ESTATE PLANNING: Current Developments and Hot Topics

December 2013

The Estate Planner's "Playbook" for 2013 and Going Forward Under the Post-ATRA "New Normal" of Permanent Large Exemptions and Portability.

Steve R. Akers

Senior Fiduciary Counsel — Southwest Region, Bessemer Trust
300 Crescent Court, Suite 800
Dallas, TX 75201
214-981-9407

akers@bessemer.com
www.bessemer.com

BESSEMER TRUST

TABLE OF CONTENTS

1. American Taxpayer Relief Act of 2012 and "3.8% Medicare Tax" 1
2. Administration's Fiscal Year 2014 Revenue Proposals 8
3. Treasury-IRS Priority Guidance Plan 17
4. Possible Tax Reform Legislative Developments... 18
5. Planning for Donors Who Made Large 2012 Gifts 20
6. Generation Skipping Transfer Tax Reporting Issues 26
7. General Approaches to Estate Planning Following ATRA; The "New Normal"................ 31
8. Portability 41
9. Trust and Estate Planning Considerations for 3.8% Tax on Net Investment Income and Income Taxation of Trusts.. 57
10. Strategies to Preserve Basis Adjustment Upon Grantor's Death 69
11. Strategies to Preserve Basis Adjustment Upon Surviving Spouse's (or Other Donee's) Death 73
12. General Gift Planning Issues for 2014 and Beyond 79
13. Gift Strategies That Provide Some Benefit to Grantor and/or Grantor's Spouse — Overview.. 83
14. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Borrowing From Trust 84
15. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Lifetime Credit Shelter Trust for Donor's Spouse (also referred to as Spousal Lifetime Access Trusts, or "SLATs"); Exercise of Powers of Appointment for Grantor and/or Grantor's Spouse 84
16. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — "Non-Reciprocal" Trusts 90
17. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Discretionary Trusts in Self-Settled Trust States 92
18. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Sale for Note or Annuity.. 95
19. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Transfer of Residence to Trust or Co-Tenancies Between Grantor/Spouse of Grantor and Trust 95

20. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Exercise Swap Power or Repurchase Assets From Trust 97

21. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Preferred Partnership Freeze 97

22. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Terminate Grantor Trust Status 97

23. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Payment of Management Fees to Grantor 98

24. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Inter Vivos QTIPable Trust 98

25. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Retained Income Gift Trust 99

26. Wealth Transfer Strategies — Generally 100

27. Defined Value Clause Updates, Including *Wandry* 101

28. GRAT Strategies 119

29. Supreme Court in *Windsor* Creates Planning Opportunities for Same-Sex Married Couples 127

30. Installment Sales to Grantor Trusts and Spousal Grantor Trusts 139

31. Installment Sales by Beneficiary to Section 678 Trust 140

32. Sale of S Corporation Stock by Beneficiary to QSST 144

33. Transfers Involving Family Limited Partnerships or LLCs 145

34. Intra-Family Loans and Notes 149

35. Planning for Surviving Spouse Who is Beneficiary of QTIP Trust; Sale of Assets for Deferred Private Annuity, *Estate of Kite v. Commissioner,* T.C. Memo. 2013-43 154

36. Value of Fractional Interests in Art; Consider Likelihood That Family Members Would Purchase Hypothetical Purchaser's Fractional Interest; 10% Fractional Interest Discount, *Estate of Elkins,* 140 T.C. No. 5 (2013) 168

37. DING Trust Letter Rulings, PLRs 201310002-201310006 171

38. Interest on Graegin Loan Not Deductible; Majority Interest in LLC Valued With Low Marketability Discount, *Estate of Koons v. Commissioner,* T.C. Memo. 2013-94 178

39. Self-Canceling Installment Notes (SCINs); CCA 201330033 and *Estate of William Davidson* 181

40. Decanting—Massachusetts Court Recognizes Common Law Decanting Authority Based on Trust Instrument, *Morse v. Kraft et al.* 197

41. Social Security and Medicare Basics—What One Needs to Know When Approaching Mid-60s 199

42. Net Gift Offset by Donee's Assumption of Potential § 2035 Estate Tax Liability if Donor Dies Within Three Years, *Steinberg v. Commissioner* 206

43. Interesting Quotations 214

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. 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 of recent developments includes observations from some of the seminars at the 47th Annual Philip E. Heckerling Institute on Estate Planning as well as other seminars and developments during the year. This summary focuses on practical planning issues that estate planning professional will be facing under the "new normal" of transfer tax certainty, large indexed transfer tax exemptions, and portability provided by the American Taxpayer Relief Act of 2012 (ATRA). Topics include:

- legislative matters and proposals (Items 1-4);
- planning for donors who made 2012 gifts, including compliance details (Items 5-6);
- planning approaches for various categories of clients going forward in light of permanent large indexed exemptions and portability (Item 7-8);
- planning considerations for the new 3.8% Medicare tax on net investment income (Item 9);
- strategies to preserve basis at death (turning some traditional planning on its head) (Item 10-11);
- wealth transfer planning strategies leaving some indirect access for the donor and donor's spouse (Items 12-25);
- other sophisticated wealth transfer planning strategies (including using defined value clauses) (Items 26-28, 30-33);
- planning considerations for commonly used intra-family loans and notes (Item 34);
- planning considerations for same-sex spouses in light of the Windsor decision (Item 29); and
- recent guidance from the IRS regarding self-canceling installment notes (SCINs) (Item 39).

It is hoped that this summary might be a useful "playbook" for planning under the new post-ATRA paradigm of permanent high indexed exemptions, portability, and higher income taxes.

1. American Taxpayer Relief Act of 2012 and 3.8% Tax on Net Investment Income

a. *Summary of Provisions*. The U.S. Senate passed ATRA in the early morning hours of New Year's Day 2013. The bill then went to the House and, after hours of speculation as to whether the House would vote on, amend, or even support the bill, the House approved the bill shortly before midnight. (Ron Aucutt quips that the American Taxpayer Relief Act *of 2012* was signed on "December 32, 2012.") The President signed ATRA into law on January 2, 2013.

b. *Transfer Tax Changes*. The following are the highlights of the transfer tax provisions of ATRA.

(1) *Sunsetting the Sunset of the 2001 and 2010 Acts*. The estate, gift and generation-skipping transfer tax provisions of 2012 law remain in effect (including the $5 million indexed estate, gift and GST exemption), with several minor modifications. This is accomplished primarily by "sunsetting" the sunset provisions of the 2001 and 2010 Acts; without any change the estate and gift exemptions would have reverted to $1 million; and the Obama administration proposed a $3.5 estate and GST exemption; Ron Aucutt quips that the compromise between $1 million and $3.5 million was, of course, $5.0 million).

(2) *Top Marginal Rate of 40%*. The top estate, gift and generation-skipping transfer tax rate is increased from 35% (under the 2012 law) to 40%. This appears to be an obvious compromise between 35%, which applied in 2012, and the Obama administration's proposed rate of 40%, and is roughly the same as the top income tax rate).

(3) *Portability Retained with Technical Revisions*. Portability is made permanent beginning in 2011 and the portability provision is modified to remove any "privity" requirement (thus adopting the "Example 3" position that appeared in the Joint Committee on Taxation Report to the 2010 Act).

(4) *Effective Date*. Other than the portability provision (which applies beginning in 2011), these provisions apply to estates of decedents dying, generation-skipping transfers, and gifts made after December 31, 2012; and

(5) *"Permanent" Changes*. Quite importantly, these provisions are adopted "permanently," rather than merely being extended for several years.

c. *Selected Other ATRA Changes*. Several other major highlights of ATRA that may be of interest for estate planning purposes are listed.

(1) *Top Income Tax Rate of 39.6%*. The income tax provisions of the 2001 Act are extended except that the top income tax bracket for individuals is increased to 39.6% for taxable income in excess of indexed threshold amounts, which, for 2013, are $450,000 for married individuals filing joint returns, $425,000 for heads of households, and $400,000 for unmarried individuals (other than surviving spouses and heads of households). (These top brackets are increased in 2014 to $457,600, $432,200, and $406,750, respectively.)

(2) *Phase-out of PEP and Pease Limitations*. The phase-out of personal exemptions and itemized deductions (the "PEP" and "Pease" limitations) was reduced under the 2001 Act in steps from 2006-2010 (with a total elimination of the phase-out in 2010, extended by TRA 2010 through 2012). ATRA reinstates the phase-out (as under pre-2001 law) for individuals with adjusted gross income in excess of new indexed threshold amounts ($300,000 for a joint return or a surviving spouse, $275,000 for a head of household, and $250,000 for an unmarried

individual other than a surviving spouse or head of household)(the indexed threshold amount would have been about $175,000 under the pre-2001 statutory provisions).

(3) *Top Rate of 20% for Capital Gains and Qualified Dividends*. The 2003 Act reduced the maximum rate on most long-term capital gains to 15% and applied the same 15% rate to "qualified dividends." Under ATRA, the rates on qualified dividends and long-term capital gains are adjusted by adding new 15% and 20% brackets (i.e., the top "general" rate is increased to 20% for high income taxpayers to which the 39.6% rates apply). Without this change, all dividends would have been taxed at ordinary income tax rates.

(4) *Alternative Minimum Tax Indexed Exemptions*. Permanent alternative minimum tax relief is enacted by providing revised exemption amounts that are indexed for inflation (there will no longer be the need for the annual "AMT patch");

(5) *State and Local Sales Taxes*. ATRA extends the deduction of state and local general sales taxes through 2013;

(6) *Charitable Distributions from IRAs*. Extending through 2013 the ability to make tax-free distributions from individual retirement plans to charity (for qualified charitable distributions up to public charities [not donor advised funds, supporting organizations or certain private foundations] of up to $100,000 for individuals who have reached age 70 ½); rollovers completed by February 1, 2013 can be treated as if made in 2012; a distribution from the individual retirement plan in December 2012 can be treated as a qualified charitable distribution in 2012 if it is transferred in cash to charity before February 1, 2013;

(7) *Conversion of Traditional Retirement Accounts to Roth Accounts.* Traditional retirement accounts may be converted to Roth accounts (beginning in 2010, distributions from traditional retirement accounts could be contributed directly to an employer-offered Roth account only when the individual separated from service, reached age 59 ½, died or became disabled). ATRA allows the conversion in all circumstances, but it differs from regular Roth conversions because the payment of income taxes on the conversion must come from outside the plan, and there is no ability to recharacterize (i.e., "unconvert") the Roth conversion, so this provision is not as advantageous as converting a regular IRA to a Roth IRA.

(8) *"Permanent" Provisions.* Again, quite importantly, these provisions are adopted "permanently" (other than the sales tax and individual retirement plan charitable rollover provisions which, as noted, apply only through 2013).

d. *Medicare 3.8% Tax on Net Investment Income*. The 3.8% tax on net investment incomt under §1411 was enacted as part of the Affordable Care and Patient Protection Act (not as a part of ATRA), and became effective for the first time in 2013. In addition to the increase in the maximum income tax rate to 39.6% for high income earners (i.e., generally joint filers having taxable income more than $450,000 and $400,000 for single filers in 2013, $457,600 and $406,750, respectively, in 2014), a new 3.8% tax on net investment income applies beginning in 2013 to net investment income if the adjusted gross income (without regard to the foreign earned income exclusion) exceeds $250,000 for joint filers and $200,000 for single individuals. Therefore, the top federal rate on investment income for high earners will be 43.4% (not including state income taxes).

The 3.8% tax on net investment income will also impact trust administration planning. The 3.8% tax applies to the undistributed net investment income of trusts in excess of the income level at which the highest trust rate applies ($11,950 for 2013, $12,150 for 2014). For further discussion of this issue see Item 9 below.

e. *Major Transfer Tax Changes ATRA Avoided*.

- Return to a $1 million exemption for estate, gift and GST tax.
- Concerns about "clawback" where estate tax exemption is lower than a prior gift exemption are now moot.
- De-unification of the gift exemption with the estate and GST exemptions.
- We will never again have to worry about the "as if it had never been enacted" provision in EGTRRA and TRA 2010 that created so much confusion.
- The loss of portability.

f. *Overview of Selected Statutory Provisions of ATRA.*

(1) *Short Title.* Section 1 of ARTA 2012 says the Act may be cited as the "American Taxpayer Relief Act of 2012." Fortunately, we again have a short acronym for the 2012 legislation compared with "TRUIRJCA" — which is why that 2010 Act is abbreviated above as "TRA 2010".

(2) *"Sunsetting" the Sunset.* The heart of the transfer tax changes in ATRA 2012 are several brief sentences in Section 101 of ATRA 2012 striking the sunset provisions in EGTRRA and TRA 2010.

EGTRRA made significant changes to estate, gift and GST tax law, but provided in Title IX thereof (which consisted of a single section--Section 901), the so-called "sunset" provision, that "[a]ll provisions of, and amendments made by, this Act [(EGTRRA)] shall not apply . . . to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010," and that thereafter, the Internal Revenue Code would be applied "as if the provisions and amendments [of EGTRRA] had never been enacted."

TRA 2010, among other provisions, increased the estate, GST ***and gift*** exemptions to $5,000,000, adjusted for inflation after 2011, and brought about "portability" of exemptions beginning in 2011. An important provision in TRA 2010 was to amend the sunset provision in EGTRRA, by providing, in Section

101(a) of TRA 2010, that the "sunset" date in Section 901 of EGTRRA would change from December 31, 2010 to December 31, 2012, and all provisions of EGTRRA, as amended by TRA 2010, would apply as if the 2012 sunset date had been included in EGTRRA from the outset. Section 304 of TRA 2010 then provided that the EGTRRA sunset provision (as changed by TRA 2010) would apply to all provisions of TRA 2010 as well, and TRA 2010 would therefore sunset after 2012.

Now, Section 101(a)(1-2) of ATRA amends EGTRRA and TRA 2010 by striking the sunset provisions of both laws, and Section 101(a)(3) of ATRA states that the provisions apply with respect to decedents dying, and gifts and generation skipping transfers occurring, after December 31, 2012, without any further sunset provision or other "built-in" expiration.

Accordingly, all of the beneficial provisions of EGTRRA and TRA 2010 in effect in 2012 have now become "permanent" provisions that will remain in effect into the future, without the need for any further action from Congress (except that the rate has changed from 35% to 40% beginning in 2013 and the portability provision has been clarified). Therefore, unlike the situation that existed starting in 2001, we now know that exemptions will not be reduced, rates will not be further increased, and all of the other helpful provisions of EGTRRA and TRA 2010 will not be lost unless and until Congress is willing to enact new legislation that expressly makes those changes.

(3) *Increase Top Rate From 35% to 40%.* Section 101(c) of ATRA increases the effective estate, gift and GST tax rate from 35% to 40%, by re-introducing the 37% ($500,000 to $750,000), 39% ($750,000-$1,000,000) and 40% (over $1,000,000) tax brackets that were eliminated by TRA 2010. From a practical standpoint, however, since the 37% and 39% rates apply to estates, gifts and GST transfers that are below the "exemption" level of $5,000,000 (inflation adjusted) the practical result will be that if the tax is imposed, it will be imposed at 40%.

(4) *Technical Correction to Portability Provisions.* The only other change to the estate tax rules brought about by ATRA is a technical correction to the portability rules.

TRA 2010 provided for portability of estate and gift tax exemptions by modifying §2010(c)(2) to define the ***applicable*** exclusion amount as the sum of the ***basic*** exclusion amount and the deceased spouse's unused exclusion amount ("DSUE amount"). The key provision, in determining the amount that could be "ported" to the surviving spouse, is the definition of the DSUE amount. Section 2010(c)(4) defines the "deceased spousal unused exclusion amount" as the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts (described in §2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under section §2001(b)(1)"). The second item is the last deceased spouse's remaining unused exemption amount. It was strictly defined as the predeceased spouse's "basic exclusion amount" less the combined amount of taxable estate plus adjusted taxable gifts of the predeceased spouse. This appears to impose a "privity" requirement.

ATRA 2012 changes this reference from "basic exclusion amount" in §2010(c)(4)(B)(ii) to "applicable exclusion amount."

This difference is critical, because an individual's "applicable exclusion amount" includes his or her basic exclusion amount **plus** DSUE amount (in the case of a decedent who is a surviving spouse of a prior decedent who left him or her with a DSUE amount). This adopts the position taken in Example 3 on page 53 of the Joint Committee on Taxation Technical Explanation of TRA 2010.

The Joint Committee on Taxation on March 23, 2011 issued an ERRATA document with a footnote suggesting precisely the technical correction included in ATRA 2012. (The IRS adopted this same position in the temporary and proposed regulations adopted in June 2012, in a rather generous construction of the statutory language of TRA 2010. The technical correction in ATRA 2012 will not have any further impact on the portability temporary and proposed regulations.)

(5) *Highlights of Significant Provisions of EGTRRA That Are Now Permanent.* There were important provisions of EGTRRA (that we now take for granted) that are now permanent, including the following:

- Increasing the GST exemption to be the same as the tax-free amount for estate tax purposes rather than $1 million indexed for inflation from 1997 (subtitle C of EGTRRA);
- Ending the qualified family-owned business interest deduction after 2003 (how soon we have forgotten the "QFOBI" complexities);
- Converting the state death tax credit over several years to a deduction for state death taxes (subtitle D);
- Deemed allocations of GST exemption to lifetime transfers to "GST trusts" (subtitle G);
- Qualified severances of trusts for GST purposes (subtitle G);
- "9100 relief" from late GST exemption elections (subtitle G);
- Expansion of conservation easement rules for estate tax purposes (subtitle F); and
- Increasing the number of allowable shareholders or partners for §6166 purposes from 15 to 45 (subtitle H).

g. *Key Transfer Tax Changes Under ATRA; Paradigm Shift in Planning*. The four key transfer tax changes under ATRA are permanence, indexing, unification, and portability.

Permanence. For more than a decade now, planners have had to deal with the constant uncertainty of the estate tax laws, with the realization that the provisions of the 2001 and 2010 Acts would vanish without further Congressional action. Some planners have used rather complicated formula provisions in wills (depending on future laws) and have employed various measures to inject as much flexibility as possible into estate plans, in light of the constant uncertainty hanging over our heads. At last, we have the benefit of some "permanent" provisions (at least as permanent as anything is in the tax world).

Indexing. The ability to transfer $5,000,000 (inflation indexed) during lifetime or at death will continue. The indexing provision is enormous. There are reports that the final major negotiation over the transfer tax provisions involved whether the exemption would be indexed. (Most of the provisions in ATRA are indexed.) In the past, planners focused on a client's future appreciation, and the fact that with future appreciation, the client's estate would far exceed the estate tax exemption amount. With indexing, the exemption may grow at roughly the same rate as the client's estate.

- Clients who failed to use the entirety of their gift and/or GST exemptions in 2012 still have the opportunity to do so in 2013 and beyond.
- Moreover, clients can expect to acquire additional gift and GST exemptions in each new year. The inflation indexed amount for 2012 was $5,120,000, and the inflation indexed amount for 2013 is increased by another $130,000 to $5,250,000. The exemption will increase by another $90,000 in 2014, to $5,340,000. (The annual exclusion will remain at $14,000 in 2014.) Long-term, the permanent indexing feature of the exemption may have the most dramatic financial impact of the transfer tax provisions in ATRA 2012.

Unification. There was considerable uncertainty in 2012 as to whether the gift exemption would revert back to $1.0 million or some other amount lower than the estate and GST exemption. Permanently unifying the gift exemption with the high estate and GST exemptions opens up broad transfer planning opportunities on a permanent basis.

Portability. Dennis Belcher wraps up the importance of making portability permanent: "Portability is a game changer."

h. *Differing Thresholds*. Observe that there are three different thresholds (with respect to both categories of income and amounts) under the provisions discussed above.

- The thresholds for the new maximum 39.6% ordinary income tax and 20% capital gains tax rate are $450,000/$400,000 of taxable income in 2013 ($457,600 and $406,750 in 2014).
- The thresholds for the PEP/Pease limitations are $300,000/$250,000 of adjusted gross income in 2013 ($305,050/$254,200 in 2014).
- The thresholds for the 3.8% Medicare tax are $250,000/$200,000 of adjusted gross income (these thresholds are not indexed).

The effect of these varying thresholds will create some strange tax rates. For example, the 3.8% net investment income tax (based on AGI) will apply in many cases where the top income tax bracket (based on taxable income) will not, so a large number of taxpayers will be paying 18.8% on dividends and capital gains.

2. Administration's Fiscal Year 2014 Revenue Proposals

a. *Overview*. The Treasury on April 10, 2013 released the General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (often referred to as the "Greenbook") to provide the details of the administration's budget proposals. ATRA was passed with apparently little consideration to revenue impact (for example, allowing indexing of the AMT exemption levels will have enormous revenue impact). The Congressional Budget Office estimates are that ATRA will result in revenue losses over 10 years of $3.63 trillion. There will be no way to offset that with spending cuts, and some members of Congress will be looking for revenue raisers as part of a balanced approach of attacking the deficit problem. Other members of Congress are vehemently opposed to raising any new net revenue. However, the revenue that would be raised by the various transfer tax proposals (discussed below) are only about $6.9 billion over 10 years (other than the proposal to revert to the 2009 exemptions and rates beginning in 2018, which would raise $71.7 billion over the five years from 2019-2023), so that these provisions may not be on the front burner of revenue raisers that Congress may consider this year. (For example, a proposal in the Greenbook to limit the tax value of specified income tax deductions or exclusions to 28% would raise an estimated $529 billion over 10 years.) In any event, a client who is considering implementing any transaction that would be affected by any of these proposals may want to act "sooner rather than later" in case any of these proposals should be enacted this year.

b. *Restore 2009 Estate, Gift and GST Tax Parameters*. The proposal would make permanent the estate, GST and gift tax parameters from 2009 (45% rate, $3.5 million estate and GST exemption, and $1 million gift exemption with no indexing). These revised rates and exemptions would not apply until beginning in 2018. (Such a 4-year delay in implementing that type of change is surprising; perhaps it was intended to target a specified revenue target.) There would be no "clawback" incurred "by reason of decreases in the applicable exclusion amount respect to a prior gift that was excluded from tax at the time of the transfer." Portability of the unused estate and gift tax exclusions between spouses would continue to be allowed. (Estimated 10-year revenue: $71.693 billion)

   Prognosis: Highly unlikely this year. (Some Congressmen have expressed their disappointment with this proposal, which in their view reopens discussion on agreements that have already been made. Ron Aucutt's ACTEC Capital Letter summary of the Greenbook proposal concludes that "there is little indication that Congress is eager to revisit what it just made permanent in January.")

c. *Require Consistency in Value for Transfer and Income Tax Purposes*. The basis for income tax purposes would be the same "as determined for estate or gift tax purposes (subject to subsequent adjustments)." The proposal does not adopt the approach suggested in a Joint Committee on Taxation report to require that the income tax basis be consistent with values as reported on gift or estate tax returns, even if the transfer tax values were subsequently adjusted on audit. Executors and donors would be required to report valuation and basis information to both the recipient and the IRS. Regulatory authority would be granted to provide implementation details, including rules for situations in which no estate tax returns are required or gifts are excluded under §2503, if the surviving joint tenant or other recipient has better information than the executor, and for timing of required reporting in the event of value adjustments after filing an estate or gift tax return. (Estimated ten-year revenue: $1.896 billion, down from $2.014 billion that was estimated in the 2013 Fiscal Year plan.)

That proposal was included in H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). The bill provides that the basis shall not exceed the value "as finally determined for purposes of chapter 11" [or chapter 12 in the similar gift tax provision]. If there has been no final determination, the basis shall not exceed the amount reported on a basis information statement that will be required under §6035 to be given to estate or gift recipients where estate or gift tax returns are required under §6018.

Carol Harrington observes that this provision is unfair because the beneficiary may have had no input in the estate tax audit negotiations, and the executor may have "traded off" on the valuation of various assets. With this provision, the executor will have to consider the effect of audit negotiations on the basis of assets received by the various individual beneficiaries.

Prognosis: Yes-when there is tax reform

d. *New GRAT Requirements*. The proposal imposes four additional requirements on GRATs: (a) a ten-year minimum term would be required for GRATs, (b) a maximum term that would be allowed is for the life expectancy of the annuitant plus 10 years, (c) the remainder interest must have a value greater than zero (the proposal confirms that it "would not prevent 'zeroing-out' the gift tax value of the remainder interest" so there is no requirement that the remainder be a specified value above zero), and (d) the annuity amount could not decrease in any year during the annuity term. The proposal applies to trusts created after the date of enactment. (Estimated ten-year revenue: $3.894 billion, up from $3.334 billion in 2013 Fiscal Year plan.)

The maximum term limitation—the grantor's life expectancy plus 10 years—would remove the planning strategy suggested by some planners of using a very long term [say 99 years]. Under this strategy, at the grantor's death, the amount included in the estate would be based on the amount which if multiplied by the AFR at the date of death would equal the annual annuity amount. If AFRs increase significantly prior to the grantor's death, this could mean that a significant portion of the assets in the GRAT would not be included in the grantor's estate.

A stir was created by S. 1286, "Trade Adjustment Assistance Extension Act of 2011" filed on June 28, 2011. It included this minimum GRAT term provision, (which has been included in a number of other bills), but this bill was unique in making the entire bill-including this revenue raising provision-effective retroactive to January 1, 2011. Apparently, no thought had been given to the inherent unfairness of applying this minimum GRAT term provision retroactively and planners generally continued to form GRATs in the second half of 2011 without the minimum term provisions.

Prognosis: Likely-when there is tax reform. (Do not dismiss the possibility of a 10% remainder value requirement at some point, but not this year.)

e. *Limit Duration of GST Exemption.* The proposal would limit the GST exemption to 90 years after a trust is created. This would be accomplished by increasing the inclusion ratio of any trust to 1 on the 90th anniversary of the creation of the trust. GST exemption would have to be reallocated after 90 years in order for the trust to remain GST exempt. Pour over trusts and trusts created under a decanting authority will be deemed to have the same date of creation as the initial trust with one exception – the inclusion ratio will not change to 1 on the 90th anniversary after the date of creation as to any assets that are distributed to a vested single-beneficiary trust (as described in §2642(c); that exception permits an incapacitated beneficiary's share to continue to be held in trust without incurring GST tax on distributions to the beneficiary). The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date (subject to rules substantially similar to the grandfather rules). (Estimated ten-year revenue impact: Negligible.)

A 90-year GST limit was included in H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). The general rule under that bill provides as follows:

> In the case of any generation-skipping transfer made from a trust after the date which is 90 years after the date on which such trust is created, the inclusion ratio with respect to any property transferred in such transfer shall be 1.

The bill provided special rules to deal with deemed separate trusts under the GST rules and the creation of pour-over trusts from another trust.

Prognosis: probably-when there is tax reform. (Ron Aucutt quips that there will be 90 years to make technical corrections.)

f. *The Bombshell From Last's Year's Proposal Requiring Estate Inclusion for Grantor Trusts Has Been Narrowed to Address Sales to Grantor Trusts.*

(1) *Proposal in 2013 Fiscal Year Plan.* The 2013 Fiscal Year budget plan added that if a trust is a grantor trust, the trust assets would be included in the grantor's estate for estate tax purposes, any distribution from the trust would be treated as a gift, and conversion to non-grantor trust status would also be treated as a gift. The same rules would apply to section 678 trusts if the deemed owner sells assets to the trust (as to the sale transaction assets, income and appreciation from those purchased assets). The transfer taxes are payable out of the trust. The amount subject to the estate tax on death or the gift tax on a distribution or conversion to non-grantor trust status would be reduced by the value of any taxable gift made to the trust by the deemed owner. However, any trusts

includable in the grantor's gross estate under existing law (e.g., GRITs, GRATs, QPRTs, etc.) would not be impacted. Regulatory authority would be granted to provide "transition relief for certain types of automatic, periodic contributions to existing grantor trusts." (Apparently the intent is that this would just provide transitional relief and not have the effect of "grandfathering" trusts that have automatic periodic contributions, such as life insurance trusts requiring annual contributions to make premium payments.)

The proposal would apply to trusts created on or after the date of enactment and the portion of pre-enactment trusts attributable to contributions made on or after the date of enactment (but not the portion attributable to sales made after the date of enactment, thus permitting sales to "grandfathered" grantor trusts as a planning strategy).

This proposal was a dramatic change with far-reaching effects. For example, many irrevocable life insurance trusts are grantor trusts under §677(a)(3).

(2) *Proposal in 2014 Fiscal Year Plan.* The proposal has been narrowed to address certain transactions with grantor trusts.

- *Transaction Triggers*. New rules apply if "a person who is a deemed owner under the grantor trust rules of all or a portion of a trust engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust."

  Observe that the reference to a "deemed owner" rather than just referring to the grantor indicates that the proposal will apply to §678 trusts.

- *Effects.* The "portion of the trust attributable to the property received by the trust in that [sale] transaction (including all retained income therefrom, appreciation thereon, and re-investments thereof, net of the amount of the consideration received by the person in that transaction) will be"

  (1) "subject to estate tax as part of the gross estate of the deemed owner,"

  (2) "subject to gift tax at any time during the deemed owner's life when his or her treatment as a deemed owner of the trust is terminated," and

  (3) "will be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to the distributee) during the life of the deemed owner."

The amount subject to transfer tax is reduced by any portion that was treated as a prior taxable gift by the deemed owner. The transfer taxes would be payable from the trust.

In general, the assets that are sold to the trust, together with appreciation and accumulated income, will be included in the estate or treated as a gift, reduced by the amount of the promissory note or other consideration in the sale and reduced by the amount of the transfer that was treated as a gift by the deemed owner.

- *Exceptions*. The proposal would not apply to the following trust situations:
  - Any trust that is already includable in the grantor's gross estate under existing Code provisions including GRITs, GRATs, PRTs, and QPRTs;
  - Any trust having the exclusive purpose of paying deferred compensation under a nonqualified deferred compensation plan if the assets of such trust are available to satisfy claims of general creditors of the grantor (presumably, a reference to "rabbi trusts"); and
  - Any trust that is a grantor trust solely by reason §677(a)(3) (i.e., life insurance trusts).
- *Effective Date; Regulations.* The proposal applies to trusts that engage in such "sale, exchange or similar transaction" on or after the date of enactment. Regulatory authority would be granted, including the ability to create exceptions.
- *Revenue Impact.* Estimated ten-year revenue: $1.087 billion; interestingly this is less than the consistency of basis provision [$1.896 billion] and the GRAT provision [$3.894 billion])
- *Planning Issues.*
  - There is no longer a grandfather rule for grantor trusts created before the effective date of legislation as there was under the 2013 Fiscal Year Plan. Sales occurring after the effective date to either pre-existing trusts or to new trusts would be subject to the new rule.
  - Under this proposal, GRATs would have significant advantages over sales to grantor trusts.

    "[T]he proposal appears to apply to all sales, no matter how leveraged, no matter what the interest rate is on any promissory note, no matter what the other terms of the note are, and no matter whether the note is still outstanding at the seller's death. A GRAT, for example, has clear regulatory safe harbors for all these features and 'works' for estate tax purposes if it falls within those safe harbors. It would be odd if a simple installment sale to a grantor trust, which is a sale and not a gift, is subjected to a harsher gift (and estate) tax treatment than the funding of a GRAT, which actually is a gift." Ron Aucutt's ACTEC Capital Letter No. 33 (April 12, 2013)
  - Observe that the new rules do not apply if the trust becomes a grantor trust ***after*** the sale transaction. If an individual is willing to pay the capital gains tax to sell assets to a trust, the trust could subsequently convert to a grantor trust,

and the grantor could pay income taxes on the trust income (which results in substantial wealth transfer over time by augmenting the trust's growth and depleting the grantor's estate).

- Query whether the new rules would apply if the sale is made to a disregarded entity that is owned by a grantor trust?
- The new rules would apply after the exercise of a substitution power; thereafter the portion of the trust represented by the substituted assets, less the consideration paid by the trust in the substitution transaction, would be subject to transfer tax.
- Transfers of life insurance policies among trusts may be treated as sales that trigger these rules. This would not be a risk if the trust is a grantor trust solely under §677(a)(3). Typically, planners do not rely solely on §677(a)(3) to cause a trust to be a grantor trust. This would create an incentive to carefully consider whether to rely solely on §677(a)(3) to cause grantor trust treatment for ILITs.
- Leveraging the GST exemption will be more difficult.
- What if GST exemption is allocated to a grantor trust, giving it an inclusion ratio of zero, but the grantor subsequently sells an asset to the trust? Because the sale is not a gift, there is generally no need to allocate additional GST exemption to maintain the zero inclusion ratio. However, a portion of the trust will be included in the grantor's estate as a result of the sale under this proposal and the ETIP rules of §2642(f) would prevent the grantor from allocating GST exemption to that portion of the trust. Would the sale to the trust result in the trust no longer having a zero inclusion ratio?
- Will the accumulated appreciation in GRATs or QPRTs be subject to the provision after the initial GRAT/QPRT term (when the GRAT would no longer be "includable in the grantor's gross estate under existing provisions of the Internal Revenue Code")? (Presumably not if the grantor did not subsequently sell or exchange assets with the trust.)
- What if there are sales or substitution transactions with a GRAT? Will the portion of the trust attributable to the purchased assets become subject to this new provision after the end of the GRAT term? If the grantor substitutes a note for appreciated assets of the trust to "lock in gains" and if the grantor survives until after the GRAT term, would interest accruals on that note be subject to the new rule? Would that be offset by some of the annuity payments made to the grantor after the note substitution?
- Will the rule apply to leases at a market rent rate of loans at the AFR?

Prognosis: No way this year. Because of the far-reaching potential impact and because of the complexity of working out the details of this provision, it is not "ripe enough" to be included in any reform package considered by Congress this year. (The GRAT provision is more likely for inclusion in a tax reform package this year, since it has been included in various prior legislative bills and is not controversial.)

g. *Section 6166 Estate Tax Lien.* The special estate tax lien under §6324(a)(1) would last for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after the date of death. (Estimated ten-year revenue: $160 million)

   Prognosis: This year (if there is tax reform).

h. *Treatment of Health and Education Exclusion Trusts.*

   (1) *Background.* The classic "HEET trust" is a trust in which no one initially has an "interest," so the creation of the trust cannot be a direct skip. The trust provides that no one can make any distributions until the transferor's death or for some other initial period—so that no one has an "interest" when the trust is created and funded. At the transferor's death (or the end of the initial period if appropriate), distributions can be made in the trustee's discretion to grandchildren or more remote descendents and charities. Under the "interest" rules, that trust is a non-skip person trust (so the transfer to it is not a direct skip) as long as the initial period is respectable. The technical issue is whether the absence of an interest could be attacked under the "certain interests disregarded" rule in the definition of an "interest" for GST purposes. After the initial period, distributions could be made to educational institutions or for medical expenses or to charities without having to pay a GST tax. There would be no GST tax until the first person with an interest in the trust dies. So when the first grandchild dies, there would be a taxable termination and a GST tax. That should be far preferable to attracting the GST tax when the child dies – because actuarially the grandchild is likely to live much later.

   A variation on the classic HEET trust is one for which distributions are allowed to someone who is not going to die, such as charities, as a non-skip person who has an "interest" in the trust under §2612(a)(1)(A) to delay indefinitely the imposition of the GST tax. The perpetual existence of the non-skip person would prevent a taxable termination from occurring. That would mean the trust could remain in place indefinitely to pay education or medical expenses of descendants.

   (2) *Proposal.* The proposal is new in the 2014 Fiscal Year Plan. It eliminates the use of HEET trusts in a very harsh manner. Rather than just limiting the ability to treat such trusts as non-skip trusts or limiting the ability to escape taxable termination treatment, the proposal denies an exclusion for GST purposes to all trusts for distributions to medical care providers or to educational institutions under §2611(b)(1). That section excludes as a GST transfer "any transfer which, if made during the donor's life, would not be treated as a taxable gift by reason of section 2503(e)." Section 2503(e) states that payments made by a donor of medical care payments or tuition payments directly to the medical care provider or educational institution are not treated as transfers for gift tax purposes.

> "The proposal would clarify that the exclusion from the definition of a GST under section 2611(b)(1) applies only to a payment by a donor directly to the provider of medical care or to the school in payment of tuition and not to trust distributions, even if for those same purposes."

(3) *Harsh Effective Date.* The proposal applies to trusts created "after the introduction of the bill proposing this change, and to transfers after that date made to pre-existing trusts." This type of effective date is traditionally applied to abusive transactions that the IRS does not want to allow taxpayers to utilize while legislation is being considered.

i. *Omission of Valuation Discount Proposal.* The prior year Revenue Proposals from the Obama administration have proposed revising §2704 to add an additional category of applicable restrictions (to be provided in regulations) that would be disregarded in valuing transferred assets. The IRS has had a §2704 regulation project on its Priority Guidance Plan since 2003. Proposed regulations purportedly have been drafted, but apparently the IRS believes that they would not be valid without legislative changes to §2704. This proposal had an estimated 10-year revenue impact of $18.079 billion in 2013 Fiscal Year plan, which is significantly more than all the estate and gift tax proposals combined in the 2014 Plan other than the proposal to return rates and exemptions to the 2009 parameters. (The Congressional Budget Office and Joint Committee on Taxation refused to score this proposal because it depends entirely on positions taken in regulations, and the IRS cannot consult with them about its thinking on provisions that might be in proposed regulations.)

   The valuation discount proposal was dropped totally from the 2014 Fiscal Year Plan. There is no indication as to why this proposal was dropped. Is the IRS dropping its plans to tighten §2704 or is it contemplating issuing the §2704 proposed regulations without the benefit of further legislation? The §2704 project continued as a project on the 2013-2014 Priority Guidance Plan ("regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships"), so additional §2704 proposed regulations may be issued at some point; however, this does not appear to be a Treasury priority.

j. *Reporting Requirements for Sales of Life Insurance Policies and Eliminating Transfer for Value Exceptions.* Under the 2013 Fiscal Year Plan, sales of policies with a death benefit of $500,000 or more would have to be reported, and the exceptions to the transfer for value rules would be eliminated for "buyers of policies." A "transfer for value" is inherently a sale, and in one sense there is always have a "seller" and a "buyer." Hopefully, the legislation would be limited to purchases of policies by third-party investors as opposed to transfers of policies among the policy owner and related persons, trusts or entities. The transfer for value exceptions provide extremely helpful flexibilities for planning with life insurance. This proposal has been repeated in the 2014 Fiscal Year Plan, and would apply to sales of policies after 2013 (see page 64 of the 2014 Fiscal Year Greenbook). The stated reason for the change is the increase in life settlement transactions with the investor relying on the transfer for value exceptions "to avoid paying tax on the profit when the insured person dies."

k. *Payment to Non-Spouse Beneficiaries of Inherited IRAs and Retirement Plans Over Five Years.* The 2014 Fiscal Year Plan adds a new proposal requiring that non-spouse beneficiaries of inherited retirement plans and IRAs generally must take distributions over no more than five years. Exceptions are provided for disabled beneficiaries, chronically ill beneficiaries, individuals not more than 10 years younger than the participant, and minor beneficiaries. The proposal would be effective for plan participants or IRA owners dying after 2013. (This is similar to a proposal introduced as a financing proposal offered as an amendment to the 2012 "Transportation Bill." That provision was controversial and was pulled within days of being introduced in the Senate Finance Committee by Chairman Baucus. Senator Baucus supports this proposal, reasoning that qualified retirement plans are not meant to be used as vehicles for transferring long-term wealth to beneficiaries. This legislative proposal was included in S. 953, Student Loan Affordability Act (introduced May 14, 2013, the Democrat approach for preventing the increase in the student loan interest rate). (Estimated 10-year revenue: $4.911 billion)

l. *Limit Total Accrual of Tax-Favored Retirement Benefits.* This proposal is also new in the 2014 Fiscal Year Plan. Very generally, it would limit the deduction for contributions to retirement plans or IRAs with total balances under all such plans that are sufficient to provide an annual benefit of an indexed amount, representing plan amounts of about $3.4 million for a 62-year old individual in 2013. No further contributions would be permitted but the "account balance could continue to grow with investment earnings and gains." If a contribution is made in excess of the maximum permitted amount, the excess amount would be included in the owner's taxable income and the owner could withdraw such excess amount from the plan within a specified grace period (and if it is not withdrawn the excess amount and attributable earnings would be subject to income tax when distributed). The proposal would be effective with respect to contributions and accruals for taxable years beginning after 2013. Commentators have observed that this provision can be complex to administer because individuals would have to disclose the value of all of their retirement plans to employers, who would then have to monitor the value of all such plans. (Estimated 10-year revenue: $9.342 billion)

m. *Eliminate Minimum Distribution Rules for Small Qualified Plans or IRAs.* There would be no required minimum distributions for an individual whose aggregate IRAs and qualified retirement plan amounts are $75,000 or less. (This proposal has been in prior Fiscal Year Plans.)

n. *Likelihood of Passage in 2013; Likely Considered Only as Part of General Tax Reform.* Ron Aucutt observes that predicting future legislative actions at this point is very difficult:

> Prediction can take the form of applying known principles, policies and preferences to a known environment, and then predicting the outcome. When the only known principle, policy or preference is to annoy, impede, embarrass or blame the other folks--that looks not so much to the outcome as to the blame for the outcome--it is not easy at all to predict.

Prediction is hard in a climate when the typical rational calculus is set aside.

The various transfer tax proposals will likely proceed only as part of a general tax reform package, and not as a package of transfer tax legislation. There have been some indications, however, that transfer taxes are not being considered in the reform measures.

3. Treasury-IRS Priority Guidance Plan

a. *2013-2014 Guidance Plan.* The 2013-2014 Treasury-IRS Priority Guidance Plan (for the 12 months beginning July 1, 2013) was released on August 9, 2013. It includes all ten projects that were included in last year's Plan under the heading "Gifts and Estates and Trusts" and also includes one additional item dealing with the application of Rev. Proc. 2001-38 "regarding the validity of a QTIP election on an estate tax return filed only to elect portability." (For a detailed discussion of this topic, see Item 8.f below.)

   Interestingly, the Plan also includes under the heading "Exempt Organizations": "Guidance under §501(c)(4) relating to measurement of an organization's primary activity and whether it is operated primarily for the promotion of social welfare, including guidance relating to political campaign intervention." This item obviously relates to the brouhaha over the IRS's review of exempt organization applications for organizations that may have significant activities relating to political campaigning, and may represent an attempt to bring more clarity to the standards that should be applied in making those decisions.

   For a detailed discussion of the 2013-2014 Priority Guidance Plan, see Aucutt, *ACTEC Capital Letter No. 34, Priority Guidance Plan Published, Commissioner Nominated* (Aug. 12, 2013).

b. *2012-2013 Guidance Plan*. The 2012-2013 Priority Guidance Plan included additional guidance on supporting organizations, and a broad range of projects regarding implementation of the Foreign Account Tax Compliance Act (FATCA). The ten items under the heading of "Gifts and Estates and Trusts" included one new item, dealing with the allocation of GST exemption at the end of an ETIP (such as at the termination of a GRAT). This new item derived from a request for guidance from the AICPA in comments to propose regulations submitted in 2004 and subsequently in a letter to the Internal Revenue Service in 2007. It raised issues regarding the allocation of GST exemption at the end of the initial term of a GRAT. For example, if the assets pass partly to a trust for children and partly to a trust for grandchildren, will GST exemption be automatically allocated to both trusts, and if so, what are the alternatives for opting out of such pro rata automatic allocation? Is it possible to opt out of automatic allocation for the trust designed just for the children?

c. *Decanting.* Notably, one of the items on that was dropped in the 2012-2013 Plan was "notice on decanting of trusts under §§2501 and 2601." Notice 2011-101 was issued (requesting comments on various tax issues regarding decanting). Apparently, the IRS view is that the issuance of any actual guidance regarding decanting will not be forthcoming for some extended time, and the neither the 2012-2013 Plan nor the 2013-2014 Plan includes any projects regarding decanting. Interestingly, the preamble to the Priority Guidance Plan states that "[t]he plan represents projects we intend to work on actively during the plan year and does not place any deadline on completion of projects." Does this suggest that the IRS is not even working on the decanting project? There are informal indications that the IRS is currently working on the decanting project, and that the project was omitted from the Plan because the IRS knew that the project could not be completed before June 30, 2014.

d. *Carryover Items.* Carryover items from prior years include, among other things: (1) final regulations under §67(e); (2) adjustments to sample CRAT forms; (3) final regulations under §2032(a) (commonly referred to as the "anti-Kohler regulations"); (4) effect of guarantees and applying present value concepts under §2053 (which could impact the use of "Graegin loans"); (5) regulations under §2704 adding additional restrictions that should be disregarded in valuing the transfer of interests to family members in entities; (6) private trust companies guidance; and (7) guidance under §2801 regarding the tax imposed on U.S. citizens and residents who received gifts or bequests from certain expatriates.

e. *Highest Priority.* The highest priority is guidance under §2801 regarding gift or estate tax imposed on gifts or bequests to U.S. persons by certain expatriates. (The §2801 tax on the recipient of a gift/bequest does not apply if the gift/bequest is reported on a timely filed gift or estate tax return. If there is not a timely filed return, Cathy Hughes has indicated that both the §2801 succession tax and the regular gift/estate tax could apply.) There are informal indications that other items having high priority are the §67(e) final regulations and final regulations under §2642(g) regarding extensions of time to make GST exemption allocations.

4. Possible Tax Reform Legislative Developments

Lindy L. Paull gave the Lloyd Leva Plaine Distinguished Lecture — Federal Tax Policy: Will Tax Reform Be the Cure-All? She is a part of PwC's Legislative and Regulatory practice in Washington D.C. She served as Chief of Staff of the U.S. Congressional Joint Committee on Taxation for five years (1998-2003), was deeply involved in the structuring and drafting of the 1986 Tax Reform Act, and has had a long experience in her career with the development of legislation in Congress and tax reform.

a. *Congressional Committees Have Been Working on Tax Reform.* The Congressional tax-writing committees have spent a lot of time over the last year laying the groundwork for comprehensive tax reform. The House Ways and Means Committee and the Senate Finance Committee have both been having hearings in 2013 about various issues related to tax reform.

b. *Tax Reform Drivers.* Drivers of tax reform include the following: (1) unpredictability (for example, there are 60 smaller provisions that are expiring at the end of 2013 unless extended); (2) complexity of the Code; (3) fairness (the relative portion of taxes paid by high income earners was a huge issue in the debate over the 2012 act, and that issue will continue); (4) business pressure (95% of consumers are outside the U.S., and this country has a difficult competitive issue because of the corporate tax rate and how we treat foreign earnings of U.S. based companies; the U.S. has the highest corporate tax rate in all of the OECD countries); and (5) fiscal pressure from budget deficits.

c. *Expedited Legislative Process.* Between now and March 1 there will be much discussion about putting in place more processes to work on deficit reduction solutions. There has been discussion behind the scenes about adopting an expedited process for comprehensive tax reform. More details will be coming about what that means, but it is possible that something could happen in the near future.

d. *Progressivity.* Progressivity is a very important aspect of reform. The Code is more progressive this year than last year, and it will remain just as progressive following tax reform. The top 10% earn about 40% of the income and pay 50% of total taxes and 78% of income taxes. That group will continue to pay that portion after any tax reform.

e. *Individual Tax Reform.* The individual income tax is the largest component of tax revenues, representing $1 trillion out of $2.3 trillion of total revenues (2011 numbers). Ninety percent of the "tax expenditures" (special exclusions, deductions, credits, etc.) relate to the individual income tax. The large ones will be difficult if not impossible politically to repeal outright. The emphasis is on looking to other ways of limiting the "tax expenditures" other than outright repeal of the large ones.

   There are various aspirational goals to reduce the top rate. The Bowles-Simpson Commission called for a 28% rate with the elimination of all tax expenditures. The House Republicans have a 25% goal (but with no details about setting limits on tax expenditures).

f. *Business Tax Reform.* The trend in the OECD is toward eliminating worldwide tax systems but adopting territorial tax systems. There were only six countries left (the U.S. is the largest) that use worldwide taxation. Other countries had an advantage when they reformed their business tax, because they had a broad-based consumption tax at the federal level. The U.S. relies on income tax for 45% of its revenues, but other countries rely on the income taxes for just 35% of revenues. That is a huge difference. At the federal level, the U.S. has very low excise taxes.

   The President's framework for business tax reform – mostly corporate – would reduce the rate from 35% to 28%. The President is not in favor of a pure territorial system (no country has a pure territorial system, there is always a mechanism to adjust for transfer pricing issues or base erosion issues). The House Republicans have a goal of reducing the corporate tax rate to 25%; House Ways and Means Chairman Camp has proposed a bill with a detailed territorial tax regime to replace the current worldwide tax system.

g. *Key Unresolved Issue.* A central unresolved issue at this point is whether reform measures will be revenue neutral or will be designed to raise additional revenue as a means of attacking the deficit. Generally, the strong Democratic position is that there should be additional revenue, and the strong Republican position is that the reform effort should be revenue neutral.

5. Planning for Donors Who Made Large 2012 Gifts

a. *The Work Has Not Ended.* Many planners were extremely busy in late 2012 working with clients who wanted to make large gifts in case the estate and gift exemptions were reduced in 2013. The work is not over. Fortunately, one potential problem that has passed is that there is no "clawback" issue that would have existed if Congress had reduced the estate exemption below the amount of gift made using the $5 million indexed gift exemption.

b. *Review Transfer Mechanics.* Make sure that the appropriate transfer mechanics were carried out.

c. *Revise Estate Planning Documents.* Determine whether estate planning documents should be revised as a result of the large gift(s).

d. *Educate Client About Administering Trusts.* Planners must educate clients how to administer trusts. It is imperative that the grantor not use any of the trust assets without paying fair rental for the use. For example, if art is transferred to a trust, the art should not be left hanging on the grantor's wall, unless the grantor pays appropriate rent. Similarly, if a vacation home is transferred to a trust, the donor or should pay a fair rental for any use of the home.

e. *File Gift Tax Returns.* An unusually large number of gift tax returns may be filed for the 2012 gifts. In 2011, there were 220,000 gift tax returns filed. Predictions are that there will be over 500,000 returns filed for 2012 gifts. With about 350 estate tax examiners, we can see what will fill the audit pipeline through 2015. (The number of estate tax returns is expected to decline from about 170,000 in 2008 to about 9,000 [of which 3,600-3,800 will be for taxable estates] for 2011 decedents.) The Tax Policy Center estimates that estate taxes will be $14.2 billion from 3,780 taxable estate tax returns filed for decedents dying in 2013. See Harris, Estate Taxes After ATRA, TAX NOTES at 1005 (February 25, 2013).

- In light of the special planning for gifts in 2012 (e.g., SLATS, non-reciprocal gifts, etc), there will be many "interesting gift tax returns." Ron Aucutt observes, "I can't think of a worse gift tax return than an interesting one."
- Despite the fact that many more gift tax returns will be filed than in the past, do not assume that a less rigorous standard of completeness is justified. Planners should apply rigorous standard of care in preparing and reviewing the gift tax returns and associated appraisals.
- Gift tax returns look deceptively simple, being only five pages long. However, they are extraordinarily difficult. Furthermore, preparers often do not prepare many Form 709s. Planners who planned the large 2012 gifts should either prepare or carefully review the gift tax returns. (Be aware that a practitioner who gives advice to someone who signs a return is treated as a return preparer under Circular 230 and is subject to the preparer penalty provisions.)

- Do not underestimate the importance of having the preparer understand the underlying assignment and trust documents.
- Review past gift tax returns to make sure that the 2012 return accurately reflects prior gift information.
- Ask the donor if prior gifts have been made. If not, back gift tax returns should be filed for those prior years. A planner may not have a duty to correct prior returns that were inadvertently incorrect, but a preparer does have a duty not to report a wrong number in this year's return that the preparer knows is incorrect because it does not reflect prior gifts.
- Standard technical issues that arise include availability of the annual exclusion, gift splitting, and proper GST exemption allocation. See Item 6 for a detailed discussion of GST exemption allocation issues on gift tax returns.
- Create a separate file jacket for the gift tax return, separate from the file jacket for the planning transaction, to help in protecting the attorney-client or accountant-client privilege for planning transactions as opposed to return preparation.
- Do not rely on automatic allocations of GST exemption; affirmatively opt in or opt out of automatic allocation; opting into automatic allocation for all future transfers to the trust can be helpful (Carol Harrington points out that it is difficult to imagine a situation where the decision would be to timely allocate GST exemption in one year and not in all later years);
- Carol Harrington gives sage advice regarding the preparation of any tax returns:

> When you are preparing a tax return, always remember that while you're representing a client, the first thing you have to worry about is yourself. We never do anything that might be considered fraud or misleading or anything that would put us in jail…We don't wish to be hit with any kind of fraud penalties and don't want to be disbarred from practice…You don't have a single client who is worth taking those risks.

f. *Consider Further Transactions With Gift Trust.* In light of the time crunch at the end of 2012, some clients made gifts of easy-to-value and easy-to-transfer cash or cash equivalents in 2012. Consider exercising substitution powers or sales to swap in assets with more appreciation potential and that may be able to take advantage of valuation discounts. Also consider additional sales to trusts to leverage the equity value in the trust from prior gifts.

