** of a substantial portion of the proceeds, because the decedent's proportionate share of the proceeds of the policy were included in the value of the decedent's partnership interest. See also section 20.2042-1(c)(6) of

> the regulations (which adopts a similar rule with regard to life insurance proceeds paid to or for the benefit of a corporation). (Emphasis added.)

A distinction regarding life insurance inclusion under §2042, however, is that §2043(a) refers to transfers under §2035-§2038 and §2041, but not transfers under §2042.

Similarly, the regulations regarding GRATs state that if the GRAT assets are included under §2036, the retained annuity interest payments that are payable after the decedent's death are not also included under §2033 "because they are properly reflected under this section." Reg. §20.2036-1(c)(1)(i).

Over the last 24 years preceding the *Moore* decision, 22 cases (listed in the last paragraph of Item 9.f above had held that the value of assets contributed to a family limited partnership or LLC were included in a decedent's estate under §2036, but *none* of those cases, other than *Powell*, included both the FLP assets and the FLP interest in the gross estate. Despite this long history of FLP/§2036 cases and other examples of avoiding double inclusion described above, the *Moore* opinion responds:

> Excluding the value of the partnership interest from Moore's gross estate might appear to be the right result because it would prevent its inclusion in the value of the estate twice. The problem is that there is nothing in the text of section 2036 that allows us to do this.

(4) **Practical Impact of Applying §2043 in FLP/§2036 Context.** Applying the double inclusion with a §2043 consideration offset analysis (rather than simply including the §2036 amount in the gross estate) has a practical impact on the overall result primarily in situations in which (1) the assets contributed to the entity have appreciated or depreciated by the time of death, or (2) distributions from the entity have been made that are still owned by the decedent at death.

For detailed examples of the effects of subsequent appreciation, subsequent deprecation, or subsequent distributions from an entity, see Summary of *Estate of Moore v. Commissioner* (April 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(5) **Summary: Double Inclusion Analysis Going Forward in FLP Context.** Using the double inclusion §2036 approach with a §2043 consideration offset rather than the single inclusion §2036 approach results in "unfair" double taxation if *appreciation* occurs and still allows the partnership discount if significant *depreciation* occurs. From a policy standpoint, the single inclusion §2036 approach seems preferable.

The fact that eight (but less than a majority) of the judges in *Powell* and now *Moore* adopted the double inclusion analysis may embolden the IRS to take that position in future cases. But we do not yet know how a majority of the Tax Court judges would rule as to that issue.

In any event, the double inclusion analysis applied in *Powell* and *Moore* raises a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer had merely retained the assets, if the assets appreciate between the time of contribution to the entity and the date of death and if §2036 applies to the transfer of assets to the FLP (or other entity).

Tax litigators observe that IRS representatives are now making the §2043 argument in FLP cases where the assets have appreciated, and estates are similarly making that argument in situations in which the assets contributed to an FLP or LLC have declined in value after the date of the contribution to the entity.

(6) **ACTEC Comments to IRS Recommending Adoption of the Position of the *Powell* Concurring Opinion.** The American College of Trust and Estate Counsel (ACTEC) filed comments with the Internal Revenue Service on May 26, 2021, recommending issues for inclusion in the 2021-2022 Treasury Priority Guidance Plan. The comments include a recommendation that if assets contributed to a partnership (or LLC) are included in the contributor's gross estate under §2036, unless what was transferred into the entity has been re-transferred or unless some third party

paid consideration for what is included in the estate under §2036, the entity interest itself should not also be included under §2033.

The comments observe that this would be consistent with the treatment of assets transferred to a GRAT if the grantor dies before the end of the GRAT term and value attributable to the GRAT is included in the decedent's gross estate under §2036. Section 2043 is not used; instead, the annuity payments that are due after the date of death are not also included in the gross estate under §2033. Reg. §20.2036-1(c)(1)(i).

The comments recommend a proposed solution to the complexities, inconsistencies, and unfairness that results under the double inclusion/§2043 analysis in *Powell* and *Moore*:

> Under the concurring opinion in *Powell*, the entire lifetime transaction should be disregarded and the transferred property should be entirely included in the gross estate at its date of death value and the partnership units ignored for such purposes. This approach would avoid the complicated analysis that results from the application of Section 2043, i.e., the valuation of the retained interest under Section 2036(a) inclusion/Section 2043(a) offset that leads to illogical results which are unfair to either the taxpayer (doubling counting post transaction appreciation) or the Service (doubling counting of post transaction depreciation). The concurring opinion would result in tax on the value of the assets actually transferred.
>
> The solution proposed here is not only the more practical one, but also the outcome that is the most "fair" to the taxpayer and to the government. And it is the most theoretically satisfying. We propose that Section 2043 should not apply where there is no consideration provided by a third party because the taxpayer's estate has received no additional assets or value in a transaction that is essentially with himself or herself. In cases where the consideration received in the transfer is from a third party, the estate is actually enlarged by the consideration received and Section 2043 should apply to exclude the additional value. (If the partnership interest received upon formation of the partnership is sold within three years of a partner's death and the sale does not qualify for the bona fide exception under Section 2035, the amount of the Section 2035 inclusion would need to be reduced by the consideration received from the third party in the sale.) [footnote omitted]
>
> …
>
> Conclusion and Recommendation
>
> Although the Tax Court has eliminated any concern that both the underlying assets contributed to a partnership as well as the partnership interest itself may be subject to full estate tax, Section 2043 is at best a crude tool to avoid double taxation. And its application in *Powell* and *Moore* runs counter to the Section 2036 regulations because it provides for both the assets transferred to be included in Section 2036 as well as the interest received in exchange (such as a partnership interest) to be included under Section 2033. The better result would be simply to include only the assets transferred by the decedent in the pre-death transaction (e.g., to the partnership) where the taxpayer had retained such a power or interest (in the partnership) and to cause Section 2036 to apply.
>
> Accordingly, we respectfully recommend that the Treasury Department and the Internal Revenue Service issue guidance, perhaps in the form of a revenue ruling, adopting the position taken in the concurring opinion in *Estate of Powell*.

d. **No Charitable Deduction for Formula Transfer Attributable to Additional Value in Gross Estate Resulting From Estate Tax Audit.**

(1) **Facts and Tax Court Analysis.** Formula transfers to charity (to the Charitable Trust) were included in two places. (1) The Living Trust transferred to the Charitable Trust a portion of assets in the Living Trust sufficient to "result in the least possible federal estate tax payable as a result of my death." (2) The Irrevocable Trust (which owned the 95% limited partnership interest in the FLP) instructed the trustee to "distribute an amount equal to the value of any asset of this trust which is includible in my gross estate for federal estate tax purposes" to the Living Trust to be distributed in accordance with its terms (which included the formula charitable transfer described immediately above).

The IRS did not contest at least some of the charitable deduction claimed on the Form 706 for the formula amount left to the Charitable Trust based on values reported on the Form 706. Thus, the initial funding of the formula charitable transferrin the Living Trust based on values of assets and deductions reported on the Form 706 was respected, at least in part.

The issue addressed by the court was whether an additional charitable deduction should be allowed as a result of "any increase in the value of Moore's estate" resulting from the estate tax examination and litigation. The court gave two reasons for denying "any charitable deduction for funds that might be transferred to the Charitable Trust under article 5, section 2 of the Irrevocable Trust": (1) a limitation based on the particular language of the trust agreement; and (2) a "more general problem" – a requirement that the charitable deduction must be ascertainable at a decedent's date of death.

(a) **Particular Trust Language Limitation.** The literal language of article 5, section 2 of the Irrevocable Trust refers to transferring to the Living Trust "an amount equal to the value of any asset *of this trust* which is includible in my gross estate." (Emphasis in court opinion). The Irrevocable Trust owned the limited partnership interest, not the FLP assets. The additional amount included in the gross estate was an amount equal to the value of the farm transferred to the FLP, not the limited partnership interest itself. Therefore, the literal language of the Irrevocable Trust did not transfer any additional amount to the Living Trust.

Observation: In one respect, this is nit-picking over words (and suggests that different drafting might have avoided the court's analysis), but in a broader respect this raises the same issue that has been referred to in the marital deduction context (at the death of the first spouse) as the "marital deduction mismatch" issue. An "amount" is included in the gross estate equal to the full undiscounted value of the farm, but all the trust owns to leave to charity is a discounted partnership interest. Indeed, footnote 23 of the opinion indicates that the IRS made an alternative argument that even if the formula clause is respected, "the Irrevocable Trust lacks the assets to donate a sum large enough to eliminate the estate tax." This issue is discussed in Item 13.d(7) below.

(b) **Charitable Deduction Must be Ascertainable at Death.** Judge Holmes reasoned that a "much more general problem" is that charitable deductions cannot depend on actions of the decedent's beneficiary or executor, and the charitable deduction must be ascertainable at a decedent's date of death. Whether the Living Trust would get additional funds from the Irrevocable Trust to transfer to the Charitable Trust was not determinable at Mr. Moore's death, but only after an audit that ultimately resulted in additional property being included in the gross estate. "For the exception to apply, it would have to have been *almost certain* that the Commissioner would not only challenge, but also successfully challenge the value of the estate." (Emphasis added).

The court distinguished the *Christiansen* and *Petter* cases (in which, interestingly, Judge Holmes wrote the Tax Court opinions). In *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), *aff'd*, 586 F.3d 1061 (8th Cir. 2009), a sole beneficiary disclaimed all of the estate (under a fractional formula) in excess of a stated dollar amount, with the disclaimed assets passing to a charitable lead trust and foundation. In *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd,* 653 F.3d 1012 (9th Cir. 2011), a gift was made of LLC units, with units up to a stated dollar value passing to trusts for the donor's children and the excess units over that stated value passing to charity. Although both of those cases recognized formula-based transfers to charity, the Tax Court opinion reasoned that in those cases "the transfer itself was not contingent on the happening of some event… [V]alue was at issue, but not whether there would be a transfer to the donee at all." Judge Holmes contrasted those situations with the *Moore* facts:

> Article 5, section 2 of Moore's Irrevocable Trust does not say that the Living Trust will receive a transfer of assets of unknown value. It says that whether the Living Trust will even receive a transfer of assets is unknown–contingent on an examination by the Commissioner. This is unlike Estate of Christiansen, where we *knew* the charity would get a transfer of assets, just not the value, or Estate of Petter, where we *knew* the charity would get some transfer of value, just not how much. Here, we *don't know* if the charity would get any additional assets at all. (Emphasis in original).

The Tax Court seemed to draw a big distinction between formulas based just on the *value* of assets and formulas based on other issues, such as what assets are in the gross estate or the amount of allowable deductions.

(c) **Unknown From Case Facts.** The actual holding by the Tax Court was that no charitable deduction was allowed for funds that might be transferred from the Irrevocable Trust to the Charitable Trust under the formula transfer clause in the Irrevocable Trust. Even aside from a formula transfer from the Irrevocable Trust, however, the Living Trust itself made a formula transfer. Unless all the Living Trust assets were originally allocated to the Charitable Trust under the Living Trust's formula charitable transfer, additional assets should have been transferred to the Charitable Trust directly from the Living Trust in an amount to result in the "least possible federal estate tax." The opinion does not directly address whether that transfer would be respected to qualify for a charitable deduction (but suggests that it would not).

Also, the Tax Court opinion focused on not allowing an additional charitable deduction because of the inclusion of the farm in the gross estate. Would an additional charitable deduction be allowed for other reasons raised in the estate tax audit, such as disallowed deductions or gift tax paid within three years of death?

(2) **Ninth Circuit Analysis**. The estate appealed only the denial of the charitable deductions to the Court of Appeals for the Ninth Circuit. In a short unpublished opinion, the Ninth Circuit affirmed on the narrow ground that the specific wording in the charitable formula from the Irrevocable Trust to the Living Trust (which had its own charitable formula transfer) was "an amount equal to the value **of any asset of this trust** which is includible in my gross estate for federal estate tax purposes." The proceeds from the sale of the farm were included in the gross estate under §2036, but the Irrevocable Trust owned 98% of the partnership that had owned the farm, not the farm itself or its sale proceeds, and the partnership agreement provided that no partner had any interest in any of the assets of the partnership. The estate argued that "assets of this trust" is ambiguous, and that clause should be construed to encompass the assets of the partnership to effectuate the settlor's intent. The court of appeals disagreed, finding that the language was unambiguous. "The Trustee of the Irrevocable Trust was therefore not required to transfer the Farm's proceeds to the Living Trust and eventually to the Charitable Trust," so the additional charitable deduction was denied.

The court of appeals did not address the second "much more general problem" posed by Judge Holmes denying the effectiveness of a formula charitable transfer on the grounds that the charitable deduction was not ascertainable at the decedent's date of death. That second rationale seems suspect (as discussed immediately below), and fortunately the Ninth Circuit did not express its approval of that analysis. Indeed, the Ninth Circuit had previously affirmed *Petter*, which had given effect to a defined value clause case involving a formula charitable transfer.

e. **Tax Court's Rationale Denying Formula Charitable Deduction Based on Subsequent Events Seems Incorrect.** The Tax Court's second rationale questioned the validity of charitable formula transfers generally, as least for formula transfers depending on any contingency other than valuation issues. The Tax Court opinion drew a distinction between estate tax examinations and court determinations of value vs. other issues. A contingency based on ultimate determination of valuation issues is not a "transfer … contingent on the happening of some event." The opinion reasoned that in *Christiansen,* (an opinion also written by Judge Holmes that recognized a formula transfer) and *Petter*, "we *knew* the charity clearly would receive assets, just not how much. Here we *don't know* if the charity would get any additional assets at all." (Emphasis in original.)

Under that second rationale in the Tax Court analysis, formula transfers to charity that depend on IRS or court determinations as to any issues other than values would be suspect. The Tax Court opinion, however, offered no support for making a distinction between a court resolution of valuation issues vs. the resolution of other issues (such as §2036 inclusion) that impacts the amount passing to charity under a formula bequest. Both involve significant uncertainties about how the issues will ultimately be resolved, based on a set of facts that existed at the date of death. For example, the Tax Court opinion cited *Estate of Marine v. Commissioner*, 97 T.C. 368, 378-79 (1991), *aff'd*, 990 F.2d 136 (4th Cir. 1993), in support of its position that charitable deductions must be ascertainable at the decedent's date of death. But in *Marine*, the personal representative could make bequests to

compensate individuals chosen by the representative who contributed to the decedent's well-being, with no limit on the number of persons who could receive such bequests, which would reduce the amount that could pass to charity under the residuary estate. That is a contingency based on future events and exercises of discretion involving distributions to an unlimited number of non-charitable beneficiaries, far different from a court determination of the tax effects of facts as they existed at the date of death. A court determination of the tax effects of transactions that had occurred involving the FLP by Mr. Moore is something that "depends only on a settlement or final adjudication of a dispute about the past" (to quote Judge Holmes' reasoning in *Christiansen*). "It should make no difference whether inclusion as of the date of death is the trigger, rather than the value of the gross estate. Both cases turn on resolution of a dispute involving the ultimate size of the gross estate." Larry Katzenstein and Jeff Pennell, Estate of Moore v. Commissioner – *Discount Planning Debacle*, LEIMBERG ESTATE PLANNING NEWSLETTER #2790 (April 20, 2020).

Classic testamentary marital deduction formula clauses traditionally take into account a wide variety of factors, not just valuation issues, to leave enough assets to a surviving spouse in order to avoid or minimize federal estate tax (analogous to the "least possible federal estate tax" formula charitable clause in *Moore*). Adjustments in estate tax examinations or litigation are taken into consideration in applying the formula marital bequest. Irrevocable life insurance trusts frequently provide that any portion of the life insurance that is owned by the trust that is determined to be in settlor's gross estate will pass to a trust designed to qualify for the marital deduction. If the formula transfer in the *Moore* case had been to a surviving spouse or marital trust, perhaps the formula bequest would have been respected, assuming sufficient estate assets were available to satisfy the formula bequest. *E.g.*, *Estate of Turner v. Commissioner*, 138 T.C. 306 (2012) (sometimes referred to as "*Turner II*").

The appeal of *Estate of Moore* was heard by the Ninth Circuit Federal Court of Appeals, which approved the *Petter* defined value clause case involving a formula charitable transfer. Fortunately, the Ninth Circuit did not express its approval of the Tax Court's second rationale, which would bring into question formula transfers generally.

f. **Transfers in Return for Notes Not Respected as Loans but Are Treated as Gifts.** Mr. Moore directed the FLP to transfer $500,000 to each of his four children in return for a five-year note bearing interest at a rate of 3.6% from each of the children. The court treated these advances as gifts from Mr. Moore rather than legitimate debt transactions, as discussed in Item 27.h of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. The loan vs. gift issue was also addressed by the court in *Estate of Bolles v. Commissioner*, T.C. Memo. 2020-71, discussed in Item 28 of Estate Planning Current Developments (December 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

11. Gift and Sale of Partnership Interests Expressed as Dollar Amounts Based on Subsequent Appraisals, Lack of Control and Lack of Marketability Discounts, Multi-Tiered Discounts, *Nelson v. Commissioner*, T.C. Memo. 2020-81, *aff'd*, 128 AFTR 2d 2021-6532 (5th Cir. November 3, 2021)

a. **Synopsis.** This gift tax case determined the value of gifts and sales of interests in a limited partnership, the primary asset of which was 27% of the common stock of a holding company that owned 100% of eight subsidiaries (six of which were operating businesses). The gifts and sales were of limited partner interests having a specified dollar value on the transfer date "as determined by a qualified appraiser within ninety (90 days) of the effective date of the Assignment" (180 days in the case of the sale). An appraisal was prepared for the holding company, which was then used to prepare an appraisal for the transferred limited partner interests. The percentage limited partner interests that were transferred were based on those appraisals and documented in the partnership's records and used for preparing subsequent income tax returns.

The IRS took the position that the transfers resulted in additional gifts of about $15 million. The taxpayers first argued that the transfers were actually of interests worth a particular dollar value rather than of particular percentage interests. The court disagreed, observing that the clauses in the

assignments "hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes."

> **Observation:** This is a practical approach that is often used in structuring assignments of hard-to-value assets. The IRS did not object to this type of assignment (determining the percentage interest transferred based on an appraisal completed relatively soon after the transfer) as abusive, but merely proceeded to enforce the assignment as drafted and then value the interests so transferred.

The court allows significant multi-tiered discounts. It ultimately determined that the 27% interest that the partnership owned in the holding company was valued using a 15% lack of control discount (slightly lower than the taxpayers' expert's position of a 20% discount but higher than the IRS's expert's 0% discount) and 30% for lack of marketability (agreed to by experts for both the taxpayers and the IRS). The holding company value was then used to determine the value of the limited partner interests, which the court determined using a 5% lack of control discount (compared to 15% by the taxpayer's expert and 3% by the IRS's expert) and a 28% lack of marketability discount (compared to 30% by the taxpayers' expert and 25% by the IRS's expert). The values determined by the court resulted in an additional gift value of about $4.5 million.

Despite the favorable valuation result, Mr. and Mrs. Nelson filed notices of appeal of the Tax Court's decision to the Court of Appeals for the Fifth Circuit on the sole ground that the Tax Court incorrectly found that the transfers consisted of percentage interests rather than fixed dollar amounts. The Fifth Circuit affirmed the Tax Court, finding that "[t]he transfer documents clearly and unambiguously state that Mary Pat was gifting and selling the percentage of limited partner interests that an appraiser determined to have a fair market value equal to a stated dollar amount." *Nelson v. Commissioner*, T.C. Memo. 2020-81 (Judge Pugh), *aff'd*, 128 AFTR 2d 2021-6532, Cause No. 20-61068 (5th Cir. November 3, 2021).

For a detailed discussion of the facts, court analysis, and planning implications of *Nelson* (including the issues relating to the sale of assets in return for a note using the AFR as the interest rate for the note and regarding split gift elections for SLATs, see Item 24 of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. For a further discussion of issues regarding the split gift election, see Item 21.a of Heckerling Musings and Estate Planning Current Developments (September 2021) found here available at www.bessemertrust.com/for-professional-partners/advisor-insights.

b. **Fifth Circuit Analysis.** The Fifth Circuit affirmed the Tax Court's finding that the "transfers consisted of percentage interests, rather than fixed dollar amounts." The Fifth Circuit agreed that the transfer documents "clearly and unambiguously" transferred a percentage of limited partner interests that an appraiser determined to have a fair market value equal to a stated dollar amount, as distinguished from formula transfer clauses defining interests transferred as the fair market value as determined for federal gift or estate tax purposes that were used in the *Petter*, *McCord*, *Hendrix*, and *Wandry* cases. Also, the transfer language did not discuss what should happen to any additional shares that were transferred should the valuation be successfully challenged. The Fifth Circuit viewed this as a simple analysis, referring to the government's folksy analogy to a farmer selling cows.

> [I]f a farmer agrees to sell the number of cows worth $1,000 as determined by an appraiser, and the appraiser determines that five cows equals that stated value, then the sale is for five cows. If a later appraisal determined that each cow was worth more, and that two extra cows had been included in the sale, nothing in the agreement would allow the farmer to take the cows back. The parties would be held to what they agreed—a transfer of the number of cows determined by the appraiser to equal $1,000. So too here. No language in the transfer agreements allows the Nelsons to reopen their previously closed transaction and reallocate the limited partner interests based on a change in valuation.

Simple as that. Furthermore, no objective facts outside the language in the documents suggest a different result. The estate merely points to the desire of the taxpayers to "protect their assets while also avoiding as much tax liability as possible." Also, the fact that the appraiser did not complete the appraisal within the allotted times specified in the agreement does not change the result.

c. **Observations.**

(1) **Not a Rejection of Defined Value Clauses.** The court's refusal to treat this as a transfer of a dollar amount based on values as finally determined for gift tax purposes might on first blush be viewed as a rejection of a defined value transfer. That is not the case. The transfer was of a defined value of interests not as finally determined for gift tax purposes but as determined by a qualified appraisal that would be completed shortly after the date of the transfer.

The taxpayers argued that the transfers were intended to be dollar amounts of units of the partnership based on values as finally determined for gift tax purposes. But was that really the intent in 2008-2009? In effect, they argued that the assignments were intended to have "*Wandry* clauses," but bear in mind that the *Wandry* case was not decided until 2012. *Wandry v. Commissioner*, T.C. Memo. 2012-88.

(2) **Importance of Using Grantor Trusts With Defined Value Transfers.** The facts of *Nelson* illustrate the importance of using grantor trusts with defined value transfers. If the amount transferred depends on values as finally determined for gift tax purposes, the amounts actually transferred may not be determined for years. In the meantime, income tax returns are filed, reflecting the anticipated amounts that were transferred. If the defined value transfer is made to a grantor trust, even if the ownership percentages change as a result of a gift tax audit, all the income and deductions will have been reported on the grantor's income tax return in any event, and no corrective returns should be necessary (unless the parties wish to file corrected entity level returns to make clear the appropriate sharing of profits and losses of the entity's owners).

(3) **Potential Disadvantage of Defined Value Clauses.** This case illustrates a potential disadvantage of using defined value clauses. This case did not involve a defined value clause, so the percentage interests transferred did not have to be adjusted to reflect the values determined by the court. Instead, the donors made additional taxable gifts and may have had to pay additional gift taxes. The court ultimately determined that the taxpayers made additional gifts of about $4.5 million, resulting in additional gift taxes of just over $2 million.

As a result of the settlement discussions with IRS Appeals, the taxpayers attempted to adjust the percentage interests transferred from 64.79% (for the gift and sale) to only 38.55%. If that had been the effect of the assignment clauses, the parties would have decreased the Trust's interest in the FLP (with underlying assets of over $60 million) by 26.24%, or a reduction of the Trust's value by about $15.9 million, without counting subsequent appreciation and income. In effect, the taxpayers will pay an additional $2 million of gift tax in order to keep in the Trust an additional $15.9 million, plus untold subsequent appreciation and income (unreduced by income tax because the grantor pays it) that has accumulated in the Trust during the intervening twelve years, which amount could now be multiples of $15.9 million. Even in the face of that seemingly outstanding valuation result compared with the taxpayers' apparent settlement position, however, Mr. and Mrs. Nelson filed notices of appeal of the Tax Court's decision to the Court of Appeals for the Fifth Circuit but wisely did not contest the Tax Court's determination of value, only that the transfer should have been of a fixed dollar amount.

(4) **Support of Planning Alternative for Transferring Hard-To-Value Assets; 90 vs. 180 Days for Appraisals.** As a practical matter, valuing hard-to-value assets on the date of the transfer is impossible. A formula transfer of a dollar value worth of a particular asset, based on an appraisal to be obtained within a specified term in the near future, is routinely used, and is not viewed by the IRS as abusive. By the time the gift tax return is filed, the appraisal will be at hand, and a specific number of shares or units that have been transferred pursuant to the formula will be known and listed on the gift tax return. *See* Rev. Rul. 86-41, 1986-1 C.B. 300 ("In both cases, the purpose of the adjustment clause was not to preserve or implement the original bona fide intent of the parties, as in the case of a clause requiring a purchase price adjustment based on an appraisal by an independent third party retained for that purpose").

The IRS apparently raised no objections to these assignments based on values as determined by appraisals within a short time after the transfers, and indeed simply proceeded to enforce the terms of the assignments.

Obviously, that approach provides no protection against gift taxes in the event of an audit. The key distinction of a classic defined value type of transfer is that the formula dollar value being transferred is based on values as finally determined for federal gift tax purposes.

12. John Doe Summons Upheld to Determine Identity of Law Firm's Clients Seeking Advice Regarding Particular Issues, *Taylor Lohmeyer Law Firm P.L.L.C. v. United States*

A client of the Taylor Lohmeyer law firm was audited, and the client agreed to pay about $4 million in tax, interest, and penalties regarding the assignment of income to foreign accounts that the law firm had helped him structure. The IRS issued a "John Doe summons" to the law firm to disclose the names of all clients over a 23-year period that had used the law firm's services "to acquire, establish, maintain, operate, or control" any foreign account, any foreign legal entity, or any asset in the name of any such foreign entity.