Leave sufficient time between funding and transferring interests in entities to avoid step-transaction arguments under the Holman/Gross/Linton/Heckerman theories.

g. *Whether to Make QTIP Election for QTIPable Trust*. The donor may have made the gift to a "QTIPable" trust for the other spouse. This allows the donor to defer the decision of whether to treat the transfer as a taxable gift utilizing the grantor's lifetime gift exemption amount (or requiring the payment of current gift taxes) until the grantor's gift tax return is filed (possibly until October 15 of the following calendar year), based on whether or not the QTIP election is made for the trust. In addition, this approach may permit making a partial QTIP election like a defined value clause to make the election by formula over so much as is needed to avoid paying gift tax. Also, if the QTIP election is made, the donor's GST exemption could be allocated to the trust by making a reverse QTIP election.

If the donor made a gift to a QTIPable trust, and if the donor's assets are well under the $5 million estate exemption amount, in light of the adoption of a permanent indexed $5 million estate tax exemption, the donor may consider choosing to make the QTIP election so that there would be a step up in basis at the death of the donor's spouse, and to rely on portability to take advantage of the donor's estate tax exemption if the donor predeceases the spouse.

h. *Gift Splitting Election For 2012 Gifts.*

(1) *Gift Splitting for Gifts to SLATs.* If a donor makes a gift to a trust of which the donee-spouse is a beneficiary, the gift splitting election applies only as to the non-spousal portion of the gift, which must be both ascertainable and severable from the donee-spouse's interest. This may be difficult to establish. See Item 15.e.

(2) *Large Gift by One Spouse In Case Exemptions Had Decreased in 2013.* In some situations, couples did not make large enough gifts to fully utilize both of their $5.12 million exemptions, and the strategic plan was to have one spouse make a full $5.12 million gift with a lower gift by the other spouse. That way, if Congress had reduced the estate exemption below $5.12 million, at least one of the spouses would have taken advantage of the possibility of removing the additional amount over the reduced estate exemption from the estate tax base without any gift or estate cost. Now that we know Congress did not reduce the estate exemption, making the split gift election may be preferable — for being able to utilize both spouses' gift exemptions in the future and if nothing else for the convenience of keeping track of the gift exemptions (and GST exemptions if appropriate) used by the spouses.

(3) *Agreement by Donee-Spouse To Consent to Gift Splitting.* If a donor made a $10 million gift in 2012 and was concerned that the donee-spouse might not agree to gift splitting, the donor or may have secured an agreement by the donee-spouse to consent to gift splitting. Is consideration required for such an agreement? Does the consenting spouse become a grantor of that trust because he or she received consideration? Another approach would be to provide that the gift is made as a net gift, so that any gift tax would be paid out of the trust and not by the donor.

(4) *Payment of Tax by Ill Spouse.* If gift tax is due even following the gift splitting election and if the donee-spouse is ill and likely to die within three years, the healthy spouse should pay all of the gift tax (assuming the healthy spouse has assets to pay the gift tax). (The gift tax is a joint and several liability of the spouses if gift splitting is elected, but the donor-spouse has primary liability for the tax.) If a spouse dies within three years, gift tax paid by the spouse will come back into the estate. §2035(b). But if the healthy spouse who lives at least three

years pays the gift tax, none of that gift tax is brought back into the estate of the spouse who died within three years of making the gift — even if the ill spouse's property was used to make the gift.

i. *Statute of Limitations; Adequate Disclosure.* One reason to file the gift tax return is to commence running the statute of limitations (three years, or six years if omitted gift assets are worth 25% of the total gifts). However, adequate disclosure under §6501 (and the §6501 regulations) is required for the statute of limitations to run. Having a timely qualified appraisal is often the easiest way to satisfy the requirements. However, an appraisal is not required with respect to a transaction that is reported as a non-gift transaction.

j. *"Donor's Remorse" Over 2012 $5 Million Gifts.* For some clients, the decision in 2012 to make $5 million (really $5,120,000) gifts was very difficult. Some of those clients did so anyway, because of the possibility that the very large $5 million exemption was a mere window of opportunity that would close after 2012. Some individuals who made the large gifts in 2012 (and may have concerns about whether they may at some point need access to some of those funds) may now wish they had not "pulled the trigger" on the gifts in 2012. Some of the issues discussed below may also be applicable in future years if the estate exemption increases substantially in the future due to indexing and the client's assets are consumed or for other reasons the client does not have substantial estate tax concerns at his or her death.

(1) *Reminder of Gift Advantages.* Even though the $5 million gift and estate exemption did not disappear in 2013 as feared, remind the donor of the advantages as well as possible disadvantages of the gift. If the client's major concern is access to funds, the possibility of distributions to the spouse or loans to the donor may satisfy that concern. Clients may overreact immediately in light of the extension of the $5 million exemption, but Dennis Belcher warns that he would not want to see a donor hate having made the gift, undo the gift and later hate undoing it.

(2) *Disclaimer.* If all of the donees disclaim, gift assets presumably would return to the donor. However, if all of the donees do not disclaim, the assets would pass to the alternate takers rather than being returned to the donor. Gifts to trusts are particularly suspect; the disclaimed assets may not return to the settlor but to other trust beneficiaries. See generally Handler & Chen, Formula Disclaimers: *Procter-Proofing Gifts Against Revaluations by Service, 96* J. TAX'N 231 (April 2002).

Some instruments provide that the trustee is authorized to disclaim. What is the effect of such a provision? Carol Harrington says that there is nothing in modern law saying that a trustee can refuse to accept property and have it returned to the donor. (Bogert cites several cases, but those appear to involve trusts designed particularly for one specific trustee.) Perhaps the "revert to donor" result would occur only for an outright gift rather than a gift in trust that is disclaimed by a beneficiary.

A trust document could provide specifically that if a trustee disclaims, the disclaimed assets would return to the donor. A possible concern is whether acceptance or implied acceptance by the trustee has already occurred, which would make the disclaimer impossible. (However, the regulations state that "[m]erely taking delivery of an instrument of title, without more, does not constitute acceptance." Treas. Reg. §25.2518-2(d)(4).) If the "revert to settlor" trust language changes the result that would otherwise occur under state law, questions may conceivably arise as to the completeness of the gift. Also, questions could exist regarding the trustee's ability to exercise the disclaimer under the trustee's fiduciary duties to preserve the trust assets for the benefit of the trust beneficiaries. The IRS has expressed concern about recognizing for tax purposes the disclaimers of powers by trustees. For example, various divergent cases and rulings have addressed whether a trustee can disclaim a power to make a distribution to a non-spouse beneficiary, in order to qualify the trust for QTIP treatment. In Cleveland v. United States, 88-1 U.S.T.C. ¶13,766 (C.D. Ill. 1988), a marital deduction was allowed for a trust, for which a corporate trustee had disclaimed its power to utilize income or principal for the children's college education. However, while some IRS rulings have approved disclaimers of powers, most have refused to recognize a disclaimer of a "tainted" power in order to qualify a trust for QTIP treatment. E.g., Tech. Adv. Memo. 8729002 (disclaimer by surviving spouse as trustee of power to invade corpus for children ineffective to qualify the trust for QTIP treatment).

A published revenue ruling makes reliance upon a disclaimer of a power particularly questionable. Rev. Rul. 90-110, 1990-2 C.B. 209; *see also* Tech. Adv. Memo. 9818005.

Some private letter rulings have recognized renouncement of powers by trustees. Letter Ruling 200401011 recognized the validity of a trustee's disclaimer of the power to make distributions to an unlimited number of charities for purposes of determining that the trust (which made the ESBT election) was a qualified shareholder of an S corporation. The ruling implicitly makes the determination that the disclaimer of the power to make distributions to an unlimited number of charities is valid under applicable local law. Letter Rul. 200401011.

Another ruling that recognized renouncing of powers by a trustee is Letter Ruling 200404013. In that ruling, an irrevocable trust named the grantor's wife and a bank as co-trustees. The trust acquired a joint and survivor life insurance policy on both spouses' lives. The wife executed an instrument renouncing her right as trustee to change the policy beneficiary, to revoke any change of beneficiary, to assign the policy, and to revoke an assignment of the policy. The ruling concluded that the wife, as trustee, would have no incidents of ownership in the policy held by the trust.

The Tax Court has refused to give effect to renunciation of powers by trustees for purposes of determining whether the trust qualifies for the estate tax marital deduction. *Estate of Charles Bennett v. Comm'r*, 100 T.C. 42 (1993). The court observed that there was no statement of intent regarding qualification for the marital deduction in the will or trust agreement, and no extrinsic evidence of the decedent's intent was presented. The Tax Court concluded that it would not permit the trustees "to disclaim powers, duties and discretions that would amount to a renunciation of their trusteeships." *See* Tech. Adv. Memo 9135003.

(3) *Rescission.* If a disclaimer will not work, could there be a rescission of the 2012 gift? If a gift is made under a mistake of a material fact, rescission may be possible under state law if the donees have not substantially changed their position in a way that would make the rescission unconscionable. The question is whether a business judgment of what legislation may or may not pass in the future is a mistake of fact or just an error of judgment. A recent rescission case, *Breakiron v. Guidonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010), allowed rescission of a disclaimer from a QPRT on the basis of a mistake of law as to the effect of the untimely disclaimer. In Stone v. Stone, (a 1947 income tax case) a rescission was permitted of gifts to children that were made under the mistaken assumption that the income tax from the gift assets would be shifted to the donees. In *Neal v. United States*, 187 F.3d 626 (3rd Cir. 1999), the donor relinquished a retained power to avoid triggering the old §2036(c), which was later repealed retroactively. *See also Berger v. United States*, 487 F. Supp. 49 (Pa. 1980) (rescinded gift not taxed); cf. Rev. Rul. 80-58, 1980-1 C.B. 181; Ltr. Ruls. 200613027, 200701019, 200911004 (income rulings relying on rescissions to undo transactions).

Rescissions have generally relied on a retroactive change in law or bad advice; no case has been located based on a wrong guess of what the law would be in the following year. For example, the rescission was allowed in *Neal* because of not knowing that §2036(c) would be repealed retroactively.

The notion that rescissions are respected only if they occur in the same taxable year is an income tax concept. See Rev. Rul. 80-58, 1980-1 C.B. 181 (rescission occurring in same year as taxable event is respected if parties are returned to their original positions). Completing a rescission in 2013 of a 2012 transaction may still conceivably be recognized for transfer tax purposes even if that were not possible for income tax purposes.

The general consensus is that rescission of 2012 gifts based on the extension of the $5 million indexed estate and gift exemptions in ATRA is a significant extension of the general concept of rescission based on a mistake of law or fact, and that rescissions of 2012 gifts on that basis will be difficult. "Whether a gift should be made is not a mistake of law."

(4) *Exercise Swap Power or Repurchase Asset From Trust.* A donor may choose to exercise a substitution power or purchase assets from grantor trusts in return for long-term low-interest notes if the donor would like to re-acquire those assets (to be able to enjoy the income produced by those assets or to be able to achieve a basis step up at the donor's subsequent death). That approach will not eliminate

the gift but it might reduce the value remaining in the trust. *See generally Clay Stevens, The Reverse Defective Grantor Trust,* TR. & ESTS. 33 (Oct. 2012).

(5) *Borrow From Trust.* A very simple way that the donor may be able receive some cash flow assistance from the trust is to negotiate a loan from the trust. See Item 14 below.

(6) *Terminate Grantor Trust Status.* The donor may be able to take steps to terminate the grantor trust status of the trust so that it pays its own income tax going forward. However, that may reduce planning flexibilities in the future (i.e., swaps or sales would be taxable events) because the trust is no longer a grantor trust.

6. Generation Skipping Transfer Tax Reporting Issues

a. *Particular Significance for 2013.* Because of the large number of gifts made in 2012, there will be a very large number of gift tax returns filed in 2013. Most of the transfers in trust were probably meant to be GST exempt, thus requiring proper GST exemption allocations. The proper reporting of gifts, and the methods for making appropriate GST exemption allocations, and the methods to avoid or take advantage of automatic allocations is quite complicated. (Interestingly, the gift tax return instructions say that 1 hour, 53 minutes is required for "learning about the law or the form," that 1 hour, 58 minutes is required for "preparing the form," and that 1 hour 3 minutes is required for "copying, assembling, and sending the form to IRS." It is interesting that the IRS thinks it takes almost as much time to copy and mail the return as to learn all of the information in this Item as well as the other substantive law regarding gift taxation.)

b. *Methods of Allocating GST Exemption.* There are five ways of allocating GST exemption: (1) affirmative allocation; (2) deemed allocation to lifetime direct skips; (3) deemed allocation to lifetime transfers to GST trusts; (4) retroactive allocations; and (5) deemed allocation at death. The reporting issues for each are addressed separately.

c. *Affirmative Allocations.*

(1) *When Possible.* Affirmative allocations of GST exemption may be made at any time before the date prescribed for filing the estate tax return, including extensions. Observe: the taxpayer has until after death to allocate GST exemption.

(2) *Appropriate Valuation Date.* The valuation of property that is used for determining the inclusion ratio of the transfer depends upon whether the allocation is made on a timely filed gift tax return. For a timely filed return, the value on the date of the transfer is used; for a late return, the value on the date of the return is used, but there is a "first of the month" rule that permits using the value on the first day of the month in which the return is filed (other than for life insurance policies if the insured has died), because as a practical matter it is impossible to value an asset on the same day the return is filed making a late allocation. (The "first of the month" rule is only a valuation rule, and does not

change the fact that the allocation does not actually take effect until the date on which the Form 709 is postmarked, as discussed below.)

(3) *Irrevocable.* An allocation of GST exemption becomes irrevocable after the due date of the return on which the allocation is made.

(4) *Coordination with Automatic Allocations.* Affirmative allocations may be very helpful in overriding automatic allocations that may inadvertently cause surprising (and bad) results. However, as discussed below, be aware that if there are any automatic allocations to lifetime direct skips, they take priority over affirmative allocations to other property in the same year (as well as to automatic allocations to indirect skip transfers).

(5) *Notice of Allocation.* The Notice of Allocation is now on Schedule D, rather than on Schedule C of the Form 709. The Return does not provide a form for notice of allocation, but Line 6 on Part 2 of Schedule D says "You must attach a Notice of Allocation." Regulations list requirements that must be included in a notice of allocation. Among other things, the value of trust assets at the effective date of allocation, the amount of GST exemption allocated, and the inclusion ratio of the trust must be specified. For these purposes, always use a formula to describe the amount of GST exemption allocated. (Diana Zeydel suggests using a formula even for cash transfers, in case there is an inadvertent mistake in the amount of the transfer.) Hundreds of requests for relief to make late but retroactive GST exemption allocations have been filed because taxpayers failed to file a Notice of Allocation.

(6) *Sample Notice of Allocation.* Materials by Diana Zeydel provide various forms for GST exemption allocations in various circumstances, including an affirmative allocation. A formula on the sample form for the amount of GST exemption being allocated states:

> The taxpayer hereby allocates to the assets transferred to The Doe Family 2012 Trust so much of the taxpayer's unused GST exemption as shall be necessary so that The Doe Family 2012 Trust shall have an inclusion ratio of zero for GST purposes or, if that is not possible, the taxpayer's entire unused GST exemption.

The Notice would state that the inclusion ratio is zero.

(7) *When Affirmative Allocation Takes Effect.* If the allocation is made on a timely filed return, the allocation is effective on and after the date of the original transfer. If the affirmative allocation is made on a late return, the allocation is effective on and after the date of filing (and as discussed above, the value on the date of the late allocation is used, taking due into account the "first day of the month" rule). If the exemption is made late, any allocation of GST exemption is deemed to precede in point of time any taxable event that occurs on that same date. Therefore, a Form 709 that is postmarked on a particular date making a late allocation could prevent the imposition of any GST tax with respect to a taxable distribution or taxable termination occurring on that same date.

(8) *Affirmative Allocations of Additional GST Exemption From Indexing to Prior Year Gifts on Timely Filed Returns.* If a donor made a gift in 2012 for which the donor did not sufficient GST exemption to "fully cover" the gift (to result in a zero inclusion ratio), can some of the additional $120,000 of GST exemption that is available in 2013 be allocated to the 2012 gift as of January 1, 2013? While there is no official guidance form the IRS, Beth Kaufman (Washington D.C.) believes that if the additional GST exemption is allocated on a timely filed return for reporting the 2012 gift, the allocation should be effective as of January 1, 2013. Under the literal statutory language, the value on the date of the gift would be used for determining the inclusion ratio, but "the IRS may take the position that the value on the effective date of the election—January 1, 2013—should be used." Beth Shapiro Kaufman, *Allocation of Indexed GST Exemption*, LEIMBERG EST. PL. NEWSLETTER #2140 (Sept. 11, 2013). There is no guidance as to how to report this allocation of additional GST exemption that is available due to indexing, and Beth suggests adding an additional separate Notice of Allocation of the additional GST exemption using the following language:

> Pursuant to I.R.C. Section 2613(c) and Section 2.13 of Rev. Proc. 2013-15, 2013-5 I.R.B. 444, the taxpayer's exemption from GST is $5,250,000 as of January 1, 2013. The purpose of this Additional Notice of Allocation is to allocate part of the additional $130,000 of GST exemption available to the taxpayer on January 1, 2013, due to indexing of the GST exemption amount, to the [name of trust] dated _____, 2012.

Id. This issue is likely to arise every year because there will likely be increases in the GST exemption amount every year in the future due to indexing.

d. *Deemed Allocations to Lifetime Direct Skips.* Unless the taxpayer opts out, GST exemption is automatically allocated to lifetime direct skip transfers (i.e., transfers directly to skip persons [generally, second-generation beneficiaries] or to trusts in which all interests belong to skip persons). That is generally good, because a direct skip would otherwise cause the imposition of a current GST tax.

(1) *Highest Priority Ordering.* A deemed allocation to a direct skip in a particular year precedes a deemed allocation to an indirect skip transfer in made in the same year, and both will precede any affirmative allocation of GST exemption made to other transfers. To change the order or priority, effective elections out of the deemed allocation rules would be necessary.

(2) *Electing Out, Checking the Box.* Direct skips made during the calendar year are reported in Part 2 of Schedule A of Form 709. Column C contains a box to elect out of the allocation. However, the instructions state that checking the box is not sufficient to elect out of deemed allocation--a separate statement clearly describing the transaction and the extent to which automatic allocation does not apply must be attached.

One method of electing out of deemed allocation to a lifetime direct skip is to pay the GST tax. However that creates uncertainty, for example, if some portion of the direct skip transfer was not reported on the return. Does the election out of deemed allocation apply as to the extra amount also? Do not rely on merely paying GST tax to opt out of automatic allocation to lifetime direct skips.

(3) *No Deemed Allocation to Nontaxable Gifts.* Annual exclusion gifts directly to skip persons or to "vested single beneficiary" trusts for skip persons are nontaxable, and there is no deemed allocation to those gifts. However, if the "vested single beneficiary" trust exception does not apply, the nontaxable gift rule does not apply for transfers to trusts even if the entire gift is covered by a Crummey withdrawal power.

(4) *Sample Election Out.*

ELECTION OUT OF AUTOMATIC ALLOCATION OF GST EXEMPTION TO DIRECT SKIPS

The taxpayer transferred the sum of $500,000 in cash as a taxable gift not qualifying as a non-taxable gift to her grandchild, B, on October 1, 2012 as reported in Item 2, Part 2, SCHEDULE A. The taxpayer hereby elects that the automatic allocation rule applicable to direct skip transfers will not apply to the $500,000 transferred to B on October 1, 2012.

e. Automatic Allocation for Lifetime Transfers to GST Trusts.

(1) *Affirmatively Elect In or Out of Automatic Allocation.* There is automatic allocation of GST exemption for lifetime transfers to "GST trusts" which are defined in great detail in the statute as all trusts from which a GST transfer might later occur unless one of six detailed exceptions apply. It was impossible to draft the statute to describe precisely when parties would or would not want GST exemption to apply, so the statutory rules do not always achieve the appropriate allocation. Fortunately, the regulations provide that the taxpayer may elect into deemed allocation (in situations where the statute would not otherwise provide for automatic allocation) or may elect out of deemed allocation (in situations where automatic allocation would otherwise apply).

This provides a great deal of flexibility; the election out can be made, for example, as to the current transfer, all future transfers, transfers in several future years, etc. Alternatively, the taxpayer can elect in to automatic allocation, whether or not the trust technically qualifies as a GST trust, and Carol Harrington likes electing into automatic allocation for all future transfers to a trust if the settlor intends the trust to be GST exempt (even if the taxpayer actually reports and makes affirmative allocations of GST exemptions to later actual transfers to that trust).

(2) *Reporting Election In or Out on Form 709.* Column C on Part 3 of Schedule A of Form 709 provides a box to make all elections regarding automatic allocation of GST exemption to lifetime indirect skips (labeled "2632(c) election"). However, the return does not specify whether the election is an "election in" or an "election out" of automatic allocation. Therefore, it is critical to attach an election statement in order to make an effective election either in or out of deemed allocation.

Materials by Diana Zeydel include a sample "ELECTION OUT STATEMENT" for various types of situations listing all the information required in the regulations. The actual election portion of the Statement provides as follows:

> The taxpayer hereby elects that the automatic allocation rules will not apply to the transfer to The Doe Family 2012 Trust made by the taxpayer in 2012 or to any additional transfers taxpayer may make to The Doe Family 2012 Trust in subsequent years.

A sample "ELECTION IN STATEMENT" makes the following election:

> The taxpayer hereby elects that The Doe Family 2012 Trust be treated as a GST trust and that the automatic allocation rules will apply to any transfer to The Doe Family 2012 Trust in 2012 and to any and all future transfers the taxpayer may make to The Doe Family 2012 Trust.

The instructions state that if a prior election (in or out) has been made with respect to future transfers, the box in Column C should not be checked and no explanatory statement should be filed. However, that seems likely to create confusion, and Diana Zeydel recommends reminding the IRS that the taxpayer made an election in an earlier year, providing the following sample:

> NOTICE OF PRIOR ELECTION OUT OF AUTOMATIC ALLOCATION
>
> The taxpayer has previously elected that the automatic allocation rules will not apply to any and all transfers to the ____ Trust described in Item __. Part 3, SCHEDULE A; accordingly, no portion of the transferor's unused GST exemption shall be deemed allocated to the transfer described in Item __, Part 3 of SCHEDULE A.

(3) *ETIP.* GST exemption cannot be allocated during the "estate tax inclusion period," which is the period after a transfer during which the transferred property would be includable in the gross estate of the transferor or transferor's spouse (other than by reason of the three-year rule of §2035).

There are several exceptions to the ETIP rule. (1) The rule does not apply if there is a less than 5% actuarial probability that property will be included in the gross estate (which creates some uncertainty as to how the ETIP rule applies to GRATs). (2) The rule does not apply to a spouse who possesses a Crummey withdrawal power limited to a "five or five" power, if the withdrawal right terminates no later than 60 days after the transfer (so that GST exemption can be allocated to the trust from the date transfers were originally made). (3) The rule does not apply to an inter vivos QTIP trust for which the reverse QTIP election is made, allocating the transferor's GST exemption to the trust.

GST exemption can be allocated at the end of the ETIP term, and in fact automatic allocation applies if the assets at that time pass to a "GST trust." The final regulations confirm that an election out of deemed allocation to a transfer subject to an ETIP may be made on a Form 709 filed for any calendar year up to and including the calendar year in which the ETIP closes.

If an affirmative allocation of GST exemption is made to property subject to an ETIP, it is irrevocable after the due date of the timely gift tax return reporting the transfer. However, the allocation does not become effective until the close of the ETIP, and is therefore unlikely to cause the trust to be fully GST exempt.

(4) *Terminating Election Out on Deemed Allocation.* An election out of automatic allocation may be terminated on a subsequent Form 709 to the extent the election out applies to future transfers or to a transfer subject to an ETIP that has not yet occurred.

(5) *Gift Splitting Effect on Automatic Allocations.* A split gift election applies for GST as well as gift tax purposes. Therefore, if an automatic allocation applies, the exemption will be made one-half from each spouse. A split gift election may be filed on a late return, as long as it is the first gift tax return filed for that year. If a late return is filed to make the split gift election, there would be automatic allocation of one-half from each of the spouses.

If a split gift election is made and the spouses want to elect out of the deemed allocation rules, the election out must be made on both spouses' returns, not just the donor's return.

f. *Retroactive Allocation.* Retroactive allocation of GST exemption may be made if there is an unnatural sequence of deaths. For example, if a trust is created for a child and grandchildren, the transferor may not allocate GST exemption, thinking that the trust ultimately will probably pass entirely to the child. If the child predeceases the transferor, the transferor may make a retroactive allocation of any GST exemption available at that time, effective from when the original transfer was made to the trust. The retroactive allocation applies on a chronological basis, beginning with the first transfer to the trust (which prevents taxpayers from using hindsight to make more effective allocations of GST exemption just to transfers to the trust that had the most appreciation).

g. *Automatic Allocation at Death.* To the extent GST exemption is not affirmatively allocated during the transferor's lifetime and is not affirmatively allocated at death, a final set of deemed allocation rules allocates GST exemption, first, to direct skips occurring at death and, second, to trusts from which a GST transfer might occur. The exemption is allocated pro rata in step one and step two, respectively, if there is not enough exemption to cover all of the transfers. The deemed allocation at death rule applies even if the transferor had made an effective election out of the automatic allocation rules with respect to all transfers to the trust. To avoid pro rata allocations to testamentary trusts that may cause the trusts to be only partially GST exempt, affirmative allocations at death are preferable.

7. General Approaches to Estate Planning Following ATRA; The "New Normal"

a. *The "New Normal."* There is a "new normal" of estate planning in light of the (i) transfer tax certainty, (ii) large indexed transfer tax exemptions, and (iii) portability provided by ATRA. (In 2001, 120,000 estate tax returns were filed, of which 60,000 were for taxable estates. In 2012, less than 4,000 taxable estate tax returns were filed.

Estimates are that less than 0.2% of Americans will be subject to the federal estate tax.) Income tax changes may significantly impact trusts.

b. *Planning For Married Couples Under $5.25 Million.* The major focus for estate planning for couples having assets under $5.25 million will be (i) core dispositive planning, (ii) income tax planning (for example, achieving basis step up at death), and (iii) preservation and management of assets.

(1) *Transfer Taxes Generally Irrelevant.* Transfer taxes will generally be irrelevant for clients in this range. One issue the clients will face is whether to make the portability election at the death of the first spouse. Filing an estate tax return and making the election will be preferable in most cases. The assets must be valued in any event for basis purposes, and the portability regulations allow a relaxed reporting procedure to merely list assets qualifying for the marital deduction rather than listing values of each of the assets. Filling out the estate tax return will not be overly onerous. If an estate tax return is not filed to make the portability election, the planner will want a clear waiver letter signed by the executor (and perhaps the beneficiaries).

(2) *Core Dispositive Planning; Review Current Plans.* Clients will continue to need estate planning documents disposing of their assets among their desired beneficiaries and coordinating beneficiary designations to achieve the desired result. Existing estate planning documents should be reviewed from a new perspective. How will formula clauses operate in light of state estate taxes, higher exclusions and lifetime gifts? Will much (or all) of the estate be left to a credit shelter trust that no longer will generate federal estate tax savings?

If clients have made large gifts in the past, trusts should be reviewed to determine the operation of those trusts. Is the trustee structure and are other provisions of the trusts working appropriately, or should modifications be made? Should adjustments be made to the estate plan in light of the prior gifts and now larger federal exemptions? Should expectations regarding future gifts be clarified with family members?

Beneficiary designations should be reviewed. Designating certain types of trusts (designed for federal estate tax savings) as beneficiaries may no longer be appropriate.

(3) *Income Tax Planning.* While transfer taxes may be irrelevant, income tax issues will remain. A key issue for clients in this range will be preserving a step up in basis at the death of each spouse. A simple will or revocable trust leaving all of the assets outright to the surviving spouse will achieve a basis adjustment at the deaths of both spouses. Alternatively, if a trust is desired for preservation, management or asset protection purposes, giving the surviving spouse a testamentary general power of appointment may be helpful to allow a basis adjustment at the surviving spouse's death.

Clients that have previously entered into estate planning transactions, such as creating entities, making gifts to trusts, etc., may want to reverse the effects of some of those transactions. For example, dissolving the entity may avoid valuation discounts that would otherwise limit basis adjustments at the owner's death. A settlor may want to take steps to attempt to cause trust assets to be included in the settlor's gross estate for estate tax purposes so that a basis adjustment would apply at the settlor's death.

Items 10-11 below address strategies to preserve basis step up in various situations.

(4) *Preservation and Management of Assets; Trust Planning.* A key decision will be whether to use trusts as part of the estate plan for non-tax reasons. (Indeed, using a trust could have tax disadvantages because the highest income tax rates and the 3.8% Medicare tax on net investment income apply to trusts with undistributed income of only $11,950 in 2013, $12,150 for 2014.) Reasons that a trust may be appropriate include:

- the surviving spouse is not capable of managing assets;
- there is a second marriage blended family and each spouse wants to control where his or her assets will pass;
- the parties have a fear of the spouse's remarriage or a concern of undue influence; or
- there is a need for asset protection or divorce protection.

As part of the decision process of whether to use trusts, keep in mind that there may be additional administrative costs for trusts (filing trust income tax returns, additional income taxes, etc.).

If a trust is used, consider allowing discretionary income and principal distributions for health, education, support and maintenance – not for tax reasons but to ensure that distributions are made when really needed. Consider giving the discretion to make distributions to children or to others with the consent of the spouse. Give the spouse a lifetime or testamentary general power of appointment in order to achieve a step up in basis at the surviving spouse's death. Be aware, however, that if asset protection is a concern, using a "HEMS" distribution standard or a general power of appointment may not be ideal.

(5) *Rethinking Traditional Planning Concepts.* In light of the fact the transfer taxes are irrelevant (absent "winning the lottery" or a change in future transfer tax laws), planners will need to rethink traditional planning concepts. For example, steps that are taken to assure qualification for the annual exclusion, to avoid retained interests in trusts, etc. may no longer be necessary. Putting up with owning life insurance in an irrevocable life insurance trust and the complexity of funding the trust to pay premiums would seem irrelevant for most of these clients. An issue that planners may increasingly face in the future is the

situation of surviving spouses who are named as executors who refuse to fund traditional bypass trusts (thinking that transfer taxes will never be an issue and the spouse would prefer to utilize the basis step-up at the second spouse's death).

(6) *Focus on Maintaining Standard of Living.* Rather than focusing on strategies for wealth transfer, these clients may focus much more on having sufficient assets to maintain the spouses during their retirement years.

(7) *Qualified Retirement Plans.* A large part of planning for retirement will be to structure withdrawals from qualified retirement plans so that they can last for the lifetimes of the spouses. Straining to use qualified retirement assets to fund credit shelter trusts, however, may no longer be necessary in light of the large federal exemption.

(8) *Elder Law Planning.* For clients with well under $1 million, planning for long-term and nursing home care is important. Endeavor to have an infirm person stay in the residence as long as possible since that is much less expensive than nursing home costs. Planning for Social Security and Medicare during retirement years is also essential. See Item 41 below regarding Social Security and Medicare essentials for persons approaching their mid-60s.

(9) *Low Interest Loans.* A common way of assisting relatives financially is to use loans at the AFR. However, bear in mind, that the interest payments will be taxable income to the client, and may or may not be deductible to the borrower, depending upon his or her use of the loan proceeds. If interest payments accrue, each year the client will still probably have to recognize the accrued income (i.e., a pro rata part of the original issue discount over the life of the loan).

(10) *Asset Protection Planning.*

- *Inter Vivos QTIP Trusts.* The clients may want to consider having one spouse create an inter vivos QTIP trust for the other spouse with spendthrift provisions. After the trust has been created, the assets should not be reachable by the creditors of either spouse. If the donee-spouse predeceases and the assets pass back into a trust for the original donor-spouse (either directly or by the exercise of a power of appointment by the donee-spouse) the assets may still be protected from the original donor-spouse's creditors. (Statutes in Arizona, Delaware, Florida, Michigan, Ohio, North Carolina, Texas, Virginia and Wyoming — and perhaps other states — make that clear. See Item 15.d below)
- *Lifetime Credit Shelter Trusts.* If one spouse creates a lifetime credit shelter trust for the other spouse, neither spouses' creditors should be able to reach the assets in the trust. If both spouses create trusts that are not reciprocal of each other (different time, different amounts, different trustees, different beneficiaries, different powers of appointment, etc.) both

trusts may be protected from claims of the spouses' creditors (but that is a state law issue, not necessarily governed by the Grace reciprocal trust federal tax doctrine). If a spouse dies and exercises a power of appointment to appoint the assets in the credit shelter trust back into a trust for the original donor-spouse, those assets may still be protected from creditors of the donor spouse (depending on application of the "relation back" doctrine.) Statutes in Arizona, Ohio and Texas—and perhaps other states—make clear that creditors could not reach the assets of the appointee trust in that situation. *E.g.,* TEX. PROP. CODE §112.035(d)(2)(effective Sept. 1, 2013). See Item 15.d below for a detailed discussion of this issue. Making transfers to a lifetime credit shelter trust also removes the assets from the gross estates of the individuals for estate tax purposes in case the exemption should later be reduced.

- *Tenancy by the Entireties.* Almost half of the states provide asset protection for assets held by the spouses in a tenancy by the entireties.
- *Homestead.* A number of states provide creditor protection for the personal residence claimed as a homestead.
- *Qualified Retirement Plans.* Assets in qualified retirement plans are generally exempt from creditors' claims.

(11) *State Transfer Taxes.* Nineteen states and the District of Columbia (representing about a third of the U.S. population) impose a state estate tax—typically with exemptions considerably lower than the $5 million indexed federal exemption. For example, Massachusetts, New York, Oregon and Minnesota have a $1 million exemption (although there is a proposal to increase the $1 million state estate tax exemption in New York and to reinstate a New York gift tax); New Jersey has a $675,000 exemption; Pennsylvania and Iowa has no exemption in some cases.

Planning to avoid state transfer taxes is important particularly in states having lower exemptions than the federal $5 indexed exemption (which applies in Delaware and Hawaii). For example, a couple relying on portability to utilize both spouses' estate exclusions may still want to fund a bypass trust at the first spouse's death with the state exemption amount. (Fully funding a bypass trust with the federal exemption amount may impose a substantial state estate tax at the first spouse's death if the state exemption is considerably lower than the $5 million indexed federal exemption. For example, fully funding a bypass trust in New York would cost about $431,000 in New York state estate tax at the first spouse's death. Prior plans should be reviewed to determine whether existing formulas in documents may result in large state estate taxes at the first spouse's death.)

Clients living in states without state estate taxes may nevertheless have to pay state estate tax if they own real estate in states that have a state estate tax. This may be the case even if the real estate in the other state does not exceed the exemption for that state; many states calculate the state estate tax that would apply on the entire estate, wherever located, and impose a tax that is proportionate to the amount of the estate represented by the in-state real property. See Item 8.j.

One looming loophole strategy for saving state estate taxes is for the client to make gifts (even deathbed gifts) rather than owning the assets at death. Only two states (Connecticut and Minnesota) have a gift tax, and a few more have "contemplation of death" provisions for transfers within a certain period of time prior to death. If there is no state gift tax, lifetime gifts covered by the $5 million indexed federal gift exemption could be made totally free of federal or state gift or estate taxes. However, an offsetting factor is that gifts of low basis assets would cause the gifted assets not to receive a basis adjustment at the donor's death (because the assets would not be included in the donor's gross estate).

Clients may even consider moving to states that do not impose a state estate tax.

(12) *Special Needs Trust Planning for Beneficiaries with Disabilities.* Third party special needs trusts that would take effect upon the deaths of parents of a disabled beneficiary may be able to provide "extras" for the beneficiary without disqualifying the person from qualifying for Medicaid assistance.

c. *Planning For Couples in $5-10 Million Range.* In addition to the planning issues discussed above, a primary estate planning decision for clients in this range will be whether to use a credit shelter trust or rely on portability at the first spouse's death. This is not an easy analysis for the planner (and is discussed in greater detail in Item 8 below).

(1) *Portability Decision — Overview.* Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. Planners know that there are a variety of advantages of employing trusts at the first spouse's death, but many clients may opt for the "cheapest" (and perhaps more important, the simplest) alternative.

An optimal approach may be to utilize planning that leaves the surviving spouse with the decision of whether or not to utilize portability. Alternatives are (1) to rely on a disclaimer provision (allowing a surviving spouse to disclaim an outright bequest with a provision that the disclaimed assets pass to a bypass trust) or (2) to leave assets to a QTIPable trust and either make a full QTIP election (and rely on portability) or make a partial QTIP election with a "Clayton" provision (so that the unelected portion would have more flexible distribution provisions than a single–beneficiary mandatory income interest trust for the surviving spouse; thus the unelected portion could look like a standard bypass trust). See Item 8.h for a discussion of the advantages and disadvantages of each of these two approaches and for further discussion of strategies to maximize planning flexibilities.

Situations favoring an approach leaving all of the assets outright to the surviving spouse and relying on portability include:

- a competent spouse who can manage assets;
- a desire by the clients to avoid using trusts (taking into consideration the possible increased income tax and costs for administering trusts as well as the general fact that many clients are unfamiliar and uncomfortable with trusts);
- a first marriage or no children existing by prior marriage of either spouse;
- clients who are more interested in basis step up than getting future appreciation out of their estate;
- situations in which it is undesirable to retitle assets (for example to be able to utilize each spouse's exemption amount);
- the desirability of the surviving spouse being able to create a trust following the first spouse's death that would be a grantor trust as to the surviving spouse;
- there is a residence or other assets that would be difficult to administer in a trust; or
- qualified retirement plan assets are the predominant assets in the estate.

If a trust arrangement is desirable in any event (see Item 8.d below for a discussion of the advantages of using trusts in this context), QTIPable or credit shelter trusts can both be structured to leave flexibility to the surviving spouse regarding the portability decision. Also, in a blended family situation, substantial inequities may result if the credit shelter approach is not used.

Major Factors. In many cases the credit shelter trust vs. portability decision will come down to the following major factors:

Credit Shelter trust — (i) desirability of omitting future appreciation from the estate, (ii) being able to take advantage of state exemptions and to make the best use of the GST exemption, (iii) being able to include the spouse and other persons as trust beneficiaries, and (iv) avoiding (or minimizing) inequities in a blended family situation; vs.

Portability — (i) administrative simplicity factors of outright ownership if a trust will not be used at all (forgoing asset management/preservation, the ability of the first spouse to control the ultimate disposition of the assets, and creditor protection advantages), (ii) desirability of a second basis step up at the second spouse's death, and (iii) ability to leave the assets in a trust for descendants of which the surviving spouse is treated as the owner under the grantor trust rules.

See Item 8 below for a more detailed discussion of portability planning issues.

(2) *State Exemption Planning.* For state estate tax planning purposes, creating a credit shelter trust to hold the state exemption amount will likely be desirable. As to the excess of the estate over the state exemption amount, some states allow a state-only QTIP election; however, using portability for the excess assets is probably simpler than using a state-only QTIP trust to hold the excess assets over the state exemption amount.

(3) *Income Tax Planning.* Income tax planning will become more important. The increased rates on high income taxpayers and the 3.8% Medicare tax will present planning opportunities. The 3.8% Medicare tax on net investment income is an additional factor that trustees will need to consider in determining the appropriateness of trust distributions. Trust distribution planning affords income shifting opportunities (and the 65 day rule allows making the distribution decisions after the end of the taxable year when the parties have the financial records.) Trust documents should give the trustee the authority to deem that distributions include capital gains. See Blattmachr & Gans, TAX NOTES at 901 (May 17, 2004). See Item 9 below for a more detailed discussion of trust planning considerations of the 3.8% tax on net investment income. Basis planning may predominate transfer tax planning (other than the portability decision) in many situations.

d. *Planning for Couples Above $10 Million.* Traditional planning strategies for large estates will continue to apply.

(1) *Transfer Planning General Issues.* Planning issues include:

- Large gifts combined with sales or other leveraged transactions afford the opportunity of removing huge amounts from the transfer tax base for estate and GST purposes;
- To the extent possible, accomplish desired lifetime transfers with strategies that minimize using the client's gift exemption (such as with GRATs or sales to grantor trusts); maximize the estate exemption remaining at death in order to be able to retain low basis assets to receive a basis step-up at the individual's death, although there may be non-tax reasons to make gifts using gift exemptions (such as for creditor planning purposes);
- Dealing with the complexities of gift splitting in order to take advantage of both spouses' large gift exemption amounts if the marital assets are owned predominantly by one spouse;
- Concerns over losing a stepped-up basis for gifted assets that are no longer owned by the individual at death;
- There will continue to be an urgency in creating and funding grantor trusts sooner rather than later in light of the Administration's proposal to restrict the advantages of subsequent sales to grantor trusts;

- Whether gifts should be made in trust—reasons include GST planning (if there is remaining exemption to allocate), asset protection, divorce protection, and management protection;
- What assets should be transferred--for valuation discounting and leverage reasons, entities will often be used; allow time between the funding of the entity and any transfers; retain sufficient assets to provide living expenses; do not transfer personal use assets to entities; follow formalities for the entity;
- Defined value formula clauses may be appropriate for gifts or sales if the transfer utilizes most of the remaining available gift exemption amount;
- Sales can leverage transfers to increase significantly the transfer of future appreciation; if $5.12 million gifts have already been made to the trust in 2012, consider sales of appreciating assets to the trust in return for AFR-interest rate long term notes; the rule of thumb is that the sale amount can be 9 times the equity value of the trust from the prior gifts;
- Grantor trusts can dramatically increase the amount transferred over time by permitting tax-free compounding for the trust; if a grantor is reluctant to utilize a grantor trust because of the ongoing income tax liability, consider reducing the amount being transferred to the trust but still leaving it as a grantor trust (with someone having the flexibility to cause the trust to lose its status as a grantor trust as some point in the future);
- The gift exemption amount will increase each year with indexing (it increased by $130,000 in 2013 from $5,120,000 to $5,250,000 and increased in 2014 to $5,340,000) and the decision will have to be made how to best use the increased gift exemption amount each year; and
- Making gifts requiring the payment of gift tax to take advantage of the tax exclusive nature of the gift tax (assuming the donor lives at least three years after the gift), discussed further in Item 12.e.

Items 12-34 below address various transfer planning strategies.

(2) *Overview of Planning Considerations For Indirect Access.* Now that we know the gift exemption will continue at the high $5 million indexed level, some of the concerns that clients struggled with in 2012 about whether they might need access to any of the gift funds and planning alternatives to address those concerns will be ongoing. These include:

- The use of "spousal lifetime access trusts" (sometimes referred to as "SLATs"), including concerns over whether the donee-spouse can be given a testamentary limited power of appointment broad enough to appoint the assets back into a trust for the original donor-spouse if the donee predeceases, and including potential effects of creditors rights with respect to those trusts;

- The use of “non-reciprocal” trusts if married individuals want to include each other as potential beneficiaries of SLATs;
- A donor may choose to purchase assets from grantor trusts in return for long-term notes if the donor would like to re-acquire those assets (to be able to enjoy the income produced by those assets or to be able to achieve a basis step up at the donor’s subsequent death); and
- If the donor is unwilling to make further gifts, the donor may be willing to make a late allocation of GST exemption to a prior trust (and if appropriate, later do a qualified severance to have a fully exempt and non-exempt GST trust).

See Items 14-25 below regarding planning strategies about possible “rainy day” concerns.

e. *Traditional Non-Tax Planning*. Lou Mezzullo, President of the American College of Trust and Estate Counsel, sent a letter to ACTEC Fellows following the passage of ATRA reminding Fellows of the many services that professionals provide to clients other than federal transfer tax planning. He provides the following list, not meant to be exhaustive, of some of those items (quoted with his permission).

1. Planning for the disposition of the client’s assets at his or her death.
2. Asset protection planning.
3. Planning for disability and incompetency.
4. Business succession planning (without the estate tax to blame for failure of a business).
5. Planning for marital and other dissolutions.
6. Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, would not be affected at all).
7. Life insurance planning (other than to provide funds to pay taxes).
8. Fiduciary litigation (enhanced because more to fight over).
9. Retirement planning.
10. Planning to pay state death taxes (in many states).
11. Planning to avoid or minimize gift taxes (and client desires to gift more than the $5 million indexed applicable exclusion amount for gift tax purposes).
12. Using business entities to accomplish nontax objectives.

13. Planning for children with disabilities.

14. Planning for spendthrift children.

15. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax).

16. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.

17. Planning for nonresident aliens with assets in the U.S. or who plan to move to the U.S.

18. Planning for citizens who intend to change their citizenship.

19. Planning for possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates.

20. Planning to pay education expenses, including contributing to I.R.C. §529 plans.

21. Planning to deal with non-tax regulatory issues, such as the Patriot Act, HIPPA, and charitable governance reform.

22. Identifying guardians for minor children, if and when needed.

8. Portability

a. *Permanent.* ATRA's making portability permanent is a major development that will arise as an issue for consideration in planning the estates of every married couple.

b. *Brief Background.* Section 303(a) of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("the 2010 Tax Act") allows portability of any unused "basic" exclusion amount (changed to "applicable" exclusion amount in ATRA) for a surviving spouse of a decedent who dies after 2010 if the decedent's executor makes an appropriate election on a timely filed estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount" (referred to in the regulations as the "DSUE amount.") The surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse."

c. *Portability Decision Is Complex.* Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. From the planner's perspective, this is a more complex decision involving a variety of factors.

Although the purpose of portability is to facilitate simplicity for clients, the possibility of relying on portability may in some cases make the planning process more complicated to communicate fully to clients the advantages and disadvantages of planning alternatives.

d. *Reasons for Using Bypass Trusts Even With Portability.* There are various reasons for continuing to use bypass trusts at the first spouse's death and not rely on the portability provision including: (a) the deceased spousal unused exclusion amount is not indexed; (b) growth in the assets are not excluded from the gross estate of the surviving spouse unlike the growth in a bypass trust which is excluded, (c) there is no portability of the GST exemption; (d) there is no statute of limitations on values for purposes of determining the unused exclusion amount that begins to run from the time the first deceased spouse's estate tax return is filed whereas the statute of limitations does run on values if a bypass trust is funded at the first spouse's death; (e) the "ported" exemption is lost if the surviving spouse remarries and the new spouse also predeceases with little unused exclusion; (f) if the decedent-spouse had received unused exclusion from a prior deceased spouse, at the decedent-spouse's death the "inherited" exclusion amount cannot be "ported" to the surviving spouse to the extent that the decedent-spouse's unused exclusion amount exceeds the basic exclusion amount at the decedent-spouse's death; (g) the state exemption amount is not portable, so at a minimum the client may want to fund a bypass trust with the amount of the state exemption (discussed in more detail below); (h) the bypass trust could be funded with discounted hard to value assets when there may be a low audit risk at the first spouse's death; (i) using a bypass trust can avoid substantial inequities that might otherwise occur in a blended family situation (in which at least one spouse has children by a prior marriage—discussed in more detail below); and (j) there are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse (although those benefits can also be utilized with portability by using a QTIP trust rather than a bypass trust).

On the other hand, leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death. One possible method of dealing with the double basis step up issue is to use a credit shelter trust and plan it so that the "Delaware tax trap" can be triggered by the surviving spouse to cause the trust assets to be includable in the spouse's gross estate. (See Item 11.d for a more detailed discussion of planning opportunities with the Delaware tax trap.) Alternatively, the surviving spouse might be given a formula general power of appointment over the bypass trust to cause estate inclusion of low basis assets to the extent that the estate tax inclusion will not result in having to pay federal or state estate taxes. (See Item 11.c for a more detailed discussion of planning with formula general powers of appointment.)

Blended Family Situation. In a blended family situation, substantial inequities may result if the credit shelter approach is not used. The following observations and examples are based on observations from a presentation by Thomas Abendroth and Barbara Sloan at the ACTEC 2013 Fall Meeting. Potential problems can arise if there is hostility between the executor (perhaps a child by the decedent's prior marriage) and the surviving spouse's family. The executor may try to "extort" consideration for making the portability election. Or the executor may be unwilling to bear the expense of filing an estate tax return to make the election. (The will could be drafted to provide that the executor would not be required to make the portability election unless the surviving spouse pays the expenses of filing the estate tax return.)

If assets are left outright to the surviving spouse, the spouse may give or bequeath the assets to persons other than the first decedent-spouse's descendants (or may favor some over others of those descendants in ways that the decedent-spouse would not have wanted). Even if a QTIP trust is used, the surviving spouse may be able to take steps that would significantly disadvantage the decedent-spouse's descendants—even though the assets are "protected" in a QTIP trust.

QTIP Trust "overpaying" estate tax in blended family situation. The assets of the QTIP trust will be included in the surviving spouse's gross estate, and the surviving spouse's estate is entitled to reimbursement under §2207A for estate taxes attributable to the QTIP trust (determined on a marginal basis: the amount of estate taxes with the QTIP trust included in the gross estate minus the amount of federal estate tax if the QTIP trusts were not included in the gross estate). This could occur if the surviving spouse makes gifts utilizing the DSUE amount or even if the spouse makes no gifts but has his or her own assets that are large enough to cause the payment of estate taxes even if the QTIP trusts were not included in the estate.

> For example, assume W dies with $2 million passing to a QTIP trust. H later dies with his own $12 million estate. H's gross estate is $14 million. H's estate exemption is $5.25 million DSUE from W + H's $5.25 million (assuming no indexed increase in the exemption), or $10.5 million. The federal estate tax is ($14 million - $10.5 million) x 40%, or $1.4 million. If there were no QTIP trust, H's estate tax would have been ($12 million - $10.5 million) x 40%, or $600,000. The difference ($1.4 million - $600,000) or $800,000 must be borne by the QTIP trust (unless H waives his reimbursement right under §2207A). W's children have to bear $800,000 of the estate tax even though her estate was well under her $5.25 million exemption amount.

Possible planning alternatives to avoid this situation are (i) use a premarital or post-nuptial agreement in which the parties agree that a decedent-spouse's executor will make the portability election only if the surviving spouse agrees to waive the §2207A reimbursement right from the decedent-spouse's QTIP trust, or (ii) if a marital agreement is not possible, the decedent-spouse's executor might agree to make the portability election only if the surviving spouse agreed to waive the §2207A reimbursement right. (Agreeing to make the QTIP election only if the surviving spouse agreed to waive the reimbursement right might conceivably create concerns as to whether the QTIP election was valid, and using the conditional portability election is preferable to a conditional QTIP election.)

QTIP Trust "underpaying" estate tax in blended family situation. Reverse fact scenarios could arise in which the surviving spouse's family would be disadvantaged and pay more than their fair share of the estate tax due at the surviving spouse's death if the surviving spouse waives the reimbursement right.

For example, assume W dies with $12 million passing to a QTIP trust. H later dies with his own $8.5 million estate. H's gross estate is $20.5 million. H's estate exemption is $5.25 million DSUE from W + H's $5.25 million (assuming no indexed increase in the exemption), or $10.5 million. H's federal estate tax is ($20.5 million - $10.5 million) x 40%, or $4 million. If there were no QTIP trust, H's estate tax would have been ($8.5 million - $10.5 million) x 40%, or $0. H's agreement to waive his §2207A reimbursement right means that his estate bears $4 million of the estate tax—and his family only receives $4.5 million of his $8.5 million estate. If the $4 million of estate tax were prorated between the QTIP trust and H's estate, the QTIP portion would be $2.34 million ($4 million x 12/20.5) and H's estate portion would be $1.66 million ($4 million x 8/20.5).

Accordingly, in a complex blended family situation, having the assets pass to a credit shelter trust to assure that the first decedent-spouse's descendants are treated fairly avoids those complexities. Alternatively, if the family wishes to use the portability approach, fund the first decedent-spouse's assets exempt amount into a separate QTIP trust and have the surviving spouse agree to waive reimbursement rights with respect to that trust only.

e. *Situations Favoring Portability.* There are some situations in which planners may strategically decide that relying on portability is better than creating credit shelter trusts in the first decedent-spouse's will. Situations favoring an approach leaving all of the assets outright to the surviving spouse and relying on portability include: (a) a strong desire for simplicity (some clients just "mistrust trusts"); (b) a competent spouse who can manage assets; (c) a first marriage or no children existing by prior marriage of either spouse; (d) clients who are more interested in basis step up than getting future appreciation out of their estates; (e) there is a residence or other assets that would be difficult to administer in a trust; and (f) the additional administrative and income tax costs of having assets in trust (see Item 9.g for a discussion of the additional income tax and "net investment income tax" that may apply to undistributed trust income) outweigh the potential tax and non-tax advantages of trusts. There are other special situations in which portability may offer distinct advantages, summarized below.

Qualified Retirement Plans. For the classic situation of a client whose major assets are a residence and retirement or IRA benefits, there is often no way to fund a bypass trust fully without using the retirement or IRA benefits. However, optimal income tax deferral typically results from naming the surviving spouse as the beneficiary. A possible planning strategy is to leave the retirement and IRA benefits directly to the surviving spouse and rely on portability to be able to utilize the deceased spouse's unused estate tax exclusion amount at the surviving spouse's subsequent death.

Retitling Assets. Traditionally, if one spouse owned most of the marital assets, in order to utilize the estate exemption amount of the less-propertied spouse if he or she died first, the wealthier spouse would have to retitle assets into the name of the less wealthy spouse or fund a QTIP trust for that spouse, often unpopular with the moneyed spouse. The reluctance will be even bigger with a $5 million exemption — a very large amount might need to be transferred to the poorer spouse. That can be avoided if the spouses are willing to rely on portability to take advantage of the less wealthy spouse's exclusion amount if he or she should die first. Many clients in this situation may find portability very attractive, but retitling may still be necessary to the extent of any state estate tax exemption amount to take advantage of the state exemption if the "non-propertied" spouse dies first.

Saving State Estate Taxes. Using a credit shelter trust for the full amount of the federal exemption amount at the first spouse's death might generate significant state estate taxes, which could be avoided by using portability. (Perhaps a bypass trust would be funded with only the amount of the state exemption.) In addition, if bequests are made outright to the surviving spouse, the surviving spouse could make gifts, which are not subject to state estate or gift taxes in most states. See Item 8.j below for further discussion of the impact of state estate taxes on portability planning.

Creating Grantor Trust as to Surviving Spouse. Leaving assets to the surviving spouse or QTIP and using portability allows the surviving spouse to makes gifts using both spouses' exemption amounts and that full amount can pass to a trust that is a grantor trust as to the surviving spouse. For this purpose, portability may be desirable even for very large estates. A further advantage of this approach, as compared to funding a bypass trust at the first spouse's death, is that minority discounts may be larger if the gift is made to multiple trusts for multiple beneficiaries. If this advantage may apply in a particular case, and if the QTIP approach is used to leave the surviving spouse the flexibility of making the portability decision, the QTIP trust should give some third party wide discretion in making principal distributions to the surviving spouse, which the spouse could then use to make the gifts. (An obvious disadvantage of this strategy is that the spouse would not be able to be a discretionary beneficiary of the gifted assets.)

This strategy is available only for a very wealthy family, for which the surviving spouse can afford to make a $5+ million gift after the first spouse's death. As a practical matter, most estates of that size have very likely already made use of the spouse's gift exemption amounts during life. Another difficulty is that the decedent-spouse must be willing to leave the assets outright to the spouse (or use a QTIP trust with very broad distribution flexibilities.) An obvious disadvantage of this strategy is that the spouse would not be able to be a discretionary beneficiary of the gifted assets. A further practical concern with this approach is that the surviving spouse may decide not to "pull the trigger" in making the gifts. Also, there is a concern about whether the surviving spouse will be competent to make the gifts following the first spouse's death. A broad power of attorney authorizing large gifts would seem appropriate with this strategy and persons holding that power of attorney may be uncomfortable making those kinds of large gifts.

Consumption Exceeding Growth, Administrative Costs. Portability may be preferable if the spouse's consumption rate is expected to exceed the assets' growth rate or if administrative costs of maintaining the credit shelter trust are not justified. For example, depreciation of estate assets may be expected if there are high anticipated end-of-life health care costs, if a business will flounder without the first decedent-key person, or if a substantial part of the estate consists of IRD (of which much of the value at the first spouse's death will be paid to the IRS in income taxes).

Utilizing Deceased Spouse's GST Exemption and Getting Double Basis Step-Up With Portability. If the QTIPable trust approach is used as a way of leaving the post-mortem flexibility of deciding how to use portability, the first spouse's GST exemption can be used even if the decision is made to make a QTIP election for the entire trust. A double benefit results: (1) the first deceased spouse's estate would make the reverse a QTIP election under §2652(a)(3) to utilize the first spouse's GST exemption; and (2) the assets would get a basis adjustment (hopefully a step up) at the deaths of both spouses. However, Rev. Proc. 2001-38, discussed immediately below, could conceivably be applied to preclude this approach.

f. *Revenue Procedure 2001-38.* Some have questioned whether Rev. Proc. 2001-38, 2001-1 CB 1335 precludes the use of QTIP trusts in connection with a portability election. It provides that the IRS will ignore a QTIP election "where the election was not necessary to reduce the estate tax liability to zero." If portability applies, the election is not required to reduce the estate tax liability to zero, so literally, the Rev. Proc. might apply. Particularly if the estate is below the exemption amount, the QTIP election clearly is not necessary to reduce the estate tax liability to zero. However, for various reasons Rev. Proc. 2001-38 does not appear to preclude making a QTIP election even though the estate is relying on portability. *See generally* Franklin, Law & Karibjanian, Portability — The Game Changer (January 2013), available here on the American Bar Association Real Property Trust & Estate Law Section website.

- The purpose of Rev. Proc. 2001-38 was to facilitate making use of the first decedent's estate tax exemption amount with proper trust planning and to keep an inadvertent QTIP election from achieving that result. It was a relief measure to protect professional advisors who inadvertently listed property on Schedule M of the estate tax return when the marital deduction was unnecessary.
- The Rev. Proc. on its face suggests that the protection of the Procedure is up to the election of the estate, by stating that "[t]o come within the scope of this revenue procedure, the taxpayer must produce sufficient evidence to that effect. For example, the taxpayer [the surviving spouse or the surviving spouse's executor] may produce a copy of the estate tax return filed by the predeceased spouse's estate establishing that the election was not necessary to reduce the estate tax liability to zero."
- Expanding on the "estate election" concept, the Rev. Proc. is based on forbearance by the IRS. Rev. Proc. 2001-38 "says, in effect, …that if there was no good news for you because you didn't need the QTIP election to save tax when the first spouse died, then we will not enforce the QTIP election to create the bad news of the tax when the second spouse dies." Freda, *Electing QTIP Trust With Portability Sole New Project on IRS Guidance Plan for Estates,* BNA DAILY TAX REPORT G-4 (September 3, 2013)(quoting Ron Aucutt).
- "[A] revenue procedure announcing the Service's administrative forbearance cannot negate an election clearly authorized by statute." Aucutt, ACTEC Capital Letter No. 34, Priority Guidance Plan Published, Commissioner Nominated (Aug. 12, 2013).

- "[T]he unseemliness of denying the collateral benefits of a QTIP election to smaller estates while allowing it to larger estates … suggest that a QTIP election should be respected in such a case." *Id*.
- The portability temporary regulations specifically refer to QTIP elections in returns filed to elect portability but not otherwise required. Reg. §20.2010-2T(a)(7)(ii)(A)(4).
- Continuing to allow voiding of a QTIP election for estates in which the portability election is made could result in a whipsaw potential against the government's interest.

> "Moreover modifying Rev. Proc. 2001-38 to prevent nullification of an applicable QTIP election when a portability election is made prevents a whipsaw. For example, if a QTIP election is made and the surviving spouse uses the deceased spouse's unused applicable exclusion amount to shelter taxable gifts made during his or her lifetime, subsequent nullification of the QTIP election pursuant to Rev. Proc. 2001-38 would provide an unintended windfall. Similarly, depending upon circumstances at the time of the death of the surviving spouse, the surviving spouse's estate could attempt to invoke Rev. Proc. 2001-38 if it determined that the tax benefits of portability were less than the benefit of nullifying the QTIP election. For example, if the surviving spouse remarried and survived his or her second spouse, continued use of the first deceased spouse's unused applicable exclusion amount would be lost. The estate of the surviving spouse could invoke Rev. Proc. 2001-38 to avoid the loss of the benefit of the applicable exclusion amount of the firs deceased spouse." American Bar Association Section of Real Property, Trust & Estate Law, *Comments to Internal Revenue Service on Revenue Procedure 2001-38 in Context of Portability Planning* (June 11, 2013).

The IRS has added "the validity of QTIP elections on an estate tax return filed only to elect portability" as an item on the IRS/Treasury Priority Guidance Plan for 2013-2014. Ron Aucutt believes that the inclusion of this item on the Priority Guidance Plan makes clear that the IRS will grant relief from Rev. Proc. 2001-38 in the context of estates making the portability election. Aucutt, *ACTEC Capital Letter No. 34, Priority Guidance Plan Published, Commissioner Nominated* (Aug. 12, 2013)("Clarifying that result is evidently what this new item on the Priority Guidance Plan is about. It is not always the case that the appearance of a project on the Priority Guidance Plan makes it clear what the outcome of the project will be, but it is clear in this case.").

g. *Major Factors.* In many cases the credit shelter trust vs. portability decision will include the following major factors: control by spouse, administrative simplicity, basis step up at both deaths, creditor protection, sheltering appreciation between the two deaths, and who pays income tax.

Credit Shelter trust — (i) desirability of omitting future appreciation from the estate, (ii) being able to include the spouse and other persons as trust beneficiaries (if a QTIP trust is used only the spouse is a beneficiary; if the spouse receives assets outright and makes a gift to a trust for descendants — which could be a grantor trust as to the surviving spouse, the spouse would not be a beneficiary; the surviving spouse and descendants could both be discretionary beneficiaries using a disclaimer approach), (iii) utilizing state exemptions and the GST exemption at the first spouse's death, and (iv) avoiding (or minimizing) inequities in a blended family situation.

Portability — (i) administrative simplicity factors of outright ownership if a trust will not be used at all (forgoing asset management/preservation, the ability of the first spouse to control the ultimate disposition of the assets, and creditor protection advantages), (ii) desirability of a second basis step up at the second spouse's death, (iii) ability to leave the assets in a trust for descendants of which the surviving spouse is treated as the owner under the grantor trust rules, and (iv) if estate values are expected to decrease during the surviving spouse's life.

h. *Optimal Approach* — Leaving Surviving Spouse Flexibility. An optimal approach may be to utilize planning that leaves the surviving spouse with the decision of whether or not to rely on portability. Alternatives are (1) to rely on a disclaimer provision (allowing a surviving spouse to disclaim an outright bequest with a provision that the disclaimed assets pass to a bypass trust), or (2) to leave assets to a QTIPable trust; portability would be used if a full QTIP election is made (and the first deceased spouse's GST exemption could be used by making a reverse QTIP election under §2653(a)(3)), and a bypass trust approach would be used if a partial QTIP election is made with a "Clayton" provision (so that the unelected portion would have more flexible distribution provisions than a single–beneficiary mandatory income interest trust for the surviving spouse).

As between those two approaches, the disclaimer approach seems simpler, but the QTIP approach may be preferable in many situations.

Disclaimer Oriented Approaches. It could start with an outright bequest to the surviving spouse, with provisions that if the spouse disclaimed, the assets would pass to a QTIPable trust, and that if the spouse disclaimed his or her interest in the QTIP trust, the assets would pass to a bypass trust. This affords a great deal of flexibility.

- The spouse could decide not to make any disclaimers and keep the assets, and the executor would then make the portability election.
- Alternatively, the spouse could disclaim some or all of the outright bequest and the disclaimed assets would pass to the QTIPable trust. The executor would have up to 15 months after the date of death (if the estate tax return is extended) to decide whether to make the QTIP election (or whether to make a partial QTIP election). If the QTIP election is not made, the unelected portion could pass to the bypass trust. If the QTIP election is made, the executor could make the reverse-QTIP election and allocate the decedent's GST exemption to the trust.
- If there is a state estate tax and if the state has a "state only QTIP election," the state QTIP election could be made as to all of the assets in the trust other than the state exemption amount (to avoid paying any state estate tax at the first spouse's death), but that excess portion would not be subject to federal estate tax at the surviving spouse's death. The effect is that all of the first decedent's federal exemption would be used, but no state estate tax would be paid at the first spouse's death.
- If there is a state estate tax, the spouse could disclaim the state exemption amount from both the outright bequest and from the QTIP trust, so that the state

exemption amount would pass to the bypass trust. The portability election could be made with respect to the balance of the decedent's unused exemption amount. The balance of the estate could remain with the spouse (under the outright bequest) or the spouse could disclaim to the QTIPable trust. The alternative choices described above for the QTIPable trust would apply, including the possibility of making the "state only" QTIP election if that is permitted in the state.

- The spouse could disclaim an amount equal to the federal exemption both the outright bequest and the interest in the QTIP trust so that the federal exemption amount would pass to a bypass trust (which could result in having to pay some state estate tax at the first spouse's death).
- A disadvantage of these approaches, relying on disclaimers, is that the surviving spouse could not have a limited power of appointment over either the QTIP trust or the bypass trust.

An alternative disclaimer approach might operate in a somewhat reverse fashion.

- The decedent's will might make a bequest first to a QTIP trust.
- The executor would have 15 months to decide whether to make the QTIP election over all or a portion of the QTIP trust. Any unelected portion could pass to a bypass trust under a "Clayton" provision. If the QTIP election were made, the portability election would be made for the decedent's unused exemption amount. This "reverse-disclaimer" approach has the significant advantage of allowing the surviving spouse to have a testamentary limited power of appointment over both the QTIP trust and the bypass trust.
- If the spouse disclaims an interest in the QTIP trust, the disclaimed assets would pass outright to the surviving spouse.
    - o The disclaimer rules do not seem to preclude this sort of approach in which the disclaimant receives a greater interest in the property than under the bequest that was disclaimed. Under §2518(b)(4)(A), the disclaimed assets can pass to the surviving spouse.
    - o A potential concern is that, because the spouse would own the assets outright at the point, the spouse would have the power to direct would subsequently receives the assets, and that power might cause the disclaimer not to be a valid disclaimer (because of the requirement in §2518(b)(4) that the assets "passes without any direction on the part of the person making the disclaimer"). However, even if it is not a valid disclaimer, the spouse purported disclaimer would result in the assets passing outright to the spouse, so the spouse would not be making a gift.
    - o Another potential problem with this approach is that the IRS might conceivably argue that the spouse makes a gift to the other trust beneficiaries of the QTIP trust if the spouse does not disclaim. *But see* Rev. Rul. 74-492

(amount of elective share that could have been acquired if the election had been made during the statutory period is not includable under §2041; "which the widow is considered to acquire only if she exercises her right to take it. The widow must accept the benefits of the state law through exercise of the personal right of election or else the inchoate right is, in effect, renounced by operation of law."). If the disclaimer is not made and if the QTIP election is made, the spouse would be the only beneficiary during the term of the trust, and the only possible gift would be to the remaindermen—but the spouse's testamentary limited power of appointment would keep that from being a completed gift. However, if the QTIP election is not made, and if the spouse is treated as making a transfer to the trust because of the failure to exercise her control to receive the assets outright, §2036/2038 might apply to cause the trust assets to be included in the surviving spouse's gross estate. That would certainly be a problem as to any unelected portion of the QTIP trust that would pass to a bypass trust under the Clayton provision, but would not be a problem if the QTIP election were made because the QTIP assets would in the surviving spouse's gross estate under §2044 in any event.

Various letter rulings have approved disclaimers of percentage undivided interests, even though the executor could use his discretion in selecting which assets would fund the disclaimed portion, e.g., Ltr. Rul. 8652016, but that discretionary authority is implicit in many rulings that have approved formula disclaimers. E.g., Ltr. Rul. 200420007 (approved disclaimer of fractional share of residuary estate by child, with disclaimed assets passing to foundation; numerator of fraction is $X and denominator is value of residue determined on the basis of values, deductions, and other information reported on the federal estate tax return),. The spouse could disclaim a pecuniary amount, or a "reverse pecuniary amount" (i.e., everything in excess of $X.) Reg. §25.2518-3(c). The disclaimed assets can pass into a trust having the spouse as a beneficiary. §2518(b)(4)(A). The surviving spouse can serve as a fiduciary over the disclaimed assets as long as he or she does not retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. Reg. §25.2518-2(d)(2). The disclaimant/fiduciary can retain the fiduciary power to distribute to designated beneficiaries if the power is subject to an ascertainable standard. Reg. §25.2518-2(e)(1)(i), §25.2518-2(e)(2), & §25.2518-2(e)(5)(Ex. 12).

Some favorable aspects of the disclaimer approach include that under the disclaimer regulations, the spouse could disclaim using a formula amount, to provide a "savings clause" against disclaiming "too much" and generating an estate tax at the first spouse's death if there is an estate tax that applies to the first spouse's estate. Reg. §25.2518-3(d), Ex. 20.

Disclaimer Approach Disadvantages. There are several significant disadvantages of relying on the disclaimer approaches. The most important is that the spouse may refuse to disclaim assets, even though a disclaimer would be appropriate based on the tax situation. However, that is much more of a concern where property passes outright to a spouse, and where the spouse may not want to give up full ownership of the asset. Another significant disadvantage to the disclaimer approach is that the surviving spouse cannot retain a limited power of appointment over disclaimed assets. Reg. §25.2518-2(e)(2) & §25.2518-2(e)(5)(Ex. 5). However, a family member other than the surviving spouse-disclaimant (such as the spouse's brother or sister) could have a power of appointment that could be exercised at the spouse's death (or earlier if that is desired). In addition, there is the risk that the surviving spouse inadvertently accepts benefits, making a disclaimer impossible, or that the spouse dies before signing a written disclaimer. *Estate of Chamberlain*, 87 A.F.T.R.2d 2001-2386 (9th Cir. 2001), *aff'g by unpub'd order*, T.C.M. 1999-181. *See* Zaritsky, *Disclaimer-Based Estate Planning—A Question of Suitability*, 28 EST. PL. 400 (Aug. 2001). Also, under the laws of some states, disclaimers may not be recognized for fraudulent transfer purposes with respect to the disclaimant's creditors (e.g., FL. STAT. §739.402(d)) and may be treated as disallowed transfers for Medicaid qualification purposes.

QTIPable Trust Approach. Even though the QTIP approach may seem more complicated to clients, in many ways, the QTIPable trust approach affords greater flexibilities.

- The executor has up to 15 months to decide whether to make the QTIP election and over what portion of the trust.
- The QTIP election could be made by a formula, thus providing a "savings clause" to assure that no estate tax would be paid at the first spouse's death.
- If the QTIP election is made, the executor could make the "reverse-QTIP" election and allocate the decedent's GST exemption to the trust.
- If the state recognizes a "state only QTIP election," having assets in the QTIP trust may make the planning easier to fully utilize the first spouse's exemption amount without paying any state estate taxes at the first spouse's death.
- Any unelected portion could pass to a standard bypass trust under a "Clayton" provision. (The surviving spouse should not be the executor making the QTIP election if there is a Clayton provision. The IRS might argue that if the spouse makes the election, the spouse makes a gift of some or all of the assets that would have been in the QTIP trust.)
- The surviving spouse can have a testamentary limited power of appointment over the assets in the QTIP trust (or the Clayton bypass trust).

If the QTIP approach is used, in light of the wide ranging factors that must be considered and the inherent uncertainties involved with the portability decision, consider using a "trust director" or "trust protector" to make the decision about how much of the QTIPable trust will be covered by the QTIP election or provide broad exculpation to the fiduciary who must make the QTIP election.

i. *Portability Election; Administrative Expenses.* The will could designate whether the executor would be required or have the discretion to make or not make the portability election. An alternative is to require the executor to make the election if the spouse so requests, or perhaps to require that the executor make the election unless the spouse agrees directs that the election not be made.

The expense of preparing an estate tax return to make the portability election will be borne by someone. Even with the simplifications allowed by the temporary and proposed regulations of not having to list the values of each asset passing to the surviving spouse or charity, there could still be a not insignificant expense in preparing the estate tax return to make the election. The will can address whether the estate or surviving spouse would pay the expenses of making the election. If the spouse is required to pay the preparation expense, that will likely reduce the marital deduction for assets passing to the spouse, which would reduce the DSUE amount. (However, the spouse's estate would be reduced by a like amount, so that should not increase the aggregate estate tax payable at the surviving spouse's subsequent death.) If the estate pays the preparation expense, it would be a estate transmission expense, and if the expenses are claimed for income tax purposes, the marital deduction would be reduced (Reg. §20.2056(b)-4(d)(1)(iii)(2)), which means the DSUE amount would be reduced by the amount of the expense.

j. *State Estate Tax Planning Implications of Portability.* The following observations and examples are based on observations from a presentation by Thomas Abendroth and Barbara Sloan at the ACTEC 2013 Fall Meeting.

Using a credit shelter trust for the full amount of the federal exemption amount at the first spouse's death might generate significant state estate taxes, which could be avoided by using portability. For example, fully funding a bypass trust in New York, with its $1 million exemption amount, would cost about $431,000 in New York state estate tax at the first spouse's death. Perhaps a bypass trust would be funded with only the amount of the state exemption. In addition, if bequests are made outright to the surviving spouse, the surviving spouse could make gifts, which are not subject to state estate or gift taxes in most states. Only two states (Connecticut and Minnesota) have a gift tax, and a few more have "contemplation of death" state estate tax provisions for transfers within a certain period of time prior to death.

Delaware has adopted a portability concept for its state estate tax. The Delaware tax provision makes reference to the federal "applicable exclusion amount" (which includes the DSUE amount).

State estate tax implications for clients who have made substantial prior gifts. If an individual has made significant lifetime gifts, the amount that can be funded into a bypass trust at the individual's death without imposing a state estate tax may be relatively insignificant. Of the 20 states (including the District of Columbia) that impose a state estate tax, many of them calculate the state tax as a pick-up or modified pick-up regime calculated as if the federal law were frozen prior to the repeal of the state death tax credit, and specifying the federal applicable exclusion amount to be used in the calculation—in some cases, $1 million (which applies in New York) or less. The state death tax credit under §2011(b) applies a graduated rate table to the "adjusted taxable estate," defined as the "taxable estate" reduced by $60,000, and the table applies only where the adjusted taxable estate exceeds $40,000. Therefore, the first $100,000 of the taxable estate is excluded from the credit. In effect, this means that the bypass trust could always be funded with $100,000 without generating any state estate taxes. The state death tax credit cannot exceed the tentative federal estate tax reduced by the applicable credit under §2010.

Wills typically direct funding of the bypass trust in an amount that will not generate any federal or state estate taxes. If the individual has made substantial prior gifts, that clause may result in only $100,000 passing to the bypass trust.

> For example, assume an individual has previously made $5 million of taxable gifts and dies in 2013 as a resident of New York when the federal gift exclusion amount has grown to $5.25 million, leaving $250,000 unused. Because the prior gifts have already exceeded $1 million, the $1 million "exemption" for state purposes becomes meaningless. The formula would operate to leave $100,000 to the credit shelter trust; that is the only amount that can pass to the trust without paying state estate tax. The remaining $150,000 (of the $250,000 available federal exemption amount) could be left to a $150,000 state QTIP trust.

To avoid the creation of such small trusts, removing the formula credit shelter bequest from the will may be prudent, and allow any unused applicable exclusion amount to pass to the surviving spouse with a portability election.

Clients in non-tax states owning real estate in decoupled states. Clients living in states without state estate taxes may nevertheless have to pay state estate tax if they own real estate in states that have a state estate tax. This may be the case even if the real estate in the other state does not exceed the exemption for that state; many states calculate the state estate tax that would apply on the entire estate, wherever located, and impose a tax that is proportionate to the amount of the estate represented by the in-state real property.

> *All to H*. Assume W dies in Florida with a $4 million estate, including a $1.5 million New York condo. Assume W leaves all of the estate to H, and makes the portability election. H dies soon thereafter (before any appreciation occurs) with an estate of $6 million (including $2 million of his own assets). H's available exemption (including the $5.25 DSUE amount from W) far exceeds his $6 million estate and he owes no federal estate tax. The New York tax on the full $6 million estate would be $510,800. The ratio of New York assets to total assets in the gross estate is 1.5/6.0, or 25%. The New York tax is $510,800 x 25%, or $127,700.
>
> *W funds $1.0 M CST with non-New York assets.* Same facts but assume W leaves $1 million to a credit shelter trust (CST). She owes no federal or state estate tax. H dies with a $5 million gross estate (his $2 million + $3 million from W). H's available exemption (including the $4.25 DSUE amount from W) far exceeds his $5 million estate and he owes no federal estate tax. The New York tax on the full $5 million estate would be $391,000. The ratio of New York assets to total assets in the gross estate is now 1.5/5.0, or 30%. The New York tax is $391,000 x 30%, or $117,000. Therefore, there is only a small savings by W's funding the $1 million CST at her death with non-New York assets.
>
> *W fund $1.*0 M CST *with New York property.* Same facts but assume W leaves $1 million of the $1.5 million condo into a CST. She owes no federal or state estate tax. H dies with the same $5 million gross estate as in the prior example and owes no federal estate tax. The New York tax on the full $5 million estate would be $391,000. The ratio of New York assets to total assets in the gross estate is now only $500,000/$5,000,000, or 10%. The New York tax is $391,000 x 10%, or $39,100. Substantial savings result from funding the CST with an interest in the New York property.
>
> *W fund CST with all New York property.* Same facts but assume W leaves the entire $1.5 million New York condo to a CST. She owes no federal tax, but now she owes a New York state tax (because

she funded the CST with more than $1 million). The New York tax would be $64,400 on the full $1.5 million; the New York property percentage of the gross estate is 1.5M/4M, or 37.5%, so the New York tax is $24,000. That is paid out of the marital share so an interrelated calculation is required, which increases the New York tax to $24,744. H dies with a $4.5 million gross estate (his $2 million + $2.5 million from W). H's available exemption (including the $3.75 DSUE amount from W) far exceeds his $4.5 million estate and he owes no federal estate tax. There are no New York assets in his gross estate, so he owes no New York state tax. In this example, the best result is from fully funding the CST with the New York property at W's death, even though that requires paying some state estate tax at the first spouse's death.

k. *Temporary and Proposed Regulations — Overview*. Temporary and proposed regulations were issued on June 15, 2012. There are a few new general regulations for §§2010 and 2505 (interestingly, regulations were never previously issued for those statutes), but the newly issued regulations primarily provide guidance regarding the portability provisions included the 2010 Tax Act). The portability provisions generally allow a surviving spouse to use any unused exclusion from his or her deceased spouse. The regulations provide guidance on a variety of issues including election requirements, details regarding computing the unused exclusion amount, and the surviving spouse's use of the unused exclusion amount (either by gifts or for estate tax purposes following the surviving spouse's death).

The regulations generally provide very taxpayer-friendly positions (surprisingly friendly as to several issues) regarding a variety of issues. The regulations adopt reasonable positions, avoiding what would seem to be nonsensical results that might occur with respect to various issues under a literal reading of the statutory provisions of §2010(c)(4) and §2505 (the sections describing the unified credit against estate tax and gift tax, respectively). Perhaps the specific authorization in §2010(c)(6) for the Secretary of the Treasury to prescribe regulations necessary or appropriate to carry out that subsection afforded comfort in interpreting the statutory language very broadly in order to reach reasonable results.

The regulations apply to estates of decedents who died on or after January 1, 2011. However, the regulations expire in three years (if the proposed regulations are not finalized before that date).

Highlights of some of the more important provisions of the regulations include:

- The portability election is made by the executor's filing a timely and complete Form 706, but in most cases there will be no need to list values of assets passing to a surviving spouse or charity if the estate was not otherwise required to file an estate tax return (but the return must include an estimate of the total value of the gross estate within specified ranges, including assets passing to a spouse or charity);
- The surviving spouse's "deceased spousal unused exclusion amount" (DSUE amount) is not subject to being reduced if Congress later reduces the basic exclusion amount;

- The regulations adopt the "Example 3" approach of the Joint Committee Technical Explanation, negating any "privity" requirement in calculating the DSUE amount (an approach adopted legislatively by ATRA);
- If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUE amount;
- The surviving spouse can use the DSUE amount any time after the decedent's death, assuming the portability election is eventually made by the executor;
- Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the spouse's own exclusion amount to cover later transfers;
- DSUE amounts from multiple spouses may be used to the extent that gifts are made to utilize the DSUE amount from a particular spouse before the next spouse dies; and
- If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUE amount until the QDOT is fully distributed (or terminates at the surviving spouse's death).

For a detailed discussion of the temporary and proposed regulations see Item 6(h-q) of the December 2012 summary, "Estate Planning Current Developments and Hot Topics" found here.

l. *Missed Filing Date.* The portability election must be made on a timely filed return (which the portability regulations state to be nine months after date of death due date that generally applies if the estate is required to file an estate tax return). Filing an estate tax return is deemed to make the portability election unless the executor elects out of making the portability election. There are simplified reporting procedures, eliminating the requirement to list the values of assets passing to surviving spouses or charities in most cases. If the estate tax return is not timely filed and if the estate is small enough that no return would otherwise be required, 9100 relief is available, but that requires a formal PLR request and is expensive.

The Section of Real Property, Trust and Estate Law of the American Bar Association have filed comments with the IRS on September 27, 2013 requesting an extension of time for late portability elections in two situations.

First, if no estate tax return or 6-month extension request is filed before the due date and if the estate was not otherwise required to file a return but wishes to do so merely to make the portability election, relief should be extended under Reg. § 301.9100-2 to file the return during the 6-month period following the due date to make the portability election. (This is done by simply filing the return and noting that it is "FILED PURSUANT TO §301.9100-2" without the need for a letter ruling request or the payment of user fees.)

Second, a simplified alternative method of obtaining an extension of time to make a portability election should be made available to smaller estates (i.e., estates that would not otherwise be required to file an estate tax return) for a specified period ending no earlier than the later to occur of (a) June 30, 2014, or (b) six months from the date of publication of guidance setting forth the simplified alternative method. The simplified method would avoid the necessity of requesting an extension under Reg. §301.9100-3, which requires the expense of filing a formal letter ruling request and payment a significant user fee (generally $10,000, although smaller estates may qualify for a reduced fee, see Rev. Proc. 2013-1).

m. *Impact of "Anti-Privity" Provision Has Reduced Significance For Many Smaller Estates.* Section 2010(c)(4)(B)(i) changed "basic" exclusion amount to "applicable" exclusion amount, changing the definition of the DSUE amount to be the lesser of (1) the basic exclusion amount, or (2) the "applicable exclusion amount" minus the taxable estate will have less significance for many smaller estates than just leaving the added unused exclusion amount to the DSUE amount from the first decedent at the second spouse's subsequent death. Look at this example. (Assume the basic exclusion amount is $5M and assume all of the below occurs in 2013).

1. W and H1 are married;
2. H1 dies – he had a $2M estate, so therefore he has $3M of unused exemption;
3. W timely elects portability; W therefore now has $8M of exemption (her $5M, and H1's $3M);
4. W remarries H2;
5. W dies;
6. W has an estate of $1M and uses that amount of her exemption, leaving $7M of unused exemption (her $5M, H1's $3M, less the $1M she used).
7. H2 timely elects portability;
8. H2 then dies. What is the DSUE amount that H2 received from W that he can use at his death?

Some initial reactions may be $7M (W's $8M applicable exclusion amount less her $1M taxable estate), or $4M (not being able to use any of the DSUE amount from H1). Neither of those is right; the correct answer is $5M of DSUE amount from W. Here's the analysis.

1. When H 1 dies, the DSUE amount W receives from H1 is the lesser of (1) H1's Basic Exclusion Amount (BEA), or (2) H1's Applicable Exclusion Amount (AEA) less his taxable estate. The AEA is the BEA plus the DSUE amount from the person's last deceased spouse. H1 did not have a prior spouse so he had no DSUE amount. So H1's AEA was $5M.
2. W's DSUE amount from H1 is the lesser of $5M (H1's BEA) or $3M (i.e., $5M AEA - $2M Taxable Estate), or $3M.

3. When W died, her AEA was her BEA + DSUE amount from H1 = $5M + 3M = $8M.

4. The DUEA amount that H2 receives from W is: Lesser of (1) W's BEA, or (2) W's AEA – TE. That equals the lesser of (1) $5M or (2) $8M - $1M. $5M is lesser than $7 M so the DSUE amount that H2 receives from W is $5M.

In this case, the effect of the anti-privity legislation is to increase the DSUE amount that H2 receives from W from $4M to $5M—it does not allow increasing the exemption by the full $3M of DSUEA that H1 left to W. (Without the change made in the legislation (and regulations), the DSUE amount H2 received from W would have been the lesser of (1) $5M (BEA), or (2) $4M (W's BEA of $5M minus her TE of $1M); or $4 M.)

The provision about lifetime gifts to use up DSUE amounts would not apply in this case. That only applies if W had received DSUE amounts from spouses BEFORE her last deceased spouse and if she made gifts using those prior DSUE amounts. That did not happen in this case. W did not have any DSUE amount from any spouse prior to H1 (who was her "last deceased spouse" at her death).

Contrast this example of a typical smaller estate with Example 3 in the Joint Committee Report. In Example 3, H1 died with $2M unused exclusion amount (compared to $3M in this example). In Example 3, W's AEA was $5M + $2M DSUE, or $7M. She had a taxable estate of $3M (compared to $1M in this example), so H2's DSUE amount that he received from W was $4M. (Example 3 just said $4M without going through the full definition of the lesser of (1) $5M, or (2) $4M.) Therefore, in Example 3, the DSUE amount of H2 was less than the BEA. Therefore, being able to take advantage of the full DSUE amount that W received from H1 was important. In this example, W's taxable estate was small enough that she had a DSUE amount of $4M even without considering the DSUE amount that W received from H1. Therefore, taking into the account the DSUE amount from H1 only gave H2 the benefit of the additional $1M (i.e., $5M maximum DSUE amount less the $4M amount that would have been available without considering the DSUE amount from H1.)

9. Trust and Estate Planning Considerations for 3.8% Tax on Net Investment Income and Income Taxation of Trusts

a. *Basic Statutory Structure; Regulations.* The tax on "net investment income" was technically part of the Health Care and Education Reconciliation Act of 2010, which was passed one week after the Patient Protection and Affordable Care Act, but the two statutes are collectively called the Affordable Care Act.

Section 1411 imposes a surtax (in addition to federal income taxes) of 3.8% on the unearned income of individuals, estates, and trusts for taxable years beginning after December 31, 2012 (which is commonly referred to as the "Medicare tax"). For individuals, the tax is 3.8% of the lesser of —

(i) the individual's modified adjusted gross income in excess of a threshold amount ($200,000 for individuals and $250,000 for couples), or

(ii) the individual's net investment income for the year.

For estates and trusts, §1411(a)(2) imposes a tax equal to 3.8% times the lesser of —

(i) the estate's or trust's adjusted gross income (as defined in §67(e)) in excess of the highest income tax bracket threshold ($11,950 for 2013, $12,150 for 2014), or

(ii) the estate's or trust's undistributed net investment income.

The threshold for individuals is not indexed. The threshold for estates and trusts is the dollar value for the highest income tax bracket for estates and trusts, which is indexed, but which is a very low number. Multiple estates and trusts cannot be used to avoid the §1411 tax (because all of Chapter 1 of the Code is intended to apply and §643 is in Chapter 1).

For an excellent overview discussion of the Medicare tax in the estate planning context, see Jonathan Blattmachr, Mitchell Gans & Diana Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts,* 40 EST. PL. 3 (April 2013) and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1,* TAX NOTES 683, at 695-96 (Aug. 12, 2013) and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2,* TAX NOTES 785 (Aug. 19, 2013). For a discussion of charitable planning strategies to minimize the §1411 tax, see Richard Fox, *Charitable Planning to Avoid New 3.8% Tax on Investment Income,* ESTATE PLANNING (Aug. 2013).

Proposed regulations were published on December 5, 2012 (with corrections on January 31, 2013). The IRS received numerous comments and final regulations were released on November 26, 2013 (scheduled for official publication on December 2, 2013). In addition, the IRS released a new set of proposed regulations regarding various topics that are not covered in the final regulations. Among other issues in the final regulations:

- No "fresh start" for making the election to consistently treat distributions as including realized capital gains is permitted (in order to satisfy one of the methods of including capital gains in DNI);

- There is no guidance regarding how a trust or estate "materially participates" in a trade or business, but the IRS has a project to give additional guidance regarding that topic for purposes of §469 as well as §1411;

- Under the final regulations, charitable remainder trusts ("CRTs") must track net investment income within each class of the trust's income to determine the amount of undistributed net investment income, but the newly proposed regulations still permit CRTs to use the "simplified method" of tracking net investment income as described in the December 2012 proposed regulations (with a few modifications);

- New proposed regulations provide additional detail regarding the determination of the amount of net investment income arising as a result of dispositions of certain interests in partnerships of S corporations; and

- New proposed regulations take the position that if a QSST sells its S stock, the determination of whether or not there is material participation in the S corporation's business (so that the resulting gain would qualify for the non-passive trade or business income exception) is made at the trust level, and not based on the activity of the trust beneficiary (even though the trust beneficiary is generally treated as the section 678 owner with respect to S corporation stock held by a QSST.

b. *AGI of Estate or Trust.* The AGI of an estate or trust is determined under §67(e). AGI is computed the same as for an individual except that deductions are allowed for charitable contributions, the personal deduction, distributions to beneficiaries, and costs "which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if property were not held in such trust or estate." Therefore, expenses that cannot be deducted because they are subject to the 2% floor may not be subtracted in arriving at AGI. To the extent that such expenses that are otherwise subject to the 2% floor exceed the 2% floor, they may be deducted in arriving at AGI.

   Accordingly, a significant factor in determining how much of the income of an estate or trust will be subject to the high rate bracket rates under ATRA and the §1411 tax depends upon whether costs are those kinds of expenses that are subject to the 2% floor (i.e., commonly incurred by individuals under the reasoning of the Knight case), and on the amount of charitable deductions and distributions to beneficiaries. (In addition, costs that are subject to the 2% floor [i.e., because they are "commonly incurred" by individuals] are AMT preference items, even to the extent that they exceed the 2% floor.)

   Grantor Trusts. The §1411 tax is not imposed on grantor trusts, but items of income, deduction or credit are treated as if they had been received or paid directly by the grantor for purposes of calculating that person's individual net investment income. Prop. Reg. §1.1411-3(b)(5). See Item 9. k(1) below for further discussion of grantor trusts.

c. *Net Investment Income and Undistributed Net Investment Income.* This term is not defined, but presumably means the net investment income minus distributions. The proposed regulations add that there is no subtraction for distributions of income that are not included in net investment income. Therefore, distributions comprised of both net investment income and "net excluded income items" will require a proration.

   Distributions reduce both AGI and net investment income.

Net investment income includes gross income from interest, dividends, rents, royalties, annuities, gains from the disposition of property, passive activities (i.e., not including income derived in the ordinary course of a trade or business), less "properly allocable" expenses. §1411(c)(1). Several types of income are specifically excluded from that investment income, including (i) distributions from IRAs and qualified plans, (ii) non-passive trade or business income, (iii) tax-exempt income and tax-exempt annuities, (iv) guaranteed payments from partnerships, and (v) income subject to self-employment tax. In addition, certain gains from the disposition of interests in partnerships and S corporations are excluded. §1411(c)(4). Various other exclusions include income covered by non-recognition provisions (such as §§1031 or 1033), income covered by various exclusion provisions (such as §§ 101, 103, or 121), wages, compensation, unemployment compensation, social security benefits, alimony, and lottery winnings.

The non-passive trade or business income exception requires that (1) there be an activity that involves a trade or business (within the meaning of §162) and (2) is a passive activity within the meaning of §469, which requires material participation by the taxpayer (however, there is no passive activity requirement if the trade or business is trading financial instruments or commodities). Prop. Reg. §1.1411-5(a-b). Thus, generally there must be *both* (1) a trade or business, and (2) material participation by the taxpayer. (See subparagraph h below for more discussion of the passive activity requirement.) There is no separate definition of a "trade or business" in the §1411 tax rules other than applying the principles of §162. As an example, if real estate that is used in a business is held in a separate entity from the operating company, such rental income will not be trade or business income (unless the real estate company is in the trade or business of leasing multiple similar real properties). Also, generally any interest, dividends, capital gains, etc. earned on investment assets held by the business will constitute net investment income, no matter how strong the business purpose for the business holding the investment assets and no matter if there is material participation so that the business is a passive activity of the trust.

As a general rule, most of the income of estates and trusts will be net investment income.

d. *Rental Income.* Rental income is generally passive for purposes of the §1411 tax. There is an exception for real estate professionals that devote 750 hours to working in the real estate business. Otherwise, taxpayers must meet two tests to be for rent to be excepted from being net investment income: (i) material participation, and (ii) the rental income activity is a trade or business.

   Self-Rental Rule. If property is rented individually to a closely held business, the rental income is treated as active income so it cannot be offset by passive deductions for income tax purposes. However, for §1411 tax purposes, self-rental income is passive (and therefore subject to the 3.8% tax). (This may suggest reorganizing entities to move the property producing rental income into the LLC or S corporation, and not have rent charged to a separate entity. However, this depends upon the amount of rent involved and whether the 3.8% tax is enough to override the non-tax reasons for keeping real estate in separate entities.)

e. *Allocating Expenses.* Expenses are first allocated directly to the income item that gave rise to the expense. For example, expenses attributable to rental property must be allocated against rental income. For indirect expenses, however, the regulations under §652 allow the fiduciary to allocate them any way desired. Accordingly, indirect expenses can be allocated against income that would otherwise be subject to the 43.4% maximum rate leaving the capital gains and dividends to be taxed at 23.8%. (Tax preparation software will not do this typically. The preparer will need to override the software output to make such special allocations of indirect expenses.)

f. *Capital Gains.* Capital gains are an item of net investment income. While distributions reduce both AGI and net investment income, capital gains cannot be distributed without authority in the trust instrument or state law for doing so. Trust instruments can either mandate how distributions are allocated against various types of taxable income, or can give the trustee discretion to allocate capital gains to income that is distributed. For an excellent discussion of various alternatives see Morrow, *Avoid the 3.8 Percent Medicare Surtax*, TR. & ESTS. 32, 35-37 (Dec. 2012).

   Capital gains ordinarily are excluded from DNI. Reg. §1.643(a)-3(a). However, the regulations provide the capital gains will be included in DNI if they are, (1) "pursuant to the terms of the governing instrument and applicable law" or (2) "pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)"

   > "(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
   >
   > (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
   >
   > (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." Reg. §1.643(a)-3(b).

   Planning possibilities using each of these three exceptions are summarized below.

   Exception (1). One possible approach is to provide the trust agreement that capital gain is allocated to income (except for mandatory income trusts—so that the capital gains would not have to be distributed). If the distribution standard allows discretionary distributions of income or principal to all of the current beneficiaries, this would not seem to have any economic impact. The "consistently exercised" requirement does not apply under the § 1.643(a)-3(b)(1) regulation where income is allocated to income if there is not a unitrust provision. Example 4 of Reg. §1.643(a)-3(e) confirms this result.

   Income From Flow-Through Entities. Another possible approach is to hold assets in a partnership or LLC. Under most state laws, distributions from the entity will be treated as fiduciary accounting income rather than principal unless the distribution is part of a liquidating distribution. The entity may have capital gains that will be reported out to the partners or owners; the entity may make distributions, but those distributions will be fiduciary accounting income—so the capital gains would be included in DNI. This planning is based on a special rule for capital gains from pass-through entities that is helpful in carrying out capital gains to beneficiaries. Capital gain that is distributed in the ordinary course of partnership operations and that is allocated to the trust on the Schedule K-1 of a partnership or LLC is permitted to pass through to the beneficiaries. *Crisp v. United States,* 34 Fed. Cl. 112 (1995); *see* Carol Cantrell, *Income Tax Problems When the Estate of Trust is a Partner,* ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 1375, 1446-47 (April 2013). Furthermore, under the Uniform Principal and Income Act (UPAIA) cash distributions from an entity are generally allocated to fiduciary accounting income unless one of several exceptions applies (the primary exception being if cash is distributed in total or partial liquidation of the entity). Therefore, under UPAIA cash distributions from a flow-through entity with capital gains that are reported to the trust are treated as being allocated to income and therefore meet exception (1) so that the capital gain from the entity would be included in DNI. (If the entity distributes less than all of its taxable income, the result may not be clear as to whether the capital gain is distributed.)

Exception (2). Another approach is to give the trustee the authority to treat principal distributions as consisting of capital gains realized during the year. This is sometimes referred to as a "deeming" rule. Example (1) of Reg. §1.643(a)-3(e) refers to a trust in which the trustee "is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year." In that example, "Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gains tax to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains." In Example (2) the trustee elects "to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year," and in Example (3) the trustee "intends to follow a regular practice of treating discretionary distributions of principal is being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of assets." In each example, this treatment of capital gains is "a reasonable exercise of Trustee's discretion." In Examples (2) and (3) capital gains are included in DNI.

Trust agreements may specifically grant the trustee to allocate all or part of realized gains from the sale or exchange of trust assets to income or to principal (within the meaning of Reg. §1.643-3(b)), or to deem any discretionary distribution of principal as being made from capital gains realized during the year (within the meaning of Reg. §1.643(a)-3(e)). See generally Blattmachr & Gans, *The Final "Income" Regulations: Their Meaning and Importance,* 103 TAX NOTES 891 (2004).

The "treated consistently" requirement applies to exception (2) (i.e., capital gain that is allocated to corpus but treated as part of a distribution). This is easy to meet if the issue arises in the trust's first year or perhaps if the §1411 final regulations allow a fresh start in light of the significant tax law changes in ATRA. Otherwise, how a trust changes its position to start deeming that capital gains are included in distributions is not clear. (Historically, capital gains typically have not been treated by trustees as being included in distributions to cause them to be included in DNI.)

Exception (3). Some commentators suggest that an allocation of capital gains to corpus under Reg. §1.643(a)-3(b)(3) when "utilized by the fiduciary in determining the amount that is to be distributed" does not have to be exercised consistently from year to year. The commentator acknowledges that the IRS has not provided further guidance regarding the meaning of revised subsection (b)(3), but that subsection (b)(3) "should be applicable when the fiduciary varies the amount of a principal distribution based upon the amount of the trust's or estate's capital gains for the year," and suggests, as a practical matter, that a trustee allocating capital gains to principal under subsection (b)(3) "make a record, before the distribution of possible, of the decision to do so." Frederick Sembler, *Including Capital Gains in Trust or Estate Distributions After ATRA,* TRUSTS & ESTATES 23 (March 2013). As an example, a trustee may study the trust income and income tax brackets of the trust and beneficiaries in making a decision about what distributions to make, and the trustee might specifically acknowledge that in determining the amount of distributions it has considered the trust income tax situation and the capital gains of the trust. Arguably the capital gains have been "utilized by the fiduciary in determining the amount that is distributed" thus satisfying exception (3). This rationale extends beyond the examples in the regulations for exception (3). Those examples include: (i) a trust that is directed to hold an assets for 10 years and then sell it and distribute the proceeds (Ex.6); (ii) amounts distributed in a year the trust terminates when all income and principal is required to be distributed (Ex.7), and (iii) a trust requiring that one-half of the principal be distributed at a particular age, at which time the trustee sells one-half the securities and distributes the proceeds (Ex.9). However, the suggested scenario seems to meet the literal requirements stated in exception (3) because the capital gains have been "utilized by the fiduciary in determining the amount that is distributed".

g. *Distributions.* Distributions from an estate or trust may reduce the income subject to the top 39.6%/20% rates on ordinary and capital gains income, respectively, as well as reducing the income subject to the 3.8% tax on net investment income. See Morrow, *Avoid the 3.8 Percent Medicare Surtax*, TR. & ESTS. 32 (Dec. 2012). Thus, distributions to beneficiaries can save 4.6% or 5% of income tax, depending on whether the income is ordinary income or capital gain, if the individual beneficiary is not in the top tax bracket ($450,000/$400,000 in 2013, $457,600/$406,750 in 2014). In addition, distributions can save the 3.8% tax on net investment income if the beneficiary does not have AGI exceeding the $250,000/$200,000 threshold. The total tax savings could be 8.4%-8.8%, and the savings may be even greater if there are state income taxes.

This may present additional pressure on fiduciaries to make distributions. Of course, the fiduciary must look to the distribution standards in the trust agreement to determine the extent to which these tax considerations come into play. If the distribution is based solely on the health, education, support, and maintenance of the beneficiary, the trustee may not have the authority to take into consideration tax effects of distributions. *Drafting Tip:* Giving a non-beneficiary trustee the authority to consider tax implications may broaden the ability of the fiduciary to consider these tax implications of distributions. Even so, the fiduciary would generally treat taxes as merely one factor to be considered in the overall factors that the fiduciary considers in determining the appropriateness of distributions.

These additional income tax implications may also factor into the trustee's investment decisions—for example, whether to include allocation to tax-exempt investments.

h. *65 Day Rule.* Under the 65 day rule, the fiduciary may elect to treat distributions made during the first 65 days following the close of the taxable year as if they had been made on the last day of the prior year. §663(b). An estate's or trust's taxable income may not be determined by the end of the taxable year, and the 65 day rule can be helpful in planning distributions to carry out income to multiple beneficiaries, each of whom have higher thresholds, than subjecting income to taxation at the trust or estate level (with its very low $11,950 taxable income threshold in 2013, $12,150 for 2014, for the high rates and §1411 tax).

i. *Minimizing Income Taxation of Trusts.* The combination of the new top rate bracket that applies to trusts with only $11,950 in 2013, $12,150 for 2014, of taxable income and the 3.8% tax on undistributed net investment income of trusts results in a dramatic percentage increase in the federal income tax rate that applies to trusts. For an excellent discussion of strategies (with helpful form suggestions) that may be helpful in minimizing trust income taxation in light of these developments, see James Blase, Drafting Tips That Minimize the Income Tax on Trusts, Part I and II, ESTATE PLANNING (July and August 2013). For example, Mr. Blase offers a form (Exhibit 1 in his article) to provide a trust beneficiary with a formula withdrawal power each year equal to the amount of trust income that would otherwise be taxed at the top rates; the withdrawal power causes that portion of the trust income to be taxed to the beneficiary under §678. Another form (Exhibit 2 in his article) gives the beneficiary a withdrawal power over the trust's net investment income so that the §1411 tax would be applied based on the threshold for individuals rather than for trusts.

j. *Passive Income.* Passive income is included in both AGI and net investment income. The material participation requirements under the §469 passive loss rules are used for this purpose. §1411(c)(2)(A). Section 469(h)(1) defines material participation as an activity in which the taxpayer participates on a "regular, continuous, and substantial basis."

Individuals can use one of seven tests (one of them being the 500 hour rule) to establish material participation to avoid passive income treatment.

The rules are not as clear regarding material participation by trusts or estates. For a detailed discussion of the application of the nonpassive trade or business income exception from the §1411 tax to trusts, see Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1,* TAX NOTES 683, at 688-700 (Aug. 12, 2013) and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2,* TAX NOTES 785 (Aug. 19, 2013).

Regulations addressing passive activity rules for trusts and estates have never been written. The IRS position is that trusts and estates are not treated as individuals for this purpose (so, for example, the 500 hour rule does not apply). The IRS position is that the trustee must be involved directly in the operations of the business on a "regular, continuous, and substantial" basis. The IRS points to the legislative history of §469, which states very simply:

> "Special rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity if an executor or fiduciary, in his capacity as such, is so participating." S. Rep. No. 99-313, at 735.

In the *Mattie Carter* case, the trust operated active ranch operations, and the trustee hired a ranch manager (who was not a trustee). The IRS maintained that was not material participation for the trust because the trustee individually did not materially participate. The taxpayer maintained that, analogous to a closely held C corporation (see footnote 3 of the opinion), it could only participate in an activity through its fiduciaries, agents, and employees and that the activities of employees and agents of the trust should be included. The District Court sided with the taxpayer, concluding that material participation should be determined by reference to all persons who conducted the business on the trust's behalf, including employees as well as the trustee. The court reasoned that measuring the trust's participation by reference only to the trustee "finds no support within the plain meaning of the statue. Such a contention is arbitrary, subverts common sense, and attempts to create ambiguity where there is none." The court observed that there are no regulations on point, but "the absence of regulations and case law does not manufacture statutory ambiguity." The court acknowledged that it had studied the "snippet of legislative history IRS supplied" (including the Senate Finance Committee Report) as well as a footnote in the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986, at 242 n.33, but the opinion concludes that "the court only resorts to legislative history were the statutory language is unclear, … which, … is not the case here." *Mattie K. Carter Trust v. United States,* 256 F. Supp.2d 536 (N.D. Tex. 2003).

Technical Advice Memorandum 200733023 provides that merely labeling a person involved in the business as a "special trustee" will not suffice. The determining factor is whether the special trustee had powers that could be exercised solely without the approval of another trustee. If so, material participation of the special trustee would suffice.

Private Letter ruling 201029014 reiterates the general IRS position that a trust materially participates in business activities only if the trustee is involved in the operations of the entity's activities on a regular, continuous, and substantial basis. It did not mention the *Mattie K. Carter* case and did not address the issue of participation as a trustee rather than participation as an individual.

If a trust owns an interest in an active trade or business operation, a planning consideration will be whether to name some individual who is actively involved in the business as a co-trustee. However, the IRS questioned that strategy in Technical Advice Memorandum 201317010 (released April 26, 2013). The trust in that TAM had owned stock in an S corporation. There was a trustee and a "Special Trustee" of the trust. The trustee "did not participate in the day-to-day operations of the relevant activities" of the company. The individual who was the Special Trustee was also the president of a qualified Subchapter S subsidiary of the S corporation. The trust instrument limited the Special Trustee's authority in selling or voting the S corporation stock. The IRS concluded that the trust did not materially participate in the activities of the company for purposes of the §469 passive loss rules. The ruling highlights two issues: (1) the Special Trustee's authority was limited to voting and selling the S corporation stock: and (2) the Special Trustee's activities as president were not in the role as fiduciary. As to the first issue, the ruling concluded that time spent serving as Special Trustee voting the stock of the company or considering sales of stock would count for purposes of determining the trust's material participation in the business, but the "time spent performing those specific functions does not rise to the level of being 'regular, continuous, and substantial.'" As to the second issue, the ruling stated in its recitation of facts that the individual serving as president and Special Trustee "is unable to differentiate time spent" as president, as Special Trustee, and as a shareholder. The ruling reasoned that under §469 the owner of a business may not look to the activities of the owner's employees to satisfy the material participation requirement, or else an owner would invariably be treated as materially participating because most businesses involve employees or agents. The ruling concluded that the work of the individual serving as Special Trustee and president "was as an employee of Company Y and not in A's role as a fiduciary" of the trust and therefore "does not count for purposes of determining whether [the trust] materially participated in the trade of business activities" of the company.