Section 7609 addresses special procedures for third-party summonses, and lists requirements for a John Doe summons, "which does not identify the person with respect to whose liability the summons is issued." One of those requirements is that "there is a reasonable basis for believing that such person or group or class of persons may fail or may have failed to comply with any provision of any internal revenue law." §7609(f)(2).

The law firm acknowledged the general rule that a client's identity is not protected from the attorney-client privilege and is subject to subpoena but argued that an exception applies when disclosure of the identity necessarily discloses the substance of the legal advice. The enforcement of the summons was upheld because the summons would not reach

> motive, or other confidential communications of [legal] advice…. Consequently, the Firm's clients' identities are not "connected inextricably with a privileged communication", and therefore, the "narrow exception" to the general rule that client identities are not protected by the attorney-client privilege is inapplicable.

Taylor Lohmeyer Law Firm P.L.L.C. v. United States, 957 F.3d 505, 513 (5th Cir. April 24, 2020), *petition for en banc rehearing denied,* 126 AFTR 2d 2020-7208 (Dec. 14, 2020), *aff'g* 123 AFTR 2d 2019-1847 (W.D. Tex.), *cert. denied,* S. Ct. Dkt. No. 20-1596 (Oct. 4, 2021).

Below is a summary by Ronald Aucutt of the analysis of the issues by the District Court and the Fifth Circuit Court of Appeals.

Upon cross petitions by the law firm to quash and by the United States to enforce the summons, the District Court (Judge Rodriguez) noted that, "to enforce the summons, the Government's burden 'is a slight one because the statute must be read broadly in order to ensure that the enforcement powers of the IRS are not unduly restricted,'" citing *United States v. Balanced Fin. Mgmt., Inc.*, 769 F.2d 1440, 1443 (10th Cir. 1985). In contrast, the court stated, the law firm's "burden to rebut a *Powell* prima facie case is 'heavy'," citing *United States v. Powell*, 379 U.S. 48, 57-58 (1964), and *Mazurek v. United States*, 271 F.3d 226, 230-31 (5th Cir. 2001).

The court described the law firm's argument that the disclosure of a client's identity is protected by the attorney-client privilege if identity disclosure also necessarily discloses the substance of the legal advice.

> The Firm argues this exception applies because the summons seeks the identities based on the advice and services sought from the firm, and 'when the specific requests are combined with the client identities (not to mention the related client files), the net effect is to identify individuals as well as the specific services and structures they were provided.' … The Firm relies on an IRS enforcement case from the Third Circuit, *United States v. Liebman*, 742 F.2d 807 (3d Cir. 1984), in which client identities were privileged. This was because the government was already aware of the advice the law firm had provided its clients (that certain fees were tax deductible), so it 'falls within the situation where so much of the actual communication had already been established, that to disclose the client's name would disclose the essence of a confidential communication.' (quoting *Liebman*, 742 F.2d at 809).

The court granted the Government's petition to enforce the summons. 123 AFTR 2d 2019-1847 (May 15, 2019). The court concluded:

> Ultimately, because blanket assertions of privilege are disfavored, the Firm bears a heavy burden at this stage, and the Firm relies only on a narrowly defined exception to the general rule that identities are not privileged, the Firm does not carry its burden. As the Government suggests, '[u]pon this Court ordering enforcement of the summons, if Taylor Lohmeyer wishes to assert any claims of privilege as to any responsive documents, it may then do so, provided that any such claim of privilege is supported by a privilege log which details the foundation for each claim on a document-by-document basis.' … Whether certain documents fit the *Liebman* argument the Firm advances is better decided individually or by discrete category.

The law firm appealed to the Court of Appeals for the Fifth Circuit, and the District Court granted the law firm a stay of its judgment pending that appeal. Citing *Weingarten Realty Inv'rs v. Miller*, 661 F.3d 904, 910 (5th Cir. 2011), the court stated that "[t]his Court need not say the Firm is *likely* to succeed on the merits; given the serious legal question at issue and the balance of the equities, the Firm need only show a substantial case on the merits, and it has done so." 124 AFTR 2d 2019-6271 (Oct. 3, 2019).

A three-judge panel of the Court of Appeals for the Fifth Circuit upheld the summons. 957 F.3d 505 (April 24, 2020). The opinion (by Judge Barksdale) relied primarily on a case involving an accounting firm, *United States v. BDO Siedman*, 337 F.3d 802 (7th Cir. 2003), which, as the court acknowledged, obviously did not involve the *attorney*-client privilege, but rather the *statutory* privilege in Section 7525 of the Internal Revenue Code. Quoting *In re Grand Jury Subpoena for Attorney Representing Criminal Defendant Reyes-Requena*, 926 F.2d 1423, 1431 (5th Cir. 1991) (*Reyes-Requena II*), the court acknowledged that "our court made clear in *Reyes-Requena II* that, '[i]f the disclosure of the client's identity will also reveal the confidential purpose for which he consulted an attorney, we protect both the confidential communication and the client's identity as privileged'." Nevertheless, citing both *BDO Siedman* and *Reyes-Requena II*, the court summarized that the summons in this case would not reach

> motive, or other confidential communications of [legal] advice…. Consequently, the Firm's clients' identities are not 'connected inextricably with a privileged communication', and therefore, the 'narrow exception' to the general rule that client identities are not protected by the attorney-client privilege is inapplicable.

On a petition seeking an *en banc* rehearing, the full court voted 9-8 not to grant the petition, without giving any reasons for their decision, despite a strong dissenting opinion by Judge Elrod, joined by five other judges. 126 AFTR 2d 2020-7208 (Dec. 14, 2020). The dissenting opinion opened with the following:

> The IRS served the Taylor Lohmeyer law firm with a broad summons requesting the identities of the firm's clients who had engaged the firm to achieve certain offshore financial arrangements from 1995 to 2017. The IRS has traditionally served such summonses on financial institutions and commercial couriers. Not lawyers. There is good reason to be wary of investigations that exert pressure on lawyers. The relationship between a customer and a financial institution or commercial courier plays little, if any, role in our system's ability to administer justice – but the same cannot be said of the lawyer-client relationship. When the IRS pursues John Doe summonses against law firms, serious tensions with the attorney-client privilege arise. Courts play a crucial role in moderating the executive power with respect to a John Doe summons. *See United States v. Bisceglia*, 420 U.S. 141, 146 (1975) ('Substantial protection is afforded by the provision that an Internal Revenue Service summons can be enforced only by the courts.').
>
> Hearing this case *en banc* would have helped clarify the boundaries of attorney-client privilege in this precarious area. [Citing amici briefs of the American College of Tax Counsel and the National Association of Criminal Defense Lawyers.] I write to explain that the opinion can and should be read – consistently with our existing precedent – not to impose any new standard with respect to what is required for the attorney-client privilege to protect client identity."

Judge Elrod closed her dissenting opinion on a similar note:

> In the district court, the enforcement order is currently stayed and the case has been administratively closed to facilitate our review of the enforcement order. Once our mandate issues, it may be that the case is reopened and the stay lifted. If so, the May 15, 2019 enforcement order provides that the Lohmeyer law firm will have the opportunity to produce a privilege log, asserting privilege on particular responsive documents. If the law firm does so, the district court may choose then to conduct an in camera review of those documents. I am confident that any such review will be guided by the following: '[i]f the disclosure of the client's identity will also reveal the confidential purpose for which he consulted an attorney, we protect both the confidential communication and the client's identity as privileged.' *Lohmeyer*, 957 F.3d at 511 (quoting *Reyes-Requena II*, 926 F.2d at 1431).

She added in a footnote that "[t]he fact that the law firm made 'blanket' assertions of privilege was perhaps because the IRS demanded a very broad array of documents to be identified using a client list. When a summons is so structured, a blanket assertion of privilege may be appropriate."

Concern regarding the erosion of the attorney-client privilege was summarized in the American College of Tax Counsel Amicus Brief cited by Judge Elrod:

> [T]he panel's decision could facilitate the issuance of John Doe summons to a law firm seeking documents identifying any companies who retained the firm for legal advice regarding structuring their businesses so that intellectual property assets were located in low tax jurisdictions, or identifying any individuals who engaged the firm for legal advice regarding *structuring a family limited partnership or annuity trust*. Departing from longstanding and established precedent in this and other circuits, the panel's decision subjects the John Doe summons power to abuse by allowing the IRS to make broad requests to law firms to circumvent the privilege.

American College of Tax Counsel Amicus Brief at 14-15 (emphasis added).

Advisors have indicated that the IRS "is actively challenging the assertion of attorney-client privileges in tax cases" and the Fifth Circuit's decision "could deter individuals from seeking legal advice." *See* Kristen Parillo, *SCOTUS Won't Review John Doe Summons Dispute*, TAX NOTES (Oct. 5, 2021). As an example, IRS officials have indicated that they will continue the increased use of John Doe Summonses as an enforcement tool against illicit cryptocurrency transactions. Mary Katherine Browne, *A Look Ahead: John Doe Summonses to Increase in Crypto Crackdowns*, TAX NOTES (Dec. 23, 2021).

The case is summarized (and strongly criticized) in James P. Dawson & Kevin E. Packman, *IRS Fishing Expedition Leads to Erosion of Attorney-Client Privilege*, LEIMBERG INC. TAX PLANNING NEWSLETTER #209 (Dec. 29, 2020).

The Supreme Court denied certiorari in an October 4, 2021 order.

13. Valuation of Majority Interests in LLCs Owning Real Estate; Estate Tax Charitable Deduction Based on Values Passing to Each Separate Charity, *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17

a. **Synopsis.** Ms. Warne made gifts of interests in five LLCs owning real estate investments in 2012 and died owning (actually in a revocable trust) majority interests in the LLCs (all over 70% and three over 80%). The operating agreements all gave significant powers to the majority interest holders (including the power to dissolve the LLCs and to remove and appoint managers). Ms. Warne owned 100% of one LLC at her death, which she left 75% to a family foundation and 25% to a church. The real estate interests were substantial; the remaining LLC interests owned by Ms. Warne at her death were valued on her estate tax return at about $73.7 million. The parties agreed on most of the values, but the court determined the values of three leased fee interests at the date of the gift and at the date of death.

   The court also determined appropriate lack of control and lack of marketability discounts for the LLC majority interests owned at death. The court suggested that it might have found zero lack of control discount for the majority interests, but the parties had agreed that some level of lack of control discount should apply. The court generally adopted the approach of the estate's expert, who compared premiums from completely controlling interests in companies (90% - 100% interests) with premiums from interests that lacked full control (50.1% - 89.9% interests) and concluded that the discount should be in the 5% - 8% range (compared to the IRS's expert's 2% lack of control discount). However, in reaching that conclusion the expert took into consideration that strong opposition and potential litigation would arise if the majority holder attempted to dissolve. The court found no evidence of future litigation risks and lowered the lack of control discount to 4%.

   Both experts used restricted stock studies to determine the lack of marketability discount (5% - 10% by the estate's expert and 2% by the IRS's expert). The court concluded that a 5% lack of marketability discount was appropriate.

   The estate argued that the 100% interest in the LLC that was left to two charities should be completely offset by the estate tax charitable deduction (because the 100% interest was donated entirely to charities), but the court concluded that a charitable deduction was allowed only for the value passing to each charity. The parties had agreed that a 27.385% discount applied for the 25% passing to the church and a 4% discount applied for the 75% passing to the foundation. (Applying discounts to the charitable deduction reduced the charitable deduction by over $2.5 million.)

The failure to file penalty was applied for the late filing of the gift tax return because the estate offered no evidence of reasonable cause for the late filing.

The case was appealable to the Ninth Circuit Court of Appeals, but it was not appealed following the entry of a stipulated decision on October 9, 2021. *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (Feb. 18, 2021) (Judge Buch).

b. **Basic Facts.** Mr. and Ms. Warne amassed various real estate properties beginning at least in the early 1970s. Over time, the real estate properties were owned in five separate LLCs. Mr. Warne died in 1999. Ms. Warne made gifts of various minority interests in the LLCs to her two sons in 2012, and Ms. Warne died in 2014. The 2012 gift tax return was filed (late) at the same time as Ms. Warne's estate tax return (which was timely filed), in May 2015.

At the time of Ms. Warne's death, the Warne Family Trust (the "Family Trust," apparently a revocable trust), the value of the assets of which was included in Ms. Warne's gross estate, owned the following majority interests in the five LLCs: 78%, 72.5%, 86.3%, 87.432%, and 100%. The remaining minority units were owned in various amounts by one of more of the sons, by three granddaughters, and by a sub-trust of the Family Trust. All of the LLC agreements "grant significant power to the majority interest holder, such as the ability to unilaterally dissolve the LLCs and appoint and remove managers."

The LLC of which the Family Trust owned 100% was Royal Gardens, LLC ("Royal Gardens) and the trust agreement provided that following Ms. Warne's death the Royal Gardens units were left 75% to the Warne Family Charitable Foundation and 25% to a church.

The estate tax return listed the values of the Family Trust's majority interest in each of the LLCs at $18,006,000, $8,720,000, $11,325,000, $10,053,000, and $25,600,000 (Royal Gardens), respectively, or a total value of $73,704,000. Those values were determined by first valuing the underlying real property interest in each LLC, and by applying lack of control and lack of marketability discounts to the LLC interests owned by the Family Trust.

The IRS asserted a gift tax deficiency for the 2012 gifts (and before trial increased the deficiency to $368,462) and asserted an estate tax deficiency of $8,351,970.

The unresolved issues addressed at trial were (i) the date of gift value of three leased fee interests (that were owned by two of the LLCs), (ii) the date of death value of those same three leased fee interests, (iii) the appropriate discount for lack of control and lack of marketability of the majority interests in the LLCs held by the Family Trust at Ms. Warne's death, (iv) whether discounts apply to the 25% and 75% interests left to separate charities in the Royal Gardens LLC, and (v) whether a failure to file penalty under §6651(a)(1) applies for the 2012 gift tax return that was filed late. Apparently, the parties came to agreement with respect to the values of the remaining real estate properties and as to the appropriate lack of control and lack of marketability discounts for the gifted LLC interests.

c. **Analysis.**

(1) **Values of Leased Fee Interests.** Three leased fee interests were valued by appraisers for the estate and for the IRS. The appraisers, in appraiser-speak fashion, referred to various approaches such as the "direct capitalization approach" (which the court determined was inappropriate for the particular property involved), "yield capitalization approach," "discounted cashflow analysis," "sales comparison approach," and "buildup method" (for determining a discount rate).

The court weighed the arguments made by the appraisers, putting more weight on the expert's appraiser as to some issues and on the IRS's expert as to other issues. The court determined which of various comparable properties were most appropriate for valuing the three leased fee interests.

(2) **Lack of Control Discount for Majority LLC Interests.** The estate and IRS each used a different appraiser than the appraiser used to value the underlying leased fee interests in order to

determine appropriate lack of control and lack of marketability discounts for the majority percentage interests owned by the Family Trust at Ms. Warne's death.

The court emphasized that majority interests were being valued and that the LLCs all grant significant powers to the majority interest holder (including the power to dissolve and to remove and appoint managers). The court pointed to cases that have held that no lack of control discount applies in similar situations (*Estate of Jones v. Commissioner*, 116 T.C. 121, 135 (2001); *Estate of Streightoff v. Commissioner*, T.C. Memo. 2018-178) and hinted that it might have concluded that *no* lack of control discount was allowed, but "[b]ecause the parties agree to a discount for lack of control, we will find one; however, given the control retained by the Family Trust, the discount should be slight."

The IRS's expert used data from nine closed-end funds to estimate a lack of control discount of 2%. The estate argued that discounts from closed-end funds are sometimes used to discern minority-interest discounts, but not discounts for lack of control for a majority interest. The court was sympathetic to that position, citing the *Richmond* (T.C. Memo. 2014-26), *Kelley* (T.C. Memo. 2005-235), and *Peracchio* (T.C. Memo. 2003-280) cases as examples of using closed-end funds for valuing *minority*-interest discounts, and noting that while the *Grieve* case (T.C. Memo. 2020-28) used closed-end funds for analyzing the lack of control discount for majority interests in LLCs, the majority interests valued in *Grieve* lacked voting rights, making the interests more similar to minority interests. The court also thought the nine closed-end funds selected as comparables were too dissimilar to the LLCs in the estate, and that a larger sample size should be used when comparables are more dissimilar (citing *Lappo,* T.C. Memo. 2003-258, and *Heck*, T.C. Memo. 2002-34). Because the IRS's expert's database was inappropriate, the court refused to adopt its 2% discount.

The estate's expert compared premiums from completely controlling interests in companies (90% - 100% interests) with premiums from interests that lacked full control (50.1% - 89.9% interests), and after considering qualities specific to the five LLCs (including "strong opposition and potential litigation" if the majority owner attempted to dissolve), concluded that a lack of control discount of 5% - 8% should apply. The court found no evidence that the minority interest holders were litigious or would pursue litigation to contest a dissolution. Citing *Olson v. United States*, 292 U.S. 246, 257 (1934), for its statement that potential occurrences "not fairly shown to be reasonably probable should be excluded from consideration," the court concluded that no adjustment should be made for future litigation risks so the discount should be lower than the 5% - 8% range suggested by the estate and that a **4% lack of control discount** was appropriate.

(3) **Lack of Marketability Discount.** Both experts used restricted stock equivalent discounts to determine the lack of marketability discount. The estate's expert determined that a 5% - 10% discount should apply, and the IRS's expert used a 2% discount. The court concluded that the estate's expert "considered additional metrics and provided a more thorough explanation of his process." Furthermore, the IRS's expert reached a 14.5% restricted stock equivalent discount but from that determined a mere 2% discount for lack of marketability "without justifying the substantial decrease in the discount." The court accepted the 5% - 10% range suggested by the estate's expert but believed that the lower end of the range was appropriate, so concluded that a **5% lack of marketability** discount applied.

(4) **Charitable Deduction Discount.** The Family Trust's 100% interest in Royal Gardens passed entirely to charity, but was split between two charities, 25% to a church and 75% to a family foundation. The estate maintained that applying a discount in determining the charitable deduction because each charity received less than 100% was not appropriate:

> The estate insists that discounts are inappropriate and would subvert the public policy of motivating charitable donations. It claims that because 100% of Royal Gardens was included in the estate and the estate donated 100% of Royal Gardens to charities, the estate is entitled to a deduction of 100% of Royal Gardens' value.

The court disagreed, applying a two-step analysis. First, the court reasoned that in valuing the gross estate, "we value the entire interest held by the estate, without regard to the later

disposition of that asset." Second, the court noted that a charitable deduction is allowed "for what is actually received by the charity" (quoting *Ahmanson Foundation*, discussed immediately below). "In short, when valuing charitable contributions, we do not value what an estate contributed; we value what the charitable organizations received."

The court cited *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981), in support of both of those steps of the analysis. In *Ahmanson*, the decedent owned the one voting share and all 99 nonvoting shares of a corporation. The voting share was left to the decedent's sons and the 99 nonvoting shares were left to a charitable foundation. The gross estate value of the 100 shares took into consideration that the decedent held full voting control of all the shares, but "the estate's deduction attributable to the donation of the 99 nonvoting shares necessitated a 3% discount to account for the foundation's lack of voting rights." The fact that the asset in *Ahmanson* was split between an individual and a charity rather than between two charities made no difference because that did not affect the value of the church's and foundation's respective interests that they received "and it is the value of the property received by the donee that determines the amount of the deduction available to the donor."

The parties reached agreement regarding the amounts of discounts if the court determined that discounts were appropriate in determining the charitable deduction for the charitable transfers to the church and to the foundation. The parties stipulated a 27.385% discount for the 25% passing to the church and a 4% discount for the 75% passing to the foundation. Discounting the interests passing to the separate charities resulted in a reduction of the charitable deduction of over $2.5 million, a quite significant reduction.

(5) **Failure to Timely File Penalty.** The IRS met its burden of showing that the taxpayer filed late, but the estate did not meet its burden of establishing reasonable cause, offering no evidence in support of that position. Therefore, the failure to timely file penalty under §6651(a)(1) was applicable as to any gift tax deficiency.

d. **Observations.**

(1) **Small Lack of Control and Marketability Discounts Allowed for Controlling Majority Interest in LLCs.** Lack of control and lack of marketability discounts were determined for the estate tax value of the estate's super-majority in five LLCs owning real estate (all over 70% and three over 80%). Several of the LLCs owned multiple real estate investments; one owned multifamily apartment buildings and a retail shopping center and another owned a multifamily apartment complex and another unleased property. The other three LLCs each owned a single real property investment (an operating farm, property surrounding a gas station, and a mobile home park). The LLC operating agreements all "grant significant power to the majority interest holder, such as the ability unilaterally to dissolve the LLCs and to appoint and remove managers." Even so, the 4% lack of control discount and 5% lack of marketability discount, a combined seriatim discount of 8.8% (.04 + [.05 x .96] = .088), might seem low for interests in LLCs owning real estate.

Fractional undivided interests in real estate are often valued with a 15% - 25% discount or more, (but a few cases have allowed lower discounts). *E.g.*, *Estate of Mitchell v. Commissioner*, T.C. Memo. 2011-194 (estate and IRS stipulated to the following fractional interest discounts: Beachfront property: 32% discount for 5% gifted interest and 19% discount for 95% interest owned at death; Ranch property: 40% discount for 5% gifted interest and 35% discount for 95% interest owned at death); *Ludwick v. Commissioner*, T.C. Memo. 2010-104 (17.2% discount for 50% interests in Hawaiian vacation home); *Estate of Baird v. Commissioner*, T.C. Memo. 2001-258 (60% discounts for undivided interests in timberland). A distinction from the fractional undivided interest situation, however, is that the majority interest holder of an LLC generally may have the power to decide to sell the assets and divide the proceeds among the members, without a court supervised partition proceeding.

(2) **Discounts Considered for Estate Tax Charitable Deduction Purposes.** *Warne* is consistent with other cases and rulings that have considered the values actually passing to specific charities in determining the estate tax charitable deduction.

The *Ahmanson* case is described in the *Warne* opinion (and summarized above).

Estate of Schwan v. Commissioner, T.C. Memo. 2001-174, also determined the estate tax charitable deduction based on the value actually passing to a charity, which was less than the value in the gross estate. The decedent in *Schwan* owned two-thirds of the voting and non-voting stock of a corporation. The decedent's estate plan provided that the shares would be distributed to a charitable foundation, and a redemption agreement provided that the voting shares would be redeemed. The court determined that the value to be included in the gross estate was a unitary unrestricted two-thirds interest in the corporation. However, the redemption agreement provided that the voting stock left to the foundation would be redeemed, leaving the foundation with only non-voting stock. The IRS took the position that the foundation received a bequest of money equal to the value of the voting stock and the non-voting stock—which should be valued at a discount for purposes of determining the amount of the charitable deduction. Thus, the amount of the deduction was less than the value in the gross estate. The estate argued that the foundation had the right to require the redemption of all its stock, because it received two-thirds of the voting stock, and before its redemption, it would have control and the ability to recapitalize the corporation and remove any distinction between the two classes of stock. The court concluded that it could not grant the estate's summary judgment motion on this issue because of the possibility under state law of rights of minority shareholders that would restrict the foundation's right to recapitalize and to force the redemption of all its stock.

The IRS took a similar position in a 2006 Technical Advice Memorandum. Tech. Adv. Memo. 200648028 (minority interest applies for charitable deduction purposes).

(3) **Charitable Deduction Discount Analysis Is Similar to Comparable Marital Deduction Cases.** If a controlling interest in an asset is left to the marital share, a control premium may be appropriate in determining the value of that asset. *See Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987) (bequest of 51% of stock of family company to surviving widow entitled to premium "control element" to increase marital deduction). However, this principle also works in reverse. The IRS took the position in several Technical Advice Memoranda that valuation *discounts* should be considered in funding marital bequests. In Tech. Adv. Memo. 9050004, the decedent left 51% of the stock of a closely held corporation to a trust for his son, and the remaining 49% to a QTIP trust. The IRS, citing the *Chenoweth* case, concluded that the stock passing to the QTIP trust should be valued with a minority interest discount. Tech. Adv. Memo. 9403005 concluded that the minority stock interest that passed to the surviving spouse had to be valued as a minority interest for purposes of the estate tax marital deduction, even though the decedent owned a controlling interest in the corporation. *See* AOD CC-1999-006, describing acquiescence in *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999), and stating that "[t]he proper funding of the QTIP trust should reflect, for example, the value of minority interests in closely-held entities or fractional interests in real estate that are used in satisfying the marital bequest".

A 1999 Tax Court memorandum case is the first case recognizing that the value of assets passing to a spouse must take into account minority interests for purposes of determining the marital deduction. In *Estate of Disanto v. Commissioner*, T.C. Memo. 1999-421, the surviving wife signed disclaimers so that only a minority interest in closely held stock passed to the wife. The court held that the stock passing to the wife must be valued as a minority interest for purposes of determining the amount of the marital deduction.

(4) **Planning Alternatives to Avoid Reduction of Charitable Deduction.** Under the *Warne* facts, if the Family Trust had left the entire 100% LLC interest to the foundation or a donor advised fund (DAF), and if 25% of the LLC had been later distributed to the church from the foundation or the DAF (perhaps based on knowing the decedent's desires, but under no legal obligation or even formal understanding to do so), the overall economic effect would have been the same, but no reduction of the charitable deduction would have applied because the entire 100% interest would been transferred from the estate to a single charity.

(5) **Policy Rationale for Discounts When Asset Passes Entirely to Multiple Charities.** The ability to avoid the reduction of the charitable deduction under the *Warne* analysis merely by leaving the

asset first to a foundation or donor advised fund, which could then distribute the asset to multiple charities, raises the question of the policy rationale of denying a full charitable deduction when an asset is left in its entirety to multiple charities. The court rejected the estate's attempt to distinguish *Ahmanson* because if involved splitting an asset between an *individual* and a charity rather than between two charities. The estate argued that applying discounts when the asset passed entirely to charities "would subvert the public policy of motivating charitable donations" and that leaving 100% of the LLC to charities should entitle the estate to a deduction of 100% of the value of the LLC. The court disagreed, focusing on allowing a charitable deduction for the value received by each donee.