TAM 201317010 creates a significant distinction in the treatment of individuals vs. trusts with respect to the "employee" issue. For individual taxpayers, their activities as employees of a business will be considered for purposes of determining their material participation in the business. For trust taxpayers, the IRS position is that the activities of a trustee as an employee of the business cannot be considered to determine the trust's material participation in the business.

Comments to the proposed regulations under §1411 by the American Bar Association Tax Section submitted on April 5, 2013 recommend that the IRS issue new proposed regulations regarding material participation for a trust or estate for purposes of §1411. The Tax Section Comments propose that such regulations recognize material participation by an estate or trust under any of three tests, one of which is that "[t]he fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the conduct of the activity."

In addition to recognizing actions through employees or contractors, material participation of a trust could be based on direct participation of the fiduciary, and in that context, the Tax Section Comments reason that

> "any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in another role, for instance as an officer or an individual investor. If there are multiple

> fiduciaries, time spent by the fiduciaries could be aggregated for purposes of determining material participation."

In light of the paucity of authority, "it is difficult to establish a framework for material participation by a trust (or an estate)." Jonathan Blattmachr, Mitchell Gans & Diana Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts,* 40 EST. PL. 3, at 9 (April 2013). Despite the *Mattie K. Carter* case, the IRS is continuing to press the issue and could issue a regulation adopting the position taken by the IRS in the private rulings. *Id*.

Quite interestingly, a case is now pending before the Tax Court regarding the requirements for material participation by a trustee for purposes of the passive loss rules. The case was tried (before Judge Morrison) in May 2012, and the last briefs were submitted in October of 2012. *Frank Aragona Trust v. Commissioner,* U.S. Tax Court Docket 015392-11. This case involves other issues as well, but if the court reaches this issue it will be the first time that the Tax Court has addressed this issue and the case will obviously be quite significant with respect to this matter. This case is discussed in some detail in Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1,* TAX NOTES 683, at 695-96 (Aug. 12, 2013).

k. *S Corporation Stock and Subchapter S Trusts — Grantor Trusts, QSSTs and ESBTs.*

(1) *Grantor Trusts.* Grantor trusts are qualified S corporation shareholders. The §1411 tax does not apply to grantor trusts (but the net investment income from the trust is treated as owned by the grantor, and will be taxed based on the grantor's individual threshold ($250,000/$200,000)). Reg. §1.1411-3(b)(1)(v). Material participation is tested based on participation by the grantor. See General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, at 242, n.33.

A common estate planning strategy involves the transfer of S corporation stock to grantor trusts. If the client materially participates in the business of the S corporation, income from the S corporation should not be a passive activity as to the client, and would not be subject to the §1411 tax. If a parent transfers S corporation stock directly to children (not in grantor trusts), and if the parent materially participates in the business but the children do not, the parent's portion of the S corporation income will not be subject to the §1411 tax, but the children's portion will be (but tested against the children's threshold ($250,000/$200,000)).

(2) *QSST.* A qualified subchapter S trust (QSST) must pay all of its income each year to the sole beneficiary of the trust. Therefore, the trust has no income taxed at the trust level (at the highest marginal rates after only $11,905 of taxable income for 2013, $12,150 for 2014)), and no §1411 tax. The beneficiary would have net investment income from the trust distributions, and the §1411 tax would apply to the beneficiary if the beneficiary has AGI in excess of the individual threshold ($250,000/$200,000). For purposes of both the high marginal income tax rate applied to trusts and the §1411 tax low threshold for

trusts, QSSTs are treated very favorably. Material participation (for purposes of the non-passive trade or business income exception) apparently is tested based on the participation by the QSST beneficiary who is treated as the owner of the trust for income tax purposes. See General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, at 242, n.33.

(3) *ESBTs.* The §1411 tax proposed regulations have very detailed rules with a detailed example for electing small business trusts (ESBTs). Prop. Reg. §§1.1411-3(c)(1), 1.1411-3(f)Ex.3. See Jonathan Blattmachr, Mitchell Gans & Diana Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts*, 40 EST. PL. 3, at 17 (April 2013). All S corporation income of an ESBT is taxed at the trust level, even if distributed. Accordingly, the highest marginal rate and the 3.8% tax on net investment income will apply if the trust has taxable income in excess of $11,950 in 2013, $12,150 for 2014. However, if the trust's interest in an S corporation constitutes an active trade or business of the trust and the trust meets the passive activity rules (i.e., the trustee meets the material participation requirement), business income from the S corporation would not be net investment income subject to the 3.8% tax. Query whether distributions from the ESBT with an "active" interest in an S corporation would be tested at the beneficiary level as net investment income of the beneficiary (depending upon whether the individual materially participated in the business), subject to the individual thresholds ($250,000/$200,000), even though there is no §1411 tax at the trust level?

(4) *Sale of S Corporation Stock.* A sale of S corporation stock (or a partnership interest) is not subject to the net investment income tax if (1) the entity is engaged in a trade or business not relating to the trading of financial instruments or commodities and (2) the transferor is engaged in at least one trade or business of the entity. The portion of the gain excluded from net investment income generally will be the portion of the total gain that is attributable to an active trade or business of the entity, determined generally as the amount of gain or loss if the entity had sold all of its assets immediately before the taxable disposition of the S corporation stock (or partnership interest) other than property used by the entity in an active trade or business. *See* Jonathan Blattmachr, Mitchell Gans & Diana Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts,* 40 EST. PL. 3, at 10 (April 2013). (The 2012 proposed regulations used a rather complicated four-step adjustment process to determine the excluded portion. Prop. Reg. §1.1411-7(c). That was not included in the final regulations. Instead the final regulations reserve §1.1411-7, and new proposed regulations were issued adopting commentators' suggestions to simplify the reporting process. Prop. Reg. §1.1411-7.)

New proposed regulations take the position that if a QSST sells its S stock, the determination of whether or not there is material participation in the S corporation's business (so that the resulting gain would qualify for the non-passive trade or business income exception) is made at the trust level, and not based on the activity of the trust beneficiary (even though the trust beneficiary is generally treated as the section 678 owner with respect to S corporation stock held by a QSST).

l. *Kiddie Tax.* Unearned income of a person subject to the Kiddie Tax (persons under age 19 and full-time students under age 24 with unearned income over $2,000 for 2013) will be taxed at the parent's tax rate. However, each child's AGI is viewed separately from the parent's AGI for purposes of testing whether the §1411 tax applies. Few persons under age 19 or full-time students under age 24 have AGI of $200,000, so they will probably not be subject to the §1411 tax. To achieve this advantage, a separate income tax return should be filed for the child rather than having the child's unearned income included in the parent's AGI on the parent's return.

m. *Funding Pecuniary Bequests.* If a pecuniary bequest is funded with appreciated property, the post-death appreciation will be taxed as capital gain to the estate or trust, subject to the 3.8% tax on net investment income as well as the 20% capital gains tax (assuming the estate or trust has taxable income in excess of $11,950 in 2013, $12,150 for 2014).

10. Strategies to Preserve Basis Adjustment Upon Grantor's Death

Some of the information in this Item is based, often verbatim, on information from Ellen Harrison, Washington, D.C. Because of the permanent $5 million indexed estate tax exemption, many estates will have no federal estate tax concerns, but may be much more concerned with assuring that the assets will receive a step up in basis at the owner's death.

A further extension of this planning would be to leave the flexibility of causing the trust assets to be included in the donee's estate for estate tax purposes if there are no estate tax concerns for the donee and if a basis step up at his or her death would be desirable. These are the same strategies as discussed in Item 11 below.

a. *Repurchase of Appreciated Asset for Cash or High Basis Property (Not a Note).* Assets with substantial appreciation that have been transferred to a grantor trust could be repurchased by the grantor before death. Most conservatively, the grantor should use cash to repurchase the assets.

   If the donor does not have sufficient other assets, repurchase will be difficult. One alternatively would be for the grantor to borrow funds from an outside lender, and use the cash proceeds to purchase the appreciated assets. The loan could be repaid following the grantor's death.

   There is uncertainty regarding the income tax consequences if a note is used to repurchase property from the grantor trust. The trust's basis in the note may equal the grantor's basis in the reacquired asset so that the payment of the trust's note would ultimately generate gain.

   An obvious difficulty with this strategy is that the repurchase must occur prior to the death of the donor, but the date of death is unpredictable. Standby purchase instruments might facilitate fast implementation of the repurchase transaction.

Section 1014(e) may apply if the purchase is from a grantor trust owned by the spouse and therefore treated as a gift under §1041.

b. *Using Freeze Partnership.* A donor may make a gift of the common interest while retaining the preferred interest in a preferred partnership. The common interest would be valued at an amount at least equal to 10% of the partnership value. The effect is to transfer cash flow and appreciation in excess of the preferred return and liquidation preference of the retained preferred interests.

   The preferred interest will be structured to satisfy the §2701 requirements (which, among other things, would require a cumulative return), so that the retained preferred interest is not valued at zero for gift tax purposes.

   The preferred interest would be includable in the gross estate at death and would be eligible for a basis step up. The key, for basis purposes, is that a §754 election would allow a corresponding step up to the partnership's inside basis in underlying assets.

   This structure requires the payment of a preferred return to the donor, which may be difficult if the yield under on the underlying assets is not sufficient.

   Charitable Planning. Preferred partnership interest can also be useful for charitable planning. The client may give some of the preferred interest to a donor advised fund. The par value of the preferred interest does not have to be paid until the partnership terminates. Instead of making a bequest to charity, for which no income tax deduction would be permitted, the client would receive a current income tax deduction for the fair market value of the preferred at the time that it is transferred to charity. In addition, the client is not taxable on the coupon that is paid to the charity (either for income tax purposes or for purposes of the §1411 tax. (In effect, a deduction is allowed for §1411 tax purposes.)

c. *Intentionally Busted §2701 Transaction.* A donor would make a gift of a common interest in a partnership/LLC while retaining a preferred interest that does not meet the requirements of §2701. The effect under §2701 is that the preferred interest is treated as having a zero value (for example, because it is noncumulative). The donor would be treated under §2701 as making a gift equal to the donor's entire interest in the entity. (The donor would need to have remaining gift exemption equal to the value of the entity to avoid having to pay gift tax.)

   At the donor's death, the value of the preferred interest is includable in the gross estate. A put right would assure that the value will be at least equal to the liquidation preference if the preferred payment right is noncumulative. Thus, a basis step up should be permitted equal to that value. There is no transfer tax on the income and appreciation to the extent it exceeds whatever the donor receives (if anything) in preferred payments. The mitigation rule in Reg. §25.2701-5(a)(3) makes the zero value rule less significant since the donor's estate will be reduced by the same amount by which the gift value was increased due to the zero value rule.

   Ellen Harrison provides the following example of how this strategy would work.

- The gift of the common interest is valued as if the preferred interest retained by the donor had a zero value if the preference is noncumulative. Assume the preference is $5MM and the value of the common would be zero if §2701 did not apply (because the assets owned by the entity are only $5MM) but because §2701 does apply the gift is assumed to be $5MM.
- All dividends and appreciation in excess of the preferred return belong to the common shareholders, partners or members because that is what the document says. That is, upon liquidation the preferred gets its preference and any additional value goes to the common. Assume that no dividend is declared during the donor's lifetime (although this doesn't matter, presumably dividends would be declared only if the donor needs the funds, but no dividends could be paid to the common until the preference was paid for a particular year) so earnings accumulate.
- Donor dies and the value of the preferred is included in the estate of the donor and the preferred gets a basis adjustment equal to its then fair market value. The value cannot exceed the liquidation preference (presumably no value would be attributed to the right to dividends because they are noncumulative); §2701 should not apply a second time since there is no transfer occurring at death.
- Under Reg. §25.2701-5(a)(3), "the amount on which the decedent's tentative tax is computed under section 2001(b)" is reduced by the amount by which the gift was increased because of the zero value rule. Thus, the value in the gross estate is not impacted, but merely for purposes of calculating the estate tax, a reduction is allowed for the amount by which the taxable gift was increased because of §2701. If the value of the preferred at the time of the gift was reduced from $5MM to zero and if the value of the preferred at the time of death is still $5MM, the estate tax base on which tax is calculated is reduced by $5MM (and in our example nets to zero). This adjustment would not affect the income tax basis because this adjustment does not change the amount included in the gross estate; it is merely a factor considered in calculating the estate tax.

d. *Allocation of Partnership Debt Under §704.* For assets subject to liabilities in excess of basis ("negative basis assets"), step up is particularly important. The client would fund a partnership (a real partnership, not a disregarded entity) with property subject to a liability in excess of basis. The nonrecourse liability is specially allocated to the contributing partner. If the other partner is an LLC owned 99% by the client and 1% by another person, so that neither the LLC nor the partnership is a disregarded entity, the client can gift interests in the LLC to children without disturbing the special allocation of the liability. At death, the partnership basis rules provide that the client's estate receives a basis equal to the value of the client's share of equity plus liabilities assumed. Although the net value in the estate is low, because of the liability, the client's estate receives a full basis step up.

This strategy is very advantageous economically because the spread between the estate and income tax rates has decreased. This is a way of both transferring appreciation and still getting the benefits of a basis step up.

e. *Triggering Estate Tax Inclusion.* Because of the permanent large indexed estate tax exemption, the client who will not have to pay any federal estate tax may want to take steps purposefully to cause previously transferred assets to be included in the gross estate in order to receive the basis step up.

(1) *How.*

- The trustee (or some other party) may have discretion to grant the settlor a limited power of appointment. The limited power of appointment could be as broad or narrow as desired, as long as it allowed the possibility of shifting benefits from one beneficiary to another. If so granted, this would cause inclusion in the grantor's estate under §2038 (and that section is based on powers that the grantor actually holds at death and not on the retention of interests at the time of the original transfer). To protect the independent third party, the instrument might exonerate the independent party from liability with respect to the decision to grant the power of appointment regardless of whether it is exercised. The instrument could provide that the independent third party has no obligation to inquire as to whether the authority should be exercised. Another approach would be to provide that the independent party has no authority to grant the power of appointment until requested in writing to do so by a designated class of persons.
- A formula power of appointment in the trust agreement may cause estate inclusion in desired circumstances. The grant of the testamentary power of appointment to the grantor could conceivably be by a formula. The trust instrument could give the donor a formula testamentary power of appointment to the extent that an amount equal to 40% of the excess of the date of death value over the date of gift value is less than an amount equal to 23.8% (i.e., 20% capital gains rate + 3.8% tax on net investment income) of the excess of the date of death value over the basis of the property (substituting the current tax rates). The disadvantage of the formula approach, if it operates immediately after the creation of the trust, is that it creates an ETIP, which would preclude immediate allocation of GST exemption to the trust. (See Item 12.c below.)
- Moving from an asset protection jurisdiction to jurisdiction in which the grantor's creditors can reach the assets may cause estate inclusion. (See Item 15.d below.)
- The estate may take the position that there was an implied agreement of retained enjoyment. For example, the parent may continue living in the house in a QPRT or other trust to which a residence was transferred without paying rent to trigger § 2036(a)(1). However, the IRS conceivably may not

take the position in that type of circumstance that the failure to pay rent, based on the changed circumstances, reflects an implied agreement to retain the interest at the outset (which is a requirement under § 2036(a)(1)). As another example, if a parent has given undivided interests in a vacation home to children, the parent may start using the vacation home exclusively without paying rent in a similar attempt to trigger an implied agreement of retained enjoyment under § 2036(a)(1).

(2) *Why.*

- The income tax cost of the loss of basis step up may outweigh the estate tax savings if the post-transfer appreciation is not sufficient. See Item 12.c below.
- The gifted property declines in value so it is desirable to exclude the gift from adjusted taxable gifts under §2001(b).

(3) *Tax Consequences.*

- The value of property at death is includable in the gross estate.
- Adjusted taxable gifts do not include gifts that are includable in the gross estate (§2001(b)), but no reduction is available for gifts treated as having been made by the spouse because of a split gift election.
- How much is excluded from adjusted taxable gifts where less than all of the cumulative value attributable to the gifted property is includable in the estate (e.g., because of distributions of income or distributions of appreciation)? (This type of strategy is described in Item 25.)

11. Strategies to Preserve Basis Adjustment Upon Surviving Spouse's (or Other Donee's) Death

If a trust is created for the surviving spouse at the decedent's death (for example, in a standard credit shelter trust), the estate tax may not be a concern at the surviving spouse's subsequent death, and building in flexibility to allow a step up in basis at the spouse's death is important. These strategies also apply if a parent makes transfers and wants to leave the flexibility for the donees to obtain a basis step up if their estates subsequently have no estate tax concerns.

This issue is emerging as a particularly important planning issue. For discussion of planning alternatives, see Ed Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust,* LISI ESTATE PLANNING NEWSLETTER #2080 (March 20, 2013); Terence Nunan, Basis Harvesting, PROB. & PROP. 54 (Sept./Oct. 2011); James Hamill, Estate Planning After ATRA Including Basis Adjustment Planning, ESTATE PLANNING (June 2013).

a. *Basis Step Up Flexibility; Broad Distribution Powers.* One method of causing estate inclusion if the surviving spouse has no estate tax concerns (which might occur, for example, because of indexing of the estate tax exclusion amount over a long term of the surviving spouse's subsequent lifetime) is to give the independent trustee broad authority to make distributions to the surviving spouse, in the absolute discretion of the trustee. (Even a "best interests" standard for a particular beneficiary might limit distributions for the purpose of allowing the beneficiary to make gifts.) An advantage of this approach is its simplicity, but possible fiduciary concerns in exercising the authority to make outright distributions of all or most of the trust assets to the surviving spouse and other possible disadvantages are mentioned in the following paragraph.

b. *Basis Step Up Flexibility; Independent Party With Power to Grant General Power of Appointment.* The trust agreement could give an independent party the power to grant a general power of appointment to the surviving spouse. It could be a power exercisable only with the consent of a non-adverse party if the settlor wishes to place some controls over the surviving spouse's unbridled ability to redirect where the assets will pass. The power could be limited to the ability to appoint the assets to the surviving spouse's creditors. Howard Zaritsky points out that he prefers this approach to the broad distribution powers approach. Making physical distributions to the spouse may be mechanically cumbersome, particularly in a deathbed situation. The mechanics may be much easier by merely having the independent party sign a one-page document granting the spouse a general power of appointment. The surviving spouse may be elderly and have management issues with respect to outright ownership of the assets, or may be susceptible to pressure to make transfers to family members or caregivers.

c. *Basis Step Up Flexibility; Formula General Power of Appointment.* Using formula general powers of appointment to the extent that the power would not result in the payment of estate taxes should be workable, but that approach should be used only after carefully considering the potential concerns with holding conditional general powers of appointment (as discussed below) and whether the ability to increase the amount subject to the general power of appointment by making marital or charitable gifts is an act of independent significance. There is concern that the beneficiary could have indirect control over all of the trust assets (for example, by determining whether to leave assets in a manner that qualifies for the marital or charitable deduction, thus decreasing the size of the taxable estate). While making a marital or charitable gift would seem to be an act of independent significance, realize there are no cases addressing this specific issue.

   Granting a general power of appointment by formula to the assets with the lowest basis up to the point that the gross estate would be no more than the estate exemption amount at the date of death would not have that particular concern (because the presence of marital or charitable gifts would not change the amount of the remaining estate exemption at the person's death). Even that approach could conceivably have concerns, however. Arguably the donor has a general power of appointment over the full amount of the gift exemption amount at the time the formula power of appointment is granted even if the donor later makes gifts "using up" the gift exemption amount—if it were determined that making a gift was not an act of independent significance

If the surviving spouse (or other beneficiary) has the power to impact the amount that would be subject to the general power of appointment under the formula, the IRS might argue that the beneficiary has a general power of appointment to that maximum extent. *See Kurz v. Commissioner*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995). In *Kurz*, the decedent was a beneficiary of both a marital trust and a family trust. The decedent was entitled to all income and the right to withdraw principal of the marital trust. She could request distributions from the family trust subject to two conditions: (1) the principal of the marital trust must have been exhausted; and (2) she could withdraw no more than 5% per year from the family trust. In fact, the decedent did not withdraw all of the principal from the martial trust, so could not withdraw any principal from the family trust at her death. However, the IRS argued that she had a general power of appointment over 5% of the family trust because the contingency to be able to exercise that power was within the decedent's control (i.e., she could have withdrawn all of the principal from the marital trust so that contingency would have been satisfied). The estate argued that the decedent's access to the principal of the family trust was subject to a contingency that did not occur, so she did not have a general power of appointment under Reg. §20.2041-3(b) ("However, a power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death. For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent's death if the condition precedent to its exercise had not occurred."). The Tax Court interpreted this regulation to conclude that the decedent could have some control over the contingency and still not have a general power of appointment, but the contingency must not be "illusory" and must have independent significant non-tax consequences:

> "…the event or contingency must not be illusory and must have some significant non-tax consequence independent of the decedent's ability to exercise the power…. We think any illusory or sham restriction placed on a power of appointment should be ignored. An event or condition that has no significant non-tax consequence independent of a decedent's power to appoint the property for his own benefit is illusory."

The Tax Court analogized to the contingency provisions under §2038, and gave two examples of situations involving independent consequences:

> "For example, for purposes of section 2038, a power is disregarded if it becomes operational as a mere by-product of an event, the non-tax consequences of which greatly overshadow its significance for tax purposes. See Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, par. 126.5.4, at 126-64 (2d ed. 1984). If the power involves acts of "independent significance", whose effect on the trust is "incidental and collateral", such acts are also deemed to be beyond the decedent's control. See Rev. Rul. 80-255, 1980-2 C.B. 272 (power to bear or adopt children involves act of "independent significance", whose effect on a trust that included after-born and after-adopted children was "incidental and collateral"); see also Estate of Tully v. United States, 208 Ct. Cl. 596, 528 F.2d 1401, 1406 [AFTR2d 76-1529] (1976) ("In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd."). Thus, if a power is contingent upon an event of substantial independent consequence that the decedent could, but did not, bring about, the event is deemed to be beyond the decedent's control for purposes of section 2038."

The Seventh Circuit affirmed, agreeing with the reasoning of the Tax Court that merely stacking or ordering withdrawal powers does not exclude the powers that come later in the list.

> "By contrast, the sequence in which a beneficiary withdraws the principal of a series of trusts barely comes within the common understanding of "event or...contingency". No one could say of a single account: "You cannot withdraw the second dollar from this account until you have withdrawn the first." The existence of this sequence is tautological, but a check for $2 removes that sum without satisfying a contingency in ordinary, or legal, parlance...
>
> No matter how the second sentence of sec. 20.2041-3(b) should be applied to a contingency like losing 20 pounds or achieving a chess rating of 1600, the regulation does not permit the beneficiary of multiple trusts to exclude all but the first from the estate by the expedient of arranging the trusts in a sequence. No matter how long the sequence, the beneficiary exercises economic dominion over all funds that can be withdrawn at any given moment. The estate tax is a wealth tax, and dominion over property is wealth. Until her death, Ethel Kurz could have withdrawn all of the Marital Trust and 5 percent of the Family Trust by notifying the Trustee of her wish to do so."

As an example of how this doctrine might apply in the context of formula general powers of appointment for basis optimization purposes, the power to make marital or charitable bequests is within the decedent's control, and if the formula refers to the maximum amount that could pass without estate tax at the decedent's death, the formula could be interpreted to assume that the decedent would leave all of his estate to a surviving spouse or charity and therefore give the decedent a general power of appointment over all of the trust (up to the decedent's exemption amount) even if the decedent in fact did not leave his estate to a surviving spouse or charity. The contingency to have a general power of appointment over the trust up to the maximum amount is within the decedent's control.

However, *Kurz* makes clear that contingencies that would have independent significant non-tax consequences are to be ignored. Those contingencies prevent the decedent from having realistic unfettered control to access the trust assets. Indeed, the contingency in *Kurz* was as non-independent as could be imagined. It involved a mere sequencing of withdrawal powers. The assets of trust 2 could not be withdrawn before the assets of trust 1 were withdrawn. The decedent still had clear authority to withdraw all of the assets from both trusts. The Tax Court questioned whether this was even a contingency at all. Compared to that, the decision to make large lifetime gifts or to leave a bequest to a spouse or charity has much greater independent non-tax consequences. In any event, *Kurz* raises uncertainties about such formulas.

As to the possibility of a marital or charitable bequest increasing the amount of the general power of appointment under the formula, such bequests would seem to be acts of independent significance. However, to avoid that argument, the formula could refer to

> "the largest portion of the assets of the Bypass Trust which would not increase any federal estate tax payable by the estate of the Surviving Trustor without taking into consideration any charitable or marital gift by the Surviving Trustor that would be deductible by the estate of the Surviving Trustor pursuant to Section 2055 or Section 2056 of the Internal Revenue Code." See Al Golden, Back to the Future – The Marital Deduction from Before ERTA to After ATRA, STATE BAR OF TEXAS ADVANCED ESTATE PLANNING COURSE at p.17 (2013)(excerpt from formula general power of appointment form suggested by Mr. Golden).

Other commentators have made the same observation regarding the impact of possible marital or charitable bequests on the operation of formula general powers of appointment.

> "Making charitable or spousal bequests should logically be deemed to be acts of independent significance, such that they would not be deemed to control the grant of a general power of appointment, but it is not certain that a court would so hold, and it is very possible that the IRS would assert this position and the taxpayer would need to litigate.
>
> One could minimize this risk by drafting the formula clause granting a general power of appointment based on the surviving spouse's taxable estate, determined without regard to marital or charitable deductible transfers. This approach significantly reduces the likelihood that a court would conclude that the surviving spouse holds a general power of appointment over a greater share of the trust assets than his or her available applicable exclusion amount. If it is known that the surviving spouse will make certain charitable bequests, these can be expressly excluded from the calculation, with the same result." Howard Zaritsky, PRACTICAL ESTATE PLANNING IN 2011 AND 2012.

For various form suggestions, see Ed Morrow, The Optimal Basis Increase and Income Tax Efficiency Trust (2013)(available from author); Al Golden, *Back to the Future – The Marital Deduction from Before ERTA to After ATRA*, STATE BAR OF TEXAS ADVANCED ESTATE PLANNING COURSE at p.17 (2013); Howard Zaritsky, PRACTICAL ESTATE PLANNING IN 2011 AND 2012 (various forms and excellent analysis); James Blase, Drafting Tips That Minimize the Income Tax on Trusts—Part 2, ESTATE PLANNING (Aug. 2013).

d. *Basis Step Up Flexibility; Delaware Tax Trap.* Another alternative to leave the flexibility to cause inclusion in the beneficiary's estate is to use the "Delaware tax trap." Delaware law at one time (perhaps still) provided that if someone exercises a power of appointment to grant a presently exercisable power of appointment to another person, even a limited power of appointment, that grant of the new power is treated as a vesting of property for purposes of the rule against perpetuities. The original power could be exercised to appoint the assets in further trust, with a new perpetuities period running from the date of exercise, which means that the trust could be extended indefinitely without having the assets subjected to estate tax. Sections 2041(a)(3) and 2514(d) were enacted to prevent avoiding the estate tax indefinitely by successive exercises of limited powers of appointment and creating new powers in other persons of new presently exercisable limited powers of appointment. Section 2041(a)(3) provides that property subject to a non-general power of appointment (which would generally not cause inclusion under § 2041) will cause estate inclusion under that section if the power holder exercises the power of appointment "by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power."

Under the law of most states, exercising a power of appointment by creating a new presently exercisable general power of appointment in another person is treating as vesting the property in the new power holder because he or she could exercise the power to appoint the property immediately to him or herself. If the new power holder were to appoint the property in further trust, the perpetuities period on the new trust would run from the time of the exercise creating the new trust. Therefore, at the time the original power holder granted a new presently exercisable general power of appointment, § 2041(a)(3) would be triggered because the new power could be exercised in a way that the vesting of the property in anyone else could be postponed for a period longer than the perpetuities period that applied originally (i.e., "for a period ascertainable without regard to the date of the creation of the first power."). For an excellent discussion of the Delaware tax trap and ways of using the concept to cause estate inclusion in a trust beneficiary (in order to avoid the GST tax), see Jonathan Blattmachr and Jeffrey Pennell, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes,* 68 J. Tax'n 242 (April 1988). For an outstanding 50-state summary of state law regarding the rule against perpetuities and whether exercising a limited power of appointment to create a presently exercisable general power of appointment causes a new perpetuities period to begin see Zaritsky, *The Rule Against Perpetuities: A Survey of State (and D.C.) Law* (2012), available on the ACTEC public website (search for "Rule Against Perpetuities").

Accordingly, using the Delaware tax trap is one way to cause inclusion in the surviving spouse's (or any other beneficiary's) gross estate, if the beneficiary would not owe estate tax in any event because of the estate tax exemption and the beneficiary would like to obtain a step up in basis on the trust assets at his or her death. **All that must be done to leave open the flexibility of using the Delaware tax trap is for the trust to give the beneficiary a limited power of appointment that includes the power to grant new presently exercisable powers of appointment (the power to appointment in further trust would generally include this authority) and confirm that the perpetuities savings clause is worded in terms of requiring that the interests of beneficiaries must "vest" within the prescribed perpetuities time frame rather than requiring that they be distributed during that time frame.** The decision of whether to trigger estate inclusion in the beneficiary's gross estate is then totally up to the beneficiary. If the beneficiary wants to trigger estate inclusion, the beneficiary would exercise the original power to create a presently exercisable general power of appointment in someone else. That would cause estate inclusion in the original power holder's gross estate under § 2041(a)(3).

In the context of planning for basis adjustment purposes, the power would be granted only over assets with significant appreciation and that are not income in respect of decedent assets (for which no basis adjustment is available).

A negative aspect of causing estate inclusion in that manner is that the assets would also have to be included in the successor power holder's gross estate as well (because the second power holder would hold a general power of appointment). A possible strategy that might avoid negative consequences of estate inclusion for the recipient of the power is if the power can be granted to a beneficiary whose estate is well below the exemption amount and for whom the estate inclusion will not likely be enough to impose estate taxation at the individual's death. For example, if the beneficiary's parent or parents have nominal assets, they may be possible appointees (assuming they survive the beneficiary). Other successor potential recipients of the power would be listed in case the parent did not survive the beneficiary.

Being able to use the Delaware tax trap in statutes that have abolished their rule against perpetuities is more complicated. In that situation, a possible strategy suggested by some planners is to provide that the original trust lasts for 1,000 years, but that the power can be exercised to create a trust that could last for 1,000 years after the power is exercised. In this manner, the vesting of the property could be postponed for a period "ascertainable without regard to the date of the creation of the first power."As an example, Steve Gorin, an attorney in St. Louis, Missouri, suggests using the following clause in a state that has abolished its rule against perpetuities:

> Notwithstanding the foregoing, if a power to Appoint that is not a general power of appointment (within the meaning of Code section 2041) is exercised by creating another power of appointment which under the applicable local law could be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, then any trust created by such exercise shall terminate no later than one thousand (1,000) years after this Agreement becomes irrevocable; provided however, that the limitations of this sentence shall not apply if the exercise specifically states an intent to create a general power of appointment or specifically refers to Code section 2041(a)(3) in a manner which demonstrates such an intent.

To exercise the Delaware tax trap under that clause, the surviving spouse would "create another power of appointment that postpones the vesting of any estate or interest in such property, or suspends the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the first spouse's death (or creation of an inter vivos irrevocable trust) that also happens to be more than 1,000 years after the first spouse's death" (quoting Steve Gorin). Steve cautions that the use of this approach would depend on particular state law, and there may be limitations if a state has a 360- or 1,000-year rule against perpetuities.

e. *Basis Step Up Flexibility For Spousal Transfers.* If the surviving spouse (or other donee) makes transfers, the planning strategies in Item 10 above may be utilized to provide basis adjustment flexibilities with respect to those transfers.

12. General Gift Planning Issues for 2014 and Beyond

a. *Overview of Tax Effects of Gifts.* The following is a brief summary of the tax effects of gifts.

- A donor can make gifts of the full additional gift exemption amount without paying gift tax. Cumulative lifetime taxable gifts above the exemption amount are subject to a 40% gift tax.
- Gifts are not removed from the base for calculating estate tax, but making gifts does not result in increasing the aggregate combined transfer taxes.
- Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include:
    - removal of appreciation/income of gift assets from the gross estate;

- o utilizing fractionalization discounts;
- o paying income taxes on income from grantor trusts to further "burn" the donor's gross estate;
- o if the donor lives three years, gift taxes paid are removed from the gross estate (after exemptions have been used, giving $100 costs $40 of gift tax but bequeathing $100 costs $66.67 of estate tax, see Item 12.e below for further discussion of this opportunity);
- o the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well; and
- o removing assets from the donor's gross estate for state estate tax purposes without payment of any federal or state transfer taxes (assuming the state does not have a state gift tax or "contemplation of death" recapture of gifts back into the state gross estate).

- The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.
- **Perhaps the most important advantage of the increased gift exemption for many individuals will be the "cushion" effect** — the ability to make gifts in excess of $1 million, but considerably less than $5 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even if "aggressive" valuations are used), which may lessen the perceived necessity to use defined value clauses to avoid paying gift taxes in making transfers. Planners have indicated that some clients who have been reluctant to implement transfer planning strategies in the past, because of fear of the possible assessment of a current gift tax, have completed transfer planning transactions after 2010 in light of the cushion effect of the $5 million gift exemption.
- Gifts can be disadvantageous from an overall tax cost perspective if (i) if the loss of a basis step up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above, or (ii) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value). However, the depreciating asset disadvantage generally applies only for gifts using the unified credit. For gifts that will incur a gift tax, the beneficiaries may still be better off in a depreciation scenario assuming the assets are invested the same way and they are in the same income tax brackets. For example, a client who has used his full exemption and has a portfolio worth $100 could give $71.4 to his children today and pay $28.6 (40%) gift tax. If the portfolio drops in value by 50%, the children are left with $35.7. If he had kept the assets until death, the assets would have dropped in value to $50, and after estate taxes his children would receive $30. Even with the depreciation, the gift was better if the donor lives three years. In addition, there may be lifetime discounting opportunities. The exceptions would be if the gifted

assets depreciated and the donor sold a different class of assets to pay the gift tax and those assets would have performed better than the assets he gave away, or if tax rates are reduced.

b. *Exemption Amount Increased for 2013 and 2014.* The gift/estate/GST exemption amount is indexed. It increased to $5,120,000 for 2012, to $5,250,000 for 2013, and to $5,340,000 for 2014. In addition the gift tax annual exclusion increased to $14,000 in 2013 (and will remain at $14,000 in 2014).

c. *Basis Concerns.* The differential between the 40% estate tax rate and a 20% (really 23.8% including the §1411 tax on net investment income) capital gains rate makes the basis concerns significant. The advantage of making a gift is that the appreciation is not subject to estate tax; but the disadvantage is that there is no step up in basis for that asset at death. Stated differently, there may be have to be a substantial amount of appreciation in order for the 40% estate tax savings on that appreciation to offset the loss of basis step up on the full value of the asset. Carlyn McCaffrey has suggested using formula clauses to address this issue. Carlyn McCaffrey, Tax Tuning the Estate Plan by Formula, 33 UNIV. MIAMI HECKERLING INST. ON EST. PL. ch. 4, ¶ 403.5 (1999).

   Example: A gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the family will lose the step up in basis, and at a 20% rate (if the family members are in the top tax bracket), this means the family will receive a net value of $800,000 from the asset (after it is sold). If the asset is not gifted, the transfer tax implications are the same but the step up in basis saves $200,000. The asset would have to appreciate to from $1,000,000 to $2,000,000 (**100%!!**) in order for the estate tax savings on the appreciation to offset the loss of basis step up (i.e., $1,000,000 post-death appreciation x 0.40 = 2,000,000 total appreciation (assuming zero basis) x 0.20 [assuming the donee is in the top income tax bracket]).

   Furthermore, if the donee has enough taxable income to be in the top income tax bracket, the donee will satisfy the AGI threshold to be subject to the 3.8% tax on net investment income, so the asset must appreciate by $1,469,136 (from $1.0 million to 2.469 million), or by almost **147%!!** ($1,469,135 x .40 = $2,469,135 x .238) before the estate tax savings will outweigh the loss of a basis step up.

   In making these calculations, consider both federal and state income and estate taxes.

   There is an example of a collectible in Mahon, The "TEA" Factor, TR. & ESTS. (Aug. 2011). If a zero basis collectible worth $5 million is given, there would have to be over $20 million of appreciation before the estate tax savings exceed the loss of basis step up (based on tax rates in 2011).

   Keep in mind that the income tax is incurred only if the family sells the asset. If the family will retain the asset indefinitely, or if real estate investment changes could be made with §1031 like kind exchanges, basis step up is not as important.

   Strategies are available to avoid the loss of basis step up if gifts are made to grantor trusts. The grantor can repurchase the low-basis assets before death, so that the low-basis assets would be in the gross estate at death and get a step up in basis under §1014. (This could be worthwhile even if the grantor has to borrow money to be able to repurchase the low basis assets and get cash into the grantor trust — which does not need a stepped-up basis.) In addition, some commentators maintain that a basis step up is available under §1014 at the grantor's death for all assets in a grantor trust. E.g., Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death,* 97 J. TAX'N 148 (Sept. 2002). See Items 10-11 above for further discussion of strategies to preserve basis step up at the taxpayer's death.

d. *Keep in Mind Downside of Depreciation.* If the gifted asset depreciates in value, the client will be worse off, from a transfer tax standpoint, than if the gift had not been made in first place.

e. *Sample Specific Gifting Strategies.* Possible gifting strategies in an environment of a large $5 million indexed gift exemption include the following:

- Gifts to Dynasty trust to utilize $5 million GST exemption (or making a late allocation of GST exemption to previously created trusts if the donor does not want to make further gifts);
- Forgiveness of outstanding loans to children;
- Gifts to grantor trusts, and leveraging grantor trusts with loans or sales from the grantor;
- Equalizing gifts to children or grandchildren;
- Gifts to save state estate taxes;
- GRATs (GRATs will continue to be advantageous even with the permanent $5 million indexed gift exemption);
- Life insurance transfers (including the ability to "roll out" of split dollar arrangements);
- Deemed §2519 transfers from QTIP trusts (for an outstanding detailed discussion of planning by a surviving spouse with QTIP trusts, 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));
- QPRTs; and
- Make a large gift requiring payment of gift tax, to reduce the estate tax if the donor survives three years (after exemptions have been used, giving $100 costs $40 of gift tax but bequeathing $100 costs $66.67 of estate tax; this opportunity is more realistic now that we have "permanent" transfer tax provisions and the possibility of repeal has receded; if the client wants to give particular assets in excess of the gift exemption amount but wants to minimize gift taxes payable currently, consider

using financed net gifts as explained at Handler, Financed Net Gifts Compared to Sales to Grantor Trusts, 44th UNIV. MIAMI INST. ON EST. PLAN. ch. 17 (2010)).

- These specific gift strategies are discussed in more detail in Item 5.o-aa of the "2012 Heckerling Musings and Other Current Developments" found here.

f. *Lapsing General Power of Appointment Held by Person With Modest Assets to Utilize That Person's GST Exemption.* In making a gift to a trust for descendants, consider providing that the client's parent would be a discretionary beneficiary (together with the client's issue) and that the parent would have an inter vivos general power of appointment over the trust, which will lapse at some point in the current year. The lapse of the general power of appointment is treated as a gift by the parent, but the parent's $5 million indexed gift exemption would fully cover the gift. No estate tax concerns would arise at the parent's death if the parent's other assets, even when added to the gift amount, would not be sufficient to cause the estate tax to apply at the parent's death. (*Having a "permanent" $5 million indexed estate tax exemption makes this strategy realistic.*) When the parent makes a transfer subject to transfer tax, the parent is treated as the transferor of the trust for GST purposes (§2652(a)(1)), and the parent could allocate his or her GST exemption to the trust. In that situation, the parent should not continue as a beneficiary of the trust after the lapse of the general power of appointment if the trust is not created in a "self-settled trust state", or else the parent's creditors might be able to reach the trust assets which might cause inclusion in the parent's estate under §2036(a)(1) and cause an ETIP, which would preclude the parent from being able to allocate the parent's GST exemption until the end of the ETIP.

13. Gift Strategies That Provide Some Benefit to Grantor and/or Grantor's Spouse — Overview

Planning alternatives for providing some benefit to the grantor and/or the grantor's spouse include:

- Borrowing of trust funds by grantor;
- Spousal limited access trust ("SLAT") and/or exercise by beneficiaries of special powers of appointment;
- "Non-reciprocal" trusts;
- Self-settled trusts established in asset protection jurisdictions;
- Sale for a note or annuity rather than making a gift of the full amount to be transferred;
- Transferring residence to trust or co-tenancies between grantor/spouse of grantor and trust;
- "Reverse defective grantor trust" transaction in which the donor purchases (including through the exercise of a substitution power) or borrows assets gifted to trust;
- Preferred partnership freeze;

- Turning off grantor trust status (to at least minimize the continuing cost to the grantor);
- Payment of management fees to the grantor;
- Inter vivos QTIPable trust; and
- Retained income gift trust.

Each of these alternatives is discussed in more detail in Items 14-24 below.

14. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Borrowing From Trust

A very simple way of dealing with the desire to keep a "back-door" for cash flow from the trust in the event of a financial reversal is that the donor could request a loan from the trustee of the trust. The trustee, subject to fiduciary duties, will likely want to require appropriate interest (perhaps greater than the AFR) and collateral for the loan. The donor may want a stronger method of a possible "back-door" to the assets, but if the loan alternative is sufficient, that is a clean and simple solution.

If the loan is bona fide indebtedness, the donor's estate may be entitled to an estate tax deduction for the outstanding liability if the loan has not been repaid prior to the decedent's death. *But see Estate of Holland v. Commissioner,* T.C. Memo 1997-302 (citing various factors mentioned in prior cases regarding loan vs. equity cases to conclude that the estate did not owe bona fide indebtedness that could be deducted under §2053).

15. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Lifetime Credit Shelter Trust for Donor's Spouse (also referred to as Spousal Lifetime Access Trusts, or "SLATs"); Exercise of Powers of Appointment for Grantor and/or Grantor's Spouse

The donor may wish to make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. A popular way of using the increased gift exemption may be for a donor to make gifts to a "lifetime credit shelter trust" for the benefit of the donor's spouse (and possibly children). The trust could be designed to give as much control and flexibility as possible to the surviving spouse without creating tax or creditor concerns.

a. Overview of Major Issues. Ellen Harrison suggests the following major issues in planning SLATs.

   - Avoid the reciprocal trust issue by making only one spouse a beneficiary, at least initially.
   - Using a SLAT prevents gift splitting if the spouse's interest is not severable, ascertainable, and de minimis.
   - The SLAT provides a benefit only while the donee spouse is living and married to the grantor.

- Consider an agreement of the spouses that the gift will be taken into consideration in any property settlement incident to a divorce.

- Consider life insurance on the donee-spouse in case the donee-spouse dies before the grantor.

- Give the donee-spouse a limited testamentary power of appointment exercisable in favor of the grantor (but carefully consider §2036 and creditors' rights against the donor before the donee-spouse exercises the power of appointment).

- The grantor may exercise a power of substitution (e.g.., for a long-term AFR note) if the parties divorce so that the donor would have the ability to re-acquire favored assets in the trust.

- The step transaction doctrine may treat the donee-spouse as a grantor if transfers were made by the grantor to the donee-spouse shortly before the trust was funded.
- If the SLAT is funded by the grantor with a residence, can the grantor reside in the residence without paying rent? (Presumably yes, under the reasoning of various §2036 cases that a donor's continuing to live with his spouse is not considered an implied agreement of retained enjoyment.) If the donor pays rent, is it a gift? (Presumably not.)

b. *Trust Terms.* The trust would be for the benefit of the donor's spouse, containing very similar terms as in standard credit shelter trusts created in wills. The trust may allow very broad control to the spouse but still not be included in the spouse's estate for estate tax purposes and may be protected against claims of both the donor's and spouse's creditors. In some ways, this is the ideal kind of trust for the spouse.

Possible terms could include:

- Spouse as a discretionary beneficiary (perhaps with children as secondary beneficiaries)
- Spouse as trustee (distributions to the spouse would be limited to HEMS)
- Provide that no distributions could be made that would satisfy the donor's legal obligation of support (and if distributions are made to the donee-spouse, preferably the spouse should use those distributions for things other than basic support needs to remove any inference that the funds are actually being used for the settlor's benefit)
- Spouse could have a "5 or 5" annual withdrawal power

- Spouse could have limited power of appointment (exercisable at death or in life)
- In case the donee-spouse predeceases, the power of appointment could be broad enough to appoint the assets back to a trust for the donor. (Exercising the power of appointment in the donee-spouse's will to include the donor-spouse as a discretionary beneficiary should not cause inclusion in the donor-spouse's estate under §2036(a)(1) if there was no pre-arrangement, but that might not prevent the donor-spouse's creditors from being able to reach the trust assets unless the trust is created in a self-settled trust jurisdiction. Several states have passed statutes addressing this situation for inter vivos QTIP trusts (and some states have provisions that also cover non-QTIP trusts), providing that such an appointment in trust for the donor-spouse would not cause the trust assets to be subject to the donor-spouse's creditors. See Item 15.d below. The power of appointment should provide that it cannot be exercised in a manner that would grant the original donor a power of appointment over the assets to avoid triggering §2038 inclusion in the donor's estate. See subparagraph c below for further discussion.
- A "trust protector" or some independent party could be given the discretion to add the donor of the trust at some time in the future (perhaps after a number of years or after the donor is no longer married to the donor's spouse at the time the trust is created). There should be absolutely no understanding (or even implied agreement) with the protector as to how the power would be exercised.
- Another way of addressing the donee-spouse predeceasing the donor would be to have some life insurance on the donee-spouse payable to the donor or a trust for the donor-spouse that has substantially different terms than this trust.
- If the donor were concerned about how the donee-spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the grantor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee-spouse to change an exercise of the power of appointment.
- To address the possibility of a divorce, in which event the donor-spouse may not want the donee-spouse to continue as a beneficiary, the trust could define the "spouse" to be the person to whom the grantor is married at the time without causing estate inclusion in the donor's estate. See Estate of Tully Jr. v. United States, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§2036(a)(2) or 2038). Therefore, the trust could also be available for the benefit of a new spouse. Also, the donor and donee-spouse may enter into an agreement that the gift will be taken into consideration in any property settlement incident to a divorce.

- If the donor gets to the point that the donor really needs to be a beneficiary of the trust and wants the spouse to exercise the power of appointment, estate taxes may be the least of the donor's concerns.
- With this approach, the trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the donor and his or her spouse, but the assets would not be included in the gross estates of the donor or the donor's spouse. Such a trust would likely be a grantor trust as to the grantor under §677 (unless the consent of an adverse party were required for distributions to the spouse).

c. *Application of §§2036-2038 If Donee Spouse (or Other Beneficiary) Appoints Assets Into Trust for Benefit of Original Donor Spouse.* This issue is receiving increased attention by planners. The IRS might argue that §2036 could apply in the donor spouse's estate if it could establish an implied agreement that the donee-spouse would leave the donated assets back into a trust for the benefit of the donor spouse. This is analogous to situations in which one spouse makes a gift to the other spouse, and the other spouse bequeaths the property back into a trust for the benefit of the original donor spouse. For a discussion of various relevant cases see Item 5.j(1) of the "2012 Heckerling Musings and Other Current Developments" located here.

There is a specific exception in the QTIP regulations providing that the §2036/2038 issue does not apply for gifts to an inter vivos QTIP trust, where the assets are left back into a bypass trust for the benefit of the donor spouse. Reg. §§25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11. However, those examples would not apply because the rationale in them is that there will be estate inclusion in the donee-spouse's estate under §2044.

The possibility of a beneficiary exercising a power of appointment for the benefit of the grantor (or grantor's spouse) applies beyond just SLATs. Trusts for descendants or other beneficiaries may grant a beneficiary a power of appointment broad enough to allow appointing the assets to a trust that may be benefit the grantor or the grantor's spouse; the same general issues apply.

Summary of Potential Application of §2038. Section 2038 can apply to an ability to alter, amend, revoke, or terminate that exists in the trust at the death of the decedent — it did not have to be retained at the outset. So in exercising the non-general power of appointment, the donee spouse must be careful not to give the donor spouse anything that would rise to the level of a right to alter, amend, revoke, or terminate. For example, the donor could not have a testamentary power of appointment by reason of the exercise.

In addition, realize that if creditors can reach the assets in a trust to which assets have been appointed by the donee-spouse under the reasoning of the relation back doctrine (discussed below), that could create a §2038 problem, even if there was no implied agreement of how the donee-spouse would exercise the power of appointment at the time of the original transfer. While various cases that have held that assets in a trust that can be reached by the donor's creditors are in the donor's gross estate under

§2036 [e.g., *Estate of Paxton v. Comm'r,* 86 T.C. 785 (1986)], some cases have also suggested that inclusion may also result under §2038. E.g., *Outwin v. Comm'r,* 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§2036(a)(1) or ***2038(a)(1))***.

Summary of Potential Application of §2036. The issue is whether the entire transaction and appointment back was pursuant to an implied understanding that these series of transactions would occur. Prof. Jeffrey Pennell's conclusion: "I think, frankly, it would be difficult for the government to make that case, but of course you could leave a trail of documents — a smoking gun — that could allow the government to say this was all part of a prearrangement, and that conceivably could get you into §2036."

d. *Creditor Rights Issue*. A totally separate issue is that, despite the tax rules, for state law purposes the donor to the lifetime credit shelter trust may be treated as the donor of the continuing trust for his or her benefit after the death of the donee-spouse. Therefore, for state law purposes, there is some possibility that the trust may be treated as a "self-settled trust" and subject to claims of the donor's creditors. This would seem to turn on what has been called the "relation back doctrine."Barry Nelson, Asset Protection & Estate Planning – *Why Not Have Both?,* at 15-11 2012 UNIV. MIAMI HECKERLING INST. ON EST. PLANNING ch. 17, ¶ 1701.2[B] (2012) (citing RESTATEMENT (FIRST) AND RESTATEMENT (SECOND) OF PROPERTY and a 1977 Florida case, concluding "[N]one of the reported cases regarding the Relation Back Doctrine address its application to the donor of a QTIP or credit shelter trust who receives trust assets upon the death of the donee spouse through the exercise of a special power of appointment ….").

See Alexander Bove, *Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined,* 36 ACTEC L.J. 333, 337 (2010) (after discussing the relation back doctrine in this context concludes, "Thus, it is not clear that a court would actually hold that it was a transfer from the donor to a trust for his own benefit through a power holder's discretionary exercise of a power of appointment, but it is a risk"). *See also Watterson v. Edgerly,* 40 Md. App. 230, 388 A.2d 934 (1978)(husband gave assets to wife and next day wife signed will leaving assets to trust for husband; held that the trust was protected from husband's creditors under the trust spendthrift clause).

At least nine states have statutes that address this situation in the context of initial transfers to an inter vivos QTIP trust, as opposed to transfers to a lifetime credit shelter trust. Those states are Arizona, Delaware, Florida, Michigan, Ohio, North Carolina,Texas, Virginia and Wyoming. The Arizona, Ohio, and Texas statutes also address the issue for all inter vivos trusts initially created for the donor's spouse (including the lifetime credit shelter trust strategy discussed in this sub-paragraph) where the assets end up in a trust for the original donor-spouse. ARIZ. REV. STAT. §14-

10505(E-F); OHIO REV. CODE §5805.06(B)(3)(a); TEX. PROP. CODE §112.035(d)(2),(g)(effective September 1, 2013).

Gross Estate Inclusion? If the donor's creditors can reach the trust assets, that would cause inclusion in the donor's estate for estate tax purposes under §2036 if the IRS could establish the existence of an implied agreement that the spouse would exercise the limited power of appointment to appoint the assets into a trust for the donor's benefit, which creates the creditor's rights problem. However, at least one case (*Outwin v. Comm'r,* 76 T.C. 153 (1981)) also states that §2038 could apply if the donor's creditors can reach the trust assets, and §2038 does not require an implied agreement of a retained interest at the time the gift is originally made, but only looks to conditions that exist at the donor's death. Accordingly, it may be important to exercise the limited power of appointment to establish a new trust in a "self-settled trust state" or a state that has passed a law similar to the Arizona, Ohio and Texas statutes discussed above. However, even using a "self-settled trust state" for the new trust provides no absolute protection; the donor's state of domicile may refuse to recognize the asset protection features of the new trust on public policy grounds. The state of the donor's residence may assert that public policy prevents using an asset protection trust in another state. See *Huber v. Huber,* 2013 WL 21454218 (Bkrtcy. W.D. Wash. May 17, 2013) (under §290 of the Restatement (Second) of Conflict of Laws (1971), the choice of law designated in the trust is upheld if it has a substantial relation to the trust considering factors such as the state of the settlor's or trustee's domicile, the location of the trust assets, and the location of the beneficiaries; held that Washington State has a strong public policy against self-settled asset protection trusts and that the trust instrument's designation of Alaska law is disregarded under the principles of §270 of the Restatement); *In re Herbert M. Zukerhorn,* BAP No. NC-11-1506, U.S. Bankruptcy Appellate Panel of the Ninth Circuit (Dec. 19, 2012)(dictum).

e. *Gift From One Spouse With Split Gift Treatment.* Instead of having each spouse make $5 million gifts, some planners have suggested that one spouse could give the entire $10 million to a trust having the other spouse as a discretionary beneficiary. The other spouse would make the split gift election, which treats him or her as the transferor for gift and GST tax purposes (meaning that the spouse's gift and GST exemption could be used) but NOT for estate tax purposes. Therefore, the assets would not generally be included in the spouse's gross estate for estate tax purposes even though he or she was a discretionary beneficiary. The problem with this approach is that split gift treatment is not allowed if the consenting spouse is a beneficiary of the trust unless the spouse's interest in the trust is ascertainable, severable and de minimis. *See* Rev. Rul. 56-439, 1956-2 C.B. 605; *Wang v. Commissioner,* T.C. Memo 1972-143 (no split gift election allowed where consenting spouse's interest in trust receiving gift assets was not ascertainable); *Robertson v. Commissioner,* 26 T.C. 246 (1956)(gift splitting allowed for full amount transferred); *see generally* D. Zeydel, *Gift-Splitting — A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules,* 106 J. TAX'N 334 (June 2007). Interestingly, Ltr. Rul. 200130030 allowed gift splitting for the full amount of the transfer without discussing the value [in particular, that it had no value] of the donee spouse's severable interest).

While the *amount* that can qualify for gift splitting may be limited for gift purposes, the regulations appear to provide that if any portion of the transfer qualifies for gift splitting, a full one-half of the transferred amount shall be treated as having been transferred by the consenting spouse for GST purposes. Reg. §26.2652-1(a)(4).

For a more complete discussion of the relevant cases and letter rulings, see Item 5.j(3) in the December 2012 "Estate Planning Current Developments and Hot Topics" found here.

Gift splitting should be allowed in full if:

- Distributions of both income and principal to the donee-spouse are subject to an ascertainable standard of distribution under §2514, preferably a standard based upon the spouse's accustomed standard of living;
- The trustee must consider other resources available to the spouse before exercising its discretion to distribute income or principal to the spouse; and
- The resources that are, and are expected to be, available to the spouse for the remainder of his or her lifetime are sufficient to meet the spouse's living expenses, such that the likelihood that the trustee will need to exercise its discretion to distribute income or principal to the spouse is so remote as to be negligible.

16. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — "Non-Reciprocal" Trusts

If the "rainy day" concern can be accommodated by having only one spouse make a gift to a trust with the other spouse as a discretionary beneficiary, that is far preferable. The gift by the other spouse would be to a trust with only descendants as beneficiaries. That clearly avoids the reciprocal trust doctrine (although an issue could arise if the spouses serve as trustees of each other's trust). Some clients may want to go further and have each of the spouses create credit shelter trusts for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. United States v. Grace, 395 U.S. 316 (1969). In Grace, the trust terms were identical, the trusts were created 15 days apart, and the trusts were of equal value. The Court reasoned:

> Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the *trusts be interrelated,* and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the *same economic position* as they would have been in had they created trusts naming themselves as life beneficiaries. (Emphasis added)

If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Commissioner,* 46 T.C.M. 910 (1983); Letter Ruling 200426008; *but see Estate of Green v. United States,* 68 F.3d 151 (6th Cir.1995) (Jones, J. dissenting).

Possible distinctions that could be built into the trusts include:

- Create the trusts at different times (separated by months, not 15 days as in *Grace*)
- Fund the trusts with different assets and different values (observe that *Grace* holds that just having different assets is not sufficient to avoid the doctrine, but it applies only to the extent of mutual value, *Estate of Cole v. Comm'r,* 140 F.2d 636 (8th Cir. 1944))
- One trust allows distributions without any standard but the other trust imposes a HEMS standard
- One trust might require considering the beneficiary-spouse's outside resources and the other would not
- One of the spouses would become a discretionary beneficiary only after the lapse of some specified time (say, 5 years) or on the occurrence of some event (for example, Letter Ruling 200426008 addresses trusts under which (i) husband would not become a beneficiary of wife's trust until three years after wife's death and then only if the husband's net worth did not exceed a specified amount and his income from personal services was less than a specified amount, and (ii) wife had a "5 or 5" withdrawal power from husband's trust after their son's death)
- One trust includes the donor's spouse as a discretionary beneficiary but the other trust would merely give an independent party (not exercisable as a fiduciary), perhaps after the passage of some specified time, the authority to add that donor's spouse as a discretionary beneficiary
- One trust allows conversion to a 5% unitrust but the other trust prohibits that
- Different termination dates and events
- Inter vivos power of appointment in one trust and not the other (like *Levy*)
- Different testamentary powers of appointment (maybe one trust has one and the other does not or perhaps there are different classes of permitted appointees or perhaps in one trust the power is exercisable only with the consent of a non-adverse party)
- Different trustees
- Different removal powers (one allows the grantor to remove and comply with Rev. Rul. 95-58 but the other puts removal powers in the hands of some third party).

There may be an advantage to making the primary beneficiary the Settlors' grandchildren, and including each other only as secondary beneficiaries.

In any event the differences need to be "real." Additionally, the structure of the trusts is only part of the equation, and probably not the most important part. How the trusts are *administered after they are created* may be the most critical factor. Clients may want to make gifts to the trusts and then immediately start flowing cash out of the trusts to each other the same as they did before the trusts were created. If that is done, the IRS would likely argue the existence of a pre-arranged plan that the income or other benefits would come right back to the grantor, even if only indirectly through the spouse.

Consider not having each of the spouses serve as trustee of the other's trust. Reciprocal dispositive powers may be sufficient to invoke the reciprocal trust doctrine if the trusts are sufficiently interrelated; reciprocal economic interests may not be required. *See Bischoff v. Commissioner, 69 T.C. 32 (1977); Exchange Bank & Trust v. United States*, 694 F.2d 1261 (Fed. Cir. 1982).

For a more complete discussion of the reciprocal trust doctrine, authorities holding that the reciprocal trust doctrine does not apply if there are substantial differences between trusts, authorities for applying the doctrine to reciprocal powers, and related creditor's rights issues see Item 5.I of the December 2012 "Estate Planning Current Developments and Hot Topics" found here (available at www.Bessemer.com/advisor website).

Creditor's Rights Issue? A possible concern with "non-reciprocal" trusts by each of the spouses for each other is that they may not be respected for state law purposes with respect to claims of creditors against the settlors. Cf. Security Trust Co. v. Sharp, 77 A.2d 543 (Del. Ct. Ch. New Castle 1950)(case did not involve a creditor attack on a reciprocal trust, but suggested in dictum that reciprocal trusts would be subject to attack by creditors). The Security Trust case was over 60 years ago, and it is difficult to locate any reported case in which creditors have attacked a reciprocal trust under this theory.

State legislatures may address this issue. An Arizona statute provides protection from a reciprocal trust attack when spouses create trusts for each other. ARIZ. REV. STAT. §14-10505(E).

The possibility of creditors attacking reciprocal trusts should not be a problem if the trusts are created under the laws of states that have adopted "self-settled spendthrift trust" provisions (as discussed in the following paragraph).

If the donors' creditors can reach the trust assets, that would cause inclusion in the donors' estates for estate tax purposes under §2036 (and possibly under §2038).

17. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Discretionary Trusts in Self-Settled Trust States

a. *Self-Settled Trust States.* Self-settled trusts may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). This will raise the issue of whether a client can create a trust, with the possibility of it serving as a "rainy day fund" in the unlikely event that financial calamities occur, without triggering §2036(a)(1) (a transfer with an implied agreement of retained enjoyment).

   Thirteen states have adopted varying approaches regarding "self-settled spendthrift trusts": Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio (the most recent state to adopt a self-settled trust statute), Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming. (In addition, Oklahoma law provides that the a settlor's creditors cannot reach the assets of a revocable trust up to $1 million established for the settlor's spouse, descendants or charities, but this does not recognize "self-settled trusts" because the settlor cannot be a beneficiary of that trust.) Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust.

Choosing the laws of a "self-settled trust state" as the governing law for the trust, however, provides no absolute protection if the settlor does not reside in that state or unless the trust otherwise has significant contacts with that state. The settlor's state of domicile may refuse to recognize the asset protection features of the trust on public policy grounds. The state of the settlor's residence may assert that public policy prevents using an asset protection trust in another state. See Huber v. Huber, 2013 WL 2154218 (Bkrtcy. W.D. Wash. May 17, 2013) (under §290 of the Restatement (Second) of Conflict of Laws (1971), the choice of law designated in the trust is upheld if it has a substantial relation to the trust considering factors such as the state of the settlor's or trustee's domicile, the location of the trust assets, and the location of the beneficiaries; held that Washington State has a strong public policy against self-settled asset protection trusts and that the trust instrument's designation of Alaska law is disregarded under the principles of §270 of the Restatement); *In re Herbert M. Zukerhorn,* BAP No. NC-11-1506, U.S. Bankruptcy Appellate Panel of the Ninth Circuit (Dec. 19, 2012)(dictum).

b. *Section 2036 Concerns.* Creating the trust under the laws of a self-settled trust state can help alleviate concerns that §2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential §2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under §2036 is tested at the moment of death, and §2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as no prearrangement exists). See Tech. Adv. Memo. 199935003 (§2035 will apply if pre-planned arrangement).

A §2036 concern may arise if the settlor ever needs distributions from the trust and distributions are made to the settlor. That might give rise to at least an argument by the IRS of a pre-arrangement or implied agreement that distributions would be made when requested. Of course, if the settlor gets to the point of needing distributions from the trust, estate tax concerns may be the least of the settlor's worries.

One alternative approach is to provide that an independent trust protector could add the settlor as a discretionary beneficiary at a later time, but only if the settlor's net worth falls below a specified level that is far less than the settlor's current net worth. That could help establish the absence of any "retained" benefit includable under §2036.

Private Letter Ruling 200944002 addressed an Alaska trust and recognized that the "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under §2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under §2036." Beginning in late 2011, the IRS has told other parties requesting similar rulings that it is not willing to issue further similar rulings. According to counsel, the Service's unwillingness to rule is not attributable to family exceptions or other differences under the laws of other states. Rather, the Service appears to be troubled by commentary about the Mortensen Alaska bankruptcy case. Battley v. Mortensen, Adv. D.Alaska, No. A09-90036-DMD (2011) allowed the bankruptcy trustee to recover assets transferred to an Alaska "self-settled trust" under the 10-year "clawback" provisions of §548(e) of the Bankruptcy Act. The agents at the Service said that PLR 200944002 probably wouldn't have been issued if they were looking at it now and that the Service since has declined other Alaska ruling requests.

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under §2036 in part based on whether trust assets can be reached by any of the grantor's creditors. For further discussion of those cases and §2036 issues surrounding the use of self-settled trusts, see Item 5.I of the December 2012 "Estate Planning Current Developments and Hot Topics" found here.

c. *Potential Incomplete Gift Issue.* Some planners have expressed concern that the IRS might take the position that the gift is an incomplete gift, because of the possibility (perhaps, however remote) that creditors might be able to reach the assets. E.g., Outwin v. Comm'r, 76 T.C. 153, 162-65 (1981)(gift to trust incomplete if creditors can reach trust assets); Herzog v. Comm'r, 116 F.2d 591 (2d Cir. 1941)(gift to trust is completed gift if state law provides that settlor-beneficiary's creditors could not reach the trust corpus or income). The Illinois Supreme Court recently held that a decedent's creditors could reach assets that had been transferred to a Cook Islands trust. *Rush University Medical Center v. Sessions*, 2012 Ill. 112906 (2012). That case involved an egregious fact situation in which an individual transferred almost all of his assets to a Cook Islands trust of which the settlor was a discretionary beneficiary, knowing that he had made a large charitable pledge and that his remaining assets would not be sufficient for his estate to satisfy the pledge. The court did not address which jurisdiction's law should apply under relevant conflict of laws principles, but held that the state's passage of a fraudulent conveyance statute did not supersede Illinois common law principles allowing the creditors of a settlor to reach trust assets to the extent that the trust assets could be distributed to the settlor. In Rush University, the Cook Islands trust owned real estate in Illinois that had sufficient value to satisfy the judgment, so apparently there was no issue about having to enforce the judgment in the Cook Islands. That case has caused concern among some planners about whether transfers to domestic asset protection trusts might arguably be incomplete gifts if the settlor resides and has assets in another jurisdiction that does not have "self-settled trust" legislation.

18. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Sale for Note or Annuity

A sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). For example, a client may make a smaller gift to a grantor trust, but make a sale of $10 million. The client continues to have access to principal and interest on the $10 million note, as compared to a $10 million outright gift where there is no retained benefit. A "leaky" freeze may not be perfect from an estate planning perspective, but the client may be much more comfortable. "Don't let the perfect get in the way of the good if the only way to get anything done is a leaky freeze."

If a client has long ago made transfers to a grantor trust, the client might consider selling substantial assets to the trust in return for a lifetime annuity. The annuity approach may be quite comforting to the client, to know that assets would continue to be paid to the client for his or her lifetime (to assure that the client would have funds for living expenses for life). An "old and cold" trust should be used to build the best arguing position that the transfer is made for full consideration so that §2036 should not apply. The trust would have to contain sufficient assets to satisfy the "exhaustion" test described in Reg. §§25.7520-3(b)(2)(i), 20.7520-3(b)(2)(i) and 1.7520-3(b)(2)(i), which assumes that the measuring life will live to age 110. If the trust does not have sufficient assets to cover all of the exhaustion test, it may be possible for individuals to guarantee the annuity to avoid the impact of the exhaustion test.

19. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Transfer of Residence to Trust or Co-Tenancies Between Grantor/Spouse of Grantor and Trust

Clients often prefer gifting residences or vacation homes to a trust rather than gifting cash and securities. If all of the residence is transferred to the trust, the grantor should be able to avoid inclusion in the grantor's estate under §2036 even if the grantor uses the residence, as long as the grantor pays fair market rent for any use of the residence.

a. *Payment of Fair Market Rent.* Applying §2036 if the grantor pays a fair rent is problematic, because the statute only applies to transfers for less than full and adequate consideration, and the donor would be paying full consideration for the right to use the property. It is ironic that paying rental payments would even further deplete the donor's estate. However, the trend of the cases is not to apply §2036 where adequate rental is paid for the use of the property. *E.g., Estate of Barlow v. Comm'r*, 55 T.C. 666 (1971) (no inclusion under §2036 even though decedent stopped paying rent after two years because of medical problems); *Estate of Giselman v. Comm'r*, T.C. Memo 1988-391. The IRS has ruled privately in several different rulings that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the end of the QPRT term under Section 2036. *E.g.*, Ltr. Rul. 199931028. However, the IRS does not concede that renting property for a fair rental value always avoids application of Section 2036. *See* Tech. Adv. Memo. 9146002 (*Barlow* distinguished). Most of the cases that have ruled in favor of the IRS have involved situations where the rental that was paid was not adequate. *E.g., Disbrow v. Comm'r*, T.C. Memo 2006-34 (court also concluded that the annual lease agreements were a subterfuge to disguise the testamentary nature of the transfer for various reasons); *Estate of Du Pont v. Comm'r*, 63 T.C. 746 (1975).

For a more complete discussion of the effect of paying fair market rent, see Item 17.b(4) of the "2012 Heckerling Musings and Other Current Developments" found here.

b. *Grantor Trust to Avoid Rental Income Recognition*. If the donor pays rent to a grantor trust, there is no recognition of rental income because the donor is treated as paying rent to herself. However, rent paid to a spouse or to a trust treated as owned by the renter's spouse under the grantor trust rules is taxable income (because §1041 merely provides that there is no income recognition for "transfers" between spouses). *See Gibbs v. Comm'r*, T.C. Memo 1997-196 (recognition of interest income on payment of interest from the grantor's spouse).

c. *Co-Tenancy to Avoid Paying Rent (or Reduce Rent).* Although paying rent further depletes the value of the donor's estate for estate tax purposes, the idea of paying rent to the trust is not appealing to some clients, although fair market rent may not be much more than the ownership costs shifted to the trust for paying real estate taxes, insurance, and major maintenance costs. If a fractional interest is given to the trust, with the donor retaining a fractional interest, the donor would not have to pay rent with respect to the retained interest. Where only a fractional interest in a property is transferred, the donor may retain proportionate use of the property consistent with the retained ownership. *Estate of Wineman v. Comm'r*, T.C. Memo. 2000-193 (2000).

To go a step further — co-tenants are each entitled to nonexclusive possession rights, so can the donor continue to live in the residence because of his or her retained undivided co-tenancy interest without paying rent as long as the donor does not want exclusive possession of the residence? *Stewart v. Comm'r*, 617 F.3d 148 (2d Cir. 2010) involved a situation in which a mother and son both co-occupied a residence. The mother transferred a 49% undivided interest in the residence to the son and they both continued living there. The court (over a strong dissent) stated that "co-occupancy of residential premises by the related donor and donee is highly probative of the absence of an implied agreement." The court suggested a test for residential premises, providing that if there is both "continued exclusive possession by the donor and the withholding of possession from the donee," §2036(a)(1) will apply. The court suggested strongly that §2036(a)(1) would not apply if there is continued occupancy by both owners.

Use a tenancy in common rather than joint tenants with right of survivorship (because §2040 causes estate inclusion for the donor except to the extent that the transferee pays consideration).

For a more complete discussion of the effect of co-tenancies and the ability to continue to use a residence as a co-tenant without invoking §2036 see Item 17.b of the "2012 Heckerling Musings and Other Current Developments" available at the www.Bessemer.com/advisor website.

20. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Exercise Swap Power or Repurchase Assets From Trust

A donor may choose to purchase assets from grantor trusts in return for long-term low-interest notes if the donor would like to re-acquire those assets (to be able to enjoy the income produced by those assets or to be able to achieve a basis step up at the donor's subsequent death). That approach will not eliminate the gift, but it might reduce the value remaining in the trust. See generally Clay Stevens, The Reverse Defective Grantor Trust, TR. & ESTS. 33 (Oct. 2012). The principles that apply to sales to grantor trusts should apply to the repurchase transaction, except that the grantor may prefer to use a higher interest rate than the AFR. While the transfers may be disregarded for federal income tax purposes, they may still be subject to local transfer and recording taxes (for real estate sales) or sales taxes (for example, for art sales). Possible advantages of asset repurchases from an existing trust include (i) insulating the trust against future a decline in value of volatile assets, (ii) "capping" the amount that will be passed to trust beneficiaries, (iii) limiting the amount in a "SLAT" if the spouses divorce and the client's ex-spouse remains as a beneficiary of the trust, and (iv) reacquiring low basis assets to achieve a basis step-up at the client's subsequent death.

21. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Preferred Partnership Freeze

Ellen Harrison summarizes that a donor may create a partnership and retain the right to a preferred return and give to an irrevocable trust the common interest that has the right to excess return and appreciation. Only the preferred interest is included in the estate (plus cumulative payments on the preferred interest that have not been consumed).

Unless the preferred interest satisfies the rules of §2701, the value of the gift of the common interest is determined by treating the preferred interest as having zero value. See §2701(a)(3)(A). However, the mitigation rule in Reg. §25.2701-5(a)(3) makes the zero value rule less significant. Reg. §2701-5(a)(3) provides for an "adjustment to mitigate double taxation." The amount on which the estate tax is calculated is reduced by an amount equal to the amount by which the taxable gift was increased under §2701. The effect is that the client has kept the preferred stock, and may have enjoyed the distributions from that stock over the client's lifetime, but the client still gets to subtract from the estate tax base the substantial amount by which the gift was increased under §2701.

22. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Terminate Grantor Trust Status

This strategy does not actually benefit the grantor or grantor's spouse but is a way of reducing the financial pain to the grantor or grantor's spouse resulting from the existence of the trust. The donor may be able to take steps to terminate the grantor trust status of the trust so that it pays its own income tax going forward. However, that may reduce planning flexibilities in the future (i.e., swaps or sales would be taxable events) because the trust is no longer a grantor trust.

Turning off grantor trust status could be accomplished by giving a protector the power to amend the trust to eliminate the grantor trust trigger provision. If the grantor's spouse is a beneficiary of the trust, this will require terminating the spouse's interest. The protector's power should be exercisable in a non-fiduciary capacity and there should be strong exculpation provisions because it is hard (although not impossible) to see how the exercise of the power could benefit the beneficiaries.

If the sole trust trigger is a retained non-fiduciary power of substitution by the grantor, the grantor probably cannot be prevented from renouncing the power, which gives the grantor the ability to turn off grantor trust status.

23. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Payment of Management Fees to Grantor

Grantors may retain control over investment decisions without triggering §2036 as long as the grantor does not indirectly control beneficial enjoyment or have the right to vote the stock of a closely held corporation. The investment power should be subject to the right of the trustee to require that cash be provided to fund distributions that are appropriate under the trust distribution standards. The grantor could be named as investment manager or could be the manager of an LLC owned by the trust. The grantor could, but is not obligated to, take a management fee for the services rendered. See Estate of Kelly v. Comm'r, T.C. Memo. 2012-73 (payment of management fee to corporation owned by decedent for serving as general partner of limited partnership did not trigger §2036 because the general partner's fiduciary duty and contractual terms of the partnership restricted the decedent from acquiring the partnership to pay more than a reasonable fee to the general partner, the management fee was reasonable and in fact was lower than the industry standard, and the decedent had a bona fide purpose for creating the corporation to manage the partnership).

24. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Inter Vivos QTIPable Trust

A spouse could make a gift to a "QTIPable" trust for the other spouse. Advantages of this planning approach include the following:

a. *Defer Taxable Gift Decision.* The grantor can defer the decision of whether to treat the transfer as a taxable gift utilizing the grantor's lifetime gift exemption amount (or requiring the payment of current gift taxes) until the grantor's gift tax return is filed (possibly until October 15 of the following calendar year). If the grantor decides that it would be best not to make a taxable gift, the grantor would make a QTIP election so that the transfer qualifies for the gift tax marital deduction (in which event the trust assets will be included in the donee-spouse's estate for estate tax purposes). If the grantor decides to treat the transfer as a taxable gift (using up the gift exemption or requiring the payment of gift tax), the QTIP election would not be made. For example, if the assets decline in value substantially, the grantor may decide not to treat the transfer as a taxable gift using up gift exemption based on the higher date of gift value.

b. *Formula QTIP Election as Defined Value Approach.* Though untested by cases but apparently allowed by regulations, a formula QTIP election may allow the grantor to limit gift tax exposure to a desired specified amount. In effect, this would have the same advantages of defined value clauses, and would be based on provisions in regulations allowing formula QTIP elections. See Treas. Reg. §§20.2056(b)-7(b)(2)(i) &

20.2056(b)-7(h) Exs. (7-8). For a discussion of the mechanics of making a formula election, see Tech. Adv. Memo. 9116003 (discussing validity of QTIP election of "an amount from the assets ... equal to the minimum amount necessary to reduce the federal estate tax payable as a result of my death to least amount possible …").

c. *GST Exemption Allocation.* There is flexibility to allocate the grantor's GST exemption (by making a "reverse QTIP" election under §2652(a)(3)), to allocate the spouse's GST exemption, or not to allocate any GST exemption to the trust. This decision can be deferred until when the gift tax return is due (possibly until October 15 of the following year).

d. *No Clayton QTIP For Inter Vivos QTIPs.* The "Clayton regulation" provides that for testamentary transfers, the instrument can provide that the portion of the assets for which the QTIP election is not made may pass to a trust having different terms than the required terms for a QTIP trust — including a trust that would be similar to a standard "bypass trust" for the spouse and descendants and that would not be in the spouse's estate for estate tax purposes. However, there is no similar regulation that clearly applies for gift tax purposes for inter vivos transfers. The Clayton provision in Treas. Reg. §20.2056(b)-7(d)(3) appears only in the estate tax regulation — it is not also in the similar gift tax regulation, Reg. §25.2523(f)-1(b). Indeed, if a Clayton provision added other beneficiaries if the QTIP election is not made, it would seem that the gift would not be complete in the year of the original transfer — because the donor would retain the power to shift benefits among beneficiaries until the gift tax return filing date has passed. (Conceivably the gift would never become complete during the donor's lifetime because the return making the election would always be due the following year, thus extending the completion of the gift to the following year, extending the due date of the return to the year after that, etc.)

25. Gift Strategies That May Benefit Grantor and/or Grantor's Spouse — Retained Income Gift Trust

The "Retained Income Gift Trust" (RIGT) is an idea that has been suggested for making a completed gift, retaining the right to the income from the trust, and shifting future appreciation so that it is excluded from the grantor's gross estate. The income itself would be distributed back to the donor resulting in a "leaky" freeze, but if the assets are invested for capital appreciation the income might be relatively small.

Advantages. If the strategy works as intended, when the grantor dies, the grantor would not be treated as having used up any of his or her estate tax exemption amount and there would be a stepped up basis for the trust assets. Furthermore, any gift taxes paid more than three years before the grantor's death would also be removed from the estate. The plan has been suggested by Igor Potym (with VedderPrice P.C. in Chicago, Illinois) and was discussed by Richard Covey in the mid-1990s. Igor describes the plan:

> There is another type of irrevocable trust where the grantor is a beneficiary, a retained income gift trust (RIGT), that seems attractive now. Donor makes a gift and retains an income interest (but not a principal interest) for life. The trust is a completed gift and the retained income interest does not reduce the gift because it is not a qualified interest under section 2702. This looks a lot like a pre-chapter 14 GRIT, except it lasts for life and we now have section 2702.
>
> The trustee is given discretion to distribute principal to descendants at any time and typically will strip off appreciation, keeping the trust at its original gift value. When the grantor dies, the trust is

> included in his gross estate. Because it is included, the gift is not treated as an adjusted taxable gift and therefore no unified credit is wasted. The assets get a stepped-up basis.
>
> The principal that was distributed to descendants during the grantor's life is not included in the gross estate and is not an additional gift because the gift was complete on day one. In effect, this is a freeze with respect to appreciation in excess of the gift, whether the gift is $5,120,000 or greater. Also, if gift tax is paid, the tax is excluded from the gross estate unless the three-year rule applies, but in such case all the assets of the trust get a stepped-up basis.
>
> This trust can be used to deal with the claw back under section 2001(b), at least in part (upon death, it can qualify for the marital deduction).
>
> In the mid 1990s, I ran this by Dick Covey and, with our permission, he mentioned it briefly in Practical Drafting (April 1997, at 4788-4789) and talked about it in Miami. He was convinced it worked. In fact, it has withstood audit every time. No agent has ever seriously questioned it, perhaps because the agents think it was a drafting mistake. I believe the technique works, possibly better than ever.
>
> Think about the client who can't afford to make a $5,120,000 gift because he needs the income, but would love to shift future appreciation on this amount without incurring an estate tax at the death of the first spouse due to the claw back. Or, possibly even better, a client who makes a gift and pays gift tax. The gift tax is out of the estate, the grantor keeps the income from principal remaining in the trust, the trust gets a stepped-up basis, there is no adjusted taxable gift at death because the trust is included in the gross estate, the estate tax on the trust is reduced by the gift tax paid dollar for dollar (in other words, inclusion in the gross estate does not generate any additional estate tax) and stripped off appreciation avoids estate tax.

Some commentators have suggested that the IRS might question whether the gift to the trust would properly be excluded from the estate tax calculation as an adjusted taxable gift under §2001(b) because the gift assets are included in the estate under §2036, in light of the fact that all appreciation of the gift assets are not being included in the gross estate.

26. Wealth Transfer Strategies — Generally

There are a wide variety of additional wealth transfer strategies in addition to the strategies addressed above that may benefit the grantor and/or grantor's spouse. Some of these may be particularly appropriate if the grantor has already used all of his or her gift exemption amount.

These strategies include:

- Defined value formula transfers;
- GRAT strategies;
- Installment sales to grantor trusts or to spousal grantor trusts;
- Installment sales by beneficiary to section 678 trusts or to QSSTs;
- Any of these strategies may involve family limited partnerships, LLCs or other family entities;
- Transactions involving intra-family loans or notes; and
- Sales for self-canceling notes (SCINs).

These issues are discussed in Items 27, 28, 30-34, and 39 below.

27. Defined Value Clause Updates, Including *Wandry*

a. *General Description of Defined Value Clauses and "Formula Transfer" vs. "Formula Allocation" Approaches.* The concept of using formula valuation clauses for inter vivos transfers, similar to the use of formula marital deduction clauses in wills, was introduced almost 30 years ago. Carlyn S. McCaffrey and Mildred E. Kalik, Using Valuation Clauses to Avoid Gift Taxes, 125 TRUSTS & ESTATES 47 (Oct. 1986). In making transfers of hard-to-value interests, such as limited partnership interests in an FLP, some planners have structured gifts or sales of a specified dollar amount of limited partnership interests. One attorney has analogized this to going to a gas station and asking for $10 worth of gasoline. While that seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless. The United States tax system is based on self-reporting with penalties to enforce self-reporting. Defined value clauses may conceivably encourage abusive low-reporting; even if the return is audited, no penalty would apply if no gift could result as a result of the defined value clause.

There are two general types of traditional defined value clauses, "formula transfer clauses" and "formula allocation clauses."

(1) *Formula Transfer Clause.* A "formula transfer clause" limits the amount transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula). An example of a very simple fractional formula transfer clause, which the IRS approved back in 1986 in Technical Advice Memorandum 8611004 (but would no longer approve), is as follows:

> such interest in x partnership…as has a fair market value of $________.

Another example, somewhat more complicated but still simple in concept (designed to produce a small gift if the IRS asserts higher values for gift tax purposes to help counter a Procter "mootness" attack) is as follows:

> I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is (a) $100,000 [i.e., the desired dollar value to be transferred by gift] plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the 'Gift Tax Value') over $100,000. The denominator of the fraction is the Gift Tax Value of the property.

McCaffrey, Tax Tuning The Estate Plan By Formula, 33rd Annual Heckerling Institute on Estate Planning ¶ 402.4 (1999).

(2) *Formula Allocation Clause*. A "formula allocation clause" allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees includes charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other

retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values. For example, the McCord and Hendrix cases used the second type of clause with the allocation being based on a "confirmation agreement" among the transferees. The two other cases addressing formula allocation clauses have both involved clauses that were based on finally determined estate (*Christiansen*) or gift (*Petter*) tax values.

The formula allocation clause is significantly more complicated and by its nature includes multiple parties other than just the donor and donees. In all of the reported cases so far, these types of cases have involved a charity to receive the "excess value" over the stated dollar amount passing to family members.

b. *Four Cases Have Approved Formula Allocation Clauses With "Excess" Value Passing to Charity.* Four cases have previously recognized formula allocation defined value clauses McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006); *Christiansen v. Commissioner,* 130 T.C. 1 (2008), aff'd, 586 F.3d 1061 (8th Cir. 2009), *Petter v. Commissioner,* T.C. Memo. 2009-280, aff'd¸ 653 F.3d 1012 (9th Cir. 2011), and *Hendrix v. Commissioner,* T.C. Memo. 2011-133).

As mentioned above, those cases have taken different valuation approaches in the formula allocation. Two of the cases relied on an agreement among the transferees as to valuation (*McCord and Hendrix*) and the other two cases on finally determined estate (*Christiansen*) or gift *(Petter*) tax values.

c. *Court Approval of Formula Transfer Approach: Wandry v. Commissioner.*

Synopsis

In *Wandry v. Commissioner* T.C. Memo 2012-88, the court upheld a stated dollar value "formula transfer" clause of, in effect, "that number of units equal in value to $x as determined for federal gift tax purposes." This is a very important development in the structuring of defined value transfers. This case literally opens up the simplicity of giving "$13,000 worth of LLC units" to make sure the gift does not exceed a desired monetary amount, or giving "$5,000,000 worth of LLC units" to make sure the donor does not have to pay gift tax as a result of the transfer of a hard-to-value asset. For sure, the planner would use a little more verbiage than that, but the simplicity of that kind of transfer is what the court recognized in *Wandry*. This is a much simpler approach than the formula allocation approach involving charities that has been approved in four earlier cases. While this kind of transfer seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless. The court rejects those arguments in *Wandry*.

Parents made gift assignments of "a sufficient number of my Units as a Member of [an LLC], so that the fair market value of such Units for federal gift tax purposes shall be as follows: [stated dollar values were listed for various donees]." Following the list of dollar values was a general statement making clear that the donor intended to have a good-faith determination of such value by an independent third party professional, but if "the IRS challenges such valuation . . . , the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

The court, in an opinion by Judge Haines, held that the parents made gifts of a specified dollar value of membership units rather than fixed percentage interests in the LLC. The gift tax returns and the attached schedules reported gifts of those dollar amounts. Unfortunately, the descriptions of the gift assets on the return created some confusion by referencing specific percentage interests, rather than clearly describing the gifts as a particular dollar amount worth of units, but Judge Haines concluded that the parties clearly intended to make dollar value gifts and the schedules of the gift tax returns indeed reported the gifts as gifts of specific dollar values. The court also rejected an argument by the IRS that the capital accounts control the nature of the gifts and that the capital accounts reflect gifts of fixed percentage interests. To the contrary, the court determined that the underlying facts determine capital accounts, not the other way around. Book entries do not override more persuasive evidence that points to the contrary. (A further problem with the structure of the transaction, which interestingly was not criticized by the court, was that the donor waited 19 months to obtain an appraisal to know the number of units that were transferred under the formula assignment.)

Finally, the court addressed the IRS's argument that the formula assignment was an invalid "savings clause" under the old Procter case. Judge Haines concluded that the transfers of Units having a specified fair market value for federal gift tax purposes are not void as savings clauses — they do not operate to "take property back" as a condition subsequent, and they do not violate public policy.

As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exceptions to the Code should be recognized only for "severe and immediate" frustrations, and analyzed why the three public policy issues raised in the Procter case do not apply. First, the opinion responds to the concern that the clause would discourage the efforts to collect taxes by reasoning that the IRS's role is to enforce the tax laws, not just to maximize revenues, and that other enforcement mechanisms exist to ensure accurate valuation reporting. As to the second and third policy concerns raised by Procter, the court responded that the case is not "passing judgment on a moot case or issuing merely a declaratory judgment," because the effect of the case causes a reallocation of units between the donors and the donees. The court noted in particular that prior cases addressing the public policy issue have involved situations in which charities were involved in the transfers, but concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

As discussed below, this case is not being appealed by the IRS, but the IRS has filed a nonacquiescence in the case.

For an excellent analysis of *Wandry* (as well as the other defined value cases), *see* Zaritsky & Aucutt, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS (WG&L), ¶12.02[1](2d ed. 1997 & Supp. June 2013).

Basic Facts

All of the facts were stipulated by agreement of the IRS and the donors. Parents made gifts of limited partnership interests beginning January 1, 2000, as advised by their tax attorney, of specific dollar amounts rather than a set number of units. (Apparently, the IRS did not raise any issues about the gifts of the limited partnership interests and they were not involved in this case.) The partnership assets were later contributed to an LLC, which also housed a family business. Parents continued their gift giving program of LLC units in a similar fashion. Because the number of membership units equal to the desired value of their gifts on any given date could not be known until a later date when a valuation could be made of the LLC's assets, the attorney advised that "all gifts should be given as specific dollar amounts, rather than specific numbers of membership units."

On January 1, 2004, each of the parents wished to give LLC units equal to their $1,000,000 gift exemption amounts equally among their four children and their $11,000 annual exclusion amounts to each of their four children and five grandchildren. Pursuant to their attorney's advice they made gifts of LLC units "*so that the fair market value of such Units for federal gift tax purposes*" equaled those desired dollar amounts.

The actual assignment documents that each of the parents used is as follows [the actual full assignment document is quoted because it may serve as a helpful form for defined transfer assignments by planners in the future]:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

The donors and family members' understanding of the nature of the gifts is summarized by the court (and stipulated by all parties) as follows--

> The only gifts with respect to Norseman membership units that petitioners ever intended to give were of dollar amounts equal to their Federal gift tax exclusions. At all times petitioners understood and believed that the gifts were of a dollar value, not a specified number of membership units. Petitioners' tax attorney advised them that if a subsequent determination revalued membership units granted, no membership units would be returned to them. Rather, accounting entries to Norseman's capital accounts would reallocate each member's membership units to conform to the actual gifts.
>
> An independent appraiser valued the LLC assets as of January 1, 2004 in its report issued July 26, 2005, finding that a 1% Norseman interest was worth $109,000. Based on that value, the CPA entered on an undated and handwritten ledger that adjustments were made to the capital accounts in 2004, decreasing the parents' combined capital accounts by $3,603,311 attributable to the gifts, resulting in increases to capital accounts to each of the children and grandchildren of approximately $855,745 and $36,066, respectively.
>
> The CPA prepared gift tax returns for the parents. Consistent with the gift documents, each of the parent's returns reported total gifts of $1,099,000 and attached schedules reporting net transfers of $261,000 to each of the four children and $11,000 to each of the five grandchildren. However, the schedules "describe the gifts to petitioners' children and grandchildren as 2.39% and .101% Norseman membership interests, respectively (gift descriptions). Petitioners' C.P.A. derived the gift descriptions from the dollar values of the gifts listed in the gift documents and the gift tax returns and the $109,000 value of a 1% Norseman membership interest as determined by the K&W report." [In retrospect, the gift descriptions should have been more detailed, reflecting them as dollar value gifts.]
>
> The IRS audited the gift tax returns. The parties ultimately agreed upon $132,134 as the value of a 1% interest in the LLC, and the IRS took the position that the gifts were of the percentage amounts listed in the "gift descriptions" and that multiplying those percentage amounts times the stipulated value of a 1% interest resulted in a gift tax deficiency.

Holdings

(1) The parents made gifts of a specified dollar value of membership units rather than fixed percentage interests in the LLC.

(2) The transfers of Units having a specified fair market value for federal gift tax purposes are not void as savings clauses because they do not operate to "take property back" as a condition subsequent, and do not violate public policy. As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exception to the Code should be recognized only for "severe and

immediate" frustrations, and analyzed why the three public policy issues raised in the Procter case do not apply. The court concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

Analysis of "Procter" Issue

(1) *Assignments Are Not Void as Savings Clauses Because They Do Not Operate to "Take Property Back" Upon a Condition Subsequent.* The IRS argued that the assignments were an improper use of a formula to transfer assets in violation of principles established in Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944). In Procter, the trust indenture making the gift included the following clause:

> Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property *hereby transferred* which is decreed by such court to be subject to gift tax, shall automatically be *deemed* not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created. (Emphasis added)

[Observation: The literal language of the transfer document in Procter contemplates that there is a present transfer that counsel believes is not subject to gift tax, and that any property "hereby transferred" that would be subject to gift tax is "deemed" not to be included in the conveyance. This is different from the clause in Wandry that only purported to transfer a specified dollar value of property and nothing else.]

The court in Wandry summarized that the "Court of Appeals for the Fourth Circuit held that the clause at issue operated to reverse a completed transfer in excess of the gift tax . . . [and] was therefore invalid as a condition subsequent to the donor's gift." (The court also summarized Proctor's public policy analysis; that is discussed below.)

The court reviewed other cases that have rejected attempts to reverse completed gifts in excess of gift tax exclusions. (*Ward v. Commissioner, 87 T.C. 78 (1986); Harwood v. Commissioner, 82 T.C. 239 (1984), aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986).) The court reviewed other cases that have recognized valid formulas to limit the value of a completed transfer. (*Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008), aff'd, 586 F.3d 1061 (8th Cir. 2009)(defined value disclaimer so that assets in excess of defined value passed to charities); *Estate of Petter v. Commissioner,* T.C. Memo. 2009-280, aff'd 653 F.3d 1012 (9th Cir. 2011); McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), rev'g, 120 T.C. 358 (2003).) (Interestingly, the court did not cite *Hendrix v. Commissioner*, T.C. Memo. 2011-133 (June 15, 2011), which also upheld a defined value sale/gift transfer.) The court noted that *King v. United States,* 545 F.2d 700 (10th Cir. 1976) upheld a formula that adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price, but the court viewed that as an adjustment to the consideration paid in the sale rather than an adjustment of the shares transferred, and therefore not controlling in this case.

To determine what types of clauses are valid and which ones are not, the court focused on the analysis in *Estate of Petter*, which drew a distinction between a "savings clause," which is not valid, and a "formula clause," which is valid.

> A savings clause is void because it creates a donor that tries 'to take property back.' [citing *Petter*]. On the other hand, a 'formula clause' is valid because it merely transfers a 'fixed set of rights with uncertain value.' [citing *Petter*]. The difference depends on an understanding of just what the donor is trying to give away. [citing *Petter*].

The court applied various analytical steps (quoted below in italics) that the 9th Circuit isolated in its description of the operation of the formula in *Petter*.

- "Under the terms of the transfer documents, the foundations were always entitled to receive a predefined number of units, which the documents essentially expressed as a mathematical formula." In *Wandry*, the units that the donees were entitled to receive essentially were expressed as a mathematical formula. Each of the children was entitled to receive a percentage of units equal to $261,000/FMV of Norseman. Each of the grandchildren was entitled to receive a percentage of units equal to $11,000/FMV of Norseman.
- "This formula had one unknown: the value of a LLC unit at the time the transfer documents were executed. But though unknown, that value was a constant." Similarly in *Wandry*, the formula had one unknown, the value of Norseman. "But though unknown, that value was a constant." The parties stipulated that the value of Norseman was $13,213,389. "This value was a constant at all times."
- "Before and after the IRS audit, the foundations were entitled to receive the same number of units." Before and after the audit in *Wandry*, the children were each entitled to receive a 1.98% interest ($261,000/$13,213,389) and the grandchildren were each entitled to receive a 0.83% interest ($11,000/$13,213,389).
- "Absent the audit, the foundations may never have received all the units they were entitled to, but that does not mean that part of the Taxpayer's transfer was dependent upon an IRS audit. Rather, the audit merely ensured the foundations would receive those units they were always entitled to receive." On the facts of *Wandry*, the donees might never have received the proper percentage interests they were entitled to without an audit but that does not mean the transfers were dependent on an IRS audit. The audit just ensured they received the percentage interests they were always entitled to receive.

Summary of "Take Back"/Condition Subsequent Issue:

It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to 'take property back'. Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the K&W report understated Norseman's value. The clauses at issue are valid formula clauses.

(2) *Formula Dollar Value Gift Assignments Do Not Violate Public Policy. The court in Wandry summarized the Procter public policy argument as follows:*

> The Court of Appeals further held that the clause was contrary to public policy because: (1) any attempt to collect the tax would defeat the gift, thereby discouraging efforts to collect the tax; (2) the court would be required to pass judgment upon a moot case; and (3) the clause would reduce the court's judgment to a declaratory judgment.

The court observed the Supreme Court's warning against invoking public policy exceptions to the Internal Revenue Code too freely, holding that the frustration caused must be "severe and immediate." *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966).

As to *Procter*'s first public policy reason, the court replied that the Commissioner's role is to enforce the tax laws, not just maximize tax receipts. Also there are mechanisms outside of IRS audits to ensure accurate valuation reporting. (In this case, the parties all had competing interests and each member of the LLC has an interest in ensuring that he or she is allocated a fair share of profits and not allocated any excess losses.)

As to *Procter's* second and third policy reasons, a judgment in these gift tax cases will reallocate units among the donors and donees. Therefore, the court is not ruling on a moot case or issuing merely a declaratory judgment.

The court very specifically addressed the fact that a charity was not involved in this case, but charities had been involved in the prior defined value cases approved by the courts as not violating public policy:

> In *Estate of Petter* we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, ***but it was not determinative***. The lack of charitable component in the cases at hand does not result in a 'severe and immediate' public policy concern. (Emphasis added.)

Dropped Appeal and Nonacquiescence

The IRS filed a Notice of Appeal on August 28, 2012, but the government subsequently filed a dismissal and dropped the appeal. The appeal would have been to the 10th Circuit Court of Appeals, which is the circuit that approved a formula price adjustment clause in King v. United States, 545 F.2d 700 (10th Cir. 1976) (formula adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price).

The IRS subsequently filed a nonacquiescence in the case. I.R.B. 2012-46 ("nonacquiescence relating to the court's holding that taxpayers made a completed transfer of only a 1.98 percent membership interest in Norseman Capital, LLC").

d. *Planning With Defined Value Clauses (Particularly in Light of Wandry).*

(1) *Defined Value Clause Not Needed if Gift is Significantly Less Than Remaining Gift Exemption Amount*. An approach that many planners and clients use is to make a gift of significantly less than the remaining $5 million indexed gift exemption amount. If enough cushion is left, there may not be concerns of having to pay gift tax, even if the valuation is not exactly correct.

(2) *Formula Transfer Based on Appraisal Is Allowed*. As a practical matter, it is impossible to value a hard-to-value asset on the date of the transfer. A formula transfer of a dollar value worth of a particular asset, based upon an appraisal to be acquired 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 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"). Obviously, that approach provides no protection against gift taxes in the event of an audit. The key distinction of the Wandry-type transfer is that the formula dollar value being transferred is based upon values as finally determined for federal gift tax purposes.

(3) *General Comfort With Formula Allocation Clauses (at Least With Charities).* Planners have a general level of comfort that defined value clauses using the formula allocation approach will be respected, at least where the excess value passes to charity. Three different circuit courts as well as the Tax Court have approved the formula allocation defined value approach (with the excess value passing the charity in all four cases).

If a client is not willing to involve charity, a formula allocation approach could be used with the excess passing to other alternatives, such as the donor's spouse, a marital trust (some planners prefer a general power of appointment trust rather than a QTIP trust because contingent QTIP elections are not allowed for inter vivos transfers, but if the transaction is structured so that some amount is designed to pass to the marital trust from the outset, a QTIP election would be allowed), an incomplete gift trust, or a zeroed-out GRAT. (A particular concern with using a zeroed-out GRAT is that the present value of the excess value would be transferred back entirely to the donor; that may represent a "taking back" concern under Procter, and perhaps a concern could be raised about the GRAT not being funded for the intervening months [or years] before the value is determined and about the failure to make required annuity payments during that time frame.)

That all involves more complexity than a straight gift or sale, or a straight gift or sale of "that number of units equal to $X." Many planners and clients have struggled with whether to make transfer under Wandry-type clauses when the clients are not willing to make transfers using formula allocations.

(4) Position of Those Planners Who Are Uncomfortable With Wandry-Type Transfers.

- *Wandry* is just a Tax Court memorandum decision by one judge (Judge Haines). (Query, why was that? Generally, Tax Court memorandum cases are those where the law is clear and the judge is just applying the law to the facts of the case. This is the first court to address a defined value formula transfer clause. Did the government lawyer not make very clear that this is a case of first impression? Did the Tax Court judges not understand that?)
- Some respected commentators view the *Wandry* opinion as poorly reasoned. (Other respected commentators have found the analysis persuasive and well-reasoned.) If Procter is still good law, no doubt there are fine semantic lines being drawn between describing what is transferred vs. providing that something returns to the donor if the initial values are incorrect. The assignment in Procter is certainly similar in broad effect to the assignment in *Wandry* (though there is language in the Procter clause suggesting that the "excess property" was originally transferred but that it is "deemed" not to be in the conveyance).
- One commentator's criticism of the *Wandry* analysis focuses on the opinion's reference in several places to "allocations" and suggests that the opinion failed to recognize the key distinction between reallocation of units among other takers vs. a reallocation of units back to the donor (suggesting that "allocation" to the donors looks more like retention, if not "taking back"), and suggesting that the "allocation" analysis fails to focus on the key distinction between an allocation of transferred units vs. a formula that describes the total amount transferred:

  > It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to "take property back." Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the appraisal report understated Norseman's value. The clauses at issue are valid formula clauses. (Emphasis added).

- Another poorly reasoned statement in the opinion is the court's statement that other enforcement mechanisms than just IRS audits exist to ensure accurate valuation reporting. That does not make sense in the context of a transaction that is just between a donor and donee, both of whom may wish to have as many "units" transferred as possible without the imposition of gift taxes. Furthermore, the donee has no input into the value used for reporting the gift and cannot participate in the gift tax audit.
- The IRS position is that *Wandry* just can't be right because "we will always lose." What is the point of auditing these cases? The taxpayers will just

correct the number of units in retrospect. (One commentator's reaction to this position is that Judge Haines shakes his finger at the IRS and says its job is to enforce the tax laws as written and not just to collect more revenues.)

- The IRS has filed a nonacquiescence.
- Planners practicing in the Fourth Circuit (i.e., Maryland, North Carolina, South Carolina, Virginia, and West Virginia) are particularly wary about using Wandry clauses. The Procter case is a Fourth Circuit case, and "the Fourth Circuit never met a tax it didn't like."
- Many of the planners who are unwilling to rely on *Wandry* nevertheless think it is properly decided.
- Potential disadvantages are: (i) red flag issue for IRS auditors, (ii) a gift tax return must be filed because valuation will be based upon values as finally determined for gift tax purposes, (iii) that the clause arguably might cause the gift to be incomplete (because the donor will make decisions in the gift tax audit about settlement or pursuing the case to litigation), (iv) the potential whipsaw effect if the courts do not respect the clause but it is still binding for state law purposes, and (v) if the gift asset explodes in value after the transfer, the donor may prefer to pay gift tax on the relatively small value at the time of the gift to keep the huge appreciation from the units that remain with the donor under the Wandry clause out of the donor's estate. See subparagraph (6) below for further discussion of the disadvantages.

(5) Position of Those Planners Who Are Comfortable With Wandry-Type Transfers.

- Even planners more comfortable with the *Wandry* approach are reluctant to rely on *Wandry* if the client is making the transfer primarily in reliance upon protection against having to pay gift taxes because of *Wandry*. However, if the client is planning to make the transfer in any event and will get good appraisals in any event, many planners are using the *Wandry* formula approach to provide an additional argument in case of a gift tax audit.
- Although this is just a Tax Court memorandum case, these planners find the reasoning of the case persuasive. Even though some of the reasoning could be better (see the discussion above), the gist of the opinion focused on the fact that the assignment just describes what is transferred, albeit using a formula. The opinion applies reasoning of the 9th Circuit in *Petter*.
- *Wandry* reached a favorable result in spite of some terrible facts: (i) the gift tax return had an attachment that, in one place, inartfully referred to a particular percentage interest that was transferred rather than a dollar value, (ii) the donor waited 19 months to get an appraisal to know how many units of the LLC were transferred (which may have suggested that the parties were

not really serious about the transfer being just a dollar value of units), and (iii) adjustments in capital accounts did not reflect reality in light of the formula clause.

- *Procter* can be distinguished. Much of the attention in Procter was that the clause would change what had previously been transferred automatically based on what the court decreed and that the clause was undoing whatever the court decided. The focus was not that an adjustment was made after the transfer, but that the adjustment occurred after the court decree had already determined that a gift tax was due. Furthermore, some planners believe that even the Fourth Circuit would not decide Procter the same as it did 60 years ago because (i) formula clauses have become very routinely used in the meantime (marital deduction formula clauses, charitable remainder trusts, GRATs, disclaimers, GST allocations, etc.), and (ii) the U.S. Supreme Court in the meantime has ruled that public policy concerns should override traditional tax principles only if the policy frustrations are "severe and immediate" (Tellier) and some of the formula allocation cases have referred to that Supreme Court pronouncement in finding that the clause did not rise to the level of a "severe and immediate" frustration of public policy.
- Formula clauses are used every day in testamentary instruments, and there should be no reason why they cannot be used in inter vivos documents either. A distinction is that testamentary formula clauses are, in effect, formula allocation clauses. By definition there are always two parties involved other than the testator. However, if the parties are a surviving spouse and children, all of the parties may want as much value as possible transferred to the children, so there may not be an "adverse" party to negotiate about the proper valuation in many testamentary formula marital deduction clauses.
- The clause can have a favorable impact on settlement discussions (and there is anecdotal evidence that has already happened in audits).
- Prof. Jeff Pennell takes the position that the formula transfer approach (using the Wandry-type clause) is less abusive than the formula allocation approach with the excess assets passing to charity because the units that remain with the donor will be subject to a future gift or estate tax to the donor. With the formula allocation/charity approach, the excess units are forever removed from the transfer tax base of the donor.
- Some of the planners using a Wandry transfer combine that with a formula disclaimer, with the beneficiaries or trustee disclaiming any property in excess of the dollar amount described in the Wandry transfer. (See subparagraph (7) below for further discussion of the formula disclaimer approach.)
- Planners have reported that in audit discussions IRS agents have indicated that the IRS is looking for the "right case" to litigate again, but that the

particular case was not the right case (perhaps the IRS is looking for a case that would be appealable to the 4th Circuit –the circuit that rendered the *Procter* case).

(6) *Basic Advantages/ Disadvantages of Using Defined Value Clauses*. The basic advantage of using the defined value transfer clause is creating the ability to make lifetime transfers without the risk of having to pay current gift taxes (if the clauses work as intended).