Commentators have questioned the public policy rationale of denying a full charitable deduction when an asset is left entirely to charity, whether that is one charity or multiple charities, and suggesting that the case should be appealed for that reason:

> Unlike in *Ahmanson Foundation,* the decedent in *Warne* did not adopt a testamentary plan severing the voting power of Royal Gardens from its economic entitlement and then give only an economic entitlement to charity. Nor did she take any other affirmative steps to diminish the value ultimately passing to charity. Instead, the decedent merely gave a 75% membership interest in Royal Gardens to one charity and the remaining 25% membership interest to another charity. Query whether the purpose of the charitable deduction of encouraging charitable gifts would be any better effectuated by requiring the decedent in this situation to give her entire interest in Royal Gardens to either her family foundation or to her church, rather than allowing her to allocate such interests among charities as she desires?
>
> The IRS has actually been more lenient in certain cases when it comes to the application of valuation discounts for property contributed to charity. In Rev. Rul. 57-293, 1957-2 CB 153, for example, the IRS ruled that the charitable income tax deduction for a contribution of a fractional interest in artwork to a museum was equal to its fair market value multiplied by the fractional interest conveyed….
>
> Query what the result would be where an individual who owns a $10 billion art collection gives at his or her death a 50% fractional interest in the collection to the Metropolitan Museum of Art and the remaining 50% fractional interest to the National Gallery of Art? The $10 billion would clearly be included in his gross estate but should the charitable estate tax deduction be any less than the same $10 billion included in the gross estate? Any valuation discount applied in determining the charitable estate tax deduction on the basis of what is actually received by the charities would result in significant estate taxes being imposed merely because the decedent desires for the collection to be displayed at two of the country's great museums following his death. Would the purpose of the charitable deduction be better served by requiring the collection in such a case to be given to only one of the museums? Or should a valuation discount not be applied where the asset being donated is used directly for the charitable purposes of the donee charity, such as works of art to be displayed by a museum?
>
> The *Warne* case, which is appealable to the United States Court of Appeals for the Ninth Circuit, the same court that decided *Ahmanson Foundation*, would seem ripe for appeal. Richard L. Fox & Jonathan G. Blattmachr, Estate of Miriam M. Warne - *Decedent's Splitting of Charitable Bequest of 100% LLC Membership Interest Between Two Separate Charities Results in Mismatch of Value Included in Gross Estate and Amount Allowed As Estate Tax Charitable Deduction*, LEIMBERG CHARITABLE PL. NEWSLETTER #306 (March 1, 2021).

(6) **Entire Interest Passing to Charity and Spouse.** A similar situation arises if the entire interest in an asset owned by an estate (or the entire estate) passes partly to a charity and partly to a surviving spouse. The intuitive reaction may be that all the interest is passing in a manner that qualifies for a deduction, thus resulting in no estate tax, but the rationale of *Warne* (and *Disanto* and *Ahmanson*) results in a reduction of the overall charitable and marital deduction when the valuation of the asset is subject to discounts, possibly resulting in an estate tax being due.

(7) **Somewhat Analogous "Marital Deduction Mismatch" Argument for §2036 FLP Situations.** The IRS has made the similar argument in cases involving family limited partnership cases if the undiscounted value of the assets contributed to the partnership is included in the gross estate under §2036, arguing that a marital deduction is allowed only for the discounted limited partnership interest that actually passes to the surviving spouse. This situation arises when a spouse contributes assets to an FLP, retains most of the partnership interests until his death, and dies with a formula marital deduction clause that leaves assets to the surviving spouse to minimize estate taxes, and the value of the assets contributed to the partnership is included in

the gross estate under §2036. In two reported cases (*Estate of Black v. Commissioner*, 133 T.C. 340 (2009), and *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21) the IRS has made the argument that while the value of the partnership *assets* is included in the gross estate (without a discount), the estate actually owns only a limited partnership or LLC interest and does not own the assets directly. The government's brief in *Black* stated the argument as follows:

> Petitioner overlooks the fact that §§2036 and 2035 include the value of property that has previously been transferred, while the marital deduction is limited to the value of the property actually passing to the surviving spouse. There is good reason for this limitation. On the death of the surviving spouse, only that property (here, the discounted value of the BILP interest) will be in includable in the spouse's gross estate under I.R.C. §2044.

All the estate can leave the spouse (i.e., all that can "pass" to the spouse for marital deduction purposes under §2056) is a discounted entity interest. Thus, there would be estate inclusion at a high level (without a discount), but the marital deduction would be allowed at a much lower level (taking into account discounts). That difference would first reduce the amount passing to the bypass trust, but if that difference were more than the remaining estate tax exemption amount available to the estate, there would be estate taxes due at the first spouse's death. *See generally* Angkatavanich, *Black Shirts (Black, Shurtz) and the Marital Deduction Mismatch*, TRUSTS & ESTATES 37 (June 2010).

The Tax Court considered a different marital deduction issue in *Estate of Turner v. Commissioner*, 138 T.C. 306 (2012). (That is the second of three reported cases involving that fact situation and is sometimes referred to as "*Turner II*.") The estate argued that the decedent's will contained a formula marital deduction clause and that the marital deduction should offset any value included in the gross estate under §2036. The marital deduction issue addressed in this supplemental opinion is whether a marital deduction is allowed for partnership assets attributable to 21.7446% limited partnership interests that the decedent had given to various family members (other than his spouse) during his lifetime. The court concluded that because the surviving spouse did not receive those 21.7446% limited partnership interests, no marital deduction is allowed for the value of assets attributable to those interests that is included in the gross estate under §2036. The court reasoned that the statutory and regulatory marital deduction provisions as well as the overall structure of the wealth transfer system support that result. The classic marital deduction mismatch issue does not arise in *Turner II* because the IRS allowed a marital deduction for the full value of assets attributable to partnership interests that the decedent owned at his death and could pass to the surviving spouse under the formula marital deduction bequest in the decedent's will.

In short, the Tax Court did not have to address the marital deduction mismatch issue in *Black* and *Shurtz* because the court held that §2036 did not apply in those cases. The classic marital deduction mismatch issue did not arise in *Turner II* because the IRS allowed a marital deduction for the full value of assets attributable to partnership interests that the decedent owned at his death and could pass to the surviving spouse under the formula marital deduction bequest.

No court has yet faced the marital deduction mismatch issue in the context of §2036 FLP cases. A tax fiction deems the value of the assets that were transferred in the §2036 transaction to be in the gross estate, and the issue is whether that same tax fiction is applied for deduction purposes as well. On the one hand, the estate owns only the discounted limited partnership interest, so arguably that is all that can "pass" to the surviving spouse for purposes of the marital deduction's "passing" requirement. On the other hand, a sense of consistency and fairness arguably may suggest that the fiction should apply for marital deduction purposes as well as estate inclusion purposes. The concept of the marital deduction is that a couple can avoid estate taxes at the first spouse's death, deferring estate taxes until the second spouse's death, and it may not be possible to avoid having to pay large estate taxes at the first spouse's death if a full marital deduction is not allowed. Take the simple situation in which all the estate is passing to the surviving spouse and the estate owns a 99% interest in the partnership that is left to the spouse. That is not a situation (like in *Turner II)* where the decedent had made gifts of most of the partnership interests to persons other than the spouse. The spouse is receiving all the estate

and all the partnership interest related to the value of the assets included under §2036, so arguably there should be a marital deduction for all that value. Or consider a situation in which the decedent made a lifetime gift of all his partnership interests to the surviving spouse, but the court applies §2036. Again, the very asset that gives rise to §2036 also ends up in the hands of the surviving spouse, and a sense of consistency may suggest that the marital deduction should match the inclusion amount. The effect of allowing a full marital deduction for the undiscounted value included under §2036, however, is that no particular disadvantage exists for having §2036 apply at the first spouse's death regarding assets contributed to the FLP by that spouse (and §2036 would not apply at the surviving spouse's subsequent death as to assets contributed to the FLP by the first-decedent spouse).

14. Sale Decisions by Sponsors of Donor Advised Funds Contrary to Expectations of Donors, *Fairbairn, et al. v. Fidelity Investments Charitable Gift Fund*, *Pinkert v. Schwab Charitable Fund*

a. Synopsis of *Fairbairn*. On December 28 (that is a key fact), successful hedge fund managers contributed 1,930,000 shares of a publicly traded company (worth over $100 million) to a DAF. The DAF sold all those shares the next day (December 29, the last trading day of the calendar year), all within 2½ hours. At the completion of trading all those shares, the stock had declined in value by about 30%, or about $9.6 million, which reduced the charitable deduction by $3.3 million.

An executive of the company that was sponsor of the DAF sent text messages saying "[we] botched the trades" and the company "has been an awful biz partner [to the Fairbairns] throughout all of this." The Fairbairns testified that the company representatives had orally promised various things:

(1) employ state-of-the-art methods for liquidating large blocks of stock;

(2) not trade more than 10% of daily trading volume [which they didn't];

(3) not liquidate any shares until the new year; and

(4) allow the Fairbairns to advise on a price limit.

The Fairbairns sued for common law misrepresentation, breach of contract, promissory estoppel, violation of unfair competition law, and negligence.

The federal district court held for the Fund, reasoning:

(1) the plaintiffs did not establish by a preponderance of evidence that the sponsor had agreed to those items;

(2) the plaintiffs did not establish that the sponsor did not in fact employ "sophisticated state-of-the-art methods";

(3) even if the sponsor owed the Fairbairns a duty of care, due to a special relationship, there was no proof that it breached that duty;

(4) the plaintiffs did not prove that a reasonably prudent DAF would not have sold all shares within 2½ hours under the market conditions on December 29, but would have spread out liquidation over several days; and

(5) the sponsor acted consistently with its published, written policies regarding the liquidation of contributed shares.

Fairbairn, et al. v. Fidelity Investments Charitable Gift Fund, No. 3:18-cv-04881-JSC (N.D. Calif, Feb 26, 2021).

b. Planning Pointers from *Fairbairn*.

- Many DAFs have similar written policies (perhaps not to sell $100 million worth of shares ALL the NEXT day and all within 2½ hours).
- This is a recent case that made headlines in the public media.
- The DAF is in control of when to liquidate assets contributed to the fund.

- A contributor should assume the DAF will sell all the next day.
- The contributor should spread out contributions to assure the fund will not sell $100 million worth the next day, all within 2½ hours (ostensibly causing a huge price decline within that short time frame). That's why the December 28 contribution date is significant in this case. The donor did not have time to spread out contributions and still get a charitable contribution for 2017.

c. **Synopsis of *Pinkert*.** A Magistrate Judge for the federal district court in the Northern District of California has similarly denied relief for a donor of a donor advised fund against the fund's sponsor, but the rejection of the donor's claim was based on a lack of standing rather than a substantive finding that the sponsor did not breach a fiduciary duty as in *Fairbairn*. The Schwab Charitable Fund (the "Fund") is legally independent of the Schwab Corporation, but the Fund used the brokerage services and investment products of Schwab Corporation, and "every person working for [the Fund] is actually an employee of the Schwab Corporation." The donor's assertions included that (i) cheaper alternative index funds and money-market funds could have been used, (ii) the Fund invested in retail products rather than lower-priced wholesale products available to institutional investors, (iii) the Fund could have used its marketing power to negotiate lower rates, and (iv) the Fund benefitted Schwab Corporation to the Fund's detriment. The order reasoned that the donor gave up exclusive legal control and ownership of the assets contributed to the Fund. To have standing under Article III of the U.S. Constitution, the plaintiff must have (i) suffered an injury in fact (an invasion of a legally protected interest that is concrete and particularized and actual or imminent), (ii) that is fairly traceable to the defendant's alleged conduct, and (iii) that is likely to be redressed by a favorable judicial decision. The court stated that the donor's advisory privileges regarding distribution or investment decisions do not equate to a concrete protected interest considering the Fund's exclusive legal control over the donated assets. A plaintiff must asset injury to his own legal rights, not the legal rights of others, and the plaintiff is not a beneficiary of the Fund. The court distinguished *Fairbairn* because it was a misrepresentation and breach of contract case involving allegations that the sponsor broke specific promises rather than a general claim of mismanagement (but, in fact, the court in *Fairbairn* stated that the plaintiff contended, apart from alleged promises, that the sponsor "violated the duty of care" owed to the donor). The order also reasoned that the plaintiff lacked standing under California law. *Pinkert v. Schwab Charitable Fund*, No. 3:20-cv-07657 (N.D. Calif. Order dated June 17, 2021).

15. Valuation of Publicity Rights, Undervaluation Penalties, *Estate of Michael Jackson v. Commissioner*, T.C. Memo. 2021-48

a. **Brief Synopsis.** The court in a 265-page opinion addressed the value of three assets in the estate of Michael Jackson, the "King of Pop"– the value of the decedent's "image and likeness" (i.e., publicity rights) and the value of two entities. There were huge differences between the estate's position and the IRS position for all three assets. (The values of other assets in the estate were stipulated.)

For the decedent's image and likeness, the estate's and the IRS's value positions were $3.078 million and $161 million, respectively. The court valued the rights at only $4.15 million, considering the poor state of Michael Jackson's reputation at his death. The court used a discounted cash flow analysis based on projected revenues and expenses.

The other two assets were interests in bankruptcy trusts that owned music catalogs. One of them owned a large catalog of Beatles songs; the assets were very valuable (the IRS valued the interest at $206 million in the notice of deficiency), but the decedent had borrowed heavily against the trust to fund his lifestyle and the court found that it had a net zero value. The second owned another large catalog of songs (most notably from Jackson himself). The estate and IRS valued it at $2.27 million and $114 million, respectively, and the court valued it at $107 million using a discounted cash flow analysis. In valuing these assets, the court refused to "tax affect" the income under an assumption that a C corporation would be the most likely hypothetical purchaser of the assets.

The IRS assessed penalties, but the court found that the estate acted with reasonable cause and in good faith in relying on the appraisals for the reported values. *Estate of Michael L. Jackson v. Commissioner*, T.C. Memo. 2021-48 (May 3, 2021) (Judge Holmes).

For an insightful discussion about case, see Scott St. Amand, *Valuing a Complex Legacy: Lessons in Valuation From Estate of Jackson*, BLOOMBERG ESTATES, GIFTS & TRUSTS J. (Sept. 9, 2021).

b. **Wild Variances in the Positions of the Estate and the IRS.** The estate's position was that the value of the entire estate was about $7.2 million vs. $1.125 BILLION as the IRS's position in the notice of deficiency. Eventually, the parties agreed on the values of all assets except for three assets. Here are the positions of the estate and IRS, as summarized by the court:

	Reported on Estate Return	Notice of Deficiency	Estate on Brief	Commissioner on Brief
Image and likeness	$2,105	$434,264,000	$3,078,000	$161,307,045
New Horizon Trust II	-0-	469,005,086	-0-	206,295,934
New Horizon Trust III	2,207,351	60,685,944	2,267,316	114,263,615

c. **Valuation of Decedent's Image and Likeness; Publicity Rights.** The decedent's legal rights in property are determined under California law, where the decedent was domiciled at his death. After the California Supreme Court held that the "right to exploit name and likeness is personal to the artist" and post-mortem uses of a person's identity are not actionable in *Lugosi v. Universal Pictures*, 603 P.2d 425 (Cal. 1979), California created a statutory post-mortem right of publicity. Accordingly, this state law property right was an asset included in the gross estate. (Many states have not recognized a post-death name and likeness property right (sometimes referred to as a post-death right of publicity) to exploit the right financially and to prevent others from exploiting the decedent's name and likeness; a decedent domiciled in one of those states might have no value to be included in the gross estate attributable to enforceable post-death publicity rights.)

The estate's and IRS's values of the decedent's image and likeness on the estate tax return and in the notice of deficiency were $2,105 and $434,264,000 -- an incredibly wide variance. After years of doing additional valuation work, their positions changed at trial to $3.078 million and $161.3 million, respectively – still a very wide difference.

Michael Jackson in reality had received almost no revenue for about a decade prior to his death, and the appraisal that was used to support the $2,105 value reported on the estate tax return was based on those facts. An expert for the estate ("the CEO of CMG Worldwide, Inc., an international licensing and rights-management company that specializes in representing celebrities both dead and alive") did substantial additional appraisal work after the estate tax return was filed. He projected 10 years of post-death revenues from the exploitation of Jackson's image and likeness and associated trademarks, and another expert estimated the date of death value based on those projections.

The IRS's expert "considered five 'opportunities' that he believed a hypothetical buyer could reasonably foresee at Jackson's death: themed attractions and products, branded merchandise, a Cirque du Soleil show, a film, and a Broadway musical. The court viewed the IRS's expert's analysis "as fantasy." The expert (1) valued the wrong asset (because the California statutory definition of the post-death image and likeness property right excludes musical compositions among other things, the consideration of a Cirque du Soleil show, film, and Broadway musical all involved musical copyright rights not included in the image and likeness property right, and the themed attractions and branded merchandise both involved existing intellectual property rights licenses that are distinct from image and likeness), (2) included unforeseeable events in his valuation, and (3) miscalculated the assets' value because of "faulty" math.

The court the valued the rights at only $4.15 million, providing a lengthy (and quite interesting) factual background about the poor state of Michael Jackson's reputation at this death and observing that the estate would have to spend a significant amount of money to rehabilitate his image. A discounted

cash flow analysis was used after projecting revenue and expenses separately for the first 10 years and decreasing net income by 5% for each of years 11-70 and using a discount rate of 15.4%.

d. New Horizon Trust II. The second asset valued by the court was an interest in a Delaware trust (a bankruptcy trust) that owned the copyrights to The Beatles catalog, which included at least 175 songs that had been co-authored by John Lennon and Paul McCartney, as well as other copyrights. The estate valued this asset at $0 and the IRS valued it on the notice of deficiency at $206 million. The court concluded that the assets were worth about $227 million but were subject to over $300 million of debts (borrowed to fund Michael Jackson's very expensive lifestyle) and had a net value of zero.

e. New Horizon Trust III. The third asset was also a bankruptcy trust, the major asset of which is a music catalog that owns compositions from a variety of artists, most notably Jackson himself. The catalog included five different groups of songs with income coming primarily from three sources. The estate valued this asset at $2.27 million and the IRS valued it at $114 million. The court adopted the experts' approach of using a discounted cash flow analysis and determined a value of $107 million.

f. Credibility of IRS's Expert. The court made a point of noting that the IRS's expert lied twice at trial. (1) When asked if he had ever represented the IRS before and whether he wrote a valuation report for the IRS in Whitney Houston's estate tax case, he said "No, Absolutely not." The court responded, "That was a lie." (After "recess and advice from the Commissioner's counsel," the expert admitted he had been retained by the IRS in that case.) (2) The expert also "testified that neither he nor his firm ever advertised to promote business. This was also a lie." He had sent an email blast bragging that he "is the expert of the century and will be testifying on behalf of the IRS," and he referred to his involvement in this "Billion Dollar Case" in a lecture given before trial. The estate moved to strike his entire testimony, as tainted by perjury. The court found that remedy "too severe," but concluded that the court would "discount the credibility and weight we give to [the expert's] opinions."

g. Tax-Affecting. One of the issues involved in valuing all three assets was whether to "tax-affect" the income on an assumption that a C corporation would be the most likely hypothetical buyer and would have to pay a corporate level income tax on the income. The court refused to extend the analysis of *Estate of Jones v. Commissioner* and refused to tax-affect the income.

This tax-affecting analysis is quite different from the tax-affecting rationale in valuing interests in S corporations and pass-through entities in many prior cases. The traditional core justifications for tax-affecting are generally (1) that a hypothetical willing buyer in the willing-buyer-willing-seller construct of fair market value is looking for a return on the investment and necessarily will enjoy and therefore evaluate that return only on an *after-tax* basis and (2) that comparable data to use in the valuation process typically comes from public sources and therefore largely comes from C corporations, for which earnings are, again, necessarily determined on an *after-tax* basis. Corollaries to those justifications are that passthrough status (3) confers a benefit of a single level of tax compared to a C corporation, but also (4) limits the universe of potential buyers and investors, who might not be able to buy or invest without forfeiting or jeopardizing (or at least complicating) the S corporation status or other passthrough status. Thus, tax-affecting sometimes includes adjustments to accommodate those corollaries, or sometimes is followed by the application of, for example, an "S corporation premium" as the next step following the tax-affecting. That approach is incorporated in a well-known model used by many appraisers in valuing S corporation stock, referred to sometimes as the S Corporation Economic Adjustment Model and sometimes as the S Corporation Equity Adjustment Model, or, in either case, "SEAM." For example, the IRS's internal examination technique handbook for estate tax examiners more than 20 years ago (before the *Gross* case, discussed below) stated:

> If you are comparing a Subchapter S Corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes using the corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will avoid distortions when applying industry ratios such as price to earnings.

In the *Estate of Jackson* case, however, the rationale of the estate's experts was based on an assumption that "the appropriate hypothetical buyer of each asset would be a C corporation, and

therefore, each of them reduced cashflows by the income-tax liability that would be paid by a hypothetical C corporation buyer." However, the court concluded that "the Estate has failed to persuade us that a C corporation would be the hypothetical buyer of any of the three contested assets."

The Tax Court refused to allow tax-affecting in valuing an S corporation on the income method in *Gross v. Commissioner*, T.C. Memo. 1999-254, and Tax Court cases after that time consistently refused to allow tax-affecting until the *Estate of Jones v. Commissioner* case in 2019, T.C. Memo. 2019-101 (Judge Pugh). In *Jones*, the court explained that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax-affecting the earnings of a flowthrough entity per se. The court viewed those cases as concluding that (1) assuming a zero income tax rate on the earnings properly reflected the overall tax savings of operating as an S corporation (*Gross v. Commissioner*), (2) the taxpayer's expert did not justify tax-affecting the earnings in balancing the burden of the individual level tax with the benefit of the reduced total tax burden (*Estate of Gallagher v. Commissioner*), and (3) tax-affecting the earnings resulted in a post-tax cash flow but the expert applied a pre-tax discount rate (*Estate of Giustina v. Commissioner*). In *Jones*, on the contrary, Judge Pugh concluded that the taxpayer's appraiser considered both the advantages as well as the disadvantages of operating as an S corporation and that the taxpayer's expert's "tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate." Judge Pugh viewed the issue as fact-based and noted that the court in the prior cases had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases. For a more detailed discussion of *Estate of Jones* (as well as another 2019 federal district court case that accepted an expert's report using tax-affecting, *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. 2019)), see Items 33 and 34 of Estate Planning Hot Topics and Current Developments (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights).

Some planners thought that the *Estate of Jones* case might represent a "crack in the 20-year old dam" of the Tax Court's reluctance to recognize tax-affecting. Judge Holmes's discussion in *Estate of Jackson* suggests otherwise.

Judge Holmes distinguished *Estate of Jones* primarily as a case in which the IRS's expert did not contest tax affecting:

> We distinguish Estate of Jones as an instance where the experts agreed to take into account the form of the business entity and agreed on the entity type. The Commissioner argued there, as he does here, that we shouldn't tax affect, but his own experts didn't seem to be on board. As we observed, "[t]hey do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers." Estate of Jones, at *39.
>
> We do not hold that tax affecting is never called for. But our cases show how difficult a factual issue it is to demonstrate even a reasonable approximation of what that effect would be. In Estate of Jones, there was expert evidence on only one side of the question, and that made a difference.
>
> That was not the case here.

h. **Penalties.** The IRS asserted valuation understatement penalties and penalties for negligence or disregard of the rules under §6662. A procedural issue under §6751 requires that no penalty assessment is allowed unless it is personally approved by the immediate supervisor of the individual making the penalty determination. Neither the estate nor the IRS offered any evidence at trial about approval by the immediate supervisor. The estate asserted that requirement was not met, but the estate had the burden of persuasion on this issue and the court concluded that the estate failed to enter any evidence of the failure to obtain supervisory approval. (This is the classic difficulty of "proving a negative.") In Judge Holmes' unique and witty style: "*Thriller* is part of the record here. So are demons, vampires, monsters, ghosts, and even the funk of 40,000 years. But the record lacks any evidence that the Commissioner's agent failed to obtain supervisory approval."

The court concluded, though, that reasonable cause and good faith existed because the estate based its values on an appraisal from a reputable accounting firm and reliance on the appraisal was reasonable even though the value of the assets was far different than the court's value. The $2,105 appraised value of the post-death image and likeness rights reported on the estate return was very

low but was because Jackson "made almost no money attributable to his name and likeness in the last decade of his life." The appraisal "followed standard appraisal procedure in this area -- it focused on the last 10 years of Jackson's life." Even though the court disagreed with the appraisal, "the Estate reasonably relied on it in good faith once it discovered how little revenue Jackson had been earning from use of his name and likeness." Similarly, the court noted that its opinion shows how complicated the valuation of that second bankruptcy trust (New Horizon Trust III) was, that the appraisal was reasonable given all the facts and circumstances, and that it was reasonable for the estate to rely on it, and it did so in good faith.

i. **Planning Considerations Regarding Post-Death Right of Publicity.** The right of publicity allows an individual to exploit the commercial use of his name, image, and identity and to sue others who misappropriate the individual's name and likeness. The right of publicity developed out of the right of privacy. Most states now recognize the right, either by case law or statutes, and about half the states recognize that it survives death. There is little uniformity among the states; some states are explicit about the ability to transfer the right, and others aren't. Jurisdiction and governing law issues are still being developed. As expressed in *Estate of Jackson*, the general rule is that the law of the decedent's domicile governs as to the contours of any post-death right of publicity. The law is still developing as to whether an individual can incorporate the laws of another state's statute regarding post-death rights by transferring the publicity rights to an entity created and operated in that state prior to death.

Two major estate planning issues need to be addressed: (1) What is the individual's vision of how his or her reputation should be preserved and used (if the individual wants those rights restricted, will that restriction be recognized to diminish the value of the rights for estate tax purposes?); and (2) How can ownership of the publicity right by structured to integrate with the individual's estate plan?