Disadvantages include:

(i) whether the defined value clause is a red flag that triggers or intensifies a gift tax audit (for formula transfer or formula allocation-type clauses) [response: with the IRS's consistent losses, using defined value clauses should no longer be perceived as a red flag of an abusive transaction];

(ii) complexities of administering the defined value clause (but a "formula transfer" type of clause approved in Wandry is easier to administer than a formula allocation among transferees);

(iii) a gift tax return must be filed if the clause is based on values as finally determined for federal gift tax purposes (and if the defined value clause is used in the sale transaction, the seller may have preferred not to report the transaction on a gift tax return);

(iv) will a *Wandry* clause cause the gift to be incomplete (because the donor will make decisions in the gift tax audit about value issues and by urging or at least refusing to fight an unreasonably high valuation position by an agent, the donor can cause more of the asset to remain with the donor than should be appropriate);

(v) if the IRS does not respect the clause, an adjustment of the amount of assets passing to the family trust may still occur (with more assets passing to a charity or other "pourover" party or remaining with the donor under a Wandry-type of clause) even though no tax benefits result from the adjustment.

(vi) if the asset may explode in value in the near future and if the IRS prevailed in asserting that the value is somewhat higher than reported on the gift tax return, the client might prefer to pay gift tax on the relatively small amount in excess of the gift exemption rather than having some of the units remain in the donor's estate, with the subsequent huge appreciation on those units being added to the donor's gross estate; and

(vii) the IRS has not given up and is still looking for the "right case" to litigate the issue again (perhaps the IRS is looking for a case that would be appealable to the 4th Circuit –the circuit that rendered the *Procter* case).

As to the incomplete gift argument, the wording of the IRS's nonacquiescence could be interpreted to hint that the IRS might raise an incomplete gift issue. The nonacquiescence stated: "nonacquiescence relating to the court's holding that taxpayers made a *completed transfer* of only a 1.98 percent membership interest in Norseman Capital, LLC" (emphasis added). The extent of the donor's control in a gift tax audit seems to be rather remote insofar as retaining dominion and control over the asset to result in an incomplete gift. It is the agent's decisions that cause more of the property to remain with the donor by urging that the property has been undervalued; all the donor can do is decide what to do in response to the agent's decisions. The donor keeps no control whatsoever to keep more of the units than originally anticipated if the agent does not argue that the units were undervalued.

The fourth potential disadvantage listed above seems to be the most dangerous in using a Wandry defined value transfer of a dollar value. If the IRS does not respect the clause and imposes a gift tax on the number of units that the donor thought was transferred, for state law purposes the formula would still seem to apply (although perhaps that would be grounds for a reformation) and some of the units may remain with the donor to be included in the donor's estate for estate tax purposes. If that happens, it seems there would not be double inclusion because under §2001(b)(last sentence; any gifts that are included in the gross estate are not treated as adjusted taxable gifts in the estate tax calculation). The units that remain with the donor are obviously included in grantor's gross estate if the donor still owns them at death. The gift tax was calculated as if those units had been transferred. Therefore, under §2001(b) the portion of the adjusted taxable gift attributable to those units that remain with the donor should not be brought back into the estate as adjusted taxable gifts for calculation of the estate tax. (Query what occurs if the donor subsequently makes a gift of those remaining units rather than retaining them until death? Would the transfer be subject to a second gift tax even though the units have already been subjected to a gift tax? Perhaps only the additional value at the time of the second gift would be subjected to gift tax at that time.) If the IRS position is upheld, is the increase in basis under §1015(d) for gift tax paid allocated to all of the shares deemed gifted by the donor even though some of those shares remain with the donor? Also, if the Wandry clause is used in connection with a formula disclaimer, the IRS would have to overcome two issues for this disadvantage to arise.

(7) *Formula Disclaimer Combined With Wandry Transfer.* Some practitioners using the formula transfer approach recommend that the trust agreement specify that any disclaimed assets will remain with the donor, and that the trustee or donee(s) immediately following the transfer execute a formula disclaimer of any portion of the gift in excess of the value that the donor intends to transfer. (A statute in Florida specifically authorizes the validity of such a provision allowing the trustee to disclaim.) The rationale is that the regulations have always recognized formula disclaimers as being valid, so even if the formula transfer for

some reason fails to limit the gift, the formula disclaimer will prevent an excess gift. Until further case law develops approving formula transfer clauses, this is a strategy that may provide additional comfort when using formula transfer rather than formula allocation clauses.

If the formula disclaimer approach is used and the disclaimer provision is included in the trust agreement, consider adding a provision in the trust agreement expressing the settlor's wish that the trustee would disclaim by a formula in order to benefit the beneficiaries indirectly by minimizing the gift tax impact to the settlor's family, and perhaps make the transfer to the trust as a net gift so that if gift tax consequences arise they would be borne by the trust. That may give the trustee comfort in being able to disclaim, even though doing so could decrease the amount of assets in the trust. In addition, the formula transfer to the trust in the first place may help give the trustee comfort in making the formula disclaimer despite potential fiduciary concerns; the formula disclaimer is given in order to effectuate the settlor's intent as much as possible in making the formula transfer to the trust. (See Item 5.i.(2) above for a discussion about the effectiveness of disclaimers by trustees.)

One planner suggests that the formula disclaimer by the trustee be combined with provisions in the trust document stating (i) that if an excess value is inadvertently transferred compared to the specified dollar value, the trustee holds the excess as agent for the donor, and (ii) that the trustee may commingle the excess assets that are held as agent with the trust assets.

(8) *Sales with Defined Value Formula Allocation Transfer.* Sale transactions as well as gifts can be structured with a defined value clause. *Petter* and *Hendrix* both involved combined gift/sale transactions. For example, the facts of *Hendrix*, T.C. Memo. 2011-133, lay out a roadmap for how gift/sale transactions can be structured with a formula allocation defined value transfer. The *Hendrix* gift/sale transaction was structured as follows. Each of the parents, the trustees of the GST trust and a charitable Foundation executed an assignment agreement irrevocably transferring 287,619.64 shares of a closely-held corporation, to be allocated between the trust and Foundation under the following provisions:

- Shares worth $10,519,136.12 were allocated to the GST trust;
- The remaining shares were allocated to the Foundation;
- Values were to be determined "as the price at which shares would change hands as of the effective date between a hypothetical willing buyer and a hypothetical willing seller, neither under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."
- The GST trust agreed to pay any gift taxes imposed as a result of the transfer.
- The GST trust trustees would sign promissory notes for $9,090,000 to each parent (thus resulting in a gift to the GST trust by each parent of

$10,519,136.12 minus $9,090,000 minus the gift tax attributable to the transfer).

- The parents had no responsibility for allocating the shares under the formula; that allocation was left to the transferees. The dispute resolution and buy-sell agreement would control, thus requiring arbitration if the parties could not agree on the values.

In addition, the formula disclaimer strategy could be used in a sale transaction as well. The trust would specifically permit a trust beneficiary or trust to disclaim any gift to the trust and the trust would provide that the disclaimed asset passes to a charity or back to the donor or to some other transferee that does not have gift tax consequences. After a sale to the trust, the beneficiary would disclaim by a formula the number of units having a value in excess of the specified dollar value of the sale.

(9) *Sales with Wandry-type Assignment.* Similarly, a sale could be structured with the assignment being of that number of shares equal to the specified purchase price. Alternatively, the sale could be structured with a clause similar to the approach approved in *King v. United States*, 545 F.2d 700 (10th Cir. 1976). That case upheld a formula that adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price.

Similarly, the same principles would seem to apply in structuring a "swap" power under a nonfiduciary substitution power as a dollar value transfer. This could be structured with either the person holding the substitution power or the trust — whichever was transferring the hard to value asset — assigning a formula dollar value of units.

(10) *There Will Likely Be Many Audits of Wandry Transfers from 2012 Gift Tax Returns.* Many planners made gifts to utilize their clients' $5.12 million gift exemption in 2012 using *Wandry*-like formulas. Presumably, a number of audits over the next several years of those returns will occur. Some planners have suggested that the IRS may strategically wait to take the next case to court that has some bad facts (indeed, as in *Wandry*) AND that would be appealable to the Fourth Circuit.

(11) *Will the IRS Issue Regulations?* The 9th Circuit expressed an invitation for regulations in Petter: "We expressly invite the Treasury Department to 'amend its regulations' if troubled by the consequences of the resolution of th[is] case [quoting the U.S. Supreme Court in Mayo Foundation, 131 S. Ct. 704, 713 (2011)]." (However, the 9th Circuit was specifically addressing the condition precedent charitable deduction regulation rather than the general public policy/Procter issue.) If so, it seems unlikely that the government will try to reverse the clear trend in the cases that have supported defined value transfers and seek to declare that all forms of inter vivos formula provisions are improper. The government understands that many forms of formula provisions are valid —

even blessed by the IRS (such as marital deduction formula bequests and formula disclaimers, among others). However, distinguishing between "good" formula gifts and abusive transactions will be difficult.

(12) *Possible Legislative Response Based on Penalties.* One commentator, who believes that *Wandry* is decided correctly under current law, acknowledges that donors would abuse the system if they purport to transfer a particular dollar value but take an unreasonable valuation position, under the impression that if the IRS audits the return and disagrees on the value, a simple adjustment would occur with no gift tax. If there is concern about the integrity of the system, an appropriate better approach, he believes, is to create a penalty. For example, legislation could provide that if the amount initially stated as being the number of units equal to the specified formula dollar value ends up being wrong by more than 20%, a penalty would apply. "That keeps the pigs in line."

(13) *Charity Involvement. Wandry* states explicitly (in two different places in the opinion) that the fact that a charity was not involved does not impact the condition subsequent or the public policy analysis.

McCord, *Christiansen*, *Petter* and *Hendrix* all address formula allocation clauses where the "excess amounts" pass to a charity, and some (but not all) of the reasons given for rejecting the IRS's public policy argument apply specifically where a charity is involved. *Hendrix* gives only two reasons for its public policy analysis: that there is no condition subsequent and that public policy encourages charitable gifts. *Christiansen* and *Petter* each have a more robust analysis of the public policy issue, and give additional reasons that the approach would not violate public policy even if a charity were not involved (some of which arguments were repeated in *Wandry*).

From *Christiansen*: (1) The IRS's role is to enforce tax laws, not just maximize tax receipts; (2) there is no clear Congressional intent of a policy to maximize the incentive to audit (and indeed there is a Congressional policy favoring gifts to charity); and (3) other mechanisms exist to ensure values are accurately reported. The court in Christiansen reasoned that "the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." *Christiansen v. Commissioner,* 586 F.3d 1061, 1064 (8th Cir. 2009). In light of the other more robust discussion of the public policy issue in Christiansen, it is perhaps significant that Hendrix cited Christiansen with approval even if it did not repeat all of its public policy reasoning.

From *Petter*: (1) There are other potential sources of enforcement (including references to fiduciary duties to assure that the parties were receiving the proper values); (2) the case does not involve a moot issue because a judgment regarding the gift tax value would trigger a reallocation, and therefore it is not just a declaratory judgment; and (3) the existence of other formula clauses sanctioned in regulations (formula descriptions of annuity amounts for charitable remainder annuity trusts, formula marital deduction clauses in wills, formula GST exemption allocations, formula disclaimers of the "smallest amount which will allow A's estate to pass free of Federal estate tax," and formula descriptions of annuity amounts in grantor retained annuity trusts) suggest there cannot be a general public policy against formula provisions.

e. *Practical Structuring Tips With Wandry Formula Dollar Transfers*.

(1) *Formula Assignment in Wandry May Become Form Templat*e. The formula assignment that was used in this case (presumably that same form was used by this attorney going back to 2000 when the Wandrys started making these stated value dollar gifts) is very clearly stated and may become a form template that will be used by planners, in light of its specific approval in this case. Anecdotally, one case has been reported in which the agent refused to give effect to a formula transfer clause because it deviated from the precise language that was used in Wandry. There's no reason to give an agent that argument (unreasonable though it may be).

John Porter observes that he would change one clause. The *Wandry* clause includes the phrase "a final determination of a different value is made by the IRS or a court of law." That phrase is not as precise as "as finally determined for federal gift tax purposes;" that phrase is clearly defined in §2001(f).

(2) *Gift Tax Return Should Properly Describe the Gift. In retrospect, the C.P.A. in Wandry* made a mistake in describing the gift on the gift tax return as a specific number of LLC units. Aside from the public policy argument, the IRS's best argument in this case was that the description of the gift on the gift tax return as a particular number of units of the LLC suggested that the gift was actually of a fixed number of units rather than a fixed dollar value. This is reminiscent of the Knight case in which the parties not only listed the gift on the gift tax return as a gift of a stated number of shares, but also argued at trial that the gift was actually less than the dollar value stated in the formula. The facts in *Wandry* were much better than in Knight in making clear that the intent was actually to transfer just a stated dollar value worth of units.

The gift tax return properly listed the value of the gifts as the stated dollar values, but the gift description should also make clear that the gift is of the number of units of the LLC having the specified value. The description could state that based on the attached appraisal, the number of units under the formula would be x, but that ultimately the number of units is based on their value as finally determined for federal gift tax purposes.

(3) *More Contemporaneous Appraisal Should Be Made*. The formula assignments were made in this case on January 1, 2004 but the appraiser did not deliver its report until July 26, 2005 — about 19 months later! The appraisal should be prepared fairly contemporaneously with the stated dollar value gift. Waiting 19 months to obtain the appraisal on which the entire transfer is based might cause some courts to refuse to recognize the formula transfer as a bona fide transaction. One wonders, in this case, how the parties allocated profits and

losses for 2004. The assignments had been made of member units, but there was no way to determine even the initial allocation of those units for the remainder of 2004. Presumably, the appraisal came in time both to file the gift tax returns as well as the relevant income tax returns, under extension.

(4) *Use a Professional Appraiser*. In all five of the defined value cases (*McCord, Christiansen, Petter, Hendrix,* and *Wandry*), the taxpayer used a reputable professional appraiser; in the first four cases to prepare the appraisal for purposes of making the original allocation among donees and, in *Wandry*, for the purpose of determining the number of units actually transferred. This helps support that the taxpayer is acting in good faith and avoid a stigma that the formula transfer is merely a strategy to facilitate (using words of the court in Petter) "shady dealing" by a "tax-dodging donor."

(5) *Use Grantor Trusts as Donees*. The government, in making its argument that the capital accounts should control the transfer, rather than the stated dollar values, noted that "if petitioners prevail it will likely require the preparation and filing of numerous corrective returns." That is certainly correct where the donees are individuals, as in *Wandry*. A much preferred planning design is to make the gifts to grantor trusts. Even if the ownership percentages change as a result of a gift tax audit, all of the income and losses 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).

28. GRAT Strategies

GRATs may not be as favored when clients can make gifts of up to $5 million without paying gift taxes and without using sophisticated planning strategies. However, GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes *or utilizing any gift exemption.* Everything else being equal, it would be advantageous to transfer the desired amount to family members via a GRAT without making any taxable gifts, if possible.

a. *Proposed Legislation.* The Administration's Budget proposal includes various restrictions on GRATs that would disallow several strategies that have been used in the past, including (i) short-term GRATs (under the legislation GRATs would have to have a term of at least 10 years), (ii) front-loaded GRATs, and (iii) very long-term GRATs. (See Item 2.d above.) The GRAT provisions have been included in prior legislative bills (though the long-term GRAT prohibition was first added to the Administration's 2012 Budget Proposal), and it is certainly possible that the GRAT proposal will be included as part of a tax reform package sometime this year. Therefore, someone wanting to use any of these strategies should complete implementation of the GRAT before the date of enactment of any such legislation.

b. *Built-In Savings Claus*e. For transferring hard-to-value assets, GRATs offer a unique significant advantage of being able to use a built-in valuation savings clause approach that is recognized in the GRAT regulations for the initial transfer to the GRAT.

(However, the valuation uncertainties would exist for in-kind payments of the annual annuity amounts if the annuity amounts cannot be made in cash.)

c. *Use Separate GRATs for Each Asset*. If a particular asset transferred to a GRAT does not produce sufficient cash flow, together with the principal of the asset in order to make all of the specified annuity payments, when there is no further value left in the GRAT, it would simply terminate for lack of any trust corpus. If other assets had been gifted to the same GRAT, the other assets would have to be used to make up the deficiencies. In order to avoid this result, it would be desirable to use a separate GRAT for each individual asset (or class of assets) so that poor performance results of one asset will not adversely affect the trust with respect to other assets.

d. *Cap on Remainder; Excess Value Over Prescribed Amount May Be Returned to Grantor*. A parent may own assets that might explode in value (such as stock in a company that may go public in the near future). The parent may be willing to transfer a substantial part of the increase in value, but be leery of transferring "too much value" to his or her children. The GRAT could be structured to provide that the first $X of value at the end of the GRAT term would pass to a continuing grantor trust for children, and that any value in excess of $X would be returned to the grantor, or whatever other arrangement the grantor desires. The formula reversionary provision would have to be included in the GRAT document from the outset.

The right to participate in future distributions will likely result in some (perhaps all — this is unclear) of the GRAT assets being included in the grantor's estate under §2036(a)(1) if the grantor dies during the GRAT term. There may be more estate inclusion than if there is no right to participate in future distributions.

An example in the regulations makes clear that the annuitant may retain a contingent reversionary interest although such a contingent reversionary interest will be valued at zero for purposes of determining the amount of the gift. Treas. Reg. §25.2702-3(e) Ex. 1.

If the grantor survives the end of the GRAT term, this reversionary provision should not trigger §2035 because the grantor takes no voluntary action to relinquish any "string" interest or power that would otherwise case estate inclusion.

In light of the ability to "zero-out" a GRAT under the Walton case, the donor has not used any gift exemption by reason of creating the GRAT. Accordingly, there is no particular tax "inefficiency" of having used gift exemption yet having excess value over a specified target amount being returned to the grantor.

This added flexibility is even more apparent if a GRAT is compared to a sale to grantor trust transaction. An inherent uncertainty with the sale approach is knowing how much to sell to the grantor trust in order to transfer a targeted desired amount to trusts for younger generations — because the result depends in large part on how much appreciation will occur in the transferred asset.

In addition, using a GRAT may allow the owner to be more aggressive in transferring a substantial part of a highly appreciating asset to the GRAT, because the grantor can retain the right to receive a certain amount of the trust assets remaining at the end of the GRAT term. For example, parent might transfer almost all of her closely held stock to a GRAT.

e. *Front-End Loaded GRAT*. There is no clear authority for using a one-year GRAT. *See* I.R.C. §2702(b)(1) (referring to qualified annuity interests as amount*s* payable not less often than *annually*; the italicized terms suggest a possible minimum term of two years). *See also Walton v. Commissioner*, 115 T.C. 589 (2000), *acq*. Notice 2003-72, 2003-2 C.B. 964 (approving 2-year GRAT); *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002) (IRS did not contest validity of 367-day GRAT). A multi-year GRAT may achieve much the same effect as a one-year GRAT if the agreement calls for a substantial payment at the end of year one and a payment equal to 0.01% of the initial contribution in later years. If the grantor were to die after year one, it appears that the amount to be included in the grantor's estate may be the amount that would be required to produce the annuity of 0.01% — which would be a very small amount. While Treasury Regulation §25.2702-3(e) Ex. 3 clearly allows the amount of the GRAT payment to decrease without limit, no rulings have addressed extreme front-loaded GRATs. Some planners have structured these transactions to have about 90% of the initial value distributed after the first year, leaving a significant payment the second year, in case the IRS were to argue that a de minimis payment in year two is essentially the same as a one-year GRAT.

f. *Use Revised Spendthrift Clause*. There are two reasons that it may be helpful for the remainder beneficiary to be able to assign its interest in the GRAT. (1) In several recent cases, the IRS was forced to value lottery annuity payments using a lower value than the §7520 value because the annuity payments are nontransferable. Could the IRS argue that the existence of the spendthrift clause means the annuity payments are nontransferable, so that the grantor could not rely on §7520 in placing a high value on the retained annuity payments? (2) It may be helpful for remainder beneficiaries to transfer their interests in the trust (for example, to a GST exempt trust or to the grantor).

g. *Re-Purchase of GRAT Assets by Grantor*. The grantor may re-purchase assets from the GRAT/grantor trust, either prior to or following the end of the initial GRAT term. The low-basis asset in the GRAT would then be in the grantor's estate and would receive a step up in basis at the grantor's death. The GRAT remaindermen would have the cash paid to the GRAT for the low-basis asset, which cash obviously would not have any built-in capital gains tax liability.

h. *Locking In Gains or "Cutting Your Losses"*. If the assets in a GRAT have appreciated substantially, the grantor may wish to take steps to lock in the gain of the GRAT, and not risk that subsequent depreciation would leave the GRAT with no assets to pass to the remaindermen. One way of doing this would be for the grantor to exercise the substitution power by substituting cash for the in-kind asset in the GRAT. If the in-kind asset subsequently depreciates in value, the depreciation would be borne by the grantor, not the GRAT.

A further refinement would be for the grantor to contribute the in-kind asset that has been "purchased" from the initial GRAT to a new GRAT. Future appreciation would then be transferred, but future losses would not reduce the amount of assets that can pass to remaindermen from the initial GRAT.

Similarly, if the GRAT assets have declined in value substantially, the grantor might also exercise the substitution power to substitute cash for the in-kind assets. The grantor could contribute the in-kind assets to a new GRAT, isolating the period of depreciation and harvesting appreciation above the GRAT hurdle rate from that point on in the new GRAT.

An alternate approach (suggested by Edward Manigault) is for the grantor to contribute the annuity from an underwater GRAT to a new GRAT. Presumably, the annuity would be valued at approximately the remaining value in the GRAT. Any subsequent appreciation would inure to the benefit of the new GRAT.

i. *Loans From Separate Grantor Trust*. The $5 million gift exemption opens up the possibility of another strategy that would minimize the valuation risks in making annuity payments. A client might give some of the $5 million gift exemption amount to a grantor trust that will be the remainder beneficiary of a GRAT. When the annuity payment is due, the grantor trust might loan funds to the GRAT which it could use to make the annuity payment, without having to make an in-kind distribution. There would be no gift valuation risk with respect to annuity payments that could be funded with such loan proceeds.

j. *Shelf GRATs*. Because of the legislative proposal to require that GRATs have a minimum 10-year term, some planners suggest currently creating "shelf GRATs." The concept is to create and fund a series of mid-term GRATs currently (say, 4, 6, 8, and 10 year terms), and fund them with fixed income assets. If short-term GRATs are subsequently outlawed, if the §7520 rate rises dramatically for new GRATs, or if the settlor acquires an asset that has high appreciation potential, one of the series of GRATs could be pulled off the "shelf," and volatile assets (with high appreciation potential) could be swapped into the GRAT, in effect resulting in a short-term GRAT (based on the remaining term).

k. *Purchase of Remainder Interest by Grantor*. If there is a really successful GRAT and there is a worry that client might die before the end of the GRAT term, the grantor might consider purchasing the remainder interest from the remainder beneficiary for its present value. If the grantor dies during the term of the GRAT, all assets in the GRAT will likely be included in the estate. But under this approach, the remainder beneficiary trust would have the dollars paid for the remainder interest that are excluded from the grantor's estate. The grantor has no interest in those funds and they would not be included in the grantor's estate for estate tax purposes.

Revenue Ruling 98-8 treated a similar sale of the remainder interest from a QTIP trust as being the equivalent of a commutation. The IRS gave so many reasons in that ruling that it was apparent that the IRS was struggling with a reason that worked. The main rationale in the ruling was §2519, which obviously would not apply outside the context of a QTIP trust. The IRS could similarly assert that the purchase of the GRAT's remainder interest is a prohibited commutation, but it is hard to understand how a commutation can occur without action by the trustee.

If the remainder purchase occurred after the statute of limitations had closed on asserting additional gift taxes with respect to the creation of the GRAT, it may be very difficult for the IRS to attack this transaction. (It would seem that the IRS's only argument would be fraud, on the basis that there was a plan from the initial creation of the GRAT to do something that was not allowed. "There should not be a memo in the file suggesting that the remainder be purchased back after four years.")

One attorney reports doing this in a transaction in which the grantor of a GRAT, who was about to die, purchased the remainder interest from the grantor trust that owned the remainder interest. That sale was audited. In that case, there were different trustees of the grantor trust remainder owner and the GRAT itself (to help show no merger). The attorney even had the grantor trusts file a Form 1041 when initially created, reporting them as grantor trusts. The grantor borrowed money from a bank to pay for the remainder interest. The IRS agent didn't like it, but it passed the audit.

l. *Remainder Purchase GRATs*. Section 2702 generally removes the estate and gift tax advantages of joint purchase transactions. The purchaser of the term interest is treated as initially purchasing the entire property and then transferring the remainder interest while retaining the income interest. The retained income interest is valued at zero because it is not a qualified annuity or unitrust interest. However, if the retained interest is a qualified annuity (or unitrust) interest, it would seem that the actuarial value of the qualified interest could be subtracted in determining the amount of the gift made by reason of the deemed transfer of the remainder interest. See Treas. Reg. §25.2702-4(d), Ex.1 (retained interest in a joint purchase transaction is valued at zero "because it is not a qualified interest"). This raises the possibility of a joint purchase transaction in which the client would purchase a qualified annuity (or unitrust) interest payable from the acquired property and the remaindermen would purchase their remainder interest. *See* Blattmachr & Painter, *When Should Planners Consider Using Split Interest Transfers?*, 21 EST. PL. 20 (1994); PRACTICAL DRAFTING 2482 (Covey ed. 1991). Under the joint purchase approach, the value paid by the grantor for the qualified annuity interest would be excluded from the gross estate, assuming the payment equaled the actuarial value of the retained annuity interest, regardless of whether the grantor survived the term of the annuity interest. (Indeed, an annuity for the grantor's life could be used.)

This approach may also be utilized to achieve generation-skipping advantages if a GST exempt trust is the party paying for the GRAT remainder interest. A twist that would help with the valuation question would be to have the client and grantor trust contribute interests in the same entity (for example an interest in a family limited partnership or LLC). Values would be proportionate to the units transferred by each party. A further twist is to structure the grantor trust that is paying for the remainder interest so that there are non-skip beneficiaries of that trust. In that situation, there would be no GST tax due at the end of the initial GRAT term in any event.

There is obviously a huge premium on getting the values right. If the values are off by even a penny, the full consideration exception would not apply, and there would be a "transferor" for GST purposes.

Several rulings have cast doubt on the ability to use this technique, suggesting that the parent (who contributes an amount equal to the present value of the retained qualified annuity interest) would receive inadequate consideration, citing the reasoning of *Estate of Gradow*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990). Letter Rulings 9515039, 9412036. However, a variety of cases have recognized sales of remainder interests, and have held that "adequate and full consideration" need only equal the value of the remainder interest transferred by the decedent. *E.g., Estate of Magnin*, 184 F.3d 1074 (9th Cir. 1999); *D'Ambrosio*, 101 F.3d 309 (3rd Cir. 1996); *Wheeler*, 116 F.3d 749 (5th Cir. 1997). *See generally* Jensen, *Estate and Gift Tax Effects of Selling a Remainder: Have D'Ambrosio, Wheeler and Magnin Changed the Rules?*, 4 FLA. TAX REV. 537 (1999); Pennell, *Cases Addressing Sale of Remainder Wrongly Decided*, 22 EST. PL. 305 (Sept/Oct 1995).

In this type of split purchase transaction, the annuity payments should be structured so that the remainder trust pays significant consideration for its interest. There would be real economic substance to the transaction, so that the rationale of the D'Ambrosio, Magnin, and Wheeler "sale of remainder interest" cases would apply.

Even if the rationale of the *Gradow* and *Pittman* (95-1 U.S.T.C. ¶60,186 (E.D. N.C. 1994)) cases do not apply, if the grantor dies during the term of the retained annuity interest, the IRS may attempt to apply the pre-Chapter 14 cases involving private annuity transactions with trusts. Some of those cases suggest that the transferor will be treated as making a transfer with a retained life estate under section 2036(a)(1) if the trust consists of little more than the transferred property and if the annuity payments approximate the amount of anticipated trust income. *E.g., Ray v. Comm'r*, 762 F.2d 1361, 1364 (9th Cir. 1985); Ltr. Rul. 9515039; *but see Fabric Estate v. Comm'r*, 83 T.C. 932 (1984).

Jonathan Blattmachr has written about this type of transaction referring to it as a "SPLAT" (split purchase annuity trust).

m. *Sale of Remainder Interest to Dynasty Trust*. GST exemption cannot be allocated to a GRAT until the end of the GRAT term. One possible planning strategy is to have the remaindermen of a GRAT sell their remainder interests (assuming the GRAT does not have a spendthrift clause that prohibits such transfers) to younger generations or to a GST-exempt trust. *See generally* Handler & Oshins, *The GRAT Remainder Sale*, TR. & EST. 33 (Dec. 2002). If the sale is made soon after the GRAT is created and before there has been any substantial appreciation in the GRAT assets, the remainder interest should have a low value. A concern is that the IRS may argue substance over form and recast the series of transfers as the creation of a GST-exempt GRAT (which is not permitted). The subsequent sale transaction by the GRAT remaindermen should be independent of the initial creation of the GRAT. (For this purpose, it would be best if the GST-exempt trust that purchases the remainder interest is created far in advance of the creation of the GRAT.) Observe that if the remaindermen of the GRAT and the GST-exempt trust that purchases the remainder interest are both grantor trusts for income tax purposes, there should not be any gain recognized as a result of the sale transaction.

The IRS at one time informally indicated its position that it will treat the sale of the remainder interest as a contribution to the trust by the seller so that the trust has two grantors for GST purposes. The portion owned by the seller of the remainder interest is just the small amount paid for the remainder interest. The original grantor is deemed to be the grantor of the balance of the trust (which is almost all of the trust) for GST purposes. Ltr. Rul. 200107015; Cf. Treas. Reg. §26.2652-1(a)(1) Example 4 (trust is created for child for life with remainder to grandchild; a transfer by child of his or her income interest will not change the transferor, and parent is still treated as the transferor "with respect to the trust" for GST purposes).

The IRS's approach is to consider the original donor who created the GRAT as a transferor along with the children who assigned their remainder interests to the grandchildren or to a dynasty trust. This argument is analogous to the one the IRS lost in *D'Ambrosio v. Comm'r*, 101 F.3d 309 (3d Cir. 1996), *Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997), and *Estate of Magnin*, 184 F.3d 1074 (9th Cir. 1999). In those cases, the IRS argued that "full and adequate consideration" for the sale of a remainder interest was much more than the actuarial value of the remainder interest. The courts disagreed. Similarly, the gift of a remainder interest by the donor's children should not be treated as something other than a gift solely by the children.

n. *Sale of Annuity Interest by Grantor.* A possible strategy to reduce the risk of the grantor dying during the trust term is for the grantor to sell his or her annuity interest in the GRAT to the remainder beneficiaries. A transfer of a retained interest that would trigger §2036 if held until death generally is subject to the three-year rule of §2035(a), but a sale for full consideration is exempt under §2035(d). Again, the IRS could argue this is a prohibited commutation; a counter argument would be that the trustee is not involved.

o. *Leveraged GRAT*. This strategy introduces leverage into a GRAT transaction, so that it has the leveraging characteristics of sale to grantor trust transactions. A simple straightforward method of introducing leverage would be for the GRAT to borrow as much as possible and invest the borrowed proceeds in assets with appreciation potential. There would be the increased possibility of "hitting a home run" but also a greater risk that the GRAT would implode and that the GRAT would be "underwater." Although that transaction might have a greater likelihood of transferring significant value from the GRAT, it also has high economic risks for the family.

Another way to introduce leverage is to use an existing family investment entity, and leverage that vehicle within the family (but not introducing the added economic risk to the family of outside leverage), so that the net equity value contributed to the GRAT is substantially lower, resulting in much lower annuity payments that hopefully can be satisfied out of cash flow if the GRAT has a long enough term.

For example, assume client owns an interest in a family limited partnership.

(1) The client might contribute 10% of the limited partnership (LP) units to an LLC in return for units in the LLC, and sell 90% of the LP units to the LLC in return for a 9-year balloon note.

(2) The net equity value of the LLC would be represented by the value of the 10% contributed as a capital contribution. The value of the LLC would be based on the discounted value of the LP units.

(3) The capital interest in the LLC (having a net value, without any discounts, equal to 10% of the value of the total LLC assets) would be contributed to a 10-year GRAT. Because of the discounted value of the LP units and because of the 9-1 leverage of the LLC and because of the ten-year term, the annuity payments may be low enough that the cash flow from the FLP to the LLC and from the LLC to the GRAT may be sufficient to pay the annuity payments in cash.

(4) At the end of the 10-year GRAT term, it would then own all of the capital interests in the LLC.

Sophisticated planners have used this strategy in various situations. It can work particularly well if the client wanted to transfer interests in a private equity fund. The client typically has both a “carry interest” and an “investment interest.” The client would contribute both the carry and investment interest to a single member LLC (that is a disregarded entity), partly as a capital contribution and partly as a sale for a note (9-1 ratio). Transferring both the carry and investment interests avoids the application of section 2701. The capital interest in the LLC would be contributed to the GRAT.

This is somewhat comparable to a gift and sale to grantor trust transaction. The leveraged GRAT is better in that the client does not have to use up any significant amount of gift exemption. If the assets do not perform, nothing is transferred to family members via the GRAT, but there is also no wastage of gift exemption (which can occur under a sale to grantor trust transaction if the assets in the grantor trust decline below the amount of the note).

p. *Back to Back GRATs.* Ellen Harrison described a strategy that could use GRATs in a manner that indirectly would benefit the grandchildren’s generation. Parent could create a trust for child, and when the child understands the potential transfer advantages and considers the child’s own planning, the child might create a GRAT for his or her children. If parent and child both own interests in the same closely-held company, for example, they could each transfer the same number of units in the company to their respective GRATs. In effect, if the parent’s GRAT transfers value to child at the end of the GRAT term, the child’s GRAT would transfer the same value to his or her children at the end of that same GRAT term. The transactions should be planned as independently as possible to assist in rebutting an “indirect gift” argument by the IRS. If the separate GRATs are part of a pre-arrangement, the IRS might conceivably make an indirect gift/step transaction argument.

q. *Creation of 99-Year Term GRAT.* Turney Berry has suggested the following transaction. Create a 99-year GRAT. With that longer term, the annual annuity payments will be very small. At the client's death, an amount will be included in the client's gross estate under §2036 equal to the small annuity amount divided by the §7520 rate at the date of death. The initial annuity amount is determined based on the current §7520 rate (about 1.0-1.2%). If, by the time of the grantor's death, the §7520 rate has increased, a substantially smaller amount will be included in the grantor's estate. For example, if a long term trusts were created today and the §7520 rates go up to 6% by the time the grantor dies, about 85% of the value will be excluded from the gross estate.

    There are various complicating issues with this strategy. First, realize that provisions must be made for paying the estate tax out of assets other than the GRAT. Next, how would family members benefit from the GRAT after the grantor dies? Perhaps the GRAT could be collapsed by bequeathing the annuity interest to the same party that holds the remainder interest, so that there would be a merger of interests under state law. Would that be a prohibited commutation? It doesn't appear to be a standard commutation, but the instrument would, of course, contain the standard prohibition on commutation.

r. *Using Delaware Series LLCs to Facilitate GRAT Transfers.* Using a "Series LLC" can be helpful with using multiple GRATs for different assets or classes of assets. This can also be helpful with using private equity in GRATs so there is no necessity of dealing with third parties when making transfers of the interests in satisfaction of annuity payments. Each series of the LLC can contain a different asset class and can be put into a separate GRAT. When making annuity payments, an interest in a series can be assigned. Also, a defined value formula can be used in making an assignment of a series.

s. *Sale of GRAT Assets to Grantor in Return for Private Annuity.* If the GRAT sells its assets to the grantor in return for a private annuity for the grantor's life, and if the grantor dies during the term of the GRAT, the GRAT would have no assets because the private annuity would expire. The viability of this approach is unclear. The trustee could potentially have fiduciary concerns if the grantor dies during the term and the GRAT ends up with no value. In addition, there could be "economic substance" concerns if there is a pre-arrangement to do this with set values that would pass to the GRAT if the settlor survives the term and that would have nothing in the trust if the settlor does not survive.

29. Supreme Court in *Windsor* Creates Planning Opportunities for Same-Sex Married Couples

On Wednesday, June 26, 2013, a divided U.S. Supreme Court rendered its highly anticipated decision in *United States v. Windsor,* 133 S. Ct. 2675 (2013), and declared that Section 3 of the Defense of Marriage Act is unconstitutional. The Court's decision, while it leaves open questions, will create estate planning opportunities and have other important implications for same-sex married couples. Clients in same-sex relationships should talk with their lawyers, accountants and Bessemer advisors about how to take advantage of the planning opportunities following the *Windsor* decision. (This summary is based on a discussion prepared by Jaclyn Feffer and Dana Fitzsimons, with Bessemer Trust.)

a. *Background.*

(1) *The Defense of Marriage Act.* The Defense of Marriage Act ("DOMA") was passed in 1996. For the purpose of over 1,000 federal laws and numerous federal regulations, Section 3 of DOMA defines "marriage" as the legal union between one man and one woman as husband and wife, and the word "spouse" as a person of the opposite sex who is a husband or a wife. Section 3 of DOMA prevented same-sex married couples from being recognized for purposes of government employee benefits, Social Security benefits, tax benefits and filing status, and other aspects of federal law.

(2) *State Laws.* Sixteen states and the District of Columbia have passed laws or have court cases recognizing same-sex marriages. (California, Connecticut, Delaware, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Hampshire, New Jersey, New Mexico, New York, Rhode Island, Utah, Vermont, and Washington.) The Illinois legislature has passed a same-sex marriage provision, expected to be signed by the Governor and become effective sometime in the summer of 2014. California has effectively allowed same-sex marriage as a result of the Perry decision, issued by the Supreme Court on the same day as Windsor. Delaware's law took effect on July 1, 2013 and Rhode Island's and Minnesota's laws took effect on August 1, 2013.) Thirty-five states specifically ban same-sex marriage, although some of those states allow civil unions and domestic partnerships which may provide state-level spousal rights. (Colorado, Delaware, District of Columbia, Hawaii, Illinois [although new legislation will change that result in Illinois], Maine, Nevada, New Jersey [but a recent trial court case, *Garden State Equality v. Dow*, held the statutory ban to be unconstitutional in light of *Windsor*, and Governor Christie withdrew his administration's initial decision to appeal the case], Oregon, Rhode Island, Washington, and Wisconsin. Civil unions are no longer available in Delaware beginning July 1, 2013 and in Rhode Island on August 1, 2013, when the states' same-sex marriage laws are in effect.) New Mexico is the only state without legislation on same-sex marriage, and the New Mexico Supreme court has held that refusing to recognize same-sex marriages is unconstitutional.

b. *Windsor Case.* In 1993, Edie Windsor and Thea Spyer registered as domestic partners under New York law. They were married in Canada in 2007 and New York deemed their marriage to be valid. Thea died in 2009, naming Edie as her executor and leaving her estate to Edie. Edie filed the estate tax return for Thea's estate and claimed the marital deduction. The IRS denied the deduction on the basis of Section 3 of DOMA. Edie paid the estate tax and sued for a refund in New York federal court.

The federal district court found in Edie's favor and held that Section 3 of DOMA was unconstitutional, and ordered a refund of $363,000 in federal estate taxes plus interest. On appeal, a divided Second Circuit also held that Section 3 of DOMA was unconstitutional.

A five member majority of the Supreme Court, under an opinion by Justice Kennedy, affirmed the Second Circuit decision and declared Section 3 of DOMA to be unconstitutional. The majority opinion reasoned that DOMA deviates from the federal government's historic deference to state law with respect to domestic relations and regulation of marriage, and that by singling out a class of persons deemed by a state entitled to recognition, and imposing a disability on that class, Section 3 of DOMA violates basic due process and equal protection principles under the Fifth Amendment. The court also points to the Fourteenth Amendment (but without any analysis how the Fourteenth Amendment specifically applies and whether a "strict scrutiny," "intermediate scrutiny," or "rational basis" analysis under the Fourteenth Amendment applies in this context), by observing that the equal protection of the Fourteenth Amendment makes the Fifth Amendment right "all the more specific and all the better understood and preserved." The court's reasoning that Section 3 is unconstitutional results in a conclusion that it was always unconstitutional and the Court's holding is applied retroactively.

c. *Revenue Ruling 2013-17*. The day after *Windsor* was decided, the Internal Revenue Service announced that it is working with the Department of Treasury and Department of Justice and "will move swiftly to provide revised guidance in the near future" regarding how federal tax laws will be applied in light of the *Windsor* case. That guidance was published on August 29, 2013 in Rev. Rul. 2013-17.

Rev. Rul. 2013-17 has three holdings and a clarification regarding its prospective application.

(1) *Terms Relating to Marriage Include Same-Sex Couples.* "For Federal tax purposes, the terms 'spouse,' 'husband and wife,' 'husband,' and 'wife' include an individual married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes such a marriage between individuals of the same sex." There is nothing surprising about this holding, and it was fully expected following the *Windsor* decision.

(2) *Place of Celebration Standard*. "For Federal tax purposes, the Service adopts a general rule recognizing a marriage of same-sex individuals that was validly entered into in a jurisdiction (whether a state, district, territory or foreign country) whose laws authorize the marriage of two individuals of the same sex even if the married couple is domiciled in a place that does not recognize the validity of same-sex marriages." This holding, adopting a "place of celebration" test rather than a "place of domicile" test, was anticipated but by no means certain. For further discussion of the place of celebration issue, see paragraph d below.

(3) *Domestic Partnerships and Civil Unions Not Included*. For federal tax purposes, the interpretation of terms to include same-sex couples does "not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship recognized under state law that is not denominated as a marriage under the laws of that state…" This holding is the most administratively feasible approach. Prior IRS private rulings have afforded favorable tax treatment to Illinois civil union partners and to California registered domestic partners. *E.g.,* Pvt. Ltr. Rul. 201021048 (each California domestic partner reports half of community property income). A practically difficulty is

that some states that recognize domestic partnerships or civil unions provide that the couple has all of the rights and privileges afforded married couples but some states do not. Drawing a distinction based on the degree to which state laws afford such relationships the benefits of marriage would have been cumbersome at best.

(4) *Prospective Application*. The holdings are applied prospectively as of September 16, 2013 (the date that the Ruling will be published in IRS 2013-38). Affected taxpayers may rely on the ruling "for the purpose of filing original returns, amended returns, adjusted returns, or claims for credit or refund for any overpayment of tax..., provided the applicable limitations period for filing such claim under section 6511 has not expired." All items on such return or claim that are affected by the marital status must be reported consistently. Similarly, taxpayers may rely retroactively on the ruling with respect to overpayment of employment tax and income tax with respect to tax-exempt employer-provided health coverage benefits or fringe benefits that are based on an individual's marital status.

Notice IR-2013-72 expands on the discussion of the prospective application, and makes crystal clear that same-sex married couples must file 2013 federal income tax using either "married filing jointly" or "married filing separately" filing status. For prior tax years, however, the taxpayer can choose whichever is the better result regarding the individual's marital status:

> "Individuals who were in same-sex marriages may, but are not required to, file original or amended returns choosing to be treated as married for federal tax purposes for one or more prior tax years still open unset the statute of limitations."

The Notice points out that refund claims can still be filed for tax years 2010, 2011, and 2012. The Notice does not point out that refunds also can be filed for 2009 income tax returns until October 15, 2013 if the due date for filing the return was extended to October 15, 2010.

If an amended return is filed, the couple will be treated as married for all purposes on that "return or claim"; for example, the attribution rules under §267 might apply. There is no indication that the couple must be treated as married for all federal tax purposes during that prior year; for example, a couple may be able to file a claim for refund of gift taxes for a prior year to claim the marital deduction without having to treat the couple as being married for income tax purposes during that same year.

One commentator has observed that the IRS may at some point wish it had not been so explicit in stating that there would be no assessment for underpayment in prior years (for example, if filing jointly would have produced a higher income tax due to the "marriage penalty"), because this may position may be precedent for a similar non-assessment if some future statute that protected an abusive transaction is later determined to be unconstitutional. Karibjanian, *George Karibjanian on Revenue Ruling 2013-17 and IR-2013-72: The Service Responds to Windsor,* LEIMBERG ESTATE PLANNING NEWSLETTER #2137 (September 3, 2013).

That same commentator points out that some taxpayer will likely challenge the inability to obtain a refund for closed tax years based on the theory that the finding that DOMA was unconstitutional means that it was *void ab initio*. However, the Mr. Karibjanian believes that the Service would likely win that argument because the ability to file a protective claim for refund provided an adequate remedy, but that the remoteness of a statute's unconstitutionality should be considered as a factor to reopen the statute of limitations. *Id.* The Supreme Court in *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco, Dept. of Business* (1990), addressed the constitutionality of not allowing refunds for prior payments of a state tax that was held to be unconstitutional under the Commerce Clause. That case suggests that refunds will not have to be given for closed years:

> "And in the future, States may avail themselves of a variety of procedural protections against any disruptive effects of a tax scheme's invalidation, such as providing by statute that refunds will be available to only those taxpayers paying under protest, *or enforcing relatively short statutes of limitation applicable to refund actions* … Such procedural measures would sufficiently protect States' fiscal security when weighted against their obligation to provide meaningful relief for their unconstitutional taxation." (emphasis added)

There may be relatively few "closed year" issues that will arise because Massachusetts was the only state that recognized same-sex marriages until 2008.

In the gift tax context, if a donor paid gift tax in prior years for which the statute of limitations has closed on obtaining a refund, even though the IRS will not allow a refund will the individual's use of unified credit be restored for purposes of subsequent gifts or for estate tax purposes at the individual's death?

Rev. Rul. 2013-17 states that the IRS will give further guidance in the future regarding the retroactive application of *Windsor* to employee benefits and employee benefit plans and arrangements. (For example, what if the surviving party of a same-sex marriage did not previously receive the benefits of a spouse rollover or other benefits available to spouses under the minimum distribution rules?)

The retroactivity impact of the *Windsor* decision arises in various contexts. While the reasoning in *Windsor* that Section 3 is unconstitutional results in a conclusion that it was always unconstitutional, issues will arise in allowing retroactive administrative relief. For example, the Pentagon's decision to make the full spousal benefits available to same-sex married couples allows benefit payments retroactive only to June 26, 2013, the date of the *Windsor* decision. The Office of Personnel Management has announced that for federal employees, benefits will be available for same-sex spouses regardless of their state of residency, but puts a limit on the retroactive effect of the availability of benefits:

> "Because existing same-sex marriages were not recognized by the Federal government before this Supreme Court decision, all legal same-sex marriages that predate the decision are being treated as new marriages; enrollees will have 60 days from June 26, 2013 (i.e., until August 26, 2013) for enrollment actions."

d. *"Place of Celebration" Standard***.** Rev. Rul. 2013-17 adopts a general rule for federal tax purposes that recognizes a same-sex marriage "that was valid in the state where it was entered into, regardless of the married couple's place of domicile." *Windsor* does not expressly address whether federal benefits are available to same-sex spouses who reside in a jurisdiction that bans same-sex marriages (the place of "domicile") but were legally married in another place that does recognize same-sex marriages (the place of "celebration"). Section 2 of DOMA provides that "No state … shall be required to give effect to any public act, record, or judicial proceeding of any other State … respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other States … arising from such relationship." *Windsor* did not address whether Section 2 is unconstitutional.

In adopting the "place of celebration" standard, the IRS did not refer to Section 2 of DOMA, whether the Full Faith and Credit clause (which applies to "judgments") of the U.S. Constitution would require that result, or other legal basis or other legal authority. The Ruling noted that the IRS has adopted the same approach for over 50 years regarding common law marriages, stressing the long term application of a place of celebration standard regarding that analogous issue. Rev. Rul. 58-66, 1958-1 C.B. 60, which states the IRS position that taxpayers who enter into a common-law marriage in a state that recognizes such relationships and later move to a state that does not recognize common-law marriage is nevertheless treated as married for purposes of the federal income tax laws (in particular to be able to take a personal exemption for the spouse and file a joint income tax return). In addition, the IRS reasoned that the place of celebration test (1) "achieves uniformity, stability, and efficiency in the application and administration of the Code," (2) avoids serious administrative concerns, for example in applying various attribution rules that are based on someone's (perhaps not even the taxpayer's) marital status, and (3) avoids "significant challenges for employers" that operate in more than one state or have employees who live in more than one state or mover between states with different marriage recognition rules.

Other federal agencies have differed on the place of celebration vs. place of domicile approach, but most seem to be applying the place of celebration method.

- Secretary of State John Kerry announced on August 1 that the United States will immediately begin issuing immigrant visas to same-sex couples, as long as the marriage is valid in the jurisdiction where it took place (i.e., a place of celebration standard).
- The Pentagon announced on August 14 that the same-sex spouses of military personnel will be entitled to the full benefits that are available to spouses (including health care and housing benefits, extra compensation when the spouse is deployed and unable to live at home, and access to base facilities). Not only did the Pentagon adopt a place of celebration standard, it will grant leave to same-sex unmarried couples who are stationed in one of the 37 states where same-sex marriage is illegal to travel to a jurisdiction where the couple may be married. The benefit payments for spouses are retroactive to June 26, 2013, the date of the *Windsor* decision.
- The Department of Health and Human Services (HHS) ruled on August 29, 2013, that legally married same-sex couples, regardless of where they live, are eligible for Medicare benefits that are available to married couples.
- The Labor Department on September 18, 2013 provided guidance affording legally married same-sex couples the right to participate in employee benefit

plans even if they do not live in states that recognize the marriage. This applies to pensions, 401(k) plans, health plans and other similar benefits. Large employers have expressed appreciation for this approach so that they can apply uniform rules across the country regarding issues such as spousal consent on distributions of benefits and survivorship rights.

- The Social Security Administration, however, seems to be applying a domicile standard. The Social Security Administration is putting a hold on applications for spousal benefits if the married couple resides in a state that does not recognize same-sex marriages (applying a "domicile standard").Some of these differences in approaches of different federal agencies may be based on statutory provisions. The Social Security statute appears to use a domicile test:

  Determination of family status

  (1)(A)(i) An applicant is the wife, husband, widow, or widower of a fully or currently insured individual for purposes of this subchapter if the courts of the State in which such insured individual is domiciled at the time such applicant files an application, or, if such insured individual is dead, the courts of *the State in which he was domiciled* at the time of death, or, if such insured individual is or was not so domiciled in any State, the courts of the District of Columbia, *would find that such applicant and such insured individual were validly married* at the time such applicant files such application or, if such insured individual is dead, at the time he died.

  (ii) If such courts would not find that such applicant and such insured individual were validly married at such time, such applicant shall, nevertheless be deemed to be the wife, husband, widow, or widower, as the case may be, of such insured individual if such applicant would, under the laws applied by such courts in determining the devolution of intestate personal property, have the same status with respect to the taking of such property as a wife, husband, widow, or widower of such insured individual. 42 U.S.C. §416(h).

- Attorney General Holder announced on September 5, 2013 that the Department of Veterans Affairs will no longer enforce a law regarding veterans benefits that excludes same-sex couples. If at least one spouse is a veteran, the couple will qualify for benefits that heterosexual veterans and their spouses receive, as long as the couple lives in a state that recognizes gay marriage (thus adopting a domicile standard). The veterans benefit statutory provision regarding the determination of family status is similar to that of the Social Security statute.

Statutory provisions requiring a domicile standard may ultimately come under constitutional attack.

e. *Tax Planning Opportunities for Same-Sex Spouses after Windsor.* The *Windsor* decision presents planning opportunities and will have significant consequences concerning federal benefits for same-sex spouses (some of which may ultimately be available only for spouses living in states that allow same-sex marriage), such as Social Security benefits, retirement benefits, health insurance, disability benefits, taxes, and more. A few of the tax planning opportunities are mentioned briefly below.

Marital Deduction. One of the most significant benefits to same-sex spouses after *Windsor* is the availability of the unlimited federal estate and gift tax marital deduction. §§2056 & 2523. Property passing from one spouse to another (either during life or after death) is free from estate and gift tax. The deduction applies to both outright gifts and certain trusts, such as “qualified terminable interest property” (or “QTIP”) trusts. Same-sex spouses will be able to pass assets to one another with no federal transfer tax cost. Same-sex spouses who previously paid estate or gift taxes on transfers may want to talk with their advisors about whether they can file amended returns and seek refunds for taxes paid. Pursuing such claims may involve seeking judicial approval to re-open statutes of limitations that have expired.

Portability. Same-sex spouses will be able to take advantage of the new “portability” rules made permanent earlier this year under the American Taxpayer Relief Act. §2010(c). The current estate tax exemption amount for each individual is $5.25 million (indexed for inflation). This exemption is “portable” between spouses. That is, if the first spouse dies without utilizing his or her full exemption, the surviving spouse may elect to utilize the remaining deceased spouse’s unused exemption in addition to the spouse’s own exemption.

Disclaimers. An individual cannot generally disclaim (i.e., relinquish rights to) property, if the disclaimer would result in the property passing for the individual’s benefit. There is an exception to this general rule for disclaimers by a surviving spouse. §2518(b)(4). This may be useful for same-sex spouses who desire the flexibility of allowing the surviving spouse to determine the extent to which a credit shelter trust is funded after the first spouse’s death.

Gift-Splitting. Same-sex spouses will be able to “split gifts” whereby one spouse makes a gift to a third party (but the other spouse does not join in that gift), and both spouses elect to treat the gift as if it came one-half from each. §2513.

Review Existing Estate Plan. Clients should review existing planning documents, such as irrevocable trusts, to determine if they are impacted by the decision (for example, whether same-sex spouses are now considered permissible beneficiaries). Clients should also consider whether they need to revisit their current life insurance plan or beneficiary designations.

Joint Income Tax Returns. After *Windsor*, same-sex spouses will no longer be treated as separate individuals for federal income tax purposes and will be allowed to file joint income tax returns. Same-sex spouses may wish to talk with their advisors about whether they can amend prior separately-filed federal income tax returns as joint returns, which may also involve statute of limitations concerns. Additionally, with respect to same-sex spouses who move to a state that does not permit same-sex marriages, income tax filings may be more complex and cumbersome and separate individual returns may be prudent in some cases. A further complication is that the couple may be treated as spouses for federal income tax purposes but not for state income tax purposes.

Non-Recognition of Gain for Interspousal Transfers. Same-sex married couples may take advantage of the special rule providing that there is no gain recognition for transfers between spouses. §1041.

S Corporation Shareholder. Spouses are treated as one person for purposes of determining the number of shareholders of an S corporation (and that the maximum number of 75 is not exceeded). §1361(b)(1)(A), 1361(c)(1).

Grantor Trusts. There are a number of special rules for spouses in applying the grantor trust rules of §§671-677, 679. (This may result in either an advantage or disadvantage for same-sex married couples, depending on whether or not they prefer that a trust be treated as a grantor trust.) Same-sex couples who have previously created irrevocable trusts should review the trust situation in light of *Windsor* to determine if the decision has changed the grantor trust status of the trust.

Qualified Retirement Accounts. Same-sex spouses will be able to elect a spousal roll-over for a qualified retirement account, thereby potentially extending the ultimate payout of the account.

Jointly Owned Property. The basis and contribution rules with respect to jointly owned property should now be simplified for same-sex spouses (but if they own property in a state that does not recognize same-sex marriage this may not apply). §2040(b).

Marriage Settlement Agreement and Divorce. The favorable tax rules for transfer of property pursuant to a marriage settlement agreement will apply to same-sex spouses. §§1041, 2516. Alimony payments to a same-sex spouse may be deductible (and income to the recipient ex-spouse), or may not produce deductions or taxable income, at the election of the divorcing parties. §71. Qualified Domestic Relations Orders (QDROs), which divide qualified retirement benefits at divorce, will be available to same-sex divorcing spouses.

Community Property. If same-sex spouses live in a community property state, their community property (both halves) will be entitled to a basis adjustment at the first spouse's death. §1014(b)(6).

Generation-Skipping Transfer Planning. Both spouses may apply their GST exemptions to trust transfers. The "reverse-QTIP election" may be made for transfers to a QTIP trust, permitting the first decedent spouse to allocate GST exemption to the QTIP trust. §2652(a)(3).

f. *Additional, Less Favorable Implications***.** Same-sex spouses need to be aware that federal recognition of their marriages may also subject them to less desirable aspects of federal law.

Marriage Penalty. Same-sex spouses with two incomes who previously filed income tax returns as separate individuals will now be required to file either joint or "married filing separate" returns, in either case being subject to the "marriage penalty." (For example, each party could have taxable income of $400,000 before being in the top 39.6% bracket if single, but both spouses together can have only up to $ without being subject to the top bracket. (These top brackets for individuals are adjusted upward to $406,750 and $457,600 and in 2014.) Another example is that the exemption from the 3.8% "Medicare tax" on net investment income is $200,000 for unmarried individuals but only $250,000 for married individuals, §1411(b).)

Mortgage Interest Deduction. Unmarried taxpayers may each benefit by being able to deduct mortgage interest with respect to $1.1 million of debt, whereas married couples may only deduct the interest on a combined maximum of $1.1 million. Thus, same-sex spouses may lose a portion of their mortgage interest deduction.

Employee Benefit Plans. Participants in certain employee benefit plans subject to ERISA will be required to obtain the spouse's written consent before designating anyone other than the spouse (such as a trust) as beneficiary of certain benefit plans.

Regulatory Requirements. Same-sex spouses may be subject to certain regulatory requirements imposed on married couples, such as financial or other disclosures required of federal government employees and their spouses.

Losses. Losses are generally not allowed for transfers between spouses. §267.

Chapter 14. A same-sex spouse will be treated as a family member for purposes of Chapter 14 (for example, common law "GRITS" will not be available to same-sex spouses and the many specific requirements for QPRTs or GRATs must be satisfied if the trust is for the benefit of a spouse, and shareholder agreements involving spouses must satisfy the §2703 requirements). E.g., §§2701(b)(2)(C), 2702(e), 2704(c)(2); Reg. §25.2703-1(b)(3).

Private Foundations. Spouses are treated as "disqualified persons" for purposes of the restrictions on private foundations. §4946(a)(1)(D), 4946(d).

Stock Attribution Rules. Stock ownership owned by a spouse is attributed to a stock owner for purposes of determining whether a stock redemption qualifies for favorable income tax treatment. §318.

Marital Agreements. Same-sex spouses who entered into prenuptial or postnuptial marital agreements have often addressed how the fact that they did not qualify for various income tax benefits affects their property rights vis-à-vis each other. Those agreements should now be reviewed, and future marital property agreements will be structured in light of the *Windsor* result.

State Income Tax. There may be uncertainties regarding the status of the couple for state income tax purposes. For example, Ohio's Constitution recognizes only marriages between "one man and one woman," but the Ohio Tax laws require that a "husband and wife" file a joint income tax return for Ohio purposes if they file a joint income tax return for federal purposes.

Miscellaneous State Law Rights. State Law rights may be impacted by being married (which may be a positive or negative depending on the client's intent). For example, the right to receive an elective share or a family allowance, the right to have preference in court appointed fiduciary appointments, and the ability to convey homesteads or receive homestead protections may be impacted by whether the couple is married for state law purposes.

Disadvantages Exacerbated For Couples Who Cannot Divorce. These detriments may apply on a long-term basis, even if the parties are no longer living together and do not want to be married, if the parties are unable to obtain a divorce. If the couple lives in a state that does not recognize the validity of the same-sex marriage performed in another state, the state of domicile may not recognize that it has any jurisdiction to grant a divorce and the parties may be unable to obtain a divorce in the state in which they were married if they have not both lived in that state for a specified period of time. Some jurisdictions have overcome this barrier. For example, effective August 16, 2013, non-resident spouses married in Canada may obtain a divorce in the province where their marriage was performed if (a) the spouses have lived separate and apart for at least one year, (b) neither spouse resides in Canada when applying for divorce, and (c) both spouses reside, and have resided for at least one year immediately preceding the application, in a state that will not grant them a divorce because that state does not recognize their marriage. Delaware, the District of Columbia and Vermont allow divorce of same-sex spouses without a residency requirement for same-sex spouses married in those jurisdictions if the couple lives in a state that will not dissolve their union (Vermont has several other requirements as well). For a good resource of current law on the availability of divorce for same-sex couples who live in non-recognition states, see the National Center for Lesbian Rights website.

g. *Impact on State Law Issues*. In *Hollingsworth, et al. v. Perry et al.*, 133 S. Ct. 2652 (2013), the Supreme Court let stand lower court decisions holding that California's Proposition 8 (which said that only a marriage between a man and a woman would be valid in California) was unconstitutional. (The Supreme Court did not reach the merits of the constitutional issue but held that the individual citizens who brought the case did not have standing to pursue the case.) In *Windsor*, the Supreme Court did not address Section 2 of DOMA, which allows states to refuse to recognize same-sex marriages performed under the laws of other states.

This issue will be addressed by future courts. (Ultimately, it is likely that the Supreme Court will address the constitutionality issue.) The outcome will impact a number of important estate planning issues for same-sex couples, including elective share rights, homestead rights, allowances for spouses, and community property rights.

The first post-*Windsor* case to address the issue is *Obergefell v. Kasich,* Case No. 1:13-cv-501 (S.D. Ohio Western Divn, July 22, 2013). The federal district court awarded a temporary restraining order compelling the state registrar of death certificates to later record the deceased person in a same-sex marriage as "married," notwithstanding state law prohibiting the recognition of same-sex marriages from other states. The federal court held that the state law would likely not survive constitutional muster. The basic facts are that James and John are Ohio residents and had been in a committed relationship for 20 years. During the course of John's hospice treatment, the couple flew to Maryland in a special medically equipped jet, were married on the tarmac in Maryland, and then flew home that same day. John has ALS and is certain to die soon. The couple sued for an order declaring as unconstitutional an Ohio law forbidding recognition of legal same-sex marriages from other states, and moved for a preliminary injunction ordering the state registrar of death certificates, upon John's later death, to record his status as "married" with James as his spouse. The Ohio federal court granted the preliminary injunction to the couple on the grounds that: (1) they are legally married in Maryland; (2) following the U.S. Supreme Court decision in *Windsor*, they have a substantial likelihood of prevailing at trial and success on the merits because the Ohio law violates the U.S. Constitution; (3) without a temporary restraining order, the last official record of John's life will be incorrect, will fail to recognize his spouse, will hinder his burial with his spouse at a family plot that is limited to family and spouses (or his burial will be delayed or exhumation will be required, and there will be irreparable emotional hardship during his end of life period; (4) there is no harm to the state or its citizens from granting the order; and (5) the public interest is promoted by the robust enforcement of constitutional rights.

A somewhat similar state law case is *O'Connor v. Tobits*, No. 2:1-cv-00045 (Dist. Ct. E. Pa, July 29, 2013). The surviving spouse of a same-sex couple who married in Canada and resided in Illinois (which recognized the validity of the marriage) did not sign a waiver of the right to receive survivor benefits of a qualified profit sharing plan. The decedent's parents were named as the beneficiary. The Retirement Equity Act of 1984 requires automatic survivor benefits that can be waived only with the proper consent of the participant and spouse. The court determined that the survivor is the "surviving spouse" under the *Windsor* case and ruled that the surviving spouse is entitled to the benefits rather than the parents because she did not consent to a waiver of the survivor benefits.

h. *State Tax Effects.* A huge uncertainty is how Windsor will affect state income taxes. There are 24 states that do not recognize same-sex marriages but require taxpayers to refer to the federal gross incomes in calculating state income taxes. For married individuals, the federal gross income is the combined income on the spouses' joint federal income tax return. It appears that many states are requiring the same-sex couple—whose marriage is now recognized for federal income tax purposes but will not be recognized in those states for state income tax purposes—to prepare "dummy" federal returns for two single taxpayers. Oregon released a directive taking this position on October 18, 2013:

> "Such individuals who file a federal income tax return as married filing jointly or married filing separately must each complete a separate pro forma federal return for North Carolina purposes with the filing status of single or, if qualified, head of household or a qualifying widow(er) to determine each individual's proper adjusted gross income, deductions and tax credits allowed under the Code of the filing status used for North Carolina purposes, and then attach a copy of the pro forma federal return to the North Carolina return."

This same issue may arise for state estate tax purposes. Four of the states with a state estate tax do not recognize same-sex couples. In those states, will a dummy federal estate tax return (prepared as if the marriage was not recognized for federal tax purposes) be required to be filed with the state estate tax return?

i. *Conclusion and Caution*. It is clear that the Windsor decision will provide numerous planning opportunities and benefits to same-sex spouses that were not previously available. There will, however, also be costs, the uncertainty of major unresolved constitutional questions, and complications arising from state legislative reactions to Windsor and the seemingly inevitable future litigation. Differences between federal and state law in this respect may add some complexity to planning, but the federal benefits are almost certain to justify dealing with that complexity.

30. Installment Sales to Grantor Trusts and Spousal Grantor Trusts

An installment sale to a grantor trust is a traditionally used strategy for shifting future appreciation, primarily through (1) the grantor's payment of the trust's income taxes under the grantor trust rules, (2) future appreciation of the sold assets in excess of the interest rate on the note to the grantor (typically using the AFR as the interest rate), and (3) fractionalization discounts. For a brief summary of best practices regarding sale to grantor trust transactions, see Item 14 of the "2012 Heckerling Musings and Other Current Developments" (summarizing a panel discussion by John Bergner, Ann Burns and David Handler) found here.

A corollary strategy is a sale to a "spousal grantor trust." If a sale is made to a grantor trust for the client that is created by the client's spouse, no gain would be recognized on the sale transfer as a result of §1041. As with "standard" sales to grantor trusts, the combined income/appreciation of the trust assets in excess of the small interest rate on the note will be excluded from the client's estate. The client may be particularly willing to engage in transfer planning opportunities with this trust because the client is a discretionary beneficiary of the trust.

A particular tax advantage of this transaction is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. That portion of the trust would continue to be included in the grantor's estate, but the client would have achieved the goal of transferring as much as possible at the lowest possible price without current gift tax exposure. Gain would not be recognized on the sale, but a downside to this approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments (although the spouse would likely receive an offsetting investment interest deduction). *Gibbs v. Commissioner,* T.C. Memo 1997-196.

A concern with this approach is that the full appreciation in the asset that is "sold/given" to the trust would be included in the grantor's gross estate, less a §2043 consideration offset for the value of the consideration (i.e., the note amount). A preferable approach would be to use a defined value transfer approach, to transfer a fraction of an asset in the sale transaction. For example, if the asset is believed to be worth $1 million, the formula could transfer a fraction of the asset with a numerator of $1 million and a denominator equal to the finally determined gift tax value of the property. The combined defined value clause and incomplete gift trust gives protection against the gift tax and minimizes potential estate inclusion.

Another approach is to use two trusts. For example, H funds Trust A with, say, $200,000. W funds Trust B with $10. W has a testamentary power of appointment over both trusts. The trust agreement provides that transfers to the trustee will generally be allocated to Trust A, but any gifts from W will be allocated to Trust B. W sells Blackacre (which she thinks is worth $1 million) to the trusts in return for a note from Trust A for $1 million. Effects of this approach are as follows.

- Seed Gift Required. A significant seed gift to the trust will be necessary before the spouse makes the sale.
- W is a Discretionary Beneficiary and Has a Power of Appointment. W is a discretionary beneficiary and has a power of appointment over the trust, which means that W will be more comfortable selling favorable assets to the trust without fear of losing control and having no beneficial interest in the assets. Even so, all of the appreciation will be excluded from her estate (but if Blackacre is worth more than $1 million, the fractional portion of the excess value will be included in her estate).
- Income Tax. There is no gain recognition on W's sale to H's grantor trust. §1041. However, the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments (although the spouse would likely receive an offsetting investment interest deduction). Gibbs v. Commissioner, T.C. Memo 1997-196.
- Gift Tax. W will not make a gift even if Blackacre ends up being worth more than $1 million (because she has a testamentary power of appointment).
- Estate Tax Effect for H. The trusts are designed so that the trusts are not included in H's estate.
- Estate Tax Effect for W. W could be a potential beneficiary of the trusts. However, even if she is a beneficiary, Trust A should not be included in her estate because she never made a gift transfer to Trust A. The advantage of using the separate Trust B is that if there is a gift element in the transfer of Blackacre the fractional portion of Blackacre represented by the gift would pass to Trust B, so that none of the appreciation in the portion equal to $1 million that passed to Trust A will be included in W's gross estate. (If a single trust had been used, and if a portion of the transfer was deemed to be a gift, the entire appreciation in Blackacre might be included in W's estate less a §2043 consideration offset for the $1 million note.)
- Creditors. To the extent that Blackacre is worth $1 million, W has not made a gift to a trust of which she is a discretionary beneficiary, so W's creditors should not be able to reach the trust. To the extent that Blackacre is worth more than $1 million, the excess portion would be a gift from W to a self-settled trust that could be reached by her creditors (unless the trust is established in a "self-settled trust state").

Possible disadvantages of this strategy are: (i) a substantial seed gift to the trust will be necessary before the client makes the sale to the trust; (ii) there is a potential step transaction risk; and (iii) if the client is deemed to be the "transferor" of the property that is sold to the trust, the client's creditors may be able to reach the trust assets.

31. Installment Sales by Beneficiary to Section 678 Trust

a. *Overview*. If the trust does not contain any provisions that would cause the original grantor to be treated as the owner of the trust for income tax purposes under the grantor trust rules, a beneficiary who has a withdrawal power over the trust may be treated as the owner of the trust for income tax purposes under §678. The IRS generally treats the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under §678(a)(1) while the power exists and under §678(a)(2) after the power lapses if the holder has interests or powers that would cause §§671-677 to apply if such person were the grantor of the trust (and that is typically satisfied by the reference to §677 if the power holder is also a beneficiary of the trust). See Ltr. Ruls. 201216034, 200949012, 200011058, 200011054 through 200011056, 199942037, & 199935046.

   After the trust has been funded, the beneficiary might sell additional assets to the trust in return for a note. If the beneficiary is treated as the owner of all of the trust under §678 for income tax purposes, there would be no gain recognition on the sale. The trust would not be included in the beneficiary's estate and future appreciation in the assets sold to the trust in excess of the low interest charge on the note would be removed from the beneficiary's estate. The decision to transfer value to the trust would be an easy decision because the beneficiary is a discretionary beneficiary of the trust (and could hold a power of appointment with respect to the trust.)

b. *Example of Potential Advantages of This Strategy.* For example, a client's parents might create a trust for the client, and contribute $5,000 to the trust, with a Crummey power that would lapse after 30 days (before any growth occurred). The goal is that the beneficiary would be treated as the owner of the entire trust for income tax purposes under §678. Because the beneficiary never makes a gift to the trust, the trust assets would not be included in the beneficiary's estate under the "string" statutes, the beneficiary could serve as the trustee of the trust, and the trust should not be subject to the beneficiary's creditors if it contains a spendthrift clause. Furthermore, the trust could give the client a broad limited testamentary power of appointment. If the client has a testamentary power of appointment, any gifts to the trust as a result of the IRS asserting that the sale price is insufficient would result in an incomplete gift, not subject to immediate gift taxes. [The trustee could then divide the trust into "exempt" and "non-exempt" portions if the trust has a typical provision authorizing the trustee to divide the trust into identical separate trusts; the incomplete gift portion would be included in the client's estate at his or her subsequent death, but lifetime distributions to the client could first be made out of the non-exempt portion to minimize the estate tax liability.]

   In many ways, this is a perfect estate planning vehicle for the client. If the client can build the value of the trust through special investment opportunities, for example, the client can build a source of funds that is available to the client (as a beneficiary) but that is not in the client's estate for estate tax purposes and cannot be reached by the client's creditors. Such leveraging might occur through sales to the trust after the lapse of the Crummey power. In order to provide a 10% (or more) "seeding" of the trust to support the note given by the trust, persons other than the grantor (such as the grantor's spouse or a beneficiary) might give guarantees, paid for by the trust. (An advantage of having the grantor's spouse give the guarantees is that if there is any gift element in the guarantee, that would not prevent having a fully grantor trust during the life of both spouses.) Sales to the trust may be able to take advantage of valuation discounts, and can accomplish an estate freeze by limiting the build-up in the client's estate (that otherwise result from the assets that were sold to the trust) to interest on the note.

The trust can deplete the client's other estate assets to the extent that the client pays income taxes on the trust income out of other assets. The depletion aspect is not as dangerous as other grantor trusts where the grantor may be subject to paying larger income taxes than anticipated; in this situation, the client is also a beneficiary of the trust, so distributions may be made to the client to assist in making the income tax payments after the client has "burned" as much of his or her other assets as desired through the income tax payments. Richard Oshins, of Las Vegas, Nevada, refers to this as incorporating "a freeze, a squeeze, and a burn." The freeze is the obvious freeze of future appreciation on assets acquired by the trust, the squeeze is taking advantage of valuation discounts, and the burn is depleting the client's other assets in making the income tax payments. In order to make a substantial sale to the trust that has been funded with a relatively small amount by the client's parents or other relatives, the planner may decide to use guarantees and to have the trust pay fair value for the guarantees. For an excellent discussion of planning considerations, see Oshins, *The Beneficiary Defective Inheritor's Trust ("BDIT")* (2008).

c. *Recent Letter Ruling.* A recent private letter ruling was consistent with the prior rulings that have ruled that the trust is treated as owned by the Crummey power holder/beneficiary under §678. Ltr. Rul. 201216034. In that ruling the beneficiary had a non-fiduciary substitution power, and the ruling reasoned that the existence of the non-fiduciary substitution power constituted the requisite retained interest or power that would cause §675 to apply if the power were held by the grantor. That ruling, like many of the other rulings issued by the IRS acknowledging that §678 applies to the trust, involved a trust that held S corporation stock, and the ruling held that the trust was a qualified shareholder of the S corporation, because it is a grantor trust.

   The ruling appears to be wrong — because the existence of the beneficiary's non-fiduciary substitution power causes the trust to be a grantor trust as to the original grantor (and §678(b) makes clear that the trust is not treated as owned by the power holder under §678(a) if the original grantor is treated as the owner). The IRS has made clear that third-party substitution powers (held by someone other than the grantor) cause the grantor trust rules to apply as to the grantor. Rev. Proc. 2007-45. (Letter Ruling 9311021 similarly concluded (apparently inadvertently and incorrectly) that a trust with a third party substitution power was a grantor trust as to the holder of the substitution power.)

d. *IRS No-Ruling Position.* There have been informal indications from the IRS that the IRS is likely to continue to give favorable §678 rulings for a trust that receives or purchases S corporation stock. The IRS will no longer issue §678 "comfort" rulings in other situations to trusts about to engage in leveraged transactions.

The IRS formally announced in Rev. Proc. 2013-3 that it will no longer issue private rulings that the trust assets in this type of situation will be excluded from the beneficiary's estate under §§2035, 2036, 2037, 2038 or 2042, that the sale will not be treated as a taxable gift under §2501, or that §2702 will not apply. This no-ruling position applies in situations in which the beneficiary meets the requirements of §678 to be treated as the owner of the trust and sells property to the trust for a note, and "the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property that is purchased." Rev. Proc. 2013-3, §§4.01(48)-(52), (55), 2013-1 IRB 113 (Jan. 2, 2013).

Rev. Proc. 2013-3 also adds that the IRS will not issue rulings under §678 "if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased." *Id*. §4.01(43).

e. *Summary of Tax Risks.* (i) There is a risk of estate tax inclusion under §§2036 and 2038 if the sale is not deemed to be a "bona fide sale for an adequate and full consideration." Reporting the sale on a gift tax return that meets the adequate disclosure requirements may assist in providing cover as to this issue. (ii) If the seed gift is insufficient to support the note, having another trust guarantee the note in exchange for fees may be necessary. (iii) If such guarantees are unreasonably high compared to the net value of the trust, courts may view that as an indication that the sale is not a "bona fide" transaction for purposes of §§2036 and 2038. (iv) If the beneficiary is deemed to be the "transferor" of the property that is sold to the trust, the beneficiary's creditors may be able to reach the trust assets. Therefore, creating the trust in a self-settled trust state may be advisable.

f. *Selected Technical Issues*. The IRS's position under §678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the "release or modification" of a withdrawal power. This arguably is not the same as the mere lapse of a withdrawal power. A "release" requires an affirmative act whereas a "lapse" is a result of a passive nonexercise of a power. Furthermore, the gift and estate tax statutes make a distinction between lapses and releases. [Sections 2041b)(2) and 2514(e) provide that "the lapse of a power … shall be considered a release of a power."] Despite this argument, the IRS clearly treats the beneficiary as an owner of the trust with respect to lapsed withdrawal rights.

   A further complication is that under §678(a), grantor trust treatment applies to "any portion" of a trust as to which the power of withdrawal exists and has been released while reserving control that would cause §§671-677 to apply if such person were the grantor of the trust. The regulations discuss the "portion" issue in Treas. Reg. §1.671-2(e)(6) Ex. 4. In that example, the beneficiary holds an unrestricted power to withdraw "certain amounts contributed to the trust." The example concludes that the beneficiary is treated as an owner of "the portion of [the trust] that is subject to the withdrawal power." Some planners believe that the "portion" refers to a fractional interest rather than an amount, so that if all gifts are subject to withdrawal power by the beneficiary, the entire trust would be treated as owned by the beneficiary under §678. However, the term "portion" might refer to the amount that can be withdrawn by the beneficiary, which would exclude growth in the trust from the time of the contribution to the time of the release of the withdrawal right. Under that view, if the initial contribution of $20,000 is covered by a withdrawal power, but the trust is worth $100,000 at the beginning of year 2, only 20,000/100,000, or 20% of the trust would be treated as owned by the beneficiary in year 2. [Observe that under this approach, in all of the private letter rulings that have been issued treating the Crummey power holder as the owner of a trust owning S stock, there would no longer be a wholly grantor trust if there were any growth in the assets before the withdrawal power lapsed, which would cause the trust no longer to be a qualified S shareholder under the grantor trust exception. None of the S stock/Crummey trust PLRs have even hinted at that limitation. Furthermore, this approach would require revaluing Crummey trusts each year in order to determine the portion of the trust that is attributable to the power holder and the portion that is attributable to the trust. It presents an administratively unworkable reporting requirement.]

32. Sale of S Corporation Stock by Beneficiary to QSST

If a beneficiary consents to a qualified subchapter S trust (QSST) election, the beneficiary "is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election is made." Reg. §1.1361-1(j)(8), referring to §1361(d)(1). Accordingly, the beneficiary is taxed on the K-1 income of the trust from the S corporation. Could the beneficiary also sell additional S stock in that same corporation to the trust and avoid having the sale treated as a taxable transaction? Presumably that is allowed because the beneficiary is treated as the owner of the portion of the trust holding the S stock — both before the sale and after the sale of additional S stock to the trust. (Rev. Rul. 85-13 said that a sale by the grantor to a trust that was not a grantor trust in return for a note without adequate security caused the trust to become a grantor trust and shielded that very sale from being a taxable sale. This seems to be an easier situation because the trust indeed is a grantor trust as to the S stock both before and after the sale.) However, note that the QSST regulations do not explicitly address whether a sale to the trust of additional S stock in the same company by the consenting beneficiary will be taxed as a sale by the beneficiary to the beneficiary's grantor trust — and therefore non-taxable.

The strategy has advantages over the sale to §678 trust described above because there is no $5,000 limit that might otherwise apply to contributions to "seed" the trust, there are no technical issues regarding the "lapse" or "partial release" of a power of withdrawal. Being able to have considerably more value in the trust prior to the sale assists in defending against potential §§2036/2038 arguments about the bona fides of the sale.

If the beneficiary sells S corporation stock to the QSST in return for a note, it is imperative that the stock serve as collateral for the note. A QSST must distribute all net accounting income as determined under state law to the beneficiary, §1361(d)(3)(B), referring to §643(b). A sale of S stock to a QSST raises the question of whether distributions from the S corporation to the trust must be entirely distributed to the beneficiary or whether some portion could be used to make principal and interest payments on the note. The interest payments should be fine — because they reduce net accounting income that must be distributed to the beneficiary. Some portion of the payment may also be used to make principal payments, as summarized by Stacy Eastland:

The distributions on the purchased Subchapter S stock can also be used by the trustee of the QSST to retire the principal on the note, if the distributions are security for a note on which the QSST is the obligor. Compare the interaction of Secs. 502(b) and 504(b) of the Uniform Principal and Income Act. There may need to be an equitable adjustment between the principal and income of the trust when the distributions from purchased Subchapter S stock are used by the trustee of the QSST to retire principal of the debt used for that purchase, depending upon the interaction of Secs. 502(b) and 504(b)(4) of the Uniform Principal and Income Act. The fact that Subchapter S distributions are part of the security for the debt, and are used to retire the principal of the debt, does not disqualify the trust from being a QSST [citing Ltr. Rul. 200140046].

33. Transfers Involving Family Limited Partnerships or LLCs

a. *Family Limited Partnership/LLC Planning Checklists*. Stephanie Loomis-Price (Houston, Texas) suggests the following checklists for properly maintaining FLPs/LLCs and structuring transfers of interests in FLPs/LLCs.

(1) *Weakest Link.* Sound advice to clients is that the strength of a family limited partnership is determined by the weakest link in the structure and implementation of the partnership. Very often, planning and structuring of the partnership is excellent, but significant problems arise in the implementation, administration, and maintenance of the partnership over the years.

(2) *Post Formation Audits.* Consider conducting post-formation audits of FLPs. When a tax controversy arises, the client who created and funded the FLP is probably not going to be available. It will be the advisors who will explain the purpose of the FLP and how it was operated. Some planners prefer to schedule partnership meetings and prepare minutes of the meetings describing activities of the partnership.

(3) *Checklist of Ideas for FLP Maintenance.*

- File required annual filings; memorialize all significant partnership decisions.
- Comply with the terms of the partnership agreement.
- Comply with loan terms, if loans are made.
- Make any distributions pro rata (and pursuant to terms of the partnership agreement).
- Refrain from the personal use of partnership assets (at least unless fair rental is paid) or using assets for the partners' personal obligations.
- Refrain from having the partners individually pay partnership obligations.
- Encourage partners to maintain current and accurate books and records.
- Avoid the following as recurring transactions between the partners and the partnership: loans, redemptions, non-regular distributions, non-pro rata distributions.

- Review the non-tax reasons for forming the partnership and follow them.
- Establish a protocol for administering the partnership in accordance with the requirements of the agreement.

(4) *Checklist of Ideas Regarding Review of Transfers of FLP Interests*.

- Review books and records of the partnership prior to transfers.
- Amend the Certificate of Limited Partnership, if necessary.
- Execute appropriate transfer documents concurrent with transfers to the FLP.
- Consider the effect of transfers if a §754 election is in effect.
- Wait until after the partnership is fully funded and operational to begin gift planning.
- Abide by transfer restrictions in the partnership agreement.
- Carefully consider tax consequences of transfers.
- Retain the services of an independent and qualified appraiser.
- Encourage open communication with appraisers; do not conceal information from the appraiser.
- Be specific about what interests need to be valued.
- Be aware of IRS settlement guidelines.
- Do not round down on appraisals and returns.
- Carefully review the appraisal report and request revisions if it is not easy to understand.

b. *Marital Deduction Mismatch General Issue If §2036 Applies to Married Decedent*. The general marital deduction mismatch issue arises when assets are included in the gross estate of the first-decedent spouse. The IRS has argued in several cases that while the full asset value is included in the gross estate, all the estate has to leave to the surviving spouse is a limited partnership interest (because it does not own the partnership assets directly), and that a marital deduction should be allowed only for the discounted value of the limited partnership interest. That is all the estate owns to "pass" to the surviving spouse, as described in §2056. In effect, the IRS argues that the tax fiction that applies for purposes of the value to be included in the gross estate under §2036 should not also apply consistently for purposes of the marital deduction. The IRS has made this argument in *Estate of Black v. Commissioner*, 133 T.C. 340, 342 (2009) and *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21. The court did not have to address the marital deduction mismatch issue in either of those cases because the court held that §2036 did not apply in those cases. Footnote 5 of "*Turner II*" [138 T.C. No. 14 (2012)] briefly discusses the marital deduction mismatch issue and the Tax Court's prior references to the issue in *Estate of Black* and *Estate of Shurtz*.

The court observes that the general marital deduction mismatch issue does not arise in this case, because the government's computation for entry of decision

> allowed an increased marital deduction that he calculated on the basis of the value of assets transferred in exchange for the partnership interests that Clyde Sr. held at death, rather than on the basis of the discounted values of the general and limited partnership interests that Clyde Sr. owned at death, to the extent that they passed to Jewell. The estate recognizes that, and we leave this mismatch problem for another day. (Emphasis added.)

It is not clear whether the IRS inadvertently failed to raise the valuation mismatch argument. Perhaps it did not do so because the surviving wife was the sole general partner and the agreement may have permitted her unilaterally to decide to liquidate the partnership at any time.

For an excellent discussion of the marital deduction mismatch issue and Turner II, see Blattmachr, Gans & Zeydel, Turner II *and Family Partnerships: Avoiding Problems and Securing Opportunity*, 117 J. TAX'N 32 (July 2012) and Loomis-Price & Angkatavanich, Turn(er)ing the Tables on Taxpayers: The Marital Deduction Mismatch Strikes Again, TRUSTS & ESTATES 18 (July 2012). Among other things, the Blattmachr, Gans & Zeydel article discusses possible planning strategies to avoid the marital deduction mismatch issue, including (1) providing in the partnership agreement and in any trust to which a partnership interest is transferred that if the interest is included in a married deceased partner's estate, the interest would pass in a form qualifying for the estate tax marital deduction (a "contingent marital deduction provision" as routinely found in irrevocable life insurance trusts), and/or (2) stating in the partnership agreement that with respect to any partnership interest inherited by the surviving spouse, he or she would have "a unilateral right to 'put' the partnership units to the partnership in exchange for a pro rata portion of the underlying partnership assets to the extent the underlying partnership assets are included in the deceased spouse's gross estate." Id. at 44. As to the put right strategy, also see Matz, *Special Concerns in FLP Planning Where Both Spouses Are Living*, 34 EST. PL. 16 (Jan. 2007).

c. *Strategy for Transfers to FLP/LLC To Achieve Valuation Discounts With Minimal §2036 Risk.* Jonathan Blattmachr suggests the following strategy to minimize the §2036 risk. One spouse (for illustration purposes, assume the Wife) forms a small limited partnership. Wife's general partnership interest would allow her to liquidate the partnership at any time pursuant to the terms of the partnership agreement. Husband makes a very large contribution to the partnership as a gift to Wife that qualifies for the marital deduction. Rev. Rul.71-443, 1971-2 C.B. 337, relying on reasoning of Reg. §25.2511-1(h)(1)(gift to corporation is treated as proportionate gift to the shareholders). If Husband predeceases Wife, §2036 should not apply because he retained no interest or control. At Wife's death, even though she received large distributions from the partnership, the only interest that would be included in her estate under §2036 would be the interest that is attributable to her small initial contribution. If Wife leaves her interest in the partnership to Husband, §2036 could not apply at Husband's subsequent death to the interest that Husband receives from Wife by inheritance from her. Rev. Rul. 84-179, 1984-2 C.B. 195, adopting the rationale of *Estate of Skifter*, 468 F.2d 699 (2d Cir. 1972) (testamentary transfer from donee-spouse to original transferor spouse viewed as unrelated to initial transfer). If Husband later sells or gives the general partnership interest to assure that partnership interest would not be valued in his estate on a liquidation basis, §2035 should not apply because §2036 cannot apply to that transfer since Husband did not make a transfer in return for the general partnership interest.

The effect of this strategy is that a happily married couple could create an FLP or LLC without §2036 risk and be able to achieve valuation discounts at the death of the surviving spouse when estate taxes would be due. The strategy is explained and analyzed in detail in Blattmachr, Gans & Zeydel, Turner II *and Family Partnerships: Avoiding Problems and Securing Opportunity*, 117 J. TAX'N 32 (July 2012).

d. *Strategy to Be Able to Purchase FLP Assets Without Gain Recognition*. Assume that an individual has created a family limited partnership and has made gifts or sales of limited partnership interests to a grantor trust. The client wants to keep the FLP intact, but is concerned that there are low basis assets inside the partnership. Jonathan Blattmachr suggests that the partnership should be structured as a disregarded entity. The general partnership interest would be a grantor trust, and the limited partnership interest would be held either by the client or in another grantor trust that would receive limited partnership interests by gifts or sale. Because the partnership is a disregarded entity, the client can purchase assets from the partnership for cash or other high basis assets without any gain recognition.

e. *What Situations Can Satisfy the Bona Fide Sale Exception to §2036?* Courts now use the standard for the bona fide sale exception to §2036 for FLPs that was announced in *Bongard v. Commissioner* [124 T.C. 95 (2005)] — there must be a legitimate and significant nontax reason for the partnership. If the planner wishes to avoid §2036 with respect to assets contributed to an FLP, see if one of the following special circumstances might apply to the specific facts of the family situation. These are the special situations that have been recognized by cases as meeting the "legitimate and significant nontax reasons" test.

- Large block of voting stock in closely held corporation, *Black v. Commissioner*
- Joint management and keeping a single pool of assets for investment opportunities, patent royalties and related investments, *Mirowski v. Commissioner*
- Closely held business; resolution of family litigation regarding active management of closely held business, *Stone v. Commissioner*
- Maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests, *Kimbell v. United States*
- Perpetuating buy-and-hold investment philosophy for du Pont stock, *Schutt v. Commissioner*

- Preserve family ranching enterprise, consolidate undivided ranch interests, *Church v. United States*
- 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, *Bongard v. Commissioner*
- Continue investment philosophy and special stock charting methodology, *Miller v. Commissioner*
- Protect family assets from depletion in divorces, *Keller v. United States*
- Centralized management and prevent dissipation of family "legacy assets," *Murphy v. Commissioner*
- Asset protection and management of timberland following gifts of undivided interests, *Shurtz v. Commissioner*
- Managing woodland parcels as a family asset for later development and sales of lakeside homes, *Stone v. Commissioner*
- Ensuring equal distribution of estate among children thereby avoiding litigation, effective management and minimizing potential liability for operation of quarries and other real estate properties requiring active management, *Kelly v. Commissioner*

f. *"Scorecard" of §2036 FLP Cases (13-21, With 2 on Both Sides)*. Of the various FLP/LLC cases that the IRS has chosen to litigate, thirteen have held that at least most of the transfers to an FLP qualified for the bona fide sale exception. Including the partial inclusion of FLP assets in two cases, 21 cases have held that §2036 applied to FLP or LLC situations. For a listing of these respective cases, see Item 17.c of the December 2012 summary, "Estate Planning Current Developments and Hot Topics" found here.

34. Intra-Family Loans and Notes

a. *Examples of Uses*. Examples of intra-family loans and notes include loans to children or grantor trusts, sales to children or grantor trusts for notes, loans between related trusts (for example to freeze the value of a Marital Trust or GST non-exempt trust), home mortgages for family members, loans for consumption, loans from children to parents for relatively high interest rate notes, and notes to document loans that a client borrows from a gift trust in case the client later has liquidity needs or needs to borrow funds in order to pay income taxes with respect to the grantor trust income.

b. *Advantages*. Intra-family loans present a very simple alternative for transferring significant value through the arbitrage of using very low interest rates (i.e., the AFR). For example, using the January 2014 mid-term AFR of 1.75% for a $1 million loan to a child in return for a nine-year balloon note, about $520,000 would be transferred to the child if the child can invest the assets to return 6% per year. Other advantages include that interest payments remain within the family, the loans may present the only financing available for family members with poor credit history, and formal closing costs the banks would require could be avoided. If loans are made to a grantor trust, there would be no recognition of interest income or the complexity of OID computations.

c. *Upfront Gift If Intent to Forgive Loan?* Revenue Ruling 77-299 concludes that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect the note, the note will not be considered valuable consideration and the donor will have made a gift at the outset to the full extent of the loan. There were prior contrary cases. The better approach seems to be that, even if there is an intent to forgive the note payments from the outset, the transfer should not be treated as a gift initially. (1) The donor is free to change his mind at any time, (2) his interest in the note can be seized by a creditor or bankruptcy trustee, who will surely enforce it, and (3) if the lender dies, his executor will be under a duty to collect the note. However, the IRS position is clear from Rev. Rul. 77-299. If there is no prearranged plan and the intent to forgive the debt arises at a later time, the donor will have made a gift only at the time of the forgiveness. Rev. Rul. 81-264.

d. *Structure Loan as a Bona Fide Loan*. The IRS presumes a transfer of money to a family member is a gift, unless the transferor can prove he received full and adequate consideration. Avoid the IRS gift presumption by affirmatively demonstrating that at the time of the transfer a bona fide creditor-debtor relationship existed by facts evidencing that the lender can demonstrate a real expectation of repayment and intention to enforce the debt. Treatment as a bona fide debt or gift depends on the facts and circumstances. A wide variety of cases, in various contexts, have addressed what is required to establish that the loan is a bona fide loan rather than an equity transfer. *E.g. Estate of Lockett v. Commissioner,* T.C. Memo. 2012-123. Factors that help to establish that the loan is bona fide include the following: sign a promissory note; establish a fixed repayment schedule; use a reasonable interest rate (the AFR should do), secure or collateralize the debt; expect and demand repayment; maintain records that reflect a true loan transaction; repayments are actually made; borrower solvency; and do not have a prearranged schedule to forgive the loan.

e. *Use an Interest Rate at Least Equal to the AFR for Cash Loans*. Under §7872 a demand or term loan with an interest rate at least equal to the AFR (determined under §1274) is not a below market loan. Sections 1274 and 7872 (passed soon after the *Dickman* Supreme Court case) seems to contemplate cash loans between individuals, but under case law the exchange of property for a note is also determined under §7872 and as long as the loan bears interest at a rate equal to the AFR for the month in question, there is not a deemed gift attributable to the note. *See Frazee v. Commissioner*, 98 T.C. 554, 588 (1992); *True v. Commissioner*, T.C. Memo. 2001-167, *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004). There is no explicit authority for using the AFR for loans between trusts, though the concepts seem to apply.

Section 7872 addresses the gift and income tax consequences of using a below market note. Forgone interest is computed by comparing the present value of all payments due under the loan (discounted using the appropriate AFR) and with the actual loan amount; if the present value is less, there is forgone interest. Forgone interest is deemed to have been transferred from the lender to the borrower as a gift, and then from the borrower to the lender as interest income.

> Income tax treatment: The forgone interest is imputed as interest income on the last day of each taxable year.
>
> Gift tax treatment: For demand loans, the foregone interest each year is deemed to be given on December 31 (or when the loan is repaid). For term loans, 100% of the foregone interest is treated as a gift upfront when the loan is made.

f. *Generally Use Term Loans Rather Than Demand Loans*. For a demand loan, the stated interest rate is compared to the AFR throughout the loan, and gifts will result for any period during which the stated interest rate is less than the AFR for that period. For term loans, however, the stated interest rate is compared to the AFR at the time the loan is originated to determine if the loan results in a gift. In light of this treatment, using term loans has two distinct advantages. (1) There is no complexity of repeatedly determining the appropriate AFR for any particular period, but the AFR at the origination of the loan controls. (2) During the current incredibly low interest rate environment, there will be no gift tax consequences for the entire term of the note as long as the interest rate of the term note is at least equal to the AFR when the note is originated.

g. *How to Determine Interest Rate for Demand Loans and Term Loans*. For demand loans, use the lower of the short-term AFR in effect the month the loan is made or the 1st month of the semiannual period (January or July). The rate is reset every 6 months to the short-term AFR for January and July. For loans that remain unchanged during the year, the interest is computed using the annual Blended rate (published annually in the July AFR ruling issued about June 20 – the 2012 Blended Rate is 0.22%).

   For term loans, the appropriate AFR is the rate in effect for the month the loan is made based on the term of the loan: short-term (3 years or less); mid-term (over 3 years but less than 9 years); long-term (over 9 years). The rate continues to apply over the life of the loan despite future rates fluctuation. For sales transactions, the appropriate AFR is based not on the term of the note but its "weighted average maturity," and the lowest AFR for the 3 months ending with the sale date can be used. I.R.C. §1274(d)(2)(3-month provision); Treas. Reg. §1.1274-4(c)(weighted average maturity description).

h. *Accrued Interest Generally Must be Recognized Each Year Even by Cash Basis Taxpayers*. If a note requires interest at the AFR but the interest accrues and is not actually payable each year, the original issue discount (OID) rules will apply. There are a few exceptions to the OID rules, but generally the OID rules require that a pro rata amount of the overall amount of the OID over the life of the loan must be recognized each year as ordinary income, even for cash basis taxpayers. §1272(a). The OID complications are avoided if the loan/note transaction is between a grantor and that person's grantor trust.

i. *Forgiving Debt Should Not Result in Income Recognition to Borrower and May Not Result in the Seller Having to Recognize Accrued But Unpaid Interest as Income*. The borrower should not have discharge of indebtedness income if the note is forgiven because §102 excludes gifts from the definition of gross income. *Helvering v. American Dental*, 318 U.S. 322 (1943).

The seller may not have to recognize accrued interest as income. By negative implication, the proposed regulations indicate that accrued interest under a note providing stated interest will not be recognized as income if the accrued interest is forgiven as long as the forgiveness "include[s] in substantial part the loan principal." Prop. Reg. §1.7872-11. The proposed regulations have been outstanding for decades but have never been finalized. However, these regulations appear to provide a reporting position that the lender will not have to recognize the unpaid interest (that has not previously been recognized under the OID rules) that is forgiven if the forgiveness includes "in substantial part" the loan principal. Do not consistently forgive accrued interest each year; that may be a factor in determining whether there is a bona fide loan.

j. *Discounting Notes in Subsequent Transactions May Be Possible*. Under gift and estate tax regulations, the value of a note is the unpaid principal plus accrued interest, unless the evidence shows that the note is worth less (e.g., because of the interest rate or date of maturity) or is uncollectible in whole or in part. A wide variety of cases have valued notes at a discount from face based on satisfactory evidence. The clear implication of §7872 is that a transfer for a note that bears interest that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note.

The estate tax regulations indicate that a note can be discounted based on the note's interest rate if interest rates generally rise by the time of the holder's death. Even if general interest rates do not change between the time the note is given and the date of death, can the note be discounted because the AFR, which is the test rate for gift tax purposes under §7872, is an artificially low rate — the rate at which the United States government can borrow? There are no cases or rulings. A proposed regulation under §7872 suggests that such discounting, merely because the AFR is an artificially low interest rate, would not be allowed. Prop. Reg. §20.7872-1. However, that regulation has never been finalized. Be aware, however, the IRS estate tax agent may feel that taking a discount merely for this reason is abusive (because the note was not similarly discounted for gift tax valuation purposes at the time of the sale) and may closely scrutinize every aspect of the loan or sale transaction. Also, beware that the income tax effects of discounting the note may offset or even outweigh discounting the note for estate tax purposes. When the note is paid, the excess payment over the note's basis is generally treated as ordinary income.

k. *Refinancing Notes to Utilize Lower Interest Rates*. There are no cases, regulations or rulings that address the gift tax effects of refinancing notes. Proposed regulations under §7872 include a section entitled "Treatment of Renegotiations," but merely reserves the subject for later guidance, which has never been issued. Commentators have generally concluded that refinancing at lower AFRs should be possible without gift consequences. See Jonathan Blattmachr, Elisabeth Madden, & Bridget Crawford, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. TAX'N 22 (July 2008). Refinancing at lower current interest rates should be permissible, but do not get greedy and do this repeatedly. To be more conservative, make some modification in return for the lender's agreeing to refinance at the lower interest rate, such as paying down some principal, reducing the term of the loan, or adding collateral.

l. *Planning Issues With SCINs*. A self-canceling installment note (SCIN) is a debt obligation containing a provision canceling the liability upon the death of the holder. If the holder dies prior to the expiration of the term of the SCIN, the automatic cancellation feature may operate to remove a significant amount of assets from what would otherwise be includable in the estate of the holder.

Planning with SCINs followed the seminal case of *Estate of Moss v. Commissioner*. 74 T.C. 1239 (1980), acq. in result, 1981-1 C.B. 2 (remaining payments that would have been due following the maker's death under a SCIN were not includable in the decedent's gross estate under §2033).

The IRS has never given guidance as to how to calculate the premium attributable to the cancellation feature of the note. There are no PLRS explaining the mathematics. Three commercial software programs, ZCalc, Tiger Tables (developed by Larry Katzenstein) and Leimberg's NumberCruncher all reach the same answer, and they all calculate the premium independently. As a practical matter, the IRS probably uses the same software programs to calculate the premium that the rest of us use.

If the SCIN is cancelled by reason of the death of the seller during the note term, any deferred gain will be recognized as income. In *Estate of Frane v. Commissioner*, the Tax Court held the income would go on the deceased seller's final return, 98 T.C. 341, 354 (1992), but the Eighth Circuit reversed and held that the estate would realize the income, 998 F.2d 567 (8th Cir. 1993). Having the income recognized on the decedent's final return would generally be preferable, so that the resulting income tax liability should be deductible as a §2053 claim against the estate for estate tax purposes. The Eighth Circuit's position has not been adopted by any other Circuits. An argument can be made that the gain should be recognized by the seller on his or her final income tax return in accordance with the Tax Court decision and §453B(f).

There is uncertainty regarding the determination of the note's basis. Is it the amount of the payments as determined initially or if the note is canceled because the person dies before the end of the note term, is the basis the total amount actually paid?

For a detailed discussion of a Chief Counsel Advice regarding SCINs and a discussion of the related Tax Court case, see Item 39 below.

m. *Loans Involving Estates; Graegin Loans*. In *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477, the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation, where the loan was for a fixed period, with a set interest rate, with a large prepayment penalty to assure the loan would remain outstanding during its entire term. T.C. Memo. 1988-477. Various subsequent cases have similarly allowed deducting projected interest on "Graegin loans." *E.g. Estate of Duncan v.*

Commissioner, T.C. Memo. 2011-255. However, some cases have refused to allow the interest deduction (if the IRS convinced the court that the only purpose was to generate an estate tax deduction). *E.g.*, *Estate of Black v. Commissioner*, 133 T.C. 340 (2009); *Estate of Koons*, T.C. Memo. 2013-94.

In *Estate of Koons*, T.C. Memo. 2013-94, the court disallowed a $71 million interest deduction on a $10.75 million note. Payments under the note were paid over 8 years beginning **18 years** after the loan was made from an LLC owned 71% by the estate. The court reasoned that the estate could have forced a distribution from the LLC to pay the estate tax, and that the loan merely delayed the time for such a distribution because the estate's only ability to repay the loan was from eventual distributions from the LLC. The estate argued that a loan from the LLC was preferable to a cash distribution because a cash distribution would leave the LLC with less cash to buy businesses. However, the court noted that the loan also depleted the LLC of cash.

The Treasury Priority Guidance Plans for 2009-2012 include a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys' fees, Tax Court litigation expenses, etc.). Graegin notes are also in the scope of that project.

35. Planning for Surviving Spouse Who is Beneficiary of QTIP Trust; Sale of Assets for Deferred Private Annuity, *Estate of Kite v. Commissioner,* T.C. Memo. 2013-43 and "*Kite II*"

a. *Synopsis*. Mrs. Kite ("Wife") created a QTIP trust for Mr. Kite ("Husband") who died a week later, and under the terms of the trust the assets remained in the QTIP trust for Wife's benefit. The assets were included in Husband's estate and a basis step-up was permitted despite §1014(e), which says that a basis step up is not permitted when an asset is given to someone who dies within one year if the asset passes back to the donor. Apparently, the IRS failed to raise the §1014(e) issue.

Subsequently, the assets of the QTIP trust as well as another QTIP trust and a general power of appointment marital trust were invested in a limited partnership. Eventually the trusts' interest in a restructured partnership was sold for notes and the notes were contributed to a general partnership. In a three-day series of planned transactions, the trusts' assets (i.e., the interest in the general partnership) were distributed to Wife, the children contributed additional assets to the general partnership, and Wife (almost age 75) sold her partnership interests to her children for a deferred private annuity (annuity payments would not begin for 10 years). Wife died three years later before receiving any annuity payments.

The court's initial decision ("*Kite I,*") ruled that the sale of assets for the private annuity was not a gift. T.C. Memo. 2013-43 (decision by Judge Paris, February 7, 2013). Using the IRS actuarial tables was appropriate, even though the annuity payments would not begin for 10 years and Wife had only a 12 1/2 year life expectancy, because Wife was not terminally ill at the time of the sale and she had at least a 50% chance of living more than one year. The sale was not illusory and was bona fide because the annuity agreement was enforceable and the parties demonstrated their intention to comply with the annuity agreement. "The annuity transaction was a bona fide sale for adequate and full consideration."

In *Kite I*, apparently, the IRS did not argue that the contribution of QTIP assets to a limited partnership was a §2519 deemed transfer of the QTIP trust, even though some of the partnership interests were later transferred with a 34% discount. In addition, *Kite I* did not address an alleged estate tax deficiency other than rejecting a rather muddled §2036 argument because of Wife's failure to sign documents admitting a new partner of the limited partnership that received the contribution of assets from the QTIP trust.

While the sale of assets for a deferred annuity was not a gift, the court in *Kite I* ruled that a deemed transfer occurred under §2519. Section 2519 provides that the transfer of any part of the qualifying income interest in a QTIP trust is treated as the transfer of the fair market value of the entire property less the value of the qualifying income interest, in effect, as the deemed transfer of the remainder interest in the trust. (The effect of the transfer of the income interest is determined under the general gift tax principles of §2511—the value of the portion of the income interest that is transferred less the consideration received for such transfer). The court accepted the government's argument that (1) the distribution of QTIP assets to Wife and (2) her sale of the assets for a 10-year deferred annuity were part of an integrated transaction that was deemed to be a disposition of her qualifying income interest that triggered §2519. The deemed transfer of the income interest was not a taxable gift under §2511 because Wife received full value. *Kite I* did not discuss what, if any, taxable gift resulted from the deemed transfer of the remainder interest.