Exploiting an individual's right of publicity requires management as a business, and ideally it will be housed in a business structure. Issues that arise generally regarding business succession will also apply to this property right.

Tom Abendroth (Chicago, Illinois) suggests several specific planning considerations:

(1) Place the right of publicity (and related copyrights, trademarks, and endorsement contracts) in multiple entities to allow the desired division of control and ownership (including transfers of particular interests to irrevocable trusts).

(2) Transfer methods are generally the same that we use for other business structures (such as a seed gift and subsequent sale to an irrevocable grantor trust, or GRATs, or growing businesses).

(3) Divide the various attributes among different entities, and owners can dis-aggregate the interest and potentially lower its value for estate tax purposes, as opposed to the decedent's owning all rights associated with the right of publicity at his death.

> For example, one entity could be created to manage endorsement contracts, appearance contracts and related existing contracts. It could receive a percentage fee for this, or actually be the recipient of the contract income. Another entity could own and license the right of publicity (to the management entity). A third could own memorabilia and other tangible assets (a potentially significant category in its own right for athletes). Tom Abendroth, *Estate Planning With the Right of Publicity*, ACTEC Estate & Gift Tax Committee (June 2021).

(Judge Holmes in *Estate of Jackson* noted that the IRS's expert kept trying to aggregate all assets associated with his right of publicity, including copyrights in musical compositions and performances, but those had already been transferred to separate entities.)

(4) To the extent possible, give the structure the characteristics of an active business (which may not be possible if all management responsibilities are outsourced). A business structure may achieve income tax benefits (such as qualifying for business deductions and avoiding the 3.8% NII tax) and estate tax benefits (such as qualifying for the bona fide sale for full consideration exception to §2036 and §2038). *Id.*

16. Intergenerational Split Dollar Life Insurance, Estate Tax Treatment of Repayment Right, *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60 and *Estate of Levine v. Commissioner*, T.C. No. 2 (February 28, 2022)

a. ***Morrissette v. Commissioner*.**

(1) Synopsis. Mrs. Morrissette (actually her revocable trust) paid large lump sum premiums ($29.9 million) for Dynasty Trusts to purchase universal life insurance policies on the lives of her three sons to fund buy-sell agreements to assure that ownership of a long-term very successful business would remain in the family. The advances were made under split dollar arrangements providing that Mrs. Morrissette would be repaid the amount of the advances or, if greater, the cash surrender values of the policies. The reimbursement amount would be repaid when the split dollar agreements were terminated at the respective deaths of the sons, when the trusts cancelled the policies, or when the parties mutually agreed to terminate the agreements. The estate valued the rights to be repaid for the premium advances at about $7.5 million (primarily because of the delay of when the repayments would be made), and the IRS valued the reimbursement rights at the cash surrender value of the policies at the date of Mrs. Morrissette's death (about $32.6 million).

The court held that (a) the advanced premiums or cash surrender values are not included in the estate under §2036 or §2038 because the $29.9 million premium advance transfers were made in a bona fide sale for adequate and full consideration, (b) the special valuation rules of §2703 do not require inclusion of the cash surrender values of the policies in the estate because the safe harbor exception in §2703(b) was satisfied, (c) the value of the estate reimbursement rights was determined under a discounted cash flow analysis, using an assumption that the repayment would be made three years after the estate tax return was filed (which greatly increased the value as compared to assuming that the repayment would not be made until the sons' respective deaths), and (d) the 40% gross valuation misstatements penalty under §6662 was appropriate, and the estate's reliance on its appraiser's valuation of the rights was not reasonable. *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60 (May 13, 2021) (Judge Goeke).

On December 13, 2021, the court entered a Decision, based on calculations implementing its opinion to which the parties had agreed, determining an estate tax deficiency of $12,575,459.24 and an accuracy-related penalty of $3,232,339.89, both subject to interest.

For an excellent summary of this second *Morrissette* opinion (sometime referred to as "*Morrissette II*") and of general planning issues involving intergenerational split dollar life insurance, see Mitchell Gans & Martin Shenkman, *Morrissette II: Why the Tax Court May Have Improperly Applied the Hypothetical Purchaser Framework*, LEIMBERG ESTATE PLANNING NEWSLETTER #2896 (July 19, 2021).

(2) Basic Facts. The Morrissette family owned a moving and logistics company with a history going back to 1943. Three sons were involved in the business, and significant family disharmony endangered a long-term goal of maintaining ownership of the business within the family. Mrs. Morrissette (actually her revocable trust) paid large lump sum premiums ($29.9 million) for Dynasty Trusts to purchase universal life insurance policies on the lives of her three sons. (The advance was made by Mrs. Morrissette's sons as trustees of the revocable trust, when Mrs. Morrissette could not participate because of her Alzheimer's disease.) Each trust purchased policies on the lives of the other two sons, and a shareholder's agreement provided that at the death of a son, trusts for the surviving sons would purchase the shares owned by the deceased son. Under split dollar agreements with each of the Dynasty Trusts, the revocable trust would be repaid the advance solely from the cash surrender values of the policies if the split dollar agreement was terminated before a son's death or from the death benefit if an agreement terminated as a result of a son's death. Accordingly, the revocable trust was entitled to receive the aggregate premiums paid (without added interest) on the policies on that child's life (or the cash surrender value of such policies, if greater). In addition, the split dollar agreement could be terminated by the cancellation of policies by a Dynasty Trust or by the mutual agreement by both parties to terminate the agreement. Mrs. Morrissette's revocable trust provided that the split

dollar reimbursement rights would be distributed at Mrs. Morrissette's death to each Dynasty Trust that was the counterparty to the agreements.

Mrs. Morrissette died in September 2009. About ten months later, one of the sons inquired about cancelling the policies (his reasons for the inquiry are unclear), but the estate planning attorney advised "that the IRS had three years to audit the estate tax return and insisted that the policies remain in effect until the IRS audit was settled." The estate filed the estate return about six months later, including the reimbursement rights under the split dollar arrangements in her estate at a value of about $7.5 million (compared to the $29.9 million lump sum premiums she had paid), considering the fact that her revocable trust would not receive the payments for many years in the future (as her children died—actuarially expected to be about 15 years later) or when the split dollar agreements were terminated before that time.

In an initial opinion, the court held that the split dollar agreements complied with the economic benefit regime, the decedent did not make taxable gifts of the premiums when the $29.9 million advance was made, and the Dynasty Trusts did not have current access to the cash surrender values immediately. *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016). The court entered an Order on June 21, 2018 denying the taxpayer's motion for summary judgment that §2703(a) was inapplicable (based on the court's reasoning in *Cahill v. Commissioner*) concluding that "[t]he restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2)." The IRS and estate subsequently filed motions for partial summary judgment regarding §2036(a)(2), §2038(a)(1), and trying again regarding §2703(a). The court entered an Order dated February 19, 2019 denying the taxpayer's motions for summary judgment that §2036(a)(2), §2038(a)(1), and §2703(a) do not apply. The court merely reasoned that *Estate of Cahill* "is directly on point" as to §2036(a)(2) and §2038(a)(1) but denied the IRS's motion for summary judgment regarding those sections because a material factual dispute exists concerning the issue of full and adequate consideration as to §2036 and §2038 and concerning whether the transfer satisfied the safe harbor in §2703(b).

For a more complete discussion of the facts and the holdings of the prior decision and orders, see Item 27 of Estate Planning Current Developments and Hot Topics (December 2016) found here and Item 13.c.(6) of Estate Planning Current Developments and Hot Topics (December 2019) found here, both of which are available at www.bessemertrust.com/for-professional-partners/advisor-insights).

(3) **Business Purpose.** A key to the court's conclusion that §2036, §2038, and §2703 do not apply (as discussed below) is the business purpose for the life insurance based on the family disharmony and the need for insurance to fund the buy-sell agreements in order to persuade Mrs. Morrissette's sons to retain the business and to keep the ownership of the business within the family. Those facts would not be present in every case involving intergenerational split dollar life insurance, and without those facts and the need for the life insurance (apart from potential tax advantages), those Code sections may have applied to negate any significant valuation discount advantages from the intergenerational split dollar arrangement.

(4) **Sections 2036 and 2038.** The IRS argued, among other things, that the reimbursement rights should be included in the estate at an amount "at least in the amount of the transferred premiums, $30 million total, or the cash surrender value of the underlying policies, approximately $32.6 million total" in part because of retained possession, enjoyment or a right to income from the transferred property under §2036(a)(1), a retained right to designate who can enjoy the property or income under §2036(a)(2), and a power to alter enjoyment of the property under §2038(a). The court rejected that argument, reasoning that the bona fide sale for adequate and full consideration exception under those sections was satisfied. The exception requires (1) a legitimate and significant nontax purpose and (2) adequate and full consideration in money or money's worth. Nontax reasons existed for the arrangement (to keep the business in the family). The opinion had a long discussion of the family disharmony and the plan to retain the sons in the business management, maintain control over the business, assure that ownership remained in the family, and avoid the need to sell the business to pay estate taxes as sons died. Adequate

and full consideration existed even though the economic value of the right to sell or collect on reimbursement rights was worth less than the $29.9 million advance because other benefits were present than just the economic value of the reimbursement rights "such as management succession and efficiency and capital accumulation."

(5) Section 2703. The IRS also argued that the reimbursement right should be valued at the full cash surrender value of the policies because the revocable trust would receive the cash surrender value upon the termination of the split dollar agreement and the restriction that the split dollar agreement could be terminated only with the mutual agreement of the parties was a "restriction on the right to sell or use" property that had to be ignored in valuing the property under §2703(a). The court had previously denied the estate's motion for summary judgment that §2703(a) did not apply (relying on the decision in *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84) but left open for trial whether the safe harbor exception under §2703(b) applied. "Section 2703(b) provides an exception where the restriction is a bona fide business arrangement, not a device to transfer property to members of the decedent's family for less than adequate and full consideration, and comparable to the terms of similar arrangements in arm's-length transactions," and in this *Morrissette II* decision the court concluded that the §2703(b) exception applied. The §§2036, 2038, and 2703 rulings were unequivocal taxpayer victories. But the taxpayer victories ended there.

(6) Value of Reimbursement Rights. The estate valued the reimbursement rights on the estate tax return at about $7.5 million. The estate conceded that a mechanical mistake in one of the taxpayer's expert's appraisal meant that the appraiser's value would have been about $10.4 million, but another appraiser for the estate valued the reimbursement rights at about $7.8 million. (The reimbursement payment rights at the date of the decedent's death would have been about $32.6 million, the cash surrender value of the policies, but the revocable trust had no way to force the immediate cancellation of the split dollar agreements and immediate payment.) The IRS's notice of deficiency valued the reimbursement rights at about $32 million, the cash surrender value of the policies. The IRS's expert valued the reimbursement rights at about $17.5 million assuming the split dollar agreements remained in effect until the sons' deaths and at about $27.9 million assuming they were terminated three years after the estate tax return was filed. (Observe: The assumed termination date has the biggest impact on the valuation of the reimbursement rights – in this case $17.5 million vs. $27.9 million in the IRS's expert's opinion.)

In valuing the reimbursement rights of the revocable trust, the estate's and IRS's experts both applied a discounted cash flow analysis. The primary factors in the analysis were determining (a) the appropriate discount rates to determine the present value of the anticipated cash flows and (b) the repayment schedule.

For the discount rates, the court agreed with the IRS's expert's use of returns on corporate bonds and company specific debt (discount rates of 6.4% and 8.85% for the two insurance companies after applying a small illiquidity premium) and rejected the taxpayer's expert's use of life settlement data (which reflected discount rates of 15% and 18%) because of the lack of transparency in that data.

Much more important in the ultimate valuation determination was the court's agreement with the IRS position assuming that the split dollar agreement would be ended following the decedent's death (three years after the estate tax return was filed) rather than much later at the sons' subsequent deaths. The taxpayer argued that no pre-arranged plan for early termination existed and that the policies would be retained until the sons' respective deaths. The court pointed to an inquiry by one of the sons 10 months after the decedent's death about cancelling the policies, but an attorney advised "that the IRS had three years to audit the estate tax return and insisted that the policies remain in effect until the IRS audit was settled." The court accepted the IRS's proposed termination date of three years after the estate tax return was filed. The court said that the "key factor in setting the December 31, 2013, maturity date [i.e., about three years after the estate tax return was filed] is the brothers' complete control over the split-dollar agreements.… [T]here are grounds for setting an earlier maturity date, but we will use respondent's date."

A significant factor in the court's reasoning is that the trusts that owned the policies could trigger the acceleration of the decedent's reimbursement rights by cancelling the policies, and one of the sons actually asked about cancelling the policies before the estate tax return was filed for the estate. Furthermore, the revocable trust left to each Dynasty Trust the decedent's interest in the reimbursement rights that were attributable to the policies owned by that trust. Changes in those facts might have led to a somewhat different outcome as to the termination date used for valuing the reimbursement rights considering that the assumed termination date was the biggest factor in the valuation of the reimbursement rights. But the judge's ultimate decision regarding the valuation issue appears colored by the court's "gut reaction" that the estate had grossly undervalued the rights. For example, the court rationalized that the decedent received adequate and full consideration for purposes of satisfying the bona fide sale for adequate and full consideration exception to §2036 and §2038 even though the immediate value of the reimbursement right was economically worth far less than the $29.9 million advance because of other nontax benefits the overall insurance and business succession plan achieved, but the court observed its agreement with the IRS "that a rational investor would not give up approximately $23 million in value to achieve the nontax purposes achieved through the split-dollar agreements." And in the discussion of penalties, the court made very clear its view of having the revocable trust "pay $30 million and [turn] it into $7.5 million for estate tax reporting purposes. They should have known that the claimed value was unreasonable and not supported by the facts."

(7) **Penalties.** The IRS revenue agent initially did not believe that an accuracy related penalty was appropriate, but his supervisor convinced him that the 40% gross valuation misstatement penalty under §6662(h) should be imposed. While reliance on professional advice may provide a reasonable cause defense if the reliance was reasonable and in good faith, the court reasoned that the estate's reliance on its professional appraisal was not reasonable (among other things, the court pointed out that the sons should have known that valuing a right to receive repayment of about $30 million (or more) at only $7.5 million "was unreasonable and not supported by the facts," and the appraiser lowered the value from his initial opinion following a review of the appraisal by the estate's attorney), and the estate did not rely on it in good faith. The harsh 40% penalty may deter taxpayers and planners from using intergenerational split dollar life insurance arrangements and claiming extremely large valuation discounts. *See* Kristen A. Parillo, *Tax Court Decision Could Chill Split-Dollar Arrangement*, TAX NOTES (June 9, 2021).

The court did not criticize the professional appraiser's credentials or experience as a professional appraiser. Indeed, the estate produced a second professional appraiser from a highly respected appraisal firm who also valued the reimbursement right at the trial and similarly valued the reimbursement right at far less than the court's determination. This factual situation is unlike that in *Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26, in which the court held that reliance on an appraisal did not meet the reasonable cause exception where the estate relied on an unsigned draft report by an accountant who had some experience preparing appraisals (having written 10-20 valuation reports) but did not have any appraiser certifications. This leaves taxpayers (and their planners) in the precarious position of having to determine the correctness of a professional appraisal that is based on technical analysis and is not just a summary estimate of value.

Morrissette II's approach as to penalties is contrasted with the approach in the recent *Estate of Michael Jackson* case (discussed in Item 15 above, in which the court held that reliance on a professional appraisal constituted reasonable cause even though the appraised value was miniscule compared to the court's determination of value ($2,105 vs. $4.15 million for the value of the decedent's image and likeness).

(8) **Decision Determining Deficiency.** On December 13, 2021, the court entered a Decision, based on calculations implementing its opinion to which the parties had agreed, determining an estate tax deficiency of $12,575,459.24 and an accuracy-related penalty of $3,232,339.89, both subject to interest. While the determined deficiency reflects estate tax values of the reimbursement

rights significantly higher than those asserted by the executors, the deficiency is significantly less than the approximately $39.4 million the IRS had asserted in its notice of deficiency.

b. *Estate of Levine v. Commissioner*.

(1) Synopsis. The fundamental background and issue in the case was summarized in the first paragraph of the opinion.

> Marion Levine entered into a complex transaction in which her revocable trust paid premiums on life-insurance policies taken out on her daughter and son-in-law that were held by a separate and irrevocable life-insurance trust. Levine's revocable trust had the right to be repaid for those premiums. Levine has since died, and the question is what has to be included in her taxable estate because of this transaction—is it the value of her revocable trust's right to be repaid in the future, or is it the cash-surrender values of those life - insurance policies right now?

The revocable trust would receive the greater of the advance ($6.5 million) and cash surrender value of the polices upon the death of the last to die of the insureds or upon the earlier termination of the agreement, which could be made solely by the life insurance trust. An investment committee, whose sole member was an unrelated long-time business associate, made investment decisions for the life insurance trust.

The issue was whether the gross estate included the approximately $6.2 million cash surrender value of the policies at the decedent's death (by reason of §2036, §2038, or §2703) or the approximately $2.2 million stipulated value of the reimbursement right.

The court determined that §2036(a)(1) did not apply -- the decedent did not retain anything because the decedent could not surrender the policies or terminate the split dollar arrangement. Sections 2036(a)(2) and 2038 also did not apply. Under the documents, the decedent had no right to the cash surrender values or to join with someone else in getting current access to the cash surrender values. But under general contract principles, all of the parties to a contract could amend it at any time; however, that was not sufficient to cause the decedent to have a right "in conjunction with" another to designate who could enjoy the property under §2036(a)2) or to alter, amend, or terminate the arrangement under §2038. The court relied on *Helvering v. Helmholz* (U.S. Sup.Ct. 1935) and *Estate of Tully v. United States* (Ct. Cl. 1976) to conclude that rights to modify contracts under general default rules of contract are not rights held "either alone or in conjunction with any other person" under §2036(a)(2) or §2038.

The specific facts of the case do not raise an "in conjunction with" §2036(a)(2) or §2038 power either. The powers of others who owed fiduciary duties to the decedent did not, in effect, give the decedent rights over the cash surrender values because they also had conflicting fiduciary duties to other beneficiaries. The court distinguished *Estate of Strangi* and *Estate of Powell*, which had held that a decedent's powers held in conjunction with other partners triggered §2036(a)(2). Those cases both distinguished *United States v. Byrum* (U.S. Sup. Ct. 1972), which determined that the fiduciary duties of a donor-shareholder to minority shareholders meant that a decedent's retained right to vote transferred stock did not cause estate inclusion under §2036(a)(2). The distinction is that in *Byrum* the decedent held fiduciary duties to other shareholders whereas in *Strangi* and *Powell*, the potential fiduciary duties were owed "essentially to himself." In *Estate of Levine*, fiduciary duties were owed to grandchildren who were beneficiaries of the life insurance trust in addition to decedent's children (who were also beneficiaries of the revocable trust).

Section 2703 did not apply to cause the reimbursement right to be valued at the current cash surrender value of the policies. Section 2703 determines the value of property without regard to certain restrictions. Section 2703 refers to restrictions on property held by the estate, which was the receivable, not the policies or cash surrender value under the policies. There were no restrictions on the receivable; it could be sold or transferred as desired by the revocable trust. The court did not view the inability to cause the immediate surrender of the policies and payment of the cash surrender value to the estate as a restriction on what was owned by the estate -- the receivable itself. *Estate of Levine v. Commissioner*, 158 T.C. No. 2 (February 28, 2022, Judge Holmes).

(2) **Basic Facts.** The decedent's revocable trust advanced $6.5 million of premiums under an intergenerational split dollar arrangement with an irrevocable life insurance trust that owned second-to-die policies on the lives of the decedent's daughter and her husband. The revocable trust was entitled to reimbursement of the advance upon the death of the last of the insureds or earlier upon the termination of the split dollar arrangement or the surrender of the policies by the life insurance trust. The revocable trust would receive the greater of the advance ($6.5 million) and cash surrender value of the polices upon the death of the last to die of the insureds or upon the earlier termination of the agreement.

If the irrevocable life insurance trust terminated the arrangement early, the revocable trust would have received the entire cash surrender value of the policies and the life insurance trust would have received nothing.

The life insurance trust had an investment committee that directed the trust's investment decisions, and the sole member of the investment committee was an unrelated long-time business associate who had a fiduciary duty to direct the investments prudently. (The business associate also was, together with the decedent's two children, an agent for the decedent under a power of attorney and a co-trustee of the revocable trust.)

The decedent reported a gift of $2,664 (as determined under the split-dollar regulations) upon making the advance, and the decedent's estate reported that the reimbursement right was valued at a little more than $2 million. The estate and IRS later stipulated that the value of the reimbursement right at the decedent's death was $2,282,195.

The IRS asserted that the cash surrender value of the policies at the decedent's death (about $6.2 million) should be in the gross estate under §§2036, 2038, or 2703 rather than just the stipulated value of the reimbursement right (about $2.28 million) and also asserted that the 40% gross undervaluation penalty applied.

The case is appealable to the Eight Circuit Court of Appeals.

(3) **Analysis.**

(a) **Split Dollar Regulation Does Not Determine Estate Tax Value.** Reg. §1.61-22 generally treats the amount transferred each year under a split dollar plan governed by the economic benefit regime as the cost of current life insurance protection in that year. However, that regulation applies for income and gift tax purposes, not for estate tax purposes.

(b) **Section 2036(a)(1).** Section 2036 (a)(1) includes the value of transferred property, except for a bona fide sale for full consideration, in which the decedent retained, directly or indirectly, the possession or enjoyment of, or the right to the income from the transferred property. The decedent had no right to force the early termination of the split dollar arrangement. Although the unrelated business associate who was the sole member of the investment committee (with the power to terminate the arrangement) was also a co-agent under the decedent's power of attorney, he could not surrender the polices as attorney-in-fact because the decedent could not do that directly. Therefore, the decedent did "not retain any right to possession or enjoyment of the property transferred."

(c) **Sections 2036(a)(2) and 2038.** The gross estate includes the value of transferred property, except for a bona fide sale for full consideration, in which the decedent, alone or in conjunction with any other person, retained the right to designate who would possess or enjoy the property or income from the property (§2036(a)(2)) or at death held the power to alter, amend, revoke, or terminate the enjoyment of the property (§2038).

An important factual difference from *Estate of Morrissette* and *Estate of Cahill*, is that in those cases the donor would have to act together with the owner of the polices to terminate the split agreement (and thereby receive the cash surrender value of the policy immediately), but in *Estate of Levine*, the insurance trust had the sole right to terminate the arrangement.

Under the documents, the decedent had no "sort of possession or rights to [the] cash-surrender values," and "if confined to the tiltyard defined by the transactional documents, we would have to conclude that section 2036(a) and 2038 do not tell us to include the policies' cash surrender values in the Estate's gross value."

That, by itself, does not necessarily mean the donor could not act in conjunction with others to terminate the agreement, because parties to a contract can always modify it. As a matter of law, though, the court states that the decedent does not hold a §2036(a)(2) or §2038 power merely because of the ability to amend the split dollar agreement under general contract law principles.

Helvering v. Helmholz, 296 U.S. 93 (1935) involved a transfer stock to a trust. The IRS argued that under state law the settlors of a trust with the consent of its beneficiaries may terminate the trust and revest the transferred property in the donor. A "persnickety textualist" may say that is a power in conjunction with others that would trigger §2036(a)(2) or §2038, but the Supreme Court in *Helmholz* held that

> [t]his argument overlooks the essential difference between a power to revoke, alter or amend, and a *condition* which the law imposes. The general rule is that all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust.

In *Estate of Tully v. United States*, 528 F.2d 1401 (Ct. Cl. 1976), decedent was a 50% shareholder. The corporation and decedent entered into a contract to pay a death benefit to the decedent's widow. Even though the beneficiary designation was irrevocable, the IRS argued that it could be amended for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary. The court concluded that the "in conjunction" language of §2038 "does not extend to powers of persuasion."

The court summarized, very strongly, that the mere power of parties to amend a contract under general default rules of contract is not enough to trigger §2036(a)(2) or §2038.

> We therefore agree with *Helmholz* and *Estate of Tully* that general default rules of contract—rules that might theoretically allow modification of just about any contract in ways that would benefit the IRS—are not what's meant in phrases like section 2036's "right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom," or section 2038's "power . . . by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power)." What's meant are rights or powers created by specific instruments. A more extensive reading, as the old Court of Claims noted in *Estate of Tully*, would swing a broadax to fell large swaths of estate and retirement planning that Congress meant to allow to stand.

The specific facts of the case do not raise an "in conjunction with" §2036(a)(2) or §2038 power either. The court addressed whether the powers of others in effect gave the decedent rights or powers over the cash surrender values under the specific facts involved. In particular, the unrelated business associate owed duties to the decedent under the power of attorney and also had fiduciary duties to beneficiaries of the insurance trust that owned the policies. In *Estate of Strangi* and *Estate of Powell* the court held that §2036(a)(2) triggered the inclusion of assets transferred to a limited partnership where the decedent could act with others. In *Strangi*, the decedent could act with others to dissolve a partnership and, through his son-in-law who was his agent under a power of attorney and general partner, could determine the amount and timing of distributions. Similarly, in *Powell*, the partners could act unanimously to dissolve the partnership.

Both of those cases distinguished *United States v. Byrum* (U.S. Sup. Ct. 1972), which determined that the fiduciary duties of a majority shareholder to minority shareholders meant that a decedent's retained right to vote transferred stock did not cause estate inclusion under §2036(a)(2). The Supreme Court also noted that an independent corporate trustee alone had the right to make trust distribution decisions. The distinction is that in *Byrum* the decedent

held fiduciary duties to *other* shareholders whereas in *Strangi* the potential fiduciary duties were owed "essentially to himself" and in *Powell* duties were "owed almost exclusively to decedent herself." In *Levine*, fiduciary duties were owed to grandchildren who were beneficiaries of the life insurance trust in addition to decedent's children (who were also beneficiaries of the revocable trust).

The IRS also argued that the decedent, through her agents, "stood on both sides of these transactions and therefore could unwind the split-dollar transactions at will." But the court noted that the unrelated business associate who held the power as the sole member of the investment committee of the insurance trust to terminate the agreement held fiduciary duties to beneficiaries (grandchildren) other than the beneficiaries of the revocable trust and those grandchildren would have received nothing if the business associate had terminated the arrangement early.

The court concluded with this analysis:

> We therefore find it more likely than not that the fiduciary duties that limit [the business associate]'s ability to cancel the life-insurance policies were not "illusory". It also persuades us that we cannot characterize his ability to unload the policies and realize their cash-surrender values as a right retained by Levine, either alone or in conjunction with [the business associate], to designate who shall possess or enjoy the property transferred or the income from it.
>
> We conclude that this precludes the inclusion of the cash-surrender values of the life-insurance policies in Levine's estate under section 2036(a)(2).

The court concluded that §2038 did not apply for the same reasons (which were not repeated by the court).

(d) **Section 2703.** The §2703(a) issue is whether restrictions on repayment rights under the split dollar agreement are treated as restrictions on the right to sell or use property that must be ignored in determining the value of property that has been transferred.

Section 2703(a) provides that the value of property is determined without regard to "any restriction on the right to sell or use such property." The court noted that the "property" referred to in §2703(a) is "property of an estate, not some other entity's property." Therefore, it could not refer to the life insurance policies that were owned by the life insurance trust and that were never owned by the decedent. The court concluded, very simply, that there were no restrictions on the receivable owned by the estate.

> The Estate argues that section 2703 applies only to property owned by Levine at the time of her death, not to property she'd disposed of before, or property like the insurance policies that she never owned at all. If the inability to surrender the life-insurance policies is considered a "restriction", it is not a restriction on any property rights held by Levine since she never owned the policies.
>
> ...
>
> The property we have to value here is the property in Levine's estate, which is the split-dollar receivable she held at the time of her death. There were no restrictions on *that* property. She could do with the receivable what she wanted. She was free to sell it or transfer it as she wished. One needs to remember that what the Estate valued on its return was the receivable owned by Levine in her Revocable Trust. Section 2703 is not relevant to the valuation of the receivable because Levine had unrestricted control of it. Section 2703 therefore does not apply.

(e) **Conclusion.** The court observed, in conclusion, that the overall effect is that the decedent made an extremely low gift and included in her estate only a fraction of the amount advanced to pay premiums. The weakness, the court concludes "lies in the calculation of the value of the gift between Levine and the Insurance Trust—the difference between the value that her Revocable Trust gave to the Insurance Trust and what it got in return. But the gift-tax case is not this estate-tax case." The court observed that the problem is with the gift valuation rule in the regulations and "the solution lies with the regulation writers and not the courts."

(4) **Observations.**

(a) **Typical Witty Judge Holmes Opinion.** Opinions by Judge Holmes invariably are very well written, clear , and easy to understand and are also very witty opinions. This opinion is no different. Take this paragraph as an example.

> But we do think he's correct that we also must avoid being so blinded by any formal gleam from the Estate's armor that we overlook some practical chinks that deals like this may have: Can the Commissioner dismount from purely legal or theoretical arguments and start wielding shorter, sharper weapons forged from the particular facts of particular cases?

(b) **Description of Facts.** The court described the transaction as part of the decedent's normal estate planning taking into consideration the client's unique family situation and not as an abusive transaction designed to save estate taxes. The results in an opinion can often be gleaned from the way a court describes the facts.

(c) **Stipulated Value of Receivable; No Enormous Discount.** Unlike in some prior cases, the value of the reimbursement right was not reported at pennies on the dollar. In *Cahill*, the decedent advanced $10 million toward the payment of premiums but reported the reimbursement right as having a value of only $183,700. The estate in *Levine* reported the reimbursement right at a discount (about $2 million vs. the $6.5 million advanced) but nothing like the 98% discount that was reported in *Cahill*. Would the court's general approach have been different if the estate had claimed a huge discount as in *Cahill*? Also, unlike the prior *Cahill* and *Morrissette* cases, the estate and IRS stipulated the value of the reimbursement right. In *Morrissette*, the court determined that §2036 and §2703 did not apply (because of the full consideration exceptions) but then valued the reimbursement right at a much higher value than proposed by the estate.

(d) **Significant Limitation of "In Conjunction With" Analysis**. The *Strangi, Powell,* and *Cahill* cases have applied a broad reach to the "in conjunction with" clause in §2036(a)(2) and §2038. Planners have noted that prior cases have placed some outer limits on how far the "in conjunction with" clause should be applied, and this court picks up on those cases. The court concludes from *Helmholz* and *Tully* that the ever-present right of parties to a contract to amend the contract will not by itself trigger estate inclusion.

(e) **Fiduciary Duties to Others is Critical; Different Beneficiaries of Insurance Trust and Revocable Trust.** *Strangi* and *Powell* distinguished the Supreme Court's fiduciary duty analysis in *Byrum* to find that the fiduciary duty of a party who acts in conjunction with the decedent does not shelter the estate from estate inclusion. In determining whether *Byrum* can be distinguished in a particular situation, *Levine* focuses on whether the fiduciary duty is illusory and in reality is just owed to the decedent and not to other parties. If so, the fiduciary duty is really no limitation at all on the fiduciary's ability to act in a way that would benefit the decedent.

For §2036 issues involving FLPs or LLCs, very important facts may be whether third parties are substantial owners of the entity and whether the third parties are different from the beneficiaries of the decedent's estate. For example, in *Levine*, the decedent's children were the beneficiaries of her revocable trust, but her grandchildren were also substantial beneficiaries of the life insurance trust. The court observed that as to the children, whether the insurance trust terminated the split dollar arrangement early just determined whether the children would benefit as beneficiaries of the revocable trust or as beneficiaries of the insurance trust. The presence of the grandchildren as beneficiaries of the insurance trust helped the court conclude that the fiduciary duties were not illusory.

(f) **Very Different Section 2703 Analysis Than in *Estate of Cahill*.** The *Levine* opinion did not point out that its analysis of the §2703 issue was markedly different than the analysis in *Estate of Cahill*. The court in *Cahill* concluded that §2703(a) applies, to disregard the irrevocable trust's ability to prevent an early termination of the agreement in valuing the reimbursement right, because the provision preventing the decedent from immediately withdrawing his advance was an agreement allowing the third party to acquire or use property at a price less than fair market value (§2703(a)(1)), and because the agreement significantly restricted the decedent's right to use his "termination rights" under the agreement (§2703(a)(2)).

The court in *Morrissette* adopted the *Cahill* reasoning. Three days after the entry of the *Cahill* decision, the Tax Court entered an Order in *Morrissette* on June 21, 2018 denying the taxpayer's motion for summary judgment that §2703(a) was inapplicable, observing that "the termination restriction prevented the decedent from terminating the split-dollar arrangements unilaterally and receiving repayment of the premium or, if greater, the policy's cash surrender value," and concluding that "[t]he restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2)." Order in Docket No. 4415-14 (June 21, 2018 (Judge Goeke).

The *Cahill* case analyzes §2703(a) in a broad manner in which many, if not most, multi-party arrangements may be subject to the general rule of §2703(a), and the determining issue will then be whether the §2703(b) exception applies.

The §2703(a) issue for split dollar arrangements generally is whether restrictions on repayment rights are treated as restrictions on the right to sell or use property that must be ignored in determining the value of property that has been transferred. A counter argument is that the right to the receivable under the terms of the split dollar contract is the very property being valued and the terms of the contract are not merely a restriction on the property transferred.

The key issue that arises in determining whether §2703(a) applies to any particular "property" is whether the property being tested under §2703(a) is an asset with inherent characteristics that impact its value or whether the property is an asset subject to some agreement or restriction that allows someone to acquire or use the asset at less than its fair market value or that restricts the right to use or sell the asset, which restriction must be ignored under §2703(a) in valuing the "property."

For example, is an automobile that has a governor limiting its maximum speed to 30 miles per hour valued as an under-30 MPH vehicle (with a minimal value), or is it valued as an automobile subject to a restriction on the right to its use because the governor restricts it from exceeding 30 MPH, which restriction must be ignored in valuing the automobile under §2703(a)?

A step removed from ignoring contractual restrictions in entity agreements, and perhaps a small step removed from the *Cahill* §2703(a) analysis, is a notion that any restriction on a person's ability to acquire the maximum possible value under a contract would be viewed as a §2703(a) restriction. The §2703(a) analysis in *Cahill* could lead to a general treatment of any contractual limitation on achieving maximum value as a §2703(a) agreement or restriction, with the key issue being whether the §2703(b) exception requirements are satisfied.

Fortunately, the *Levine* analysis approaches the §2703 issue in a much more straight-forward manner and just reasons that there is no restriction on the estate's ability to sell or transfer its reimbursement right and that §2703 does not apply.

(g) **Discounted Estate Tax Value May Just Represent a Tax Deferral; Income Tax Effects.** The taxpayer in *Estate of Levine* emphasized that discounting the value of the reimbursement right may merely result in a deferral of taxes. The basis of the reimbursement right would be the finally determined discounted estate tax value, but when the reimbursement right is satisfied, the difference between the amount paid and the basis of the reimbursement right would be income. The income probably would be ordinary income; for example, §§1271-1276 deal with original issue discount (OID) by requiring the debt holder to take any discount into income as ordinary income, not as capital gain. *See Hudson v. Commissioner*, 20 T.C. 734 (1953), *aff'd sub. nom. Ogilvie v. Commissioner*, 216 F.2d 748 (6th Cir.1954).

A gift or bequest to the obligee in satisfaction of the obligation may not trigger discharge of indebtedness income. *See Helvering v. American Dental*, 318 U.S. 322 (1943) (interpreting predecessors to §§102 and 61); *Bosse v. Commissioner*, T.C. Memo. 1970-355 (§102 applied because forgiveness was gratuitous); Letter Rul. 9240003 (cancellation of debt by lender in lender's will was not discharge of indebtedness income but in the nature of a testamentary

bequest excludable under §102). However, bequeathing the reimbursement claim to the obligee might impact the estate tax valuation of the reimbursement right.

17. Conservation Easements – Savings Clause Rejected in Conservation Easement Cases, *TOT Property Holdings, LLC v. Commissioner* (And Others); Judicial Extinguishment Proceeds Regulation Invalid Because It Did Not Satisfy Procedural Requirements of the Administrative Procedures Act, *Hewitt v. Commissioner*, 128 AFTR 2d 2021-7033 (11th Cir. December 29, 2021)

a. Synopsis of *TOT Property Holdings, LLC v. Commissioner*. In a case reminiscent of the *Belk v. Commissioner* Fourth Circuit Court of Appeals case seven years ago, the Eleventh Circuit has similarly rejected a savings clause as an impermissible "condition subsequent" clause (citing *Commissioner v. Procter*) in a conservation easement case, with an extended discussion of savings clauses. The court concluded that the easement did not satisfy the "protected in perpetuity" requirement of §170(h)(5)(A) because upon termination or extinguishment of the easement, the grantee would receive an amount reduced by the increase in value of the easement after the grant attributable to improvements, which is inconsistent with the regulations. The taxpayer argued that several clauses in the easement deed overrode extinguishment payment provision to the extent required by regulations. The last phrase of the extinguishment clause provided that the payment proceeds be "determined in accordance with Section 9.2 **or 26 C.F.R. Section 1.170A-14, if different**." Section 9.2 (which provided how the payment amount would be calculated) concluded as follows: "It is intended that this Section 9.2 **be interpreted to adhere to and be consistent with 26 C.F.R. Section 1.170A-14**." These savings clauses were referred to by the court as the "Treasury Regulation Override." The court also upheld substantial taxpayer penalties. *TOT Property Holdings, LLC v. Commissioner*, 127 AFTR 2d 2021-2420 (11th Cir. June 23, 2021).

The court emphasized the difference between clauses that merely assist in interpreting operative provisions in a deed or other agreement (which are taken into consideration for tax purposes) and clauses that impose a condition subsequent – a subsequent IRS or court determination that the provision in the deed would be inconsistent with regulations -- and are not respected for tax purposes. The court relied primarily on two Fourth Circuit Court of Appeals cases in its analysis, *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014), and *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). The court observed that in *Belk*,

> The Fourth Circuit held that the clause was unenforceable because it rested on a future occurrence to save the deed and deduction and amounted to an "ask . . . to 'void' the offending . . . provision to rescue the[ ] tax benefit." Id. There was also "no open interpretive question for the savings clause to 'help' clarify." Id. at 230. Instead, the Belks hoped for the court to rewrite their easement deed where — if their intent had truly been as they said — they would have written the deed to be compliant with the applicable regulations in the first place. Id. "[T]o apply the savings clause as the Belks suggest[ed]" would be "sanctioning the very same 'trifling with the judicial process' [the court] condemned in" the second of our guiding Fourth Circuit cases (discussed next), and would lead to the "dramatic[ ] hamper[ing] [of] the Commissioner's enforcement power" and tax collection "grind[ing] to a halt." Id. (citation omitted).

The court also relied on *Procter*, which refused to give effect to a clause that would reduce the amount of a gift if a court of last resort determined any part of the transfer was subject to gift tax

> because the only way a gift tax could be assessed was by way of collection and court proceedings, and the above-quoted clause, if valid, would operate to nullify any such proceedings. Id. Such a condition subsequent was void as "contrary to public policy." Id. "It is manifest," explained the court, "that a condition which involves this sort of trifling with the judicial process cannot be sustained." Id. Thus, the clause impermissibly contained a condition subsequent that attempted to save the assignment from taxation and was unenforceable. Procter reasoned that the clause "ha[d] a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat" the attempt. Id. The Fourth Circuit also held that "the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case" since "the only possible controversy" would be "the validity of the" clause's operation "between the donor and persons not before the court." Id.

The taxpayer argued that the Override provisions in the easement deed were not conditioned on any adverse action by the IRS or a court, so the Override clauses were interpretive provisions that should be recognized for tax purposes. The court disagreed because "whether Section 9.2 is 'different' from

§1.170A-14(g) or whether Section 9.2's formula can be interpreted as consistent with the regulation are questions that only the IRS or a court can determine."

In summary, the court held that the Override provisions are unenforceable savings clauses, not merely interpretive provisions "because the formula in Section 9.2 is unambiguous, the Override nullifies it, and it does so only in the event of some future occurrence."

b. **Similar Cases.** Other conservation easement cases have reasoned similarly. *E.g.*, *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019); *Pine Mountain Preserve, LLLP v. Commissioner*, 51 T.C. 247 (2018); *Palmolive Building Investors, LLC v. Commissioner*, 149 T.C. 380 (2017); *Railroad Holdings LLC v. Commissioner,* T.C. Memo. 2020-22; *Carter v. Commissioner*, T.C. Memo. 2020-21.

For a discussion of the court's analysis in *Coal Property Holdings, Belk,* and other savings clauses cases, see Item 37 of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. For a summary of *Railroad Holdings* see Item 39.b. of Heckerling Musings 2020 and Estate Planning Current Developments (August 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

c. **Guidance From IRS Chief Counsel.** Chief Counsel Advice 202130014 (July 30, 2021) discusses extinguishment clauses that remove post-donation increases in property value in the charity's share of proceeds if a conservation easement is extinguished. Chief Counsel Memorandum AM 2020-01 (March 27, 2020), provides that an amendment clause in an easement does not necessarily violate the requirements of §170(h), but the amendment clause must be considered in the context of the deed as a whole and the surrounding facts and circumstances. The Memorandum provides an example of a permissible amendment clause.

d. **Application to Defined Value Clauses and Savings Clauses Generally.** These cases are interesting regarding their discussion of savings clauses generally and their strict rejection of clauses that change results after the fact based on court or IRS determinations. For a discussion of the application of these cases to defined value clauses and savings clauses generally, see Item 21.e.-f. of Estate Planning Current Developments and Hot Topics (December 2020) found here and Item 39.e. of Heckerling Musings 2020 and Estate Planning Current Developments (August 2020) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

e. **Analysis of Status of Intense Attack on Conservation Easements.** For a review of the status of the extensive case law developments regarding the "proceeds regulation," see Nancy A. McLaughlin, *Conservation Easements and The Proceeds Regulation*, 56 REAL PROP., TRUST & EST. LAW J. (Summer 2021). For an analysis of the 26 (26!! – talk about an area of intense IRS focus) decided conservation easement cases in 2020, see Ronald D. Aucutt, The Top Ten Estate Planning and Estate Tax Developments of 2020 (January 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights).

f. **Validity of the "Protected-in Perpetuity" Regulation (At Least Regarding Improvements).** The latest development in the conservation easement "protected-in-perpetuity" requirement under the judicial extinguishment proceeds regulation (Treas. Reg. §1.170A-14(g)(6)(ii), which is intended to assure that easement donations comply with the "protected-in-perpetuity" requirement in §170(h)(5)), is whether the regulation is valid (at least as to improvements). The Sixth and Eleventh Circuits have recently reached opposite results as to that issue.

(1) ***Hewitt v. Commissioner*, Eleventh Circuit.** The Eleventh Circuit Court of Appeals held that the prohibition of subtracting the value of post-donation improvements in determining the portion of extinguishment proceeds attributable to the easement is arbitrary and capricious and violates the procedural requirements of the Administrative Procedures Act (APA). *Hewitt v. Commissioner*, 128 AFTR 2d 2021-7033 (11th Cir. December 29, 2021).

One of the statutory requirements for rulemaking under the APA is that the agency promulgating a rule "must consider and respond to significant comments received during the period for public

comment." Of 90 commenters on the conservation easement regulations, 13 offered comments about the proposed extinguishment proceeds regulation, and seven specifically expressed concern that the process under the proceeds regulations "was unworkable, did not reflect the reality of the donee's interest, or could result in an unfair loss to the property owner and a corresponding windfall for the donee." The most detailed comment by the New York Landmarks Conservancy (NYLC) specifically addressed inequities about applying the proposed regulation to post-donation improvements. The court observed that Treasury stated that it had "consider[ed] ... all comments regarding the proposed amendments," but in the "Summary of Comments" section "Treasury did not discuss or respond to the comments made by NYLC or the other six commenters concerning the extinguishment proceeds regulation." Id. Instead, the court observed that Treasury "simply stated that it had considered 'all comments.'"

> Because Treasury, in promulgating the extinguishment proceeds regulation, failed to respond to NYLC's significant comment concerning the post-donation improvements issue as to proceeds, it violated the APA's procedural requirements. ... We thus conclude that the Commissioner's interpretation of § 1.170A-14(g)(6)(ii), to disallow the subtraction of the value of post-donation improvements to the easement property in the extinguishment proceeds allocated to the donee, is arbitrary and capricious and therefore invalid under the APA's procedural requirements.

The analysis of whether the regulation (and the IRS's interpretation of the regulation to bar subtracting improvements from the reimbursement calculation) satisfies the requirements of the APA to be a valid regulation is very interesting. Whether a Treasury regulation satisfies the procedural requirements of the APA does not often arise in reported cases. The Supreme Court has interpreted Section 553 of the APA to prescribe a three-step procedure for "notice-and-comment" rulemaking. *Perez v. Mortg. Bankers Ass'n*, 575 U.S. 92, 96 (2015). First, the agency must issue a general notice of proposed rulemaking. Second, the agency must give interested persons an opportunity to participate through submission of views, and the Supreme Court has interpreted this requirement in *Perez* to include that the agency "must consider and respond to significant comments received during the period for public comment." Third, in promulgating the final rule, the agency must include in the rule's text "a concise statement of its basis and purpose." 5 U.S.C. §553(c).

The Tax Court held that the regulation was procedurally valid, relying on its decision in *Oakbrook Land Holdings, LLC v. Comm'r*, 154 T.C. 180 (2020). *Oakbrook* is discussed in Item 17.f(2) below.

A concurring opinion in *Oakbrook* by Judge Toro reasoned that the regulation was procedurally invalid if it is interpreted to bar the subtraction of post-donation improvements. The *Hewitt* appellate opinion includes a detailed summary of Judge Toro's concurring opinion in *Oakbrook*.

> Judge Toro explained that the "Treasury received more than 700 pages of comments" during the comment period and that, in the final regulations, Treasury responded to those comments and other administrative matters in just two of the twelve pages—"six columns in the Federal Register"—consisting of the final regulations. *Id.* at 221. In his view, it was likely that Treasury "was simply following its historical position that the APA's procedural requirements did not apply to these types of regulations," noting that the final regulations referenced Treasury's belief that they did not require notice and comment and that this belief was mistaken. *Id.* at 222.
>
> Judge Toro then found that the "Treasury failed to 'respond to "significant points" and consider "all relevant factors" raised by the public comments.'" *Id.* at 223 ... The proposed regulations' preamble explained that they reflected Congress's "major policy decisions," and NYLC "in effect countered that the proposed rule on future donor improvements was contrary to those policy decisions, would lead to inequitable results that were inconsistent with the statute, and would deter future contributions." *Id.* at 225 (quoting 48 Fed. Reg. at 22,940). In other words, Judge Toro found that NYLC "offered comments that, 'if adopted, would require a change in an agency's proposed rule,'" and that "were both 'relevant and significant,' [as to] require[e] a response." *Id. ...*
>
> ... Judge Toro also explained that the *Oakbrook* majority's reasoning as to the issue was flawed for several reasons. He explained that courts were "not required to 'take the agency's word that it considered all relevant matters,'" as the majority asserted. *Id.* at 226–27 (quoting *PPG Indus., Inc. v. Costle*, 630 F.2d 462, 466 (6th Cir. 1980)). He further noted that "[a] 'relevant and significant comment' requires a response, regardless of whether the point is made by many, a few, or even a single commenter," and "a comment does not lose its significance because it is presented succinctly." *Id.* at 227 (quoting *Carlson*, 938 F.3d at

> 347). And, if the scope of the project "was too large to permit an appropriate response to all 'relevant and significant comments,' then Treasury could have broken the project down into smaller parts." *Id.*

The *Hewitt* opinion also pointed to reasons given by a dissenting opinion in *Oakbrook*.

> In his dissenting opinion, Judge Holmes reached a similar conclusion to Judge Toro on the regulation's procedural invalidity under the APA. He concluded that comments from NYLC and other organizations "were significant and [were] entitled to an agency response." See id. at 245 (Holmes, J., dissenting). Judge Holmes explained that Treasury's statement that it considered "all comments" was not sufficient under the APA .... Treasury failed to "even acknowledge the relevant comments or expressly state its disagreement with them" such that there was not even "a minimal level of analysis." Id. at 248 (quoting Encino Motorcars, 579 U.S. at 2120).

Commentators have emphasized the significance of this case as representing "one of the few successful challenges to a Treasury regulation on procedural grounds." Miller & Chevalier Tax Alert, In Case You Missed It: Hewitt v. Commissioner Has Broken New Ground in Disputes Over Conservation Easements (January 19, 2022), available at https://www.millerchevalier.com/publication/case-you-missed-it-hewitt-v-commissioner-has-broken-new-ground-disputes-over.

> Treasury and the IRS were long considered immune from the APA's requirements, but the trend has shifted in recent years. We expect that this trend could continue, and we may continue to see more challenges to Treasury and IRS agency determinations in appropriate cases. Miller & Chevalier Tax Alert (January 19, 2022).

(2) **Oakbrook Land Holdings, LLC v. Commissioner; Sixth Circuit.** The Tax Court held that the regulation was procedurally valid not only in *Hewitt* but also in *Oakbrook Land Holdings, LLC v. Comm'r*, 154 T.C. 180 (2020). The Tax Court opinion included a detailed analysis of why the regulation was procedurally valid regarding the requirement that a proportionate share of post-donation improvements be shared with the easement holder if the easement was extinguished. Included in that analysis was a statement that "[t]he APA 'has never been interpreted to require the agency to respond to every comment, or to analy[z]e every issue or alternative raised by the comments, no matter how insubstantial.'" (quoting *Thompson v. Clark*, 741 F.2d 401, 408 (D.C. Cir. 1984)). The Tax Court majority opinion in *Oakbrook* also observed that "[o]nly one of the 90 commenters"— NYLC—"mentioned donor improvements, and it devoted exactly one paragraph to this subject." The majority opinion in *Oakbrook* also refuted an objection to the regulation because the conservation easement regulations did not include a "basis and purpose "statement specifically regarding the judicial extinguishment provision of the regulations. It reasoned that a regulation does not need to include a statement of the basis and purpose "where the basis and purpose... [are] considered obvious." Furthermore, the judicial extinguishment provision is a very small provision in the lengthy regulations and the APA did not "mandate that an agency explain the basis and purpose of each individual component of a regulation separately."

The Sixth Circuit Court of Appeals affirmed the Tax Court and upheld the validity of the "in perpetuity" regulation. 129 AFTR 2d 2022-XXXX (6th Cir. March 14, 2022). A majority of the three-judge panel upheld the validity of the regulation, but the third judge in a concurring opinion reasoned that the regulation was invalid. The majority agreed with the Tax Court that the very concise statement of basis and purpose of the regulation was sufficient and that the comments, including the comment by the NYLC mentioning donor improvements, do not raise valid concerns about how the regulation served the policy of restricting the conservation easement deduction to where the easement's purpose can be protected forever and "do not qualify as significant;" therefore, the comments do not require a response under the APA. The NYLC's comment "left Treasury to guess at the connection, if any, between the organization's problems and the proceeds regulation's basis and purpose." The Sixth Circuit specifically found the Eleventh's Circuit's reasoning in *Hewitt* "to be unpersuasive."

A concurring opinion by Judge Guy concluded that the in-perpetuity regulation is procedurally invalid under the APA

> for substantially the same reasons stated by the Eleventh Circuit in *Hewitt v. Commissioner of IRS*, 21 F.4th 1336 (11th Cir. 2021), and by the concurring and dissenting opinions in *Oakbrook Land Holdings, LLC v.*

Commissioner of IRS, 154 T.C. 180, 200-30 (2020) (Torro, J., concurring in the judgment, joined in full by Urda, J., and joined in part by Gustafson and Jones, JJ.); *id.* at 230-259 (Holmes, J., dissenting).

18. Estate Tax Value of Shares Included Proceeds of Corporate-Owned Life Insurance to Fund Buy-Sell Agreement; Buy-Sell Agreement Did Not Meet §2703(b) Safe Harbor or Other Requirements to Fix Estate Tax Value, *Connelly v. U.S.*, 128 AFTR 2d 2021-5955 (E.D. Mo. September 2, 2021).

a. **Synopsis.** A buy-sell agreement required that a company purchase a decedent's shares of a corporation owned by two brothers. The pricing provision called for the parties to agree annually on the company value, and if an annual value had not been agreed on, the price would be determined by securing two or more appraisals (that would not consider control premiums or minority discounts). The company funded the agreement with life insurance policies on the two brothers' lives. The brothers never entered into any agreement about the company value and on the death of the brother owning about 77% of the company, the estate and the company did not comply with the appraisal requirement in the agreement but agreed to pay the estate $3 million (using part of the $3.5 million of life insurance proceeds paid to the company) (as well as providing other benefits for the deceased brother's son).

The estate reported the shares at about $3 million, but the IRS assessed an additional $1 million of estate tax, maintaining the $3.5 million of life insurance proceeds should have been taken into consideration in setting the value. The estate paid the additional estate tax and sued for a refund. The parties stipulated that the value of the decedent's shares was $3.1 million if the life insurance proceeds were not considered, and the only issue was whether the life insurance proceeds should be considered in determining the value of the shares for estate tax purposes.

The court determined that the buy-sell agreement did not fix the value of the shares. First, it did not satisfy the §2703(b) safe harbor; although the agreement met the bona fide business purpose test it failed to meet the device test (because the purchase price did not include the life insurance proceeds in determining the company's value, the *process* of selecting the redemption price indicates the agreement was a testamentary device, and the agreement prohibited considering control premiums or minority discounts) and the comparability test (the estate "failed to provide any evidence of similar arrangements negotiated at arms' length"). Second, the agreement did not satisfy requirements recognized by various courts for buy-sell agreements to fix estate tax values: the agreement did not provide a fixed and determinable price; it was not binding at death (evidenced by the fact that its procedures were not followed); and it was a substitute for a testamentary disposition for less than full consideration.

Having determined that the agreement did not fix the estate tax value of the decedent's shares, the court determined the value of the stock without regard to the agreement. The court concluded that the life insurance proceeds should be considered, disagreeing with the Eleventh Circuit's rationale in *Estate of Blount v. Commissioner* that the contractual obligation of a company to purchase a decedent's shares offset the life insurance proceeds on the decedent's life paid to the company. A hypothetical willing buyer of a company would not factor the company redemption obligation into the value of the company because the buyer would merely be obligated to redeem the shares the buyer then held, and "the buyer would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The taxpayer's request for a refund was denied. *Connelly v. United States of America, Department of the Treasury, Internal Revenue Service*, 128 AFTR 2d 2021-5955 (E.D. Mo. September 2, 2021).

b. **Basic Facts.** Two brothers owned an operating business (Michael owned about 77% and Thomas owned about 23%). As is typical for family businesses, they entered into a buy-sell agreement regarding the purchase of shares at the death of a brother. The surviving brother had an option to purchase the shares, but if he chose not to do so, the company would be required to purchase the shares. The company purchased life insurance on each of the brothers' lives (including a $3.5 million policy on Michael's life) to fund the purchase agreement.

The purchase price would be determined under a two-step process. First, the brothers "shall, by mutual agreement, determine the agreed value per share by executing a new Certificate of Agreed

Value" at the end of every year. Second, if they failed to do so, the "Appraised Value Per Share" would be determined by securing two or more appraisals.

The brothers never signed a single Certificate of Agreed Value. One brother died on October 1, 2013, Michael, who owned about 77% of the shares. The other brother, Thomas, chose not to purchase the shares, so the company purchased the shares, using $3 million of life insurance proceeds on Michael's life to fund the purchase price. The parties did not obtain appraisals, as required by the agreement, but Thomas and Michael's estate agreed (1) the estate would receive $3 million cash (from the life insurance proceeds), (2) Michael's son had a three-year option to purchase the company for $4,166,666, and (3) if Thomas sold the company within 10 years, Thomas and Michael's son would split evenly any gains from the sale.

The estate reported the value of Michael's shares at $3 million, but the IRS asserted that the value of Michael's shares should also include the value of the $3 million of life insurance proceeds that were used to redeem the shares as a corporate asset and assessed "over $1 million in additional taxes." (The estate tax rate for decedents dying in 2013 was 35%, and $3 million times 35% is $1,050,000. Apparently, that is how the IRS assessed the "over $1 million" amount, but that is not made clear in the opinion.)

During the audit, the estate obtained an appraisal of the decedent's shares from an accounting firm. The appraisal reasoned that the buy-sell agreement created "an enforceable obligation to use the life-insurance proceeds to purchase" the decedent's stock and that, pursuant to the holding in *Estate of Blount v. Commissioner* (428 F.3d 1338 (11th Cir. 2005)), the life insurance proceeds should be excluded in determining the value of the company.

The estate paid the tax and sued for a refund of over $1 million. The estate and the IRS stipulated that if the life insurance proceeds should not be considered in determining the value of the shares, the value of the decedent's shares was $3.1 million. The only remaining issue was whether the life insurance proceeds received by the corporation as a result of the decedent's death should be considered in determining the value of the estate's shares.

c. Court Analysis.

(1) Estate Tax Value of the Shares Is Not Fixed Pursuant to the Buy-Sell Agreement.

(a) Section 2703(b) Safe Harbor Does Not Apply. Under §2703(a), the value of property is determined without regard to an agreement to acquire property at less than fair market value or any restriction on the right to sell the property. The court stated that a buy-sell agreement must meet the three statutory requirements of the §2703(b) safe harbor to control the value of a decedent's property for estate tax purposes –

a. It is a bona fide business arrangement;

b. It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and

c. Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

i. Bona Fide Business Arrangement, §2703(b)(1). The parties stipulated that the purpose of the buy-sell agreement was to ensure continued family ownership of the company, and the court held that was sufficient to satisfy the bona fide business arrangement requirement.

ii. Device to Transfer Property to Family for Less than Full and Adequate Consideration, §2703(b)(2). The court acknowledged that the brothers' good health when they executed the buy-sell agreement weighed in favor of the estate's position that the agreement satisfied the device test, but the court reasoned that the agreement did not satisfy the "device" test for three reasons. (a) The $3 million redemption price was not full and adequate consideration; that purchase price did not include the life insurance proceeds in determining the company's value. (b) The *process* of selecting the redemption price

indicates the agreement was a testamentary device. The parties to the purchase excluded a significant asset (the life insurance proceeds) in determining the valuation of the company, failed to obtain an outside appraisal or professional advice in setting the redemption price, and disregarded the appraisal requirement in the buy-sell agreement. (c) The agreement specified that appraisals would not take into consideration control premiums or minority discounts, which led to undervaluing substantially the estate's 77% of the company and overvaluing Thomas's 23% of the company.

iii. **Comparability Test, §2703(b)(3).** The report and testimony of the taxpayer's appraiser was not persuasive regarding the exclusion of life insurance proceeds in determining the company's value because it merely relied on *Estate of Blount*. Also, the failure of the parties to comply with the detailed valuation mechanism in the buy-sell agreement suggests that the agreement and its valuation mechanism were not comparable to similar arms' length agreements. The estate "failed to provide any evidence of similar arrangements negotiated at arms' length. That closely-held family corporations generally use life-insurance proceeds to fund redemption obligations does not establish that this particular Stock Agreement was comparable to an arm'- length bargain, particularly when the $3 million valuation was so far below fair market value." In addition, the prohibition in the agreement of considering control premiums or minority discounts raises question as to whether the agreement is comparable to similar arrangements negotiated at arms' length.

(b) **Additional Requirements Under Regulations and Case Law Not Satisfied.** Various cases have recognized several requirements for a buy-sell agreement to determine the price that will be recognized for estate tax purposes. These requirements are also embodied in Reg. §20.2031-2(h). The court summarized these requirements as follows.

> (1) the offering price must be fixed and determinable under the agreement; (2) the agreement must be legally binding on the parties both during life and after death; and (3) the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition for less than full-and-adequate consideration.

i. **Fixed and Determinable Offering Price.** The price was not determined under the agreement. The parties did not follow either of the two steps in the pricing mechanism in the agreement. "Instead they completely disregarded the Stock Agreement and negotiated their own value, which not surprisingly was less than the value of the life-insurance proceeds." The $3 million price "has no mooring in the Stock Agreement."

ii. **Binding During Life and Death.** The IRS argued that the agreement was not binding during life and at death because (1) the brothers ignored their obligations to value the company each year during their lives, (2) they ignored the pricing mechanism in the agreement, and (3) they agreed to allow the decedent's son to retain a profits interest in the company and to split evenly any gains from a future sale of the company, so the $3 million redemption price did not actually account for the decedent's entire interest in the company.

The court concluded that the failure to agree annually on the company's value was not dispositive in finding the agreement did not apply during life, but "[t]he parties own conduct demonstrates that the Stock Agreement was not binding after Michael's death." The estate argued that the pricing mechanism in the agreement "was only meant to determine the value of the shares if the parties disagreed over the value," but the court pointed out that the agreement repeatedly used the word "shall" in describing the pricing requirements under the agreement. The court also pointed to the windfall effect to a surviving shareholder if life insurance proceeds paid to a company are not considered in determining the value of the decedent's interest in the company.

iii. **Bona Fide Business Reason and Not Substitute for Testamentary Disposition for Less Than Full and Adequate Consideration.** As discussed previously in the §2703(b) analysis,

the court reiterated that while the agreement was a bona business arrangement it was a substitute for a testamentary disposition for less than full and adequate consideration.

(c) **Summary Regarding Agreement.** Accordingly, the buy-sell agreement did not require that the redemption price under the parties' agreement after the decedent's death fixed the estate tax value of the decedent's shares.

(2) **Determination of Fair Market Value.** Because the buy-sell agreement did not control the value of the decedent's shares, the court determined the fair market value of the shares. Under the stipulation of the IRS and the estate, the only issue was whether the life insurance proceeds paid to the company at the decedent's death should be considered in valuing the decedent's shares.

The estate's primary argument was based on the Eleventh Circuit's opinion in *Estate of Blount*. The court in that case held that the fair market value of a closely-held corporation did not include life insurance proceeds used to redeem the shares of a deceased shareholder under a stock purchase agreement. The court summarized the *Blount* holding and rationale:

> The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life insurance proceeds. [Citation omitted] The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate."

The court in *Connelly* disagreed with the Eleventh Circuit's analysis, preferring the reasoning of the Tax Court in *Blount*: a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued."

The court pointed out that a hypothetical willing buyer purchasing a company subject to a redemption obligation would not reduce the value of the company by the redemption obligation "because with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation." The buyer would merely be obligated to redeem the shares the buyer then held, and "the buyer would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The court observed that "construing a redemption obligation as a corporate liability only values [the company] post redemption (i.e., excluding Michael's shares), not the value of [the company] on the date of death (i.e., including Michael's shares)."

The court reasoned that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." The court concluded that the IRS's assessment of "over $1 million" (apparently by applying the 35% estate tax rate to the $3.0 million of life insurance proceeds used to redeem the estate's shares) had not been established to be an incorrect determination, and the estate was not entitled to a refund.

> Because the insurance proceeds are not offset by [the corporation's] obligation to redeem Michael's shares, the fair market value of [the corporation] at the date of date of [*sic*] death and of Michael's shares includes all of the insurance proceeds. Therefore, based on the undisputed facts in the record, the Estate failed to prove that the IRS's tax determination is incorrect and that it is entitled to a tax refund.

d. **Observations.**

(1) **Result of Considering Corporate-Owned Life Insurance Is Not Surprising.** Taking into consideration the life insurance proceeds received by a company at the decedent's death in valuing the decedent's interest in the corporation for estate tax purposes is not at all surprising. At a minimum, outside the Eleventh Circuit and perhaps the Ninth Circuit *Connelly* highlights that corporate-owned life insurance used to fund buy-sell agreements may be considered in some manner in determining the value of a decedent's shares.

Some commentators maintain that corporate-owned life insurance that is used to fund a buy-sell agreement should not be included in determining the value of the company. Among the reasons given are (1) including life insurance as a corporate asset should be offset by the obligation to redeem stock because the value of the company actually decreases after the life insurance proceeds are used to redeem stock (though the value per share of the remaining shareholders as

a result of the stock purchase should not be diminished), (2) the bargained purchase price between unrelated or even related parties should be recognized (though the IRS has historically viewed with "heightened scrutiny" purchase agreements between related parties), (3) including life insurance in the value would increase the amount of life insurance coverage required to fully fund the purchase price, and (4) including life insurance proceeds received after the decedent's death is an unwarranted expansion of §2042 (though prior cases have consistently addressed whether corporate-owned life insurance received after the decedent's death should be included in some manner in determining the value of the corporation without any application of §2042). *See* Paul Hood & Ed Morrow, *Are Redemption Buy-Sell Agreements Using Life Insurance Still Effective After Connelly v. United States*, LEIMBERG BUSINESS ENTITIES NEWSLETTER (February 23, 2022).

(2) **Manner of Considering Corporate-Owned Life Insurance in Determining Value of Decedent's Shares.** The lack of detail in *Connelly* regarding how life insurance proceeds were considered in determining the value of the decedent's shares raises questions about whether the IRS's approach was appropriate. For a strong criticism of *Connelly's* analysis of the impact of the corporate-owned life insurance on the value of the decedent's shares, see Paul Hood & Ed Morrow, *Are Redemption Buy-Sell Agreements Using Life Insurance Still Effective After Connelly v. United States*, LEIMBERG BUSINESS ENTITIES NEWSLETTER (February 23, 2022); Steve Seel & Dan Griffith, *Connelly v. IRS: Casting Shadow Agreements*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #246 (January 18, 2022);

The corporation received $3.5 million of life insurance proceeds following Michael's death. The IRS apparently did not simply add $3.5 million to the value of the decedent's shares, because $3.5 million times 35% would have been $1,225,000, not "over $1 million." Adding $3 million to the value of the estate's shares (resulting in an additional $1,050,000 of estate tax at a 35% rate) appears to be what the IRS did, and that seems questionable (or at least perplexing) for various reasons.

(a) **Effect of Considering Life Insurance Proceeds in Determining Value.** If a buy-sell agreement does not effectively fix the estate tax value of the stock, the corporate insurance proceeds should be considered as a factor in determining the corporation's value, and the proceeds should **not merely be added to the value of the corporation** determined without regard to the proceeds. *See Estate of John L. Huntsman*, 66 T.C. 861, 872-76 (1976), *acq*. 77-1 C.B. 1 ("determine fair market value … by giving 'consideration' to the insurance proceeds"); *Newell v. Commissioner,* 66 F.2d 102, 103-04 (7th Cir. 1933) (key man shareholder's estate established that stock increase was offset by decrease in corporation's value caused by the loss of a key man). For example, if a corporation is valued primarily based on its ability to produce income, having additional cash as an asset of the entity may not produce dollar-for-dollar additional value (or indeed may not add any additional significant value). Reg. §20.2031-2(f)(2) ("consideration should also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity").

(b) **Cash Surrender Value vs. Death Proceeds.** Before the moment of death, the corporation is entitled to the cash surrender value of the policy, but the moment after the death, the corporation is entitled to the death proceeds. Which amount should be considered in determining the value of a decedent's shares? Even cases relied on by the estate in *Connelly* had recognized that the life insurance death proceeds, and not just the cash surrender value, payable to a corporation at the decedent's death should be considered in valuing the decedent's interest in the corporation (although those cases ultimately determined that the life insurance proceeds were offset by liabilities). *Estate of Blount v. Commissioner* (428 F.3d 1338 (11th Cir. 2005); *Estate of Cartwright v. Commissioner*, 183 F.2d 1034 (9th Cir. 1999); see Reg. §20.2031-2(f)(2) ("consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company").

(c) **$3.5 Million vs. $3.0 Million.** The corporation actually received $3.5 million of death proceeds after the decedent's death, but the IRS apparently just took into consideration $3.0 million of the insurance proceeds that were used to redeem the estate's shares. If the decision is to consider the death proceeds rather than the cash surrender value, why was just $3.0 million of the death proceeds considered?

(d) **Impact of Life Insurance on Value of Decedent's Shares.** No individual shareholder would have rights to the life insurance value owned by the corporation. Perhaps a 77% shareholder with a clearly controlling interest would have a much greater ability to force a distribution of some or all of those death proceeds from the company than a 23% minority shareholder, but a determination should be made of the value of the additional corporate assets to a particular shareholder's shares.

Presumably, at most 77% of that additional value should be considered for a 77% shareholder (even if there is no marketability discount, the most that a 77% shareholder could receive of that value is 77%). For example, even if the IRS considered the full $3.5 million paid to the corporation as adding to the value of the decedent's shares, that should have resulted in additional estate tax of $3.5 million x 77% x 35% or $943,250. But the opinion clearly says that the "fair market value of [the corporation] should have included the $3 million in life-insurance proceeds used to redeem the shares." If $3 million is considered as additional corporate value, that should have resulted in additional estate tax of no more than $3 million x 77% x 35%, or $808,500, not "over $1 million."

As indicated in subparagraph d.(2)(a) above, life insurance payable to a corporation at an owner's death is merely treated as a factor that must be considered in valuing the decedent's shares in the entity. Life insurance is generally treated like other nonoperating assets "to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity." Reg. §20.2031-2(f)(2) (penultimate sentence).

The IRS's calculation of additional estate tax of "over $1 million" is perplexing.

(3) **Buy-Sell Agreement With Life Insurance Funding.** One of the factors in determining whether to use a corporate purchase or a cross-purchase arrangement in structuring a buy-sell agreement that will be funded with life insurance is that life insurance proceeds received by the company may be included in the estate tax value of the decedents' shares, resulting in escalating values of the shareholders' interests in the company. (If the purchase price is fully funded with life insurance, as each owner's interest is purchased at death using the life insurance proceeds the company value remains constant, but the remaining owners have increasing percentage interests in the entity as each owner dies, which increases the value of their interests and requires more life insurance funding.) A pricing formula that does not include the full amount of insurance proceeds is suspect as failing to satisfy the §2703(b) safe harbor under the reasoning of the *Connelly* opinion.

The economic impact of not including insurance proceeds in valuing a decedent's shares is to produce a huge windfall to the surviving shareholders. If the purchase price is fully funded with life insurance, the surviving shareholders end up owing the company free of the decedent's shares without having to pay anything following the decedent's death.

The windfall to the surviving shareholders may be greatly reduced by including the amount of the insurance proceeds on the decedent stockholder's life in the value of the corporation. However, this approach will be circular and thus greatly increase the amount of insurance coverage needed in order to fund fully the buy-sell agreement. But including life insurance proceeds in determining the value of the company following a shareholder's death reflects the economic reality of the value of the company at that time. That the IRS maintains that the estate tax value of the decedent's shares following an insured shareholder's death should reflect that economic reality is not surprising.

(4) **Buy-Sell Agreement Structuring.** A very important issue in structuring a buy-sell agreement is whether an entity purchase or cross purchase arrangement will be used. For example, the *Connelly* agreement gave the surviving shareholders the first option to purchase a decedent's shares, but if that option was not exercised, the agreement required the corporation to buy the shares.

- Entity Purchase – the parties may feel more comfortable with the entity taking steps to fund the purchase agreement rather than relying on other owners to accumulate funds (or purchase life insurance) to fund a purchase obligation, but the funding in the entity (such as life insurance) may increase the value of the entity (as in *Connelly*); for a corporation, tax considerations include whether the redemption of stock by the corporation will be given sale or exchange vs. dividend treatment.
- Cross purchase – the parties must rely on the remaining owners to purchase their interests at death, funding will be outside the entity, not increasing the entity's value at the death of an owner, and a basis step up for the units purchased will be permitted; these advantages are quite significant; a disadvantage if an entity has multiple owners is that a multiplicity of policies would be required for each owner to own a policy on every other owner's life, and a possible solution is to have the owners form a separate partnership to own a single life insurance policy on each owner's life. (However, one commentator suggests that a trusteed cross-purchase or life insurance LLC "may suffer from some of the same issues as *Connelly*." Paul Hood & Ed Morrow, *Are Redemption Buy-Sell Agreements Using Life Insurance Still Effective After Connelly v. United States*, LEIMBERG BUSINESS ENTITIES NEWSLETTER (February 23, 2022).)

(5) **Agreement Provision to Determine Value Without Regard to Discounts.** While a prohibition on considering control premiums or minority discounts may not be included in a majority of buy-sell agreements, it is not rare either. Business partners may, when planning the amount that would be paid to a deceased owner's family, make the decision that a full pro rata portion of the business's value should be paid to the estate without considering minority discounts. To conclude that such a prohibition in the agreement results in the purchase price under the agreement being necessarily disregarded for estate tax valuation purposes (because the §2703(b) safe harbor would not be satisfied) is a novel concept.

(6) **Section 2703(b) Analysis Consistent With Various Other Cases Regarding Comparability Analysis.** The *Connelly* opinion observed that the estate "failed to prove any evidence of similar arrangements negotiated at arms' length" [about determining the purchase price without including life insurance proceeds received by the company at the decedent's death]. Various other cases regarding §2703 have similarly been pretty strict in requiring examples or evidence of actual comparable arrangements negotiated at arms' length. *E.g.*, *Kress v. U.S.*, 123 AFTR 2d 2019-1224 (E.D. Wi. 2019) ("Though Plaintiffs contend *restrictions* like the Kress Family Restriction are common in the commercial world, they have not produced any evidence that unrelated parties at arms' length would agree to such an arrangement."); *Estate of Blount v. Commissioner*, T.C. Memo. 20014-116, *aff'd in part, rev'd in part*, 428 F.3d 1338 (11th Cir. 2005) ("He did not present evidence of other buy-sell agreements or similar arrangements, where a partner or shareholder is bought out by his coventurers, *actually entered into* by persons at arm's length…Because Mr. Grizzle has failed to provide any evidence of *similar arrangements actually entered into* by parties at arm's length, as required by section 2703(b)(3), and his opinion is based solely on his belief that the purchase price for decedent's BBC shares was set at fair market value, Mr. Grizzle's conclusion that the terms of the Modified 1981 Agreement are comparable to similar agreements entered into by parties at arm's length is unsupportable."); *Smith v. Commissioner*, 94 AFTR 2d 2004-5283 (W.D. Pa. 2004) ("In this case, both parties concede that it would be inherently difficult to find an agreement between unrelated parties dealing at arms' length that would be comparable to a family limited partnership, which, by its terms, is restricted to related parties.… Nevertheless, Plaintiffs have submitted the affidavits of two attorneys…who essentially state that restrictive provisions requiring installment payments and charging interest at the applicable federal rate are common in both family limited partnerships and transactions

involving unrelated parties…. Upon review, these affidavits merely state opinions that are conclusory in nature and do not constitute evidence sufficient to dispel any genuine issue of material fact as to whether of [*sic*] the restrictive provision in the Smith FLP agreement meet the test set forth in Section 2703(b)(3).")

The comparability test was satisfied in *Amlie v. Commissioner*, T.C. Memo. 2006-7, involving a rather complicated fact pattern. The court concluded that an agreement met the comparability test because it was based on price terms in an earlier agreement, which was based on a survey of comparables.

(7) Contractual Obligation vs. Estate Tax Value Mismatch. The *Connelly* opinion highlights the risk of contractual obligations to sell stock under a buy-sell agreement not being respected for estate tax purposes. The possibility exists that a contractual obligation to sell shares at a specified amount under a buy-sell agreement would be enforced even though the estate may eventually be determined to owe estate tax on a much higher value, with the estate tax liability possibly even exceeding the total value paid to the estate under the agreement. Buy-sell agreements often have mechanisms to increase the purchase price to the amount ultimately determined to be value of the decedent's interest in the entity for estate tax purposes.

(8) Buy-Sell Agreements Structuring Takeaways.

> While Connelly is something of a bad facts case, the court's broad pronouncements unfortunately do not turn on the existence of those facts. Going forward, as practitioners draft or review existing redemption agreements, they should consider the following:
>
> 1. Rethink insurance funded redemption agreements (while rare, they are out there). *Connelly* will make planning for more than two owners challenging, given the complexities involved in a cross-purchase involving multiple owners.
>
> 2. Get an appraisal at death and follow it.
>
> 3. To avoid the *Connelly* court's concern over creating a windfall in value, consider defining the term *value* in entity agreements as the value determined by a third-party appraiser, without requiring or prohibiting discounts. However, note that if discounts are considered, a decedent's interest will likely be undervalued; if ignored, an interest may be overvalued.
>
> 4. Prepare for the possibility that a shareholder agreement is both effective for state law purposes to set the actual amount payable to the decedent's estate for entity interests, and also ineffective to set value for federal estate tax purposes. The result could be a cash-poor estate and an unfunded federal estate tax liability.
>
> 5. Avoid using certificates of value, and certainly do not to make them mandatory.
>
> 6. Respect the entity agreement in its entirety; courts in general abhor structures that are simultaneously ignored and hidden behind.
>
> Steve Seel & Dan Griffith, *Connelly v. IRS: Casting Shadow Agreements*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #246 (January 18, 2022).

19. Real Estate Undivided Interests Gifts to Separate Donees In Each of Four Years Valued Separately and Not Aggregated for Valuation Purposes, *Buck v. U.S.*, 128 AFTR 2d 2021-6043 (D. Ct. September 24, 2021)

a. Synopsis. Gifts of 48% undivided interests in timberland to each of the donor's two sons (the donor retained the remaining 4%), were valued with a 55% discount for gift tax purposes compared to the purchase price of the tracts. The IRS maintained that no fractional interest discounts should be allowed unless the donor owned only the fractional interest prior to the gift and that the donor could not value simultaneously gifted portions of the property separately. The court denied the government's motion for partial summary judgment requesting that "the value of each donee's interest is simply the value of the whole times the percent ownership." Valuing each gift separately at the time it passes from the donor to the donee is supported by the relevant statute, regulations, and case law. (The court did not mention Rev. Rul. 93-12, which is the IRS's published position that gifts of 20% of the stock in a closely-held corporation to each of the donor's five children should be

valued separately without assuming that all voting power held by family members would be aggregated.) *Buck v. U.S.*, 128 AFTR 2d 2021-6043 (D. Ct. September 24, 2021).

In a separate opinion delivered the same day, the court allowed the government to compel production of the donor's will and information about his estate planning. The court rejected the donor's arguments to reject discovery because of (1) attorney-client privilege (the donor did not provide basic information necessary to support the elements of attorney-client privilege, and the requested information had been shared with the donor's financial manager without any showing that his presence was necessary or highly useful for the attorney's advice) and (2) relevance (the information was relevant to the propriety and proper extent of any discounts as a factual matter). AFTR 2d 2021-6041 (D. Ct. September 24, 2021).

b. **Basic Facts**. The donor purchased about $82 million in tracts of timberland between 2009 and 2013. Over a period of four years (2010-2013), he gave a 48% undivided interest in each of these tracts to each of his two sons (with the donor retaining the remaining 4%). The donor reported the gifts with fractional interest discounts totaling about $37 million, reflecting a 55% discount from the purchase price.

The IRS challenged the valuations and alleged deficiencies. The donor paid the deficiencies and sued for refunds. The government moved for a partial summary judgment denying any fractional interest discounts on the gifts.

c. **Court Analysis.**

(1) **Government Position.** The court described the government's position as follows.

> It asks the court to "conclude as a matter of law that no discount should be available for a gift of a fractional interest unless the taxpayer held such interest in fractional form before the gift, rather than viewing several simultaneously gifted portions of the property as fractional interests in the hands of the donor for purpose of valuing the gift." ... The government maintains that gift tax law categorically prohibits such a discount because it is contrary to one of the primary purposes of the gift tax.... It contends ... that "it is not appropriate to apply fractional interest discounts in valuing a gift of land to more than one individual" ... and "that the value of each donee's interest is simply the value of the whole times the percent ownership."
>
> ...
>
> ... The government notes, correctly, that "[t]here is no question that ... there would be no discounts based on the separate values of the interests received by each son" if this were a case about the estate tax.... The government argues that, when valuing interests in property like the property interests here, discounts should be prohibited for gift tax purposes because "the gift tax is construed *in pari materia* with the estate tax" in order to prevent taxpayers from "avoiding the estate tax altogether" by "depleting their estates through *inter vivos* transfers."

(2) **Cases Interpreting Gift and Estate Tax In Pari Materia Do Not Support Aggregating Gifts for Valuation Purposes.** The court distinguished cases cited by the government holding that the gift and estate are *in pari materia* as being in different contexts (such as not reducing gifts by relinquished marital rights). Those cases support that words appearing in the gift and estate tax statutes should be understood to have the same meaning and that a donor should not have to pay gift tax with respect to property retained by that donor that will be included in the donor's gross estate, but they do not provide support for aggregating separate gifts for valuation purposes. To the contrary, the court cited various cases that have allowed fractional interest discounts for gifts of fractional interests to separate donees.

(3) **Each Gift Should be Valued Separately Rather Than Basing Gift Amount on Value to the Donor.** The government's position is that value of a gift for federal gift tax purposes is the value to the donor, not the donee. The government's position in the court's words: "[E]ven if the property is now worth less because of the creation of fractional interests, the property was worth more in the donor's hands before the fractional interests were created, and it is that value, not the new value, that should be the basis for calculation the gift tax."

The court disagreed, reasoning that "[t]he gift tax statute, the regulations and relevant case law require the court to look at the value of each gift at the time it passes from the donor to the

donee." Footnote 1 observes that the gift tax statute (§2512(a)) might reasonably be interpreted as applying to multiple gifts made from the same property, but the gift tax regulations (Reg. §25.2512-1 & §25.2512-2) are reasonably read as only applying to individual gifts.

Cases cited by the court as allowing fractional interest discounts for gifts made to multiple donees include *LeFrak v. Commissioner*, T.C. Memo. 1993-526, and *Shepherd v. Commissioner*, 115 T.C. 376 (2000).

(4) **Discovery Permitted of Donee's Will and Estate Plan Information.** In a separate opinion delivered the same day, the court compelled production of the donor's will and information about his estate planning.

The donor objected first on the ground of attorney-client privilege. The court noted three requirements for establishing attorney client privilege ((a) communication between client and attorney, (b) intended to be kept confidential, (c) made for the purpose of obtaining legal advice) but said the donor had just made conclusory assertions without providing the basic necessary information to support the privilege. In addition, the information had been shared with donor's financial manager without offering evidence that his presence was :necessary, or at least highly useful, for the effective consultation between the client and the lawyer" under the *Kovel* doctrine.

The donor also objected as to the information's relevance, but the court agreed with the government that the information reflects part of the objective circumstances under which the gift was made and "may lend support to the government's position with respect to the propriety and proper extent of any discounts as a factual matter."

d. **Observations.**

(1) **Inconsistent Positions.** This summary quotes and summarizes the government position at some length because it seems so directly contrary to the government's published position in Revenue Ruling 93-12 (discussed below). Furthermore, the government contends that the value of a gift is determined by the value to the donor and not to the donee. The government's view is that the value to the donor before gifts were made determines the value, not the new values of the gifts in the hands of the donees. It is not surprising that no regulations or cases were cited in the case to support that position. That is a fundamental distinction between valuations for gift tax vs. estate tax purposes.

(2) **Rev. Rul. 93-12.** The government was in a 30-year time warp; the arguments may have made some sense 30 years ago. The government's published position in Revenue Ruling 93-12, 1993-1 C.B. 202, though, clearly makes the government's position in *Buck* inappropriate. That revenue ruling addressed a situation in which a donor who owned all the stock of a corporation gave 20% of the shares to each of the donor's five children at the same time. The IRS had previously nonacquiesced in *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978), *nonacq*., 1980-C.B. 2, which held that corporation shares owned by other family members could not be attributed to an individual family member for determining whether the individual family member's shares should be valued as a controlling interest, and Rev. Rul. 81-253 ruled that a minority discount generally is not allowed for transfers of stock between family members if majority voting control or de facto control through family relationships exists in the family unit.

The IRS changed its position in Rev. Rul. 93-12, in which the IRS substituted acquiescence for its nonacquiesence in *Estate of Lee*, ruling that for estate and gift tax valuation purposes the IRS would not assume that all voting power held by family members may be aggregated for purposes of determining if transferred shares should be valued as part of a controlling interest. More specifically in the gift context, the ruling concluded that "the minority interests transferred to A, B, C, D, and E should be valued for gift tax purposes without regard to the family relationship of the parties."

Furthermore, Rev. Rul. 93-12 cites *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982), which allowed a discount in valuing a decedent's one-half fractional interest in parcels of real estate that the decedent and his wife held as community property at the time of his death.

The IRS followed the reasoning of Rev. Rul. 93-12 in Tech Adv. Memo. 9449001, which allowed discounts for simultaneous gifts of 100% of a corporation's stock to the donor's 11 children. The TAM observes that various cases "have consistently recognized that simultaneous gifts were to be valued separately for gift tax purposes." The TAM cites *Mooneyham v. Commissioner*, T.C. Memo. 1991-78, which allowed a 15% discount for a gift of a 50 percent undivided fractional interest in real property.

Rev. Rul. 93-12, TAM 9449001 and the reliance of those rulings on *Propstra* and *Mooneyham*, both involving gifts of undivided fractional interests in real property, all suggest that the IRS was totally off base thirty years later in disallowing discounts for 48% undivided fractional interest gifts to each of the donor's two sons in *Buck*.

(3) ***Rauenhorst v. Commissioner*.** The Tax Court in *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002) lambasted the IRS for taking a position in litigation contrary to its position in a revenue ruling:

> Rev. Rul. 78-197, 1978-1 C.B. 83, is contrary to respondent's litigation position in this case. Instead of accepting the legal principles articulated in that ruling, respondent's counsel contends that the Commissioner is not bound by revenue rulings, and his reliance on Blake v. Commissioner, 697 F.2d at 480-481, demonstrates that he is taking the position in this case that the ruling is incorrect.
>
> ...
>
> Surely, given these statements [in section 601.601(d)(2) of the Department of the Treasury's Statement of Procedural Rules], taxpayers should be entitled to rely on revenue rulings in structuring their transactions, and they should not be faced with the daunting prospect of the Commissioner's disavowing his rulings in subsequent litigation.
>
> ... These stated goals [of using published guidance to achieve "increased taxpayer compliance" and resolve "frequently disputed tax issues"] will not be achieved if the Commissioner refuses to follow his own published guidance and argues in court proceedings that revenue rulings do not bind him or that his rulings are incorrect. Certainly, the Commissioner's failure to follow his own rulings would be unfair to those taxpayers, such as petitioners herein, who have relied on revenue rulings to structure their transactions. Moreover, it is highly inequitable to impose penalties, which respondent has done in this case. Accordingly, in this case, we shall not permit respondent to argue against his revenue ruling, and we shall treat his revenue ruling as a concession. 119 T.C. at 182-183.

It is interesting that the court in *Buck* did not even mention that the government was taking a position that is contrary to its published position in Revenue Ruling 93-12, in which contemporaneous gifts of 20% interests in a corporation to each of five siblings were not aggregated for gift tax valuation purposes based on the family relationship of the donees.

20. Indirect Gifts – Step Transaction, Reducing Value of LLC by Present Value of Guaranteed Payment Obligation to Manager, *Smaldino v. Commissioner*, T.C. Memo. 2021-127

a. **Synopsis.** Mr. Smaldino ("Donor") owned in his revocable trust all of the voting and nonvoting units of an LLC that owned 10 rental properties. He had an overall goal of leaving his business interests to his descendants (or trusts for them) and leaving many of his remaining assets to his wife. The following transactions occurred effective over a two-day period:

- Donor gave about 41% of the nonvoting units to his wife (the transfers effective during this two-day period were stated as *Wandry*-type assignments but the parties for tax purposes treated them as percentage interests in the LLC) effective April 14, 2013;
- Effective the following date, April 15, 2013, the wife gave her 41% interest in the LLC to an irrevocable trust (the "Dynasty Trust") that Donor had created earlier for his descendants by a prior marriage (the units were appraised to have a value about equal to the amount of the wife's gift exclusion amount);

- Effective that same day, Donor gave about 8% of the nonvoting units to the Dynasty Trust; and
- Effective that same date, April 15, 2013, Donor amended the LLC operating agreement, in an undated document identifying his revocable trust as the "SOLE MEMBER," to provide that Donor as the sole owner of voting units would receive $10,000 per month as guaranteed payments rather than his prior arrangement of receiving compensation as manager equal to 10% of the net cash flow.

The result was that the Dynasty Trust owned 49% of the LLC units (nonvoting units) as a result of these transfers effective over a two-day period. The court treated the Donor as making the entire 49% gift of units directly to the Dynasty Trust, treating the 41% "purportedly" given to his wife as an indirect gift from Donor to the Dynasty Trust.

In valuing the gifted units, the court agreed with the taxpayer's appraiser's approach of reducing the value of the nonvoting units by the present value of the guaranteed payments, treating them as a 40-year annuity. (Part of the court's analysis was an acknowledgement of the favorable treatment of guaranteed payments under §2701, even though chapter 14 is not directly applicable.) The court agreed with the IRS's expert's application of a 36% discount for lack of control and lack of marketability (rather than the taxpayer's expert's 38.43% discount). The court's valuation analysis increased the gift tax value of the 49% interest from $6,281,000 to $7,820,008. *Smaldino v. Commissioner*, T.C. Memo. 2021-127 (Senior Judge Thornton).

b. Basic Facts. Donor owned in his revocable trust all of the Class A voting and Class B nonvoting units and served as manager of an LLC that owned 10 rental properties. He had an overall goal of leaving his business interests to his descendants (or trusts for them) and leaving many of his remaining assets to his wife. The rental properties were contributed to the LLC in late 2012, and Donor also created the Dynasty Trust for his descendants (by a prior marriage) in December 2012 with a son of Donor as trustee. Donor "resolved to transfer up to 50% of the LLC interests, the maximum he could transfer without triggering reassessment of property taxes on the LLC's assets." The following transactions were documented to have occurred effective over a two-day period, resulting in a transfer of 49% of the LLC interests to the Dynasty Trust:

- Donor gave a "sufficient number" of Class B nonvoting units to Donor's wife "so that the fair market value of such nonvoting units as determined for federal gift tax purposes shall be" $5,249,118.42 (she had $5,250,000 of gift exclusion, see footnote 12). While this and other transfers during this two-day period were stated as *Wandry* transfers of units equal to a dollar amount, the parties merely reported the transfers as "INTEREST IN SMALDINO INVESTMENTS, LLC" and Donor conceded "that these defined value clauses do not define or limit the amount of his taxable gifts to be determined in this proceeding." (Footnote 8). Donor contended that this transfer to his wife was a 40.95% Class B nonvoting member interest. The undated assignment stated it was "Effective: April 14, 2013."
- The wife gave an identically described (i.e., purportedly as a *Wandry* defined value transfer) interest in the LLC to the Dynasty Trust. The undated assignment was "Effective: April 15, 2013" (the day after the effective date of the gift of the units to the wife). (The units were appraised to be about equal to the amount of the wife's $5,250,000 gift exclusion amount). The wife reported this gift on her 2013 gift tax return. The wife testified that before the transfer was made to her, she made "'a commitment, promise' to her husband and family that she would transfer the LLC units to the Dynasty Trust, and when asked if she could have changed her mind, she responded: 'No, because I believe in fairness.'"
- Effective that same day, Donor gave about an 8.05% nonvoting member interest (again, purportedly stated as a *Wandry* assignment of a $1,031,882 dollar value but treated as a transfer of a percentage interest) to the Dynasty Trust.
- Effective that same date, April 15, 2013, Donor amended the LLC operating agreement, in an undated document identifying his revocable trust as the "SOLE MEMBER," to provide that Donor as the sole owner of voting units would receive $10,000 per month as guaranteed

payments rather than his prior arrangement of receiving compensation as manager equal to 10% of the net cash flow. That undated amendment of the operating agreement also revised Exhibit A to show that the Dynasty Trust owned a 49% nonvoting interest (which consisted of the combination of 40.95% and 8.05% interests, but the Exhibit A did not reflect that the wife ever owned the 40.95% interest).

Donor obtained an appraisal dated August 22, 2013, of a 49% Class B nonvoting member interest valued as of April 15, 2013. The appraised value was $6,281,000, and the dollar amounts listed in the *Wandry* dollar-amount transfers in the assignments totaled that exact same amount. The court interpreted that as meaning that the assignments and the amendment to the operating agreement "were executed no earlier than August 22, 2013."

On December 31, 2013, the operating agreement was amended to delete the provision for guaranteed payments and to restore the previously deleted provision for manager compensation but increasing the compensation from 10% to 20% of annual net cash flow.

Donor's 2013 gift tax return reported a gift of "INTEREST IN SMALDINO INVESTMENTS, LLC" valued at $1,031,882 (i.e., the 8.05% nonvoting interest) to the Dynasty Trust. He did not report the gift to his wife. The wife's 2013 gift tax return reported a gift to the Dynasty Trust with that same description and with a reported value of $5,249,118 (i.e., the 40.95% interest).

The IRS treated both transfers to the Dynasty Trust as coming from Donor, including the 40.95% interest given indirectly through his wife, and valued the 49% interest at $8,180,000 (rather than the $6,281,000 value of a 49% interest as determined by Donor's appraiser). The primary difference in the appraisals was whether the present value of the guaranteed payment obligation should be subtracted in determining the value of the Class B nonvoting interests of the LLC.

c. Court Analysis.

(1) Burden of Proof. "For the most part" the case is decided based on the preponderance of evidence rather than by placement of the burden of proof.

(2) Indirect Gift. The court's statement of the facts foreshadowed its indirect gift result in the very *first* short paragraph of the opinion by noting that Donor "purportedly" transferred about 41% member interests to his wife and she "purportedly" transferred them to the Dynasty Trust the next day. The statement of facts also noted that Donor provided his wife with additional moneys and properties "[i]n exchange for the use of Mrs. Smaldino's available Federal estate and gift tax exemption."

The court noted that "Section 2511(a) implicitly embodies principles of substance over form by including 'indirect' transfers in the definition of a taxable gift," and that heightened scrutiny applies for transactions between relatives. Various cases have applied substance over form principles to recharacterize multistep property transfers among related parties as indirect gifts between the actual donors and donees. *E.g.*, *Heyen v. United States*, 945 F.2d 359 (10th Cir. 1991); *Estate of Bies v. Commissioner*, T.C. Memo. 2000-338; *Estate of Cidulka v. Commissioner*, T.C. Memo. 1996-149. The Donor tried to distinguish those cases because they did not involve an initial interspousal transfer, under the theory that the gift tax marital deduction "exempts interspousal transfers from gift tax." The court rejected that argument for the simple reason that the units were never effectively transferred to the wife.

Furthermore, Donor never expressly disputed that the transactions were part of a pre-arranged plan. Donor's express goal was to leave the business interests to his descendants and to leave other assets to his wife, and the wife acknowledged that she committed to re-transfer the LLC membership interests to the Dynasty Trust after she received them.

The formal transfer of units to the wife is not controlling because courts have "never regarded 'the simple expedient of drawing up papers,' … as controlling for tax purposes when the objective economic realities are to the contrary" (quoting *Kerr v. Commissioner*, 113 T.C. 449, 464 (1999), which in turn quoted *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1979)). The tax consequences of transactions involving a nominee or straw party must be determined with

regard to the true beneficial interests involved (citing *Snyder v. Commissioner*, 66 T.C. 785 (1976)).

The court pointed to various glitches in the documentation and failures to follow formalities. The formalities for admitting the wife as a member of the LLC were not followed, the Donor signed an amendment to the operating agreement stating he was the sole member but the effective date of the amendment was after the effective date of his transfer of units to his wife, Exhibit A to the operating agreement was never amended to show the wife as a member, the assignment document to the wife was undated and was actually signed long after the effective date of her subsequent transfer to the Dynasty Trust so that "as a practical matter there was never a time when" she could have exercised any ownership rights, and the LLC's income tax return did not reflect the wife as ever having owned a membership interest.

The court concluded:

> On the basis of all the evidence in the record, we conclude that petitioner never effectively transferred any membership interest in the LLC to Mrs. Smaldino and consequently that the Dynasty Trust received its entire 49% of the class B membership interests as a gift from petitioner.

(3) **Value of 49% Nonvoting Member Interest.**

(a) **Valuation Approach.** The taxpayer's and IRS's appraisers used about the same value for the LLC's net asset value (NAV). (The court used the IRS's slightly higher value because it included a few additional incidental assets and better explained how it identified the assets and liabilities.) The appraisers also used about the same discounts for lack of control and marketability (38.43% and 36%). The primary difference was whether the present value of the guaranteed payment should be subtracted in determining the value of the Class B nonvoting member interests, and the mathematical manner of applying that reduction.

(b) **Deducting Present Value of Guaranteed Payment.** Donor's appraiser treated the guaranteed payment as a contractual liability of the LLC that should be subtracted in determining its value under a net asset value approach. The appraiser treated the guaranteed payment as a 40-year annuity of $10,000 a month (which was not expressly disputed by the IRS and which the court viewed as a concession), and determined the present value using the AFR as the discount rate. That appraiser subtracted the present value in its entirety from the 49% interest (i.e., from 49% of the NAV) and the 38.43% discount was applied to the resulting number.

The IRS position was that the guaranteed payments were a substitute for future management fees, which ordinarily would not be subtracted in determining the value of an entity under the NAV method. The IRS's expert

> opined that the guaranteed payments are comparable to asset management fees paid by comparable real estate investment holding companies, the values of which would not ordinarily be affected by asset management fees within the range indicated by the amounts of the guaranteed payments.

Donor countered that the guaranteed payments must be made "whether or not entity level management fees are paid" and that the minority interest is less marketable because of the required future guaranteed payments.

(c) **Section 2701 Analogy.** Donor by analogy pointed to §2701. Even though no party maintains that §2701 applies in this situation, Donor pointed out that §2701 allows value to be assigned to a retained guaranteed payment owed by an entity when valuing the transfer of an interest in an entity rather than being valued at zero like some senior interests in the entity. The court observed in a footnote that one commentator concluded that "even if a guaranteed payment were governed by § 2701, it would constitute a qualified payment right and thus would be subject to the same fair market value principles as a guaranteed payment not subject to § 2701, with a couple of exceptions." Louis Harrison, *Special Valuation Rules Can Save Transfer Taxes*, 11 J. PARTNERSHIP TAX'N 239, 247 n.29 (1994).

Although §2701 was not applicable to these transactions, the court looked by analogy to the calculation procedures under §2701. The value of transferred junior interests is determined by subtracting the value of senior interests (that are retained or held by applicable family members) from the aggregate value of all family-held equity interests, and then allocating the remaining value among the transferred interest and other interests of the same or junior classes, and then applying minority or similar discounts, as appropriate. Retained senior interests under §2701 would be analogous to the guaranteed payment held by Donor, so consistent with the calculation approach under §2701

> it is appropriate, in valuing the transferred class B units for gift tax purposes, to subtract from the LLC's NAV (before applying any discounts) the value of the class A units retained by petitioner, including the value of his priority claims, i.e., the guaranteed payments; to then allocate the remaining value among the transferred and retained class B units; and to then apply appropriate minority and marketability discounts to the transferred class B units.

(d) **Method for Subtracting Present Value of Guaranteed Payment.** The *McCord* case applied a similar method in valuing gifted class B limited partnership interests when the class A limited partner interests consisted of a guaranteed payment. The class A priority claims were subtracted from the partnership's NAV (before applying any discounts) in valuing the class B interests. *McCord v. Commissioner*, 120 T.C. 358, 376 (2003), *rev'd on other grounds*, *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006).

That same method is used by the court. The initial step in the valuation is to subtract from the NAV of the LLC the value of the class A voting interests, including the present value of the guaranteed payment rights (the guaranteed payments are made solely to the single owner of the class A voting interest – Donor). That difference is the value of all of the class B nonvoting member interests. That number is multiplied by 49% and is further reduced by the appropriate discount for lack of control and marketability.

(e) **Discount Rate.** To determine the present value of the assumed 40-year annuity represented by the guaranteed payments, the court agreed with the IRS appraiser to use a higher discount rate than the AFR, which is a risk-free rate. The court agreed with the appraiser to use a 6.75% rate which is consistent with capitalization rates used to value the LLC's underlying assets (compared to the 2.67% AFR that was used by Donor's appraiser).

(f) **Subsequent Elimination of Guaranteed Payment.** The IRS argued that the subsequent elimination of the right to receive guaranteed payments about four months later (the time from August 22, 2013, the first date the court thinks the amendment applying the guaranteed payment was signed, until December 31, 2013) is a reason to disallow any reduction in value by reason of the guaranteed payments. However, the court observed that subsequent events that are not reasonably foreseeable are not considered in fixing fair market value. The court did note that the IRS did not raise as an issue whether the elimination of the guaranteed payment was a separate gift from Donor to other owners of the nonvoting member interests.

(g) **Result.** The court's valuation analysis increased the gift tax value of the 49% interest from $6,281,000 to $7,820,008 (but less than the $8,180,000 value asserted by the IRS).

(4) **Discount for Lack of Control and Lack of Marketability**. Both experts used very similar combined discounts for lack of control and lack of marketability (38.43% by Donor's expert and 36% by IRS's expert). Donor's expert said that his slightly higher combined discounts rate "is explained by his taking into account the guaranteed payment." The court concluded that because it allows subtracting the present value of the guaranteed payment, it will not also allow including the additional LOC and LOM discounts because of the guaranteed payments. That would result in "inappropriate ... redundant adjustments."

(5) **Summary and Calculation of Gift**. The opinion concludes with a helpful summary chart of the calculation of the value of the gifted 49% class B nonvoting member interest.

LLC's NAV as of 4/15/13	$26,852,186
Less: Value of retained class A member interests, including guaranteed payment rights -Present value of guaranteed payments ($1,647,412) + 1% of NAV ($268,522) = $1,915,934)	(1,915,934)
Value allocated to aggregate class B member interests	24,936,252
Value allocated to 49% class B member interest before discounts ($24,936,252 x 0.49)	12,218,763
Less: 36% combined discount	(4,398,755)
Value of transferred 49% class B member interest	$ 7,820,008

d. **Observations.**

(1) **Indirect Gift Result Not Surprising.** It is hard to imagine a clearer case for applying an indirect gift/substance over form analysis. Donor's stated goal was to leave the business interests entirely to his descendants, so a gift of the LLC interest to his wife effective Day 1 followed by a gift from her to the Dynasty Trust for the descendants effective Day 2 strongly suggests that the wife was just a straw party for Donor to give the interest to the Dynasty Trust. Furthermore, the wife testified that she indeed made a "commitment, promise" to re-transfer the interest to the Dynasty Trust. The crystal-clear goal was simply to use the wife's available gift exclusion to shield some of the transfer from gift tax.

The three cases cited in the opinion about recharacterizing multistep property transfers among related parties as indirect gifts (*Heyen*, *Bies*, and *Cidulka*) all involved attempts to make use of increased numbers of annual exclusions. *See also Schuler v. Commissioner*, 282 F.3d 575 (8th Cir. 2002), *aff'g* T.C. Memo. 2000-392; *Sather v. Commissioner*, 251 F.3d 1168 (8th Cir. 2001).

Section 2511 applies the gift tax to "direct or indirect" gifts, and Treasury regulations also explicitly incorporate the indirect gift concept. Treas. Reg. 25.2511-1(h)(2)-(3) (examples of indirect transfers for gift purposes).

While the result in *Smaldino* is not surprising, the reasoning is interesting. Because of the documentation issues and failure to follow formalities, the court's rationale is that Donor never effectively transferred the nonvoting member interests to his wife, so the transfer of the 41% interest to the Dynasty Trust must have come from Donor and not his wife. Under the various cases cited, even if a transfer is effectively completed to an intermediate straw party, the indirect gift principle is applied where the clear intent is that the straw party will reconvey the assets to the intended donee. Even if the transfer had effectively been made to the wife, the clear pre-arrangement was that she would reconvey the assets to the Dynasty Trust, and that should be sufficient to apply the indirect gift/substance over form principle.

(2) **Other Implications of Indirect Gift Principle; SLAT Danger; Planning Considerations.** Often, the goal with indirect gifts is to do what was done in *Smaldino* – make use of the intermediate person's gift exclusion amount. Alternatively, the goal may be to have annual exclusion gifts both by the donor and also purportedly by the intermediate person. The downside in that situation if the IRS makes the indirect gift argument is simply to disallow use of the additional gift exclusion amount or annual exclusions. A possible further downside would be if the IRS were to allege that the returns reporting the gifts are fraudulent (and indeed, sometimes gift tax returns might be not be filed at all to report the gifts if they are all within the annual exclusion amounts of the multiple parties involved).

Alternatively, the indirect grantor may be identified for purposes of applying §2035 to gift tax paid on a transfer within three years of that "real" grantor's death. *See Brown v. U.S.*, 329 F.3d 664 (9th Cir. 2003) (husband made gift to wife; wife made gift to trust; husband died within three

years; applied step transaction doctrine to determine that husband was the "real donor" so that §2035 applied to gift tax on transfer within three years of death).

A more devastating result can occur, though, if the "actual donor" is also a beneficiary of or has tax-sensitive powers over the recipient trust. For example, if A transfers cash to B, with the understanding that B will transfer property to a trust for A's benefit, A is treated as the grantor of the trust even though he never owned the property that was transferred to the trust. *Estate of Shafer v. Commissioner*, 749 F.2d 1216 (6th Cir. 1984) (§2036 applied where decedent had purchased property and directed seller to convey life estates to decedent and his wife and remainder to his sons rather than receiving the property outright and conveying the property to his sons with a retained life estate). As another example, if a husband owes funds to his wife from a prior loan but pays the funds into a trust for the wife instead of repaying her, the wife will be treated as the grantor of the trust for purposes of applying §2036. *Estate of Marshall v. Commissioner*, 51 T.C. 696 (1969), *nonacq.* 1969-2 C.B. xxvi.

The §2036 situation can readily arise in creating a spousal lifetime access trust (SLAT). For example, both spouses may wish to create SLATs with the other spouse as a permissible beneficiary (building in a variety of differences to overcome the "reciprocal trust" doctrine under the *Grace* case, 395 U.S. 316 (1969)), but one spouse may not own substantial assets. The wealthy spouse may make a gift to the less-wealthy spouse that he or she could use to make a gift to a trust having the wealthy spouse as a permissible beneficiary. If the indirect gift principle is applied, the wealthy spouse would be treated as a grantor to such trust for estate tax purposes and §2036 may cause inclusion in the gross estate, or if the wealthy spouse is a trustee of the trust or otherwise holds tax-sensitive powers, estate inclusion may result under §2036(a)(2) or §2038. This is a frequently recurring situation for spouses having substantially unequal wealth.

Planning considerations, for those who want to be as conservative as possible to avoid a possible "indirect gift" attack, include:

- Very purposefully avoid any express agreements (or even legally binding commitments) for the initial donee to make a subsequent gift;
- The facts should support that the initial donee is making an independent decision to make the subsequent transfer (the initial donee may be aware at the time of the initial gift of possible advantages of making a subsequent gift, but the decision to do so should be that of the initial donee);
- Allow some appropriate passage of time (don't make the re-transfer at the same closing or even the next day as in *Smaldino*); analogy to the indirect gift/step transaction analysis of the *Holman* line of cases regarding contributions to partnerships supports the passage of time approach, *Holman v. Commissioner*, 130 T.C.170 (2008) (transfer of Dell stock to partnership and gift of limited partnership interests six days later did not result in an indirect gift of the Dell stock itself because there was a "real economic risk of a change in value" between the time of funding and the time of the subsequent gift), *aff'd on other grounds*, 601 F.3d 763 (8th Cir. 2010);
- Consider not making the re-transfer of exactly the same assets received in the initial gift;
- Report the transfers correctly on gift and income tax returns;
- Consider having the initial donee retain the assets long enough to receive some distributions from the gifted asset; and
- Consider having subsequent transfers made in a subsequent calendar year.

(3) **Transfer Documents With Prior Effective Date.** Backdating documents is obviously a big no-no, with potential fraud implications. The parties in *Smaldino* did not do that and made clear they were merely signing documents with an effective date. As pointed out by the court, they selected an effective date more than four months (!!) prior to when the documents were signed. The opinion gave no indication that other documents contemporaneous with the stated effective

date existed to reflect the intent of the parties to make these transfers once they knew the values. The parties must have had some intention to make the gifts, or they would not have obtained the appraisal, but if the appraisal had reflected a much higher value than anticipated, Donor might have decided in August not to make the April 15, 2013 gift.

Still, it is interesting that apparently the IRS raised no questions about assignment documents made with an effective date at least four months prior to when the documents were signed. Maybe the IRS did raise questions about that. Maybe that is why Donor agreed to drop any argument that these were *Wandry* transfers of a defined dollar amount. After all, they could have signed documents making *Wandry* transfers on April 14 and April 15. They did not need an appraisal to transfer a specific dollar value worth of units. On the other hand, if they were making transfers of specified percentages of units, they did need the appraised value to know how many units to transfer to the wife to equal her gift exclusion amount.

(4) ***Nelson* Transfers.** This case points to the practical chicken-and-egg problem with making gifts of a particular dollar amount. The appraisal needs to list the date of the transfers and the date the property was appraised to satisfy the "appraisal safe harbor" under the adequate disclosure regulations. Reg. §301.6501(c)-1(f)(3)(ii)(A). But on the date of the transfer, the appraised value will not yet be known to know how many units to transfer within a desired dollar-amount of gift. The solution is to use the procedure employed in the *Nelson* case (see Item 11 above), making a transfer of a stated dollar amount based on an appraisal to be obtained within 90 (or 180) days. For example, in *Smaldino*, Donor could have signed an assignment to his wife on April 14, 2013 of a sufficient number of Class B nonvoting units in the LLC so that the fair market value of such nonvoting units shall be $5,249,000 as determined by XYZ appraisal firm within 180 days of the assignment. His wife could have signed an assignment the following day to the Dynasty Trust using the same description. Donor could have also made an assignment to the Dynasty Trust of Class B nonvoting units representing 49% of the ownership units of the LLC (Class B nonvoting units) less the number of nonvoting units having a fair market value $5,249,000 as determined by XYZ appraisal firm within 180 days of the assignment.

The IRS did not find that approach abusive in *Nelson*, and indeed took steps to enforce the assignments for tax purposes as written.

Another alternative is to make *Wandry* transfers and be consistent in treating and reporting them as *Wandry* transfers. A downside of this approach is that the IRS has never formally conceded the effectiveness of *Wandry* transfers and maintains that it is still looking for an appropriate case to test the *Wandry* result in another court opinion. But *Wandry* transfers have become relatively common.

Another alternative for dealing with the practical problem of obtaining an updated appraisal as of the transfer date is that the appraiser may update the appraisal based on facts as of the close-in-time transfer date for relatively little additional expense, or obtaining an updated appraisal may be negotiated in the initial engagement with the appraiser.

(5) **Subtracting Present Value of Guaranteed Payments in Determining Value.** The court allowed reducing the value of the class B nonvoting interests by the approximately $1.9 million present value of the guaranteed payments. It is interesting that the IRS did not raise objections to an assumption that the guaranteed payments would be made for 40 years, especially when they knew in hindsight that the payments lasted only for a matter of months! But more important is the issue of whether the guaranteed payments, to provide for the manager's compensation, should have been allowed as a reduction at all in determining the value. It seems rather arbitrary to say that ongoing management fees are not subtracted in determining the value of an entity on the NAV approach but that payments to the manager expressed as a guaranteed payment instead of a management fee would be subtracted. They can be structured to be the same anticipated approximate amount. An obvious difference is that the entity is liable for the guaranteed payment notwithstanding the actual cash flow or profit of the entity. But in large part, whether the fee paid to the manager is structured as a guaranteed payment or as a management fee is typically based on the differences in the income tax treatment of the two approaches.

If this approach is followed in future cases and if management fees will be substantial for an entity that will be the subject of a gift or transfer at death, the parties may purposefully structure them as guaranteed payments in order to achieve a substantial reduction in the value of transferred interests. At the time of the transfer, the parties could not have a prearranged plan or perhaps even an intention to change that, but they could still always make adjustments in future years and switch back to a management fee approach if that became more appropriate.

The opinion raised the issue of whether Donor made a gift by switching from guaranteed payments to a management fee approach for compensation later in the year. That would not necessarily result in a gift – the anticipated amount of the management fees (especially with the increase from 10% to 20% of annual net cashflow) may have been worth even more than the value of the guaranteed payments. Switching to guaranteed payments and then back to a management fee, with the result that a big reduction in value for gift purposes may result on the date of the transfer, could certainly have the appearance of abusive manipulation. (If such a change becomes desirable, it would seem far preferable to wait at least until the following tax year to make the adjustment.)

(6) **Potential §2036(a)(1) Issue with Guaranteed Payments.** Paying reasonable compensation to a donor as manager of a transferred entity should not result in estate inclusion as a retention of income from the transferred property under §2036(a)(1). But egregious management fees, with the result that a donor as a practical matter receives all of the income (or more) from an entity, in excess of the value of services provided, could arguably result in transfers of entity interests being brought back into the donor's gross estate under §2036(a)(1).

(7) **First Case to Discuss §2701.** This appears to be the first reported case with any substantive discussion of §2701. Over thirty years have elapsed since the passage of §2701, with all its complexity. At last, an opinion has a discussion about §2701, but in a case in which §2701 was not even applicable. The opinion had a discussion about guaranteed payments not being treated as the type of "senior interest" that would be valued at zero under §2701, and the opinion summarized the calculation method under §2701 and applied that same general method in accounting for guaranteed payments (which it analogized to a senior interest under §2701) when valuing transfers of interests in the entity that were analogous to junior interests under §2701. In addition, "for the sake of completeness" the opinion in footnote 20 summarizes the lookback rule in §2701(d).

(8) **Gift Splitting.** The result of the case was that Mr. Smaldino was treated as making the entire gift of the 49% interest, using none of Mrs. Smaldino's gift exemption amount. If Mr. Smaldino had simply reported the entire gift himself and they elected gift-splitting, he would have avoided gift tax on half of the court-determined value of $7,820,008. Of course, that would not have been as favorable as sheltering $5.25 million of the gift with Mrs. Smaldino's gift exemption if that had been possible.

21. Application of "Atkinson Rationale" to GRAT and Valuation Issue Regarding Anticipated Merger, CCA 202152018

a. **Basic Facts**. Donor, who was the founder of a "very successful company, Company," transferred shares of the Company to a two-year grantor retained annuity trust (GRAT) that appeared to satisfy the requirements for a qualified interest under §2702. The required annuity payments were a fixed percentage of the initial fair market value of the trust (whether that was the fair market value as finally determined for federal tax purposes, as described in the GRAT regulations, is not specifically stated). The value of the transferred shares was determined based on an appraisal as of a date about seven months earlier that had been obtained to report a nonqualified deferred compensation plan under §409A.

Prior to the transfer to the GRAT, however, Donor had been negotiating with several corporations about a possible merger and had received offers from five different corporations within two and a half weeks before the transfer to the GRAT. Within three months after the initial offers, four of the corporations had submitted higher offers, and, three months after that, Donor accepted one the

offers, an initial cash tender offer for some of the outstanding shares at an amount that was nearly three times greater than the value used for the GRAT, with an option to purchase the remaining shares under a formula valuation.

Several weeks prior to closing the tender offer purchase, Donor had gifted shares to a charitable remainder trust and valued the shares pursuant to a qualified appraisal at an amount equal to the tender offer value. The charitable remainder trust also took advantage of the tender offer.

About six months after the end of the GRAT's two-year term, the purchasing corporation purchased the balance of the Company's shares at for a price per share almost four times the value used for the GRAT valuation.

b. Analysis.

(1) Valuation Should Take Into Consideration Pending Merger. CCA 202152018 has analysis very similar to the reasoning in CCA 201939002 in a similar situation involving a transfer of pre-merger stock to a GRAT. Indeed, the following concluding language in CCA 202152018 is almost word for word the same as the corresponding conclusion in CCA 201939002:

> Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of [the date the GRAT was created], would be reasonably informed during the course of negotiations over the purchase and sale of the shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger undermines the basic tenets of fair market value and yields a baseless valuation...

For a discussion of CCA 201939002 and planning considerations and remaining questions in light of the CCA, see Item 25.b.(2) of Heckerling Musings 2020 and Estate Planning Current Developments found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(2) GRAT Treated as Not Being a Qualified Interest Under §2702 Because of Using Undervalued Appraisal (by Analogy to *Atkinson*). The conclusion quoted above regarding the valuation issue goes a step further than CCA 201939002, however, by adding the following clause not found in CCA 201939002:

> ... and thereby casts more than just doubt upon the bona fides of the transfer to the GRAT.

This is a big further step that treats the GRAT annuity as not being a qualified interest because of the undervalued appraisal used to determine the annuity amounts that were paid by the GRAT over its two-year term. Accordingly, Donor was treated as making a gift equal to the full finally determined value of the shares transferred to the GRAT, without any offset for the value of Donor's retained two annuity payments.

The CCA reasons by analogy to *Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002). In *Atkinson*, no annuity payments were actually made from a charitable remainder annuity trust during the two years from the creation of the CRAT until the donor's death. Although the trust met the statutory requirements for five percent annual distributions, the trust did not operate in accordance with those terms, and the court denied an income tax charitable deduction. On appeal, the taxpayer argued that the deduction was denied because of a "foot fault," or a minor mistake, but the appellate court concluded that the trust failed to comply with the rules governing CRATs throughout its existence and denied the deduction. The deduction was denied because of the manner in which the trust was operated, even though the agreement itself met the technical requirements for CRATs.

Similarly, the CCA reasons that basing the annuity payments on an undervalued appraisal was an "operational failure" that resulted in Donor not having retained a qualified annuity interest under §2702.

> In addition, although the governing instrument of Trust appears to meet the requirements in § 2702 and the corresponding regulations, intentionally basing the fixed amount required by § 2702(b)(1) and § 25.2702-3(b)(1)(i) on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust. The trustee's failure to satisfy the "fixed amount" requirement under

§ 2702 and § 25.2702-3(b)(1)(ii)(B) is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust; instead, the amount was based on an outdated and misleading appraisal of Company, at a time when Company had received offers in the multi-billion dollar range. When asked about the use of the outdated appraisal, the company that conducted the appraisal stated only that business operations had not materially changed during the 6-month period. In contrast, in valuing the transfer to the charitable trust, the company that conducted the appraisal focused only on the tender offer, and accordingly gave little weight to the business operations for valuation purposes.

The operational effect of deliberately using an undervalued appraisal is to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under § 2702. See Atkinson.

c. Observations.

(1) IRS Reaction Understandable But.... A feature of GRATs that is especially attractive is the "savings clause" feature that is authorized in the GRAT regulations, which allow basing the annuity payments on a specified percentage of the initial fair market value of assets contributed to the GRAT, as finally determined for federal tax purposes. Reg. §25.2702-3(b)(1)(ii)(B). If the contributed assets are initially undervalued, the annuity amounts automatically readjust based on the finally determined fair market value of the assets so that the gift value of the remainder interest in the GRAT is still nominal.

The IRS's main concern with defined value clauses generally and the GRAT valuation "savings clause" may be that unscrupulous taxpayers will use very unreasonably low valuations and if "caught," will simply make adjustments based on a proper valuation with no risk of being penalized for trying to get by with the initial unreasonably low valuation.

Indeed, that seems to be what happened factually in the facts of this CCA. The donor used a seven-month-old appraisal that was prepared before negotiations had commenced with merger prospects and used a value that apparently was substantially lower than an actual outstanding offer at the time shares were transferred to the GRAT. Shares were actually sold six months later for nearly three times the value that was used for determining the GRAT annuity payments.

Rather than merely adjusting the amount of the annuity payments, so that the donor received back annuity payments equal to (actually, on a non-discounted basis, somewhat greater than) the full value that was contributed to the GRAT, the IRS took the unprecedented position that the retained annuity payments should be valued at zero, resulting in a very large, unexpected gift. That result is not described in the regulation. The only authority for that Draconian result is a broad extension of the reasoning of the *Atkinson* case. But the *Atkinson* case is a very different situation; the CRAT regulations require five percent annual distributions for CRATs, and the trust made no payment whatsoever, so the regulatory requirements were not satisfied. That is not the case with the GRAT. There are no mandated payments that were unpaid, and as soon as a higher value of the contributed shares is finally determined, the annuity payment amounts will be adjusted, as specifically permitted by the regulation addressing "incorrect valuations of trust property." Reg. §25.2702-3(b)(2). At a bare minimum, the present value of the payments that were made should be subtracted in determining the amount of gift made upon the GRAT's creation.

(2) Potentially Horrendous Effect. The result of the CCA may be to treat the entire contribution to the GRAT as a gift, while the donor may have expected that the taxable gift would be a nominal value (the value of the remainder interest). The CCA makes reference to the company having received offers "in the multi-billion dollar range." The value of shares transferred to the GRAT might have been many millions of dollars. Furthermore, the IRS may allege that the 40% undervaluation penalty would apply.

(3) Are All GRATs Involving Hard-To-Value Assets at Risk? The logical extension of CCA 202152018 is that if the value of assets contributed to any GRAT is ultimately "finally determined" to be larger than the initially anticipated amount on which annuity payments are based, the "operational failure" to pay the required annuity amounts on the annuity payment dates will

cause the donor to be treated as having made a taxable gift equal to the full amount contributed to the GRAT, notwithstanding the fact that the donor will actually receive annuity payments having a present value equal to almost the full value contributed to the GRAT. The regulations that planners have viewed as a very helpful savings feature of GRATs will instead be turned into a huge trap – resulting in treating retained annuity payments as having zero value for purposes of determining the gift upon the GRAT's creation. The result would be especially egregious in light of the regulation's specific provision for making adjustments in the case of "any incorrect determination of the fair market value of the property in the trust." Reg. §25.2702-3(b)(2).

(4) How Much Undervaluation Is Required Before Applying the *Atkinson* Result? The IRS may respond that the *Atkinson* result would be applied only in extreme situations. The conclusion in CCA 202152018 refers to "deliberately using an undervalued appraisal ... to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars." The question will then be how low must the initial valuation be before the IRS will apply the Draconian result? Any GRAT with hard-to-value assets would inherently be subject to the possibility of facing the risk of having the full amount contributed to the GRAT being treated as a taxable gift.

On the other hand, the nature of a Chief Counsel Advice is that it arises from a specific audit of a specific case, and therefore possibly with a specific back-story, not revealed in the CCA itself, that explains the IRS's apparent sensitivity and aggressive reaction.

Perhaps the IRS concern in this CCA was not so much with the appraised *amount* but with the *process.* The donor appeared to have used a valuation that the donor knew was seven months out of date, prepared for another purpose, and which substantially undervalued the shares because of intervening events (obviously unknown to the appraiser).

The result seems totally inconsistent with the authority in the regulations for basing the annuity amount on the finally determined fair market value of contributed assets and allowing adjustments for "incorrect valuations of trust property."

(5) Planners Can Use CCA As a Warning to Overly Aggressive Clients. Clients who push planners to take aggressive valuation positions (such as relying on old appraisals or using low estimated values without appraisals) or other aggressive positions regarding GRATs may be reminded of the potential horrendous gift tax result under the reasoning of the CCA if the IRS should view the planning as abusive. Not only might the IRS take the position that the transfer to the GRAT resulted in a huge gift (of the entire amount transferred to the GRAT), but the IRS might allege that 40% undervaluation penalties would apply as well.

The CCA is a warning to clients who might be tempted to "cheat" by using unreasonably low valuations, thinking that there is no downside if they get caught because they could just adjust the annuity amounts without risking having to pay gift taxes. Furthermore, Stephanie Loomis-Price, a transfer tax litigator, reports that she has seen the IRS take this same overly aggressive approach in several cases involving GRATs, though they were all resolved out of court. *See* Jonathan Curry, *Estate Planners Ponder IRS's 'Overaggressive' GRAT Slapdown*, TAX NOTES (February 15, 2022).

22. Malpractice Action Regarding Advice Involving Creation of FLP and Sale of LP Interests, *Wellin v. Farace*, (4th Cir. November 22, 2021)

a. Synopsis. Mr. Wellin ("Wellin"), on the advice of his estate planning attorney, in 2003 transferred about $90 million of Berkshire Hathaway Class A stock to a limited partnership, apparently to reduce estate taxes with valuation discounts. He owned 98.9% and an LLC controlled by his three children (from a prior marriage) owned the remaining 1.1%. In 2006, the attorney advised Wellin that the valuation discounting plan "was now considered questionable" and recommended that Wellin sell his limited partnership units to a grantor trust with his three children as trustees. Wellin did not proceed at that time, but after being diagnosed with cancer in 2008 he implemented the sale

strategy in 2009 by creating a grantor trust and selling his units to the trust in exchange for a note with a face amount of about $50 million. The attorney predicted future estate tax savings of $14 - $18 million resulting from the 2009 sale transaction.

After Wellin expressed confusion about the 2009 sale transaction, the attorney sent several letters in January 2010 and November 2011 explaining that the sale was "a very efficient strategy for reducing estate tax" by "freezing" the estate, and that "more wealth" would pass to the children.

On February 8, 2012, Wellin's wife sent an email to the attorney expressing concern over the attorney's loyalty to Wellin and suggesting he was giving priority to the interests of the children regarding advice about Wellin's tangible personal property. Wellin changed attorneys in mid-2013, and the new attorney filed suit in July 2013 to set aside the sale because Wellin did not understand that he had relinquished control of the partnership interests and would be liable for income taxes if the children sold the stock owned by the partnership before Wellin's death. That litigation was eventually dismissed without prejudice upon settlement of the case.

In late 2013, the children sold the Berkshire Hathaway shares for $157 million. Wellin died in 2014.

The Estate sued the attorney in February 2016 (within three years of when the new attorney was engaged), alleging that the original attorney "failed to inform Mr. Wellin about the risks and consequences of the 2009 transaction, including Mr. Wellin's potentially substantial tax exposure." Expert witnesses filed reports regarding alleged breaches of the standard of care, including:

- the attorney "misrepresent[ed] the actual risks [and] benefits" of the 2009 sale;
- the statement that the sale would result in "more wealth" for the children was "grossly misleading;"
- the attorney failed to advise of "potential gift tax liability of $17.5 million, plus interest and penalties, in exchange for only a *potential* savings in estate tax;"
- the attorney failed to inform Wellin that "he risked 'extreme' income tax liability if the Wellin children liquidated their assets in [the FLP] during Mr. Wellin's lifetime;" and
- Wellin "may not have [had] sufficient assets and liquidity to pay income taxes" that could have resulted, and that the potential income tax exposure exceeded $40 million, plus interest, from the sale of the partnership's assets while Wellin was still alive.

The lawsuit also alleged claims (i) relating to the 2003 creation of the FLP, (ii) regarding a conflict of interest in representing both the Estate and one or more of the Wellin children, and (iii) regarding aiding and abetting two of the children in breaching their fiduciary duties in connection with the 2009 sale transaction, but those claims were later abandoned.

The defendant-attorney moved for summary judgment on grounds that the claim was barred by the three-year statute of limitations because Wellin's wife's 2012 email reflected that the Estate was on notice of its potential claims against the attorney by that time. The district court granted defendant's motion for summary judgement. The Fourth Circuit reversed, reasoning that the purported conflict of interest in handling the disposition of the personal property referred to in the 2012 email and alleged failure to advise of tax risks were "different types of injuries." Knowledge of the attorney's interaction with the children concerning the personal property "did not place Mr. Wellin on notice that he should investigate the defendants' work performed three years earlier regarding a complicated tax strategy." "[A] person of common knowledge could not readily have discovered the alleged breach of duty involving the tax implications of the 2009 transaction ... [and] nothing in the documents relating to the 2009 transaction revealed any information about the transaction's tax consequences." Disputed issues of material fact exist regarding whether the purported malpractice was discoverable before the defendant hired the new attorney in mid-2013, and the summary judgment barring the claims under the statute of limitations was vacated. *Wellin v. Farace*, 2021 WL 5445968 (4th Cir. Nov. 22, 2021).

b. **Observations.**

(1) **Illustrative of Potential Claims Regarding Tax Advice and Representation of Multiple Family Members.** The case is an example of malpractice claims that potentially could arise regarding advice in connection with the creation of an FLP and the sale of units to a grantor trust controlled by the trust beneficiaries. The experts pointed out potential breaches related to the failure to advise about potential gift tax claims, the overstatement of estate tax advantages, and the failure to warn of potential income tax risks associated with the sale of assets prior to Wellin's death.

In addition, the case is an example of conflict of interest claims that could arise involving multi-family member representation without clear disclosure and waivers in engagement letters. (Planners should be especially sensitive to later possible allegations of conflicts of interest that may arise between a spouse and children by a prior marriage.)

(2) **Litigation Pending.** The litigation is still pending. The defendant-attorney no doubt will present evidence in defense against the malpractice allegations and will attempt to limit the scope of potential damages. (For example, footnote 4 of the opinion states: "The Estate did not pay any tax on the Wellin children's sale of the stock shares, and any attempt to collect such a tax by the IRS appears now to be barred by the statute of limitations.")

(3) **Resource.** For an excellent discussion of planning implications for estate planning attorneys arising from fact scenarios similar to the *Wellin* situation, see Sandra Glazier, Martin Shenkman, Jonathan Blattmachr & Joseph Garin, Wellin v. Nixon, Peabody, LLP – *Case Lessons on Defensive Practice,* LEIMBERG ESTATE PLANNING NEWSLETTER 934 (January 20, 2022).