"*Kite II*" is the court's Order and Decision (Cause No. 6772-08, unpublished op. Oct. 25, 2013) regarding the Rule 155 computations of the gift tax as a result of the decision in "*Kite I*." The estate argued that no gift resulted from the deemed transfer of the remainder interest under §2519 because of the court's decision in *Kite I* that the Wife's sale of assets that she received from the QTIP trust in return for a deferred private annuity was a bona fide sale for adequate and full consideration. The estate argued that the deemed transfer was offset by the "adequate and full consideration" received in return for the transfer, resulting in a zero gift value. 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." The court made this determination despite the following statement in the legislative history to §2519: "If the property is subject to tax as a result of the spouse's lifetime transfer of the qualifying income interest, the entire value of the property, *less amounts received by the spouse upon disposition*, will be treated as a taxable gift by the spouse under new Code sec. 2519." (emphasis added). The Order imposed gift tax in the amount of $816,206 for calendar year 2001. An Order dated October 28, 2013 determined that there had been an overpayment of estate tax in the amount of $304,605.

This case is appealable to the 10th Circuit Court of Appeals.

b. *Section 2519; Statute and Regulations.* 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."

The regulations clarify 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."

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. The statute and regulations do not directly address whether the amount of the deemed *gift* is reduced by the amount paid to the spouse that replaces the remainder value in the spouse's estate to be subject to gift or estate taxation in the future. There is one regulation referring to the spouse "as making a *gift* under section 2519 of the entire trust less the qualifying income interest…." Reg. §25.2519-1(a)(third sentence). However the statute and numerous other places in the regulations refer merely to the deemed "*transfer*" under §2519. §2519(a); Reg. §§ 25.2519-1(a)(first sentence and second sentence), 25.2519-1(c)(1), 25.2519-1(c)(2), 25.2519-1(c)(4), 25.2519-1(c)(5). There are various examples in Reg. §25.2519-1(g) that refer to the amount of the *gift* but no consideration was paid to the spouse in any of those examples to replace the remainder value in the spouse's estate.

c. *Integrated Transaction Triggering §2519. Kite I* ruled that a deemed transfer occurred under §2519. The court accepted the government's argument that (1) the distribution of QTIP assets to Wife and (2) her sale of the assets for a 10-year deferred annuity were part of an integrated transaction that was deemed to be a disposition of her qualifying income interest that triggered §2519. The deemed transfer of the income interest was not a taxable gift under §2511 because Wife received full value. *Kite I* did not discuss what, if any, taxable gift resulted from the deemed transfer of the remainder interest.

d. *Positions of Parties in Kite II Regarding Gift Tax Effect of Deemed Transfer of Remainder Interest Under §2519.* The estate position was that the deemed transfer of the remainder interest under §2519 resulted in a zero gift. Section 2519 states that for gift tax purposes, "any disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of all interests in such property other than the qualifying income interest." Under traditional gift tax principles, a transfer is subject to the gift tax to the extent that it is not made for an adequate and full consideration in money or money's worth. Commissioner v. Wemyss, 324 U.S. 303, 307 (1945); Reg. §25.2511-1(g) ("[t]he gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth"). Kite I viewed the termination of the QTIP trusts and the immediate sale of their assets as a single transaction that constituted a disposition of Wife's qualifying income interest, which caused a deemed transfer of the value of the QTIP assets less the value of the qualifying income interests in the trust. Because Kite I also determined that the sale of the assets for the annuity was a bona fide sale for adequate and full consideration, the estate maintained that the deemed transfer of the remainder was completely offset by the value received by Wife in return, so no gift resulted.

The government's position is that any consideration received by the surviving spouse in a transaction that triggers §2519 is irrelevant in determining the value of the deemed gift of the remainder interest in the QTIP trust.

e. *Kite II Analysis.*

(1) *Overview.* The estate incorrectly interpreted Kite I to mean the Wife "received full and adequate consideration for both the qualifying income interest and the remainder interest." Focusing on just the full consideration aspect of the annuity transaction "ignores the QTIP terminations that immediately preceded the annuity transaction."

(2) *Rev. Rul. 98-8*. Revenue Ruling 98-8 considered the gift tax consequences to a surviving spouse upon purchasing the remainder interest in a QTIP trust by conveying to the trust a note equal to the remainder value. The trust would then distribute the QTIP trust assets to the spouse who would pay off the promissory note with the QTIP trust assets. The effect was a commutation—the spouse ended up owning assets equal in value to the income interest. The ruling concluded that a commutation results in a deemed transfer of the remainder interest under §2519. [Observation: Under the fact situation addressed in Rev. Rul. 98-8, the spouse did not end up owning assets equal to the value of the remainder interest.]

(3) *Termination of QTIP Trusts Alone Can Trigger §2519.* Without further analysis, the court reaches this conclusion in applying the reasoning of Rev. Rul. 98-8 to this case:

> "Under the reasoning provided in Rev. Rul. 98-8, the termination of the QTIP trusts alone triggered section 2519 …."

The court stated that it did not need to determine whether the termination of the QTIP trusts alone triggered §2519. Instead, Kite I found that the termination of the QTIP and the annuity transaction were a single transaction resulting in the disposition of the income interest. Even so, the estate's focus on the annuity transaction without also considering the termination of the QTIP trusts "is misguided because the termination of a QTIP trust can result in a transfer of a qualifying income interest for purposes of section 2519." [Observation: Consider the broad implications of that statement if it is true. If the termination of a QTIP trust can trigger §2519, do principal distributions constitute a deemed disposition of part of the qualifying income interest—thus also triggering a §2519 deemed transfer of the remainder interest?]

(4) *Replacement of Income Interest Value Does Not Avoid §2519 Trigger.* The receipt of value by the spouse of value equal to the value of the qualifying income interest does not prevent a disposition of the income interest from triggering §2519. Reg. §25.2519-1(f). [Observation: The point of that regulation presumably is to keep the remainder value in the QTIP trust from being excluded from the estate—by merely receiving consideration equal to the value of the income interest.]

(5) *Basic Statement of Court's Position.* After citing that regulation (and for some reason also citing legislative history pointing out that qualifying income interests do not necessarily have to be in trust) the court states its ultimate position::

> "In fact, a deemed transfer of a remainder interest under section 2519 cannot be made for adequate and full consideration or for any consideration."

(6) *Reg. §25.2519-1(a); Remainder Interest is Not Owned by Spouse So Spouse Cannot Receive Consideration For It.* One sentence in Reg. § 25.2519-1(a) states that "the donee spouse is treated as making a gift under section 2519 of the entire trust less the qualifying income interest…." (Emphasis added). The court says "the term 'gift' is not an accident." The reason the court gives for this statement is that

> "[t]he remainder interest is a future interest held by the remainderman and not the donee spouse. Accordingly, the donee spouse cannot receive full and adequate consideration, or indeed any consideration, in exchange of the remainder interest."

[Observation: The court's reference to this one sentence in the regulations as saying the "gift" is the entire trust less the qualifying income interest" seems somewhat disingenuous without also mentioning that numerous other places in the regulations and the statute itself (see paragraph 2 above) refers to the entire trust less the qualifying income interest as being the amount "transferred" rather than referring to it as the amount of the "gift." If it is merely the amount "transferred," traditional gift principles would suggest that any consideration received by the deemed transferor would be subtracted to determine the amount of the "gift."]

(7) *Policy; Intent of QTIP Regime*. The court reasons that its conclusion is supported by the policy of the marital deduction and QTIP regime, which is merely to defer the tax by including the asset transferred to the QTIP trust in the done-spouse's gross estate for estate tax purposes. [Observation: If the spouse receives consideration equal to the full value of assets in the QTIP trust, the policy of merely deferring transfer tax is achieved. The consideration received by the spouse will be included in the spouse's gross estate. There was no amount to include in the spouse's estate

in this case not because of the sale of the QTIP assets by the surviving spouse for its full value, but because the spouse made a terrible investment decision in the sale transaction, with the sale proceeds ultimately becoming worthless.]

(8) *Rebuttal of Legislative History Supporting Taxpayer's Position*. The estate argued that there is a statement in the legislative history to §2519 supporting that the amount of the gift resulting from a §2519 transfer is the entire value of the trust less amounts received by the spouse. Indeed, the legislative history states that almost verbatim:

> "If the property is subject to tax as a result of the spouse's lifetime transfer of the qualifying income interest, the entire value of the property, less amounts received by the spouse upon disposition, will be treated as a taxable gift by the spouse under new Code sec. 2519." H.R. Rept. No. 97-201 at 161, 1981-2 C.B. at 378.

The court agrees that "when read in isolation this statement from the House report seems to support petitioner's position…." The court says, however, that the statement must be read in the context of the entire report. The "first sentence" (immediately preceding the sentence stating that the gift is determined after subtracting any amounts received by the spouse) says that property subject to a QTIP election will eventually be subject to a gift or estate tax. The sentence that follows the sentence quoted above (i.e., the "third sentence") is that the deemed gift of the remainder interest under §2519 is not a present interest qualifying for the annual exclusion but the gift of the income interest is a present interest gift that qualifies for the annual exclusion. The court draws the conclusion from these two sentences, despite the middle sentence saying that the gift under §2519 is determined after subtracting "amounts received by the spouse upon disposition," that "the deemed transfer of a remainder interest under section 2519 is a gift." [Observation: The court's analysis from the surrounding sentences is not persuasive. The first sentence is actually consistent with saying that the deemed gift is reduced by a consideration received by the spouse because that consideration will be subject to a transfer tax in the future. The third sentence merely states the obvious that a gift of a remainder interest is a future interest that does not qualify for the annual exclusion. The court reasons that the third sentence supports the finding that the remainder interest is held by the remainderman and not the surviving spouse so the spouse cannot transfer it for consideration. However, the third sentence merely says that the deemed transfer of the remainder interest is a future interest—not that the fiction of a deemed gift of that interest would be determined ignoring traditional principles of subtracting any consideration received in return for that deemed gift.]

(9) *Procedural Issue*. The government also argued that the taxpayer's objections (i.e., that the gift should be calculated after subtracting consideration received by the donor) were new issues that were waived because they were not raised in briefs. The court (in footnote 4) observed that it addressed the estate's objections without making a determination as to whether the estate raised new issues.

f. *Observations from Kite II Result.*

(1) *Surprising Result.* The result of this Rule 155 Order, following the court's reasoning in T.C. Memo. 2013-43, is surprising. Most planners and commentators have believed that a zero gift would result, based on the court's prior determination that there was a deemed transfer of the QTIP remainder interest under §2519 combined with the court's determination that the Wife received full value 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). Instead, the court determines, as a matter of law, that a deemed transfer under §2519 results in a taxable gift of the full actuarial value of the remainder interest regardless of any consideration received by the spouse. This is particularly poignant when the very event that triggered §2519 was the *sale* of the QTIP trust assets in connection with the termination of the QTIP trust for the full value of those assets.

(2) *Mere Termination of QTIP Trust Triggers §2519.* The Order states in dictum that "the termination of the QTIP trusts alone triggered section 2519," and in the following paragraph again reiterates that "the termination of a QTIP trust can result in a transfer of a qualifying income interest for purposes of section 2519." These statements are quite troubling. This means that if a trustee distributes all of the QTIP trust assets to the spouse, either a distribution under the trust distribution standard or under a small trust termination provision, the surviving spouse is automatically treated as making a gift of the actuarial value (immediately prior to the termination) of the remainder interest. Having all of the trust assets distributed to the trust beneficiary is not necessarily unusual; does the surviving spouse really risk being treated as making a large taxable gift (i.e., the full value of the remainder interest) upon merely receiving the assets of the QTIP trust?

If the termination of the QTIP trust results in a disposition of the qualifying income interest, it would seem that any principal distribution from the QTIP trust to the spouse would constitute a disposition of a portion of the qualifying income interest—which by itself triggers a deemed transfer of *all* of the remainder interest under §2519. This is a quite surprising notion.

The court's reasoning to treat a termination of a QTIP trust as triggering §2519 is suspect. The court reasons that result follows from Rev. Rul. 98-8. However that revenue ruling 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. Despite this key distinction, the court draws the conclusion that "[u]nder the reasoning provided in Rev. Rul. 98-8, the termination of the QTIP trusts alone triggered section 2519."

(3) *Termination of QTIP Trust (or Perhaps Distribution of QTIP Assets) Followed by Sale of Assets by Spouse.* The court's reasoning indicates that a sale of assets by a spouse upon receiving a terminating distribution from a QTIP trust, in and of itself, triggers §2519. (The court's Order [on page 2] states that "the termination of the QTIP trusts and the immediate sale of their assets" was a single transaction that triggered §2519.) If a terminating distribution has that effect, a principal distribution (i.e., a partial termination) may have the same result. Planners previously have not been concerned with a spouse selling assets that the spouse receives from the QTIP trust, as long as it is a bona fide legitimate sale.

(4) *Policy; Intent of Marital Deduction.* The court's reasoning that the policy and intent of the marital deduction supports its conclusion is quite ironic. The court 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 done-spouse. But in this case the spouse received back assets, directly owned by the spouse, equal in value to the full value of assets in the QTIP trust. Those assets would later be subject to gift or estate tax. It so happened that the assets received by Wife later plummeted in value, but at the time of the transaction that triggered §2519 Wife received back assets equal to the full value of the QTIP assets. 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.

(5) *Double Inclusion.* The court never once addressed the distinct possibility of taxing the same value twice as a result of its ruling—once as a gift equal to the value 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. In this case, the assets happened to fall in value to zero, but the court's reasoning is not so limiting. The court interprets §2519 as resulting in a taxable gift of the full actuarial value of the remainder interest, even if that value is replenished in the wife's direct ownership of assets. (It was merely the gamble of the private annuity transaction that caused the value to vanish in Wife's estate. Alternatively, the value in Wife's gross estate could have been multiplied several times if Wife had lived beyond her actuarial life expectancy. That same scenario could also happen if the spouse invests the QTIP assets in a single volatile stock—it could explode in value or it could fall to zero. It is the investment decision that causes the asset value to vanish—not the deemed disposition of the income interest and the deemed transfer of the remainder interest under §2519.)

Perhaps the double inclusion would 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. However, would a tracing analysis be required and would the estate be able to satisfy that tracing requirement to prove that amounts that were included in the deemed gift under §2519 remain (possibly through many permutations) at the spouse's death?

(6) *Legislative History.* The legislative history to §2519 seems to make clear that in determining the amount of the *gift*, as opposed to the amount of the *transfer*, resulting under §2519, any consideration received by the spouse should be considered:

> "If the property is subject to tax as a result of the spouse's lifetime transfer of the qualifying income interest, the entire value of the property, *less amount received by the spouse upon disposition*, will be treated as a taxable *gift* by the spouse under new Code sec. 2519." H.R. Rept. No. 97-201, at 161, 1981-2 C.B. at 378.

The court attempts (feebly) to rebut what seems to be the clear intent of that sentence by immediately preceding and following sentences in the House Report. (See the discussion in Paragraph 4. h above regarding the *Kite II* Analysis.)

(7) *Visceral Reaction.* The court's attempt to find some reason to keep the estate from being able to avoid estate taxation is understandable (and laudable to protect the integrity of the marital deduction system). However, the court's reasoning creates very troubling concerns. As discussed above, what caused the removal of asset value from the transfer tax base was the private annuity transaction, not the distribution of assets from the QTIP trust. But under the court's reasoning, the termination of a QTIP trust and subsequent sale of assets by the spouse triggers 2519, even if assets do not "disappear" from the transfer tax system.

g. *Basis Increase at Husband's Death*. Husband apparently was near death when Wife made the transfer to the inter vivos QTIP. Presumably, the purpose in making the transfer to the QTIP trust was so that the assets would be included in Husband's gross estate and would receive a basis step-up at Husband's death. Indeed, footnote 9 notes that a basis step-up was allowed at Husband's death with respect to the assets in the initial QTIP trust. However, §1014(e) provides that the basis of property received from a decedent will be equal to the decedent's basis immediately prior to death, rather than its estate tax value, if the property had been given to the decedent within one year before the date of death if the property passes back to the original donor (or his or her spouse). In this case, the assets did not pass back to Wife, but instead remained in the QTIP trust for Wife's benefit. Wife had a mandatory income interest in the trust, so that a portion certainly passed back to Wife. However, arguably, the remainder value in the QTIP did not pass back to the Wife for purposes of this income tax statute (even though it would be included in her estate under §2044 for estate tax purposes). Letter Ruling 9026036 (reversed as to other issues and reissued as PLR 9321050) may provide some support for this argument. Letter Ruling 9026036 addressed a situation in which property transferred by a wife to a QTIP trust for her husband would return to a QTIP-able trust for wife if husband predeceased her (similar to the Kite facts). The IRS ruled that only the portion of the trust allocable to the life income interest would be affected by §1014(e), and the remainder interest would not be deemed to pass back to the donor spouse and thus would qualify for a basis step-up.

Perhaps a reason that this issue was not raised by the IRS is that the daughters ended up with a zero basis in the assets that they purchased with the deferred annuity (since they never actually made any annuity payments, see subparagraph d below). Therefore, the family may have received no benefit from the basis step-up.

h. *Deferred Private Annuity Transaction Upheld*. The court did not treat the transfer of assets in return for the private annuity as a gift; the IRS apparently did not raise whether §2036 would apply to treat the private annuity as a retained indirect beneficial interest in the assets transferred. The private annuity transaction was recognized even though there was a 10-year deferred annuity and Wife's health suggested that she might not live to receive any payments under the annuity. (In fact, Wife died about three years after the private annuity sale and she did not receive any annuity payments in return for the $10.6 million of partnership interests that she conveyed for the private annuity.)

The opinion lays out a roadmap for a successful private annuity transaction.

- Wife retained assets for her living expenses other than from the annuity payments, which helps thwart a §2036 attack.
- Children had enough personal assets to pay the annuity payments for Wife's life expectancy (though they apparently did not have enough assets, without using the assets they received in return for the private annuity to make payments if Wife lived more than 6 months beyond her life expectancy).
- There were no indications whatsoever that children intended not to pay the annuity payments as they became due.
- The three-day planned steps of (i) terminating the marital trusts, (ii) having Baldwin (owned by the children or their trusts) contribute $13.6 million of assets to KIC, and (iii) having Wife sell her assets received from the QTIP to her children for the private annuities were unusual (and not recommended as a general planning strategy). However, the transaction was planned conservatively in that no discounts were applied when Wife transferred her KIC general partnership interests in return for the private annuity.
- The parties obtained a letter from Wife's physician stating that she did not have an incurable illness or other deteriorating physical condition that would cause her to die within one year, and that she had at least a 50% probability of surviving for 18 months or longer, thus satisfying the presumption afforded under Reg. §1.7520-3(b)(3).

Quite interestingly, the court viewed as primarily important only the 50% chance of death within a year, even though this was a 10-year deferred annuity. The court did not view other health factors as relevant with respect to that 10-year deferred term (though the court did observe that the parties reasonably expected Wife to live to her life expectancy). For an individual in poor health, but not terminal, structuring a private annuity as a deferred annuity increases the leveraged nature of the transaction. The annuity payments will be much larger when they begin after the deferral period to still have a present value equal to the value originally transferred. For example, in this case, with a 12.5 year life expectancy, Wife would receive three payments if she lived to her life expectancy, so the present value of only three payments must equal the value originally transferred. There may be a significant chance that no payments at all will be made back to the transferor. However, if the transferor does live beyond his or her life expectancy, annuity payments back to the transferor may be significantly larger than if a straight annuity had been used rather than a deferred annuity.

Validating use of the actuarial tables merely on the basis of the physician's letter was not a given. For example, various cases involving long-term payouts from lottery winnings have reached contrary results as to whether the actuarial tables are appropriate to value the annuity. Taxpayers have argued that because the right to receive the payments is non-transferable, they should be valued at significantly less than the present value produced by the actuarial tables. The Second, Eighth, Ninth Circuits have refused to use the actuarial tables in this situation. *Estate of Gribauskas v. Commissioner*, 342 F.3d 85 (2d Cir. 2003); *O'Reilly v. Commissioner*, 973 F.2d 1403 (8th Cir. 1992); *Estate of Shackleford v. United States*, 262 F.3d 1028 (9th Cir. 2001). For example, the Ninth Circuit in *Shackleford* held that departure from the actuarial tables is permitted once a party proves (1) the tables produce an unrealistic and unreasonable value and (2) a more realistic, reasonable, and accurate valuation method exists. (Based on the court's finding in Kite that "Mrs. Kite and her children reasonably expected that she would live through the life expectancy determined by IRS actuarial tables," the Ninth Circuit's analysis would not have required deviating from the actuarial tables.) The Fifth and Sixth Circuits have applied the IRS actuarial tables in lottery payment situations. *Estate of Cook v. Commissioner*, 349 F.3d 850 (5th Cir. 2003); *Negron v. United States*, 553 F.3d 1013 (6th Cir. 2009).

i. *Income Tax Consequences of Private Annuity Transaction*. At the time of the private annuity transaction in 2001, the income tax consequences of an unsecured private annuity transaction were outlined in Revenue Ruling 69-74. It provided that that the seller was entitled to recover her investment in the contract (i.e., the basis in the property transferred) ratably over her life expectancy, and any capital gain was also reported ratably over that period. The balance of each annuity payment, as well as any payments beyond the seller's life expectancy, was taxed as ordinary income. Upon the annuitant's death, the purchaser's basis was the total of all payments actually made. This approach permitted significant deferral of income recognition on the sale of assets for a private annuity. The IRS changed the approach to taxing private annuity sale transactions in Proposed Regulations §§1.72-6(e)(1) & 1.1001-1(j)(1). The proposed regulations are effective for transactions occurring after October 18, 2006, (although the effective date is delayed to April 18, 2008 for unsecured private annuity transactions where the annuity is given by an individual and the property transferred is not sold or disposed of for two years after the date of the exchange). However, the immediate gain recognition result can be avoided if assets are sold to a grantor trust in return for the private annuity; then there would be an issue of whether the trust has sufficient assets to respect the annuity transaction.

j. *Investment of QTIP Assets in FLP*. *Kite* did not view the investment of QTIP trust assets in a limited partnership (in return for discounted partnership interests) as a deemed disposition under §2519. Footnote 35 acknowledged that Wife received the benefit of 34.354% discounts when later making a gift of assets from the QTIP. The opinion does not make clear whether discounts were applied when the QTIP trusts sold their interests in Baldwin Limited Partnership to the children in return for $12.5 million secured promissory notes.

Reg. §25.2519-1(f) states that "[t]he conversion of qualified terminable interest property into other property in which the donee spouse has a qualifying income interest for life is not, for purposes of this section, treated as a disposition of the qualifying income interest." Thus, a sale of QTIP assets in exchange for full consideration is not a deemed disposition that triggers §2519. *See* P.L.R. 9523029 (trust's purchase of shares of closely held corporation not a §2519 transfer if the purchase price paid by the trust was equal to the fair market value of the shares the trust purchased).

In FSA 199920016 the IRS suggested that the investment of QTIP trust assets in a family limited partnership might trigger a §2519 disposition if the conversion of the trust assets limited the spouse's right to income. This issue has also been raised in at least several gift and estate tax audits. In that FSA, the IRS National Office ultimately advised the Examination Division not to pursue litigation. *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). Under the facts of the FSA, the surviving spouse continued to received distributions in approximately the same amounts she would have received had the partnership not been created. The surviving spouse was also a co-trustee of the trust. The IRS's reasoning focused on whether the investment constituted a limitation on the spouse's right to income:

> Thus, in order to invoke 2519, the conversion of the trust assets must work such a limitation on her right to the income as to amount to a disposition of that income. Although the conversion to partnership interests could yield this result, it does not necessarily follow. An investment in a partnership, despite possible restrictions on distribution, could be, under the right circumstances, a very lucrative investment.

Another potential IRS argument is that if the surviving spouse fails to enforce a valuable right, she will be deemed to have made a gift. Tech Advice Memoranda 9301001, 8403010, & 8723007. If a trust sells trust property at an improper price and if the beneficiary does not pursue a breach of fiduciary duty claim against the trustee, the IRS could argue the resulting deemed gift constituted a disposition of the income interest that triggers §2519. 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).

k. *Planning For Surviving Spouses' Interests in QTIP Trusts*. Planning for surviving spouses who are beneficiaries of substantial QTIP trusts is complicated. This case is an example of clients entering into complicated transactions in planning with QTIP trusts. For an outstanding detailed discussion of planning by a surviving spouse with QTIP trusts, 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).

One possible alternative is for the QTIP trust to invest in assets that may result in discounted values, as discussed immediately above. Another planning alternative is for the trust to distribute sizable assets to the surviving spouse so the spouse can subsequently enter into estate planning transactions with the assets. A common problem is how to justify making large distributions to the spouse. The Kite children as trustees terminated the marital trusts despite the lack of authority to do so under the trust agreements. Apparently, the IRS did not argue that the subsequent transactions should not be recognized because of the unauthorized termination of the trusts. Finding the authority to make distributions from a QTIP trust to a surviving spouse so that the spouse can enter into estate planning transactions is a recurring complexity in planning with QTIP trust interests. See Read Moore, Neil Kawashima & Joy Miyasaki, Estate Planning for QTIP Trust Assets, 44th U. Miami Heckerling Inst. on Est. Plan. ch. 12 ¶ 1201.1-1201.5 (2010). (Drafting a QTIP trust to allow broad discretion in making principal distributions to the surviving spouse is helpful in overcoming this difficulty.) One of the complicating issues is whether children/trustees who make a large distribution of trust assets to the surviving spouse (particularly if it is not strictly authorized under the trust agreement) are making a gift to the surviving spouse for federal gift tax purposes. See Item 35.I below.

Is the purchase by a QTIP of a deferred annuity a viable planning alternative for QTIP trusts? If the QTIP assets have appreciated significantly after the first spouse's death, realize that entering into a private annuity transaction will cause the immediate recognition of the gain (i.e., the present value of the annuity minus the adjusted basis of the sold assets) based on Prop. Reg. §1.1001-1(j)(1) after October 18, 2006(or after April 18, 2007 for many situations). See also Prop. Reg. §1.72-6(e). If the income tax consequences are bearable, is the purchase of a deferred annuity by a QTIP trust a useful planning alternative? If the surviving spouse is in poor health, but is not terminally ill and is expected to live at least one year, a transfer in return for a long-deferred private annuity (such as the 10-year deferred annuity in Kite) might result in no value being included in the surviving spouse's gross estate attributable to the QTIP trust if the spouse indeed dies before the annuity payments begin.

The integrated transaction analysis concluded that the combination of the termination of the QTIP trust followed by the surviving spouse's sale of the QTIP assets for a deferred annuity was a deemed disposition of the qualifying income interest for life. Does that suggest that a direct sale of a QTIP trust's assets for a deferred annuity would be a §2519 transfer? Under the court's reasoning, that result would not follow, because the court relied on the regulation stating that a sale of QTIP trust assets followed by payment to the surviving spouse of a portion of the proceeds equal to the value of the income interest would be treated as a disposition of the qualifying income interest. If the trust merely sold its assets for a deferred annuity but did not pay any of the sale proceeds directly to the surviving spouse, that regulation would not be triggered. However, as discussed above, if the trust assets are sold for a non-negotiable deferred annuity, that would seem to be a disposition of the surviving spouse's mandatory income interest, because there would be no income to distribute during the deferral period, and the spouse would have no ability to force the trust to change the trust investments to assets that would produce reasonable income. In that event, the surviving spouse would be treated as making a transfer of the entire QTIP trust value less the value of the qualifying income interest, but the spouse would not have received any consideration in return for that transfer, unlike in Kite where the assets were distributed to the surviving spouse and the spouse directly received the annuity, which presumably would be adequate and full consideration to offset any gift. If there is a deemed gift of the QTIP remainder interest, or for that matter the income interest, some or all of that gift may be omitted as adjusted taxable gifts from the surviving spouse's estate tax calculation because the gross estate may include assets that were the subject of that taxable gift (at least to the extent that annuity payments are actually made to the trust).

In conclusion, there is significant uncertainty regarding the treatment of a QTIP trust's sale of QTIP assets for a long-deferred non-negotiable annuity. However, if the QTIP trust distributes assets to the surviving spouse and the spouse (when in ill health but not terminally ill) in a separate and independent transaction later sells the assets for a deferred private annuity, the transaction may result in a substantial reduction of the surviving spouse's gross estate for estate tax purposes (although it could dramatically increase the spouse's estate if the spouse lives significantly beyond his or her life expectancy). Even if the distribution and private annuity sale are treated as integrated transactions, the result should be that the spouse is not treated as making a taxable gift under §2519 because the spouse receives full value for the QTIP assets.

If some subsequent transaction by the spouse is treated as an integrated transaction that triggers §2519, the *Kite II* Rule 155 Order raises the considerable complexity that the deemed gift may be the full amount of the QTIP remainder trust value even if the subsequent transaction is a sale for full consideration. Query, what if the subsequent transaction is a gift of the assets? If that is somehow treated as an integrated transaction that is a deemed disposition of the income interest, would there be a direct gift of the assets under §2511 and also a deemed gift of the remainder interest under §2519? (Presumably the integrated transaction theory would not apply in that circumstance to trigger §2519.)

I. *Taxable Gifts By Children's Actions in Distributing Trust Assets*. Footnote 37 says that the IRS did not raise whether the children's actions as trustees to terminate the marital trusts was a gift from the children (as the trust remaindermen) to Wife. The court did not address the issue because it determined the termination of the marital trusts followed by the sale of the marital trust assets as a single transaction for purposes of §2519. Why combining the termination and sale as a single transaction would necessarily avoid potential gift issues is not clear. Wife sold the assets to the children (or their trusts) for full value, which would seem to mean that Wife received the full benefit of the trust assets rather than the trust remaindermen. (Of course, the amount that Wife would actually receive depended on how long she lived. Perhaps that is why the court did not view the combined termination/sale transaction as a gift — because the children might end up benefiting from the transaction — as indeed they did because they not have to actually make any annuity payments to Wife. If that was the court's reasoning, the court effectively was treating the deferred private annuity sale transaction as being for full consideration for some purposes [i.e., not a §2511 gift by Wife] but not for other purposes [i.e., no gift by children because Wife might not receive full value depending on how long she lived].) In any event, the Kite children were fortunate that the IRS did not raise the gift issue.

The court cited Letter Ruling 199908033. That letter ruling involved a situation in which the children consented to a trust modification action permitting the termination of a QTIP trust due to unforeseen circumstances. The letter ruling concluded that the proposed transfer would constitute a gift:

> If Taxpayer were to transfer the remainder interest to a third party other than Spouse, the transfer would clearly be a gift. The result is the same if the donee is the surviving spouse. The fact that the receipt of the remainder interest by Spouse will not increase the value of Spouse's potential taxable estate is not pertinent to the determination of the federal gift tax consequences to Taxpayer with respect to Taxpayer's proposed transfer. § 25.2512-2(a).
>
> Accordingly, the proposed transfer by the Taxpayer will constitute a gift for gift tax purposes.

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).

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.

36. Value of Fractional Interests in Art; Consider Likelihood That Family Members Would Purchase Hypothetical Purchaser's Fractional Interest; 10% Fractional Interest Discount, *Estate of Elkins,* 140 T.C. No. 5 (2013)

a. *Synopsis*. Decedent owned 73.055% interests in 61 works of art and 50% interests in three other works of art having an undiscounted value of about $35 million. The remaining fractional interests were owned equally by his three children. A Cotenants' Agreement provided that any item of the art could be sold only with the unanimous consent of all cotenants. The IRS argued that this restriction was included merely to reduce the value of the decedent's fractional interest for estate tax purposes. The court concluded that §2703 does not refer to intent as a controlling or even relevant factor. The parties disagreed as to whether the unanimous consent requirement constituted a restriction on the right of the individual owners to sell their fractional interests. The court concluded that the more important issue is that the unanimous consent to sale provision constituted a waiver of the cotenants' right to institute a partition action, and concluded that any restriction on decedent's right to partition would be disregarded under §2703(a)(2).

The estate claimed a fractional interest discount of about 45% and the IRS argued that no discount should be permitted in valuing fractional interests in art. One of the IRS's arguments is that "the market for fractional interests in art (as well as for other types of personal property) [is] one in which the holder of the fractional interest either purchases or inherits the interest under circumstances in which the holder and the other co-owners (who may be family members, friends, or, in the case of art, art dealers) hold, or simultaneously acquire, their interest with a shared goal of selling (or, if the fractional interests are purchased, of reselling) the entire item of property at retail, either directly or after a partition of the property." Under any of those scenarios, "the interest holders would each receive a pro rata share of the property or of the proceeds from the sale thereof, and no fractional discounts would be applied." The IRS reasons that in this circumstance, Reg. §20.2031-1(b) applies, so that the value "is the price at which the item or a comparable item would be sold at retail." The court suggests that the IRS's argument (which the IRS reasoned would apply in valuing other types of personal property as well) "would have merit in the absence of 'relevant facts' that would render that approach unrealistic and, therefore, inapplicable." The court observes that such contrary facts do exist in Elkins because of the children's "probable resistance to any sale or partition of the art that would result in new ownership." [The court's reasoning suggests that in valuing fractional interests in personal property in particular, evidence of the reticence of other co-owners to agree to a partition or sale of the property may be very important.]

In addition, the IRS's argument that no discounts should be allowed for fractional interests in art is based, in part, on "the Commissioner's long-standing position that fractional interests in art are not discounted for purposes of valuing charitable contributions," citing Rev. Rul. 58-455 and Rev. Rul. 57-293. The court observed that it is not bound by revenue rulings and viewed the Scull and Stone cases as supporting a discount in valuing the decedent's fractional interest in an art collection "in order to account for various uncertainties that would confront a hypothetical buyer of the art." The court concluded that there is no bar, as a matter of law, to an appropriate discount from pro rata fair market value in valuing undivided fractional interests in art.

In determining an appropriate discount for the undivided interests in this case, the court noted that the three children had strong sentimental and emotional ties to each of the works of art so that they treated the art as "part of the family." The estate argued that a hypothetical purchaser of the estate's fractional interest would apply a discount, knowing that the children were unlikely to sell their fractional interests in light of their strong sentimental attachment to the art. The court turned this argument on its head — reasoning that a hypothetical third-party purchaser of the estate's fractional interest "would be in an excellent position to persuade the Elkins children, who, together, have the financial wherewithal to do so, to buy the buyer's interest in any or all of the works, thereby enabling them to continue to maintain absolute ownership and possession of the art." The court pointed to cases involving "swing votes" (*Estate of Winkler*) and properties with enhanced "assemblage" value (*Pittsburgh Terminal Corp.* and *Serdar*) in assessing the bargaining position that a hypothetical buyer of the decedent's interest would have in negotiating with the Elkins children. The court concluded that the Elkins children would be anxious to acquire the decedent's fractional interest to preserve for themselves 100% ownership and possession of the art, and that a hypothetical willing buyer and seller of decedent's interest in the art would agree upon a price at or fairly close to the pro rata fair market value of those interests. It allowed a nominal 10% discount because a hypothetical purchaser could not be certain that the Elkins children would agree to pay the full pro rata fair market value for those interests. *Estate of Elkins v. Commissioner*, 140 T.C. No. 5 (March 11, 2013, opinion by Judge Halpern, not a "reviewed" opinion by the Tax Court).

At least the estate can be comforted that the 10% fractional interest discount in *Elkins* is greater than the 5% discount that was allowed in the *Scull* (T.C. Memo 1994-211) and *Stone* (103 AFTR 2d 2009-1379 (9th Cir. 2009)) cases.

b. *Strategic Buyer.* Various cases have emphasized that courts cannot use the price that a strategic buyer would pay, but must consider what a hypothetical willing buyer would pay. *Estate of Jung v. Comm'r*, 101 T.C. 412, 437-438 (1993) (assumption that closely held entity will redeem interests to maintain family harmony violates hypothetical willing buyer/willing seller test); *Estate of Andrews v. Comm'r*, 79 T.C. 938, 956 (1982) (Commissioner cannot "tailor 'hypothetical' so that the willing seller and willing buyer were seen as the particular persons who would most likely undertake the transaction"). Court of appeals cases from the 5th and 9th Circuits have reiterated this approach. *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001) (reversing Tax Court because "the court should not have assumed the existence of a strategic buyer… Fair market value analysis depends instead on a hypothetical rather than an actual buyer"); *Morrissey v. Comm'r*, 243 F.3d 1145 (9th Cir. 2001)("[t]he law is clear that assuming that a family-owned corporation will redeem stock to keep ownership in the family violates the rule that the willing buyer and willing seller cannot be made particular"); *Estate of Simplot v. Comm'r*, 249 F.3d 1191, 1195 (9th Cir. 2001)(Tax Court assumed buyer "would probably be well-financed, with a long-term investment horizon and no expectations of near-term benefits;" reversed, holding that "[t]he facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be… [A]ll of these imagined facts are what the Tax Court based its 3% premium upon. In violation of the law the Tax Court constructed particular possible purchasers").

These cases all have strong language saying not to assume particular purchasers, and in particular, not to assume that the entity will redeem interests of a prospective seller of an interest in the entity.

The *Elkins* opinion is consistent with the reasoning in *Holman v. Commissioner*, 130 T.C. 170, *aff'd*, 601 F.3d 763 (8th Cir. 2010). (Interestingly, the Tax Court opinion in

Holman was also written by Judge Halpern.) Holman allowed only a 12.5% marketability discount for limited partnership interests in a family limited partnership, partly based on a consideration that the remaining partners would have an economic interest to purchase an interest for a value somewhere between the discounted price that a third party was willing to pay and a pro rata share of net asset value, thus placing a floor on the marketability discount. The 8th Circuit affirmed that approach and held that it did not violate the hypothetical willing buyer/willing seller valuation standard.

Despite the body of case law saying not to base valuation on what a strategic buyer would pay, the 8th Circuit majority opinion in *Holman* agreed with the Tax Court:

> "When assessing hypothetical transactions between hypothetical buyers and sellers, it is improper to ascribe motivations that are personal and reflective of the idiosyncrasies of particular individuals. [Citations omitted.] Rather it is necessary to view such persons as economically rational actors possessing all relevant information and seeking to maximize their gains. [Citations omitted.]
>
> Here we believe the Tax Court's approach in adopting Mr. Burns's analysis comports with this general rule of casting the potential buyer merely as a rational economic actor. A buyer possessed of all relevant information would know that (1) the underlying assets are highly liquid and easily priced; (2) the amount held by the partnership could be absorbed by the broader market…; (3) the partnership agreement permits the buying out of exiting partners or dissolution upon unanimous consent of all partners; and (4) there would be little or no economic risk and likely no additional capital infusion necessary for remaining partners to buy out an existing partner.
>
> Against this backdrop, it is not necessary to look at the personal proclivities of any particular partner or the idiosyncratic tendencies that might drive such a specific person's decisions. Rather it is only necessary to examine what is technically permissible in accordance with the agreement and forecast what rational actors would do in the face of a pending sale at a steep discount relative to net asset value. Simply put, the Tax Court did not ascribe personal non-economic strategies or motivations to hypothetical buyers; it merely held that, presented with the opportunity, rational actors would not leave money on the table."

The dissent believed that a critical element of the analysis was ignored by the majority:

> "That is not to say that courts err whenever they consider partnership agreements' dissolution provisions while calculating an appropriate marketability discount. For example, if the Holman limited partnership had a significant history of dissolving and buying out wishing-to-assign partners, a hypothetical willing buyer would consider this fact while assessing the partnership interests' marketability…"

The dissent concluded that the misapplication of the willing buyer/willing seller test was reversible error and the case should be remanded to the Tax Court for a new determination of the marketability discount.

The *Elkins* case is appealable to the 5th Circuit Court of Appeals. If the case is appealed, query whether the court will apply its reasoning in Jung rejecting the approach of considering the likelihood of a purchase by a strategic buyer to the valuation of fractional interests in art? If it is inappropriate to consider the price that a strategic buyer would pay, it would also seem inappropriate to consider that a hypothetical purchaser would assume that he or she could sell to a strategic buyer at close to pro rata fair market value.

37. DING Trust Letter Rulings, PLRs 201310002-201310006

a. *Background.* "Delaware Incomplete Non-Grantor" Trusts are trusts used to avoid state income tax by having the trust sitused in a jurisdiction that will not tax the accumulated and capital gains income in a non-grantor trust. (Income of a grantor trust would presumably be subject to tax in the state of the grantor's residence.) The trust is merely designed to avoid state income tax, and the donor most certainly does not want to risk having to pay federal gift taxes (at a 40% rate) to have an argument of avoiding state income taxes at a much lower rate.

The DING trust typically allows a distribution committee to make distributions to the beneficiaries, including the grantor. The distribution committee typically consists of several beneficiaries other than the grantor. The trust avoids grantor trust treatment under §674 by requiring the consent of an adverse party to all distributions during the grantor's lifetime. The grantor retains a testamentary limited power of appointment. Various rulings have ruled that the transfer to the trust is an incomplete gift for gift tax purposes, and some have also ruled that the distribution committee members do not have gift tax consequences. *E.g.*, PLRs 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005.

No DING Trust rulings have been issued for five years. The status of DING Trust rulings has been in doubt for several reasons.

(1) *Gift tax consequences for distribution committee members*. IR-2007-127 (July 9, 2007) announced that the IRS was reconsidering its position in these rulings with respect to the gift tax consequences of trust committee members. The IRS expressed concern that the prior letter rulings may be inconsistent with Revenue Ruling 76-503 and Revenue Ruling 77-158. The IRS announcement says that those Revenue Rulings indicate that "because the committee members are replaced if they resign or die, they would be treated as possessing general powers of appointment over the trust corpus." The ABA Real Property Trust and Estate Law Section submitted comments to the IRS on September 26, 2007. The letter was prepared by prominent members of the estate planning bar, including Jonathan Blattmachr, Prof. Mitchell Gans, Carlyn McCaffrey, Diana Zeydel, and others. The letter concludes that the DING PLRs are not inconsistent with Rev. Ruls. 76-503 and 77-158 (or 79-63). The letter points out various distinctions, and that the co-powerholders in the DING rulings situations have considerably more adversity to each other than the co-powerholders in the revenue rulings. It also points out that the regulation at issue does not necessarily require succession to a power on the powerholder's death to create adversity; it merely gives that as an additional way that a co-holder of a power can be deemed to be adverse if his only interest in the trust is as a co-holder of a power. In addition, it reasons that no one can have a general power of appointment over property the transfer of which is incomplete (addressing a revenue ruling, a case and several PLRs that might arguably be inconsistent with that proposition). As a corollary to this argument, the letter states that if the original donor has not made a gift to a beneficiary, the beneficiary should not be able to make a gift back to the donor by agreeing to a distribution to the grantor.

(2) *Incomplete gift treatment for grantor*. CCA 201208026 concluded that retained testamentary powers of appointment over a trust under which the grantors were not beneficiaries cause the *remainder interest* to be an incomplete gift, but concluded that the testamentary powers of appointment relate only to the remainder interest. During the grantors' lifetimes, they had no ability to keep the trustee from making distributions among the potential trust beneficiaries — which might potentially include all of the trust assets. Therefore, the CCA reasoned that the gift was complete as to the "beneficial term interest" that existed before the grantors' deaths — but was an incomplete gift as to the remainder interest. (Reg. §25.2511-2(b) states that if the donor is the discretionary income beneficiary, a retained testamentary power of appointment causes the transfer to the trust to be an incomplete gift.) The issue then became to determine the relative values of the term interest (a completed gift) and the remainder interest (an incomplete gift). The CCA reasoned that §2702 applied, and because the retained interest (i.e., the interest passing to "applicable family members") was not a qualified interest, it had to be valued at zero under §2702. Therefore, the completed gift of the term interest was the full value transferred to the trust. CCA 201208026 raised concerns that merely reserving a testamentary limited power of appointment in the grantor may be insufficient by itself to cause the transfer to a DING trust to be an incomplete gift by the grantor.

b. *PLRs 201310002-201310006.* PLRs 201310002-201310006, issued March 8, 2013, address the grantor trust and gift tax issues for DING trusts.

The trusts are believed to be Nevada DING trusts (though the rulings do not state explicitly that they are Nevada trusts) Based on local law limitations, it is clear that this cannot be a Delaware trust, as discussed in paragraph b.(1) below regarding Grantor's sole power over principal.

The rulings all involve identical fact situations, and the rulings are identical (except that PLR 201310003 inadvertently [apparently] deleted a phrase in the paragraph about Grantor's Consent Power in the discussion of Rulings 2 and 3).

Basic Facts. Grantor created an irrevocable trust of which Grantor and his issue were discretionary beneficiaries. There was a corporate trustee, who was required to distribute income or principal at the direction of a distribution committee or principal upon direction from Grantor. The distribution committee consists of Grantor and each of his four sons. Three alternative methods are provided for distribution directions: (1) *Grantor consent power*-distribute income or principal upon direction of a majority of the distribution committee members with the written consent of Grantor; (2) *Unanimous member power*-distribute income or principal upon direction by all distribution committee members other than Grantor; and (3) *Grantor's sole power*-distribute principal to any of Grantor's issue (not to Grantor, and not income) upon direction from Grantor as Grantor deems advisable in a nonfiduciary capacity to provide for the health, maintenance, support and education of his issue. Distributions can be directed in an unequal manner among potential beneficiaries.

There must always be two "eligible Individuals" (defined) serving as distribution committee members. "A vacancy on the Distribution Committee" must be filled by the eldest of Grantor's adult issue other than then serving members of the committee (with alternate successors if there are no such surviving adult issue). (The rulings do not clarify whether this is interpreted to mean that a vacancy occurs when any member ceases to serve or only when there are less than two members serving. Some commentators say that a distribution committee member is not replaced unless there is only one remaining committee member, and that this provision may be important in resolving the IRS's concern that prior DING rulings may be inconsistent with Rev. Ruls. 76-503 and 77-158. Under this reasoning, it is not clear whether the distribution committee members would have a general power of appointment once the committee has been reduced to only two individuals. *See Bill Lipkind on PLR 201310002: DING Redux,* LEIMBERG EST. PL. EMAIL NEWSLETTER #2076 (March 12, 2013).) The distribution committee ceases to exist upon Grantor's death.

There is a decanting power, authorizing the distribution committee to distribute assets to qualified trusts. Grantor has a testamentary power of appointment to appoint the assets to any persons or entities other than Grantor's estate, creditors, or creditors of the estate. In default of exercise of the power appointment, the assets will pass to the issue of Grantor's deceased father.

Rulings. The IRS gave four important rulings.

(1) *Non-Grantor Trust*. The trust is not a grantor trust. Without any explanatory analysis, the ruling merely concludes that §§673, 674, 676, and 677 do not apply. Whether §675 applies is a question of fact to be determined when federal income tax returns of the parties are filed. Section 678 does not apply because no beneficiary can unilaterally vest trust income or corpus in himself.

Section 674(a) provides that a grantor is treated as the owner of any portion of a trust for which the beneficial enjoyment of corpus or income is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, *without the approval or consent of any adverse party*. Similarly, §§676(a) and 677(a) provides that a grantor is treated as the owner of a trust subject to certain other powers that can be exercised without the approval of an adverse party. Section 672(a) provides that for purposes of the grantor trust rules, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. With respect to the grantor consent power and unanimous member power, distributions can be made only with the consent of an adverse party. (The rulings do not specifically reason that the distribution committee members are adverse to the grantor for this income tax purpose, but that must be the basis of the rulings' conclusion. Observe that the rulings conclude that the distribution committee members are NOT adverse to Grantor for gift tax purposes, as discussed in the discussion below regarding the impact of Grantor's consent power on the issue of whether the transfer to the trusts is an incomplete gift by Grantor.)

With respect to the "Grantor's sole power" alternative, the grantor has the power to distribute principal *(not income)* in a nonfiduciary capacity (the nonfiduciary capacity element is important as a basis for finding that the transfer to the trust is not a completed gift by Grantor, as explained below), §674(b)(5)(A) has an exception for the power to distribute corpus that is limited by reasonably definite standard.

(2) *Incomplete Gift by Grantor.* The rulings give four reasons that Grantor does not make a completed gift upon creation of the trust.

- *Grantor's consent power*. Under Reg. §25.2511-2(b) a gift is complete if the donor "has so part with dominion and control as to leave him in no power to change its disposition." Grantor's consent power is deemed to be such a power over disposition (which makes the gift incomplete), because a donor is considered as having a power exercisable in conjunction with someone else as long as the other person does not have a substantial adverse interest in the disposition of the transferred property. Reg. § 25.2511-2(e). The rulings conclude that the other distribution committee members do not have interests adverse to Grantor for this purpose. Reg. §25.2511-2(e) does not define "substantial adverse interest," but Reg. §25.2514-3(b)(2) states that a "taker in default of appointment under a power has an interest which is adverse to an exercise of the power." The ruling gives no explanation as to why the four sons are not deemed to be "takers in default" if a distribution is not made. (Perhaps it is because of Grantor's retained testamentary limited power of appointment, so that none of the four sons could be assured of receiving any undistributed trust assets, but the rulings do not discuss that reasoning.) The next two sentences of Reg. §25.2514-3(b)(2) state:

  > "A coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the possessor's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate."

  Rather than treating this as merely a possible method of showing adversity, the rulings reason that continued holding of the power after the possessor's death is a prerequisite to showing adversity by the coholder of a power:

  > "Under §25.2514-3(b)(2), a coholder of a power is only considered as having an adverse interest where he may possess the power after the possessor's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. In this case, the Distribution Committee ceases to exist upon Grantor's death. Accordingly, the Distribution Committee members do not have interests adverse to Grantor under §25.2514-3(b)(2) and for purposes of §25.2511-2(e)." (Emphasis added).

  The comments submitted to the IRS by the ABA Real Property Trust and Estate Law Section on September 26, 2007 take the position that the regulation does not necessarily require succession to a power on the power holder's death to create adversity, but merely gives that as an additional way that a coholder of the power can be deemed to be adverse if his only interest in the trust is as a coholder of the power.

In any event, the rulings conclude that Grantor's consent power (i.e., the ability to join with the other distribution committee members in making distributions by consenting to distributions that a majority of the distribution committee members want to make) "causes the transfer of property to Trust to be wholly incomplete for federal gift tax purposes."

- *Grantor's sole power over principal*. Grantor's sole power to make distributions (for health, maintenance, support or education) causes the transfer of property to the trust to be "wholly incomplete" for federal gift tax purposes. The rulings do not specifically discuss how this provision causes the transfer to be "wholly incomplete" even though it is only a power over principal and not income. The rulings do not discuss regulations providing that a transfer will not be incomplete for gift tax purposes if the donor has a power to change beneficial interest but the power is held in a fiduciary capacity and is subject to a "fixed and ascertainable standard." Reg. §§25.2511-2(c) & 25.2511-2(g). In this situation, however, Grantor's authority to direct distributions was held in a nonfiduciary capacity. Interestingly, the IRS treats whether a grantor holds a substitution power in a nonfiduciary capacity for purposes of §675(4)(C) as a question of fact to be determined in each year for income tax purposes. The IRS gave no analysis of whether Grantor actually held the power in a nonfiduciary capacity as a factual matter.

  Grantor's sole power over principal in effect gives Grantor a lifetime power of appointment. CCA 201208026, discussed immediately below, held that a mere testamentary power of appointment caused the trust to be incomplete only as to the remainder interest. A lifetime power of appointment in effect would cause the transfer to be incomplete as to the term interest as well prior to the termination of the trust. However, if including this provision is essential to cause incomplete gift treatment, the plan could not be used in states such as Delaware that do not permit the grantor to retain a lifetime power of appointment in order for a self-settled trust to be protected from claims of the grantor's creditors (and if the grantor's creditors can reach the trust, it would be a grantor trust). See Delaware Qualified Dispositions in Trust Act §§3570(11)b.2 & 3571.

- *Grantor's testamentary limited power of appointment*. **The rulings reiterate the limitation under CCA 201208026 on incompleteness by retaining a testamentary limited power of appointment**. The rulings state that the testamentary power of appointment causes "a retention of dominion and control over **the remainder**," and concludes that the retention of the testamentary power causes the transfer of property to the trust to be incomplete "with respect to **the remainder**" for federal gift tax purposes.

Accordingly, retaining a testamentary limited power of appointment would not, under the reasoning of these rulings or CCA 201208026, cause a transfer to be incomplete as to the term interest prior to the termination of the trust.

- *Unanimous member power does not remove Grantor's dominion and control*. Grantor retains dominion and control over the income and principal until the distribution committee members exercise their unanimous member power. Therefore the existence of the unanimous member power does not remove Grantor's ability to shift beneficial interests under the other two alternatives for giving distribution directions to the trustee (thereby causing the gift upon transfer property to the trust to be incomplete).

(3) *No Completed Gift by Distribution Committee Members Upon Making Distribution to Grantor*. The rulings reason very simply that "[a]ny distribution from Trust to Grantor is merely a return of Grantor's property. Therefore, we conclude that any distribution of property by the Distribution Committee from Trust to Grantor will not be a completed gift subject to federal gift tax, by any member of the Distribution Committee." (This adopts the reasoning of the comments from the ABA Real Property Trusts and Estate Law Section submitted on September 26, 2007.)

(4) *No Completed Gift by Distribution Committee Members Upon Making Distribution to Another Person Other Than Grantor.* The issue is whether distribution committee members have general powers of appointment; if so, the exercise or release of a general power of appointment is treated as a transfer by the individual possessing the power under §2514(b). The rulings conclude that the distribution committee members do not have general powers of appointment. Distribution committee members can participate in distribution decisions under the (1) Grantor's consent power, or (2) Unanimous member power.

- With respect to the Grantor's consent power, §2514(c)(3)(A) provides that if the power is exercisable only in conjunction with the creator of the power, it is not deemed a general power of appointment.
- With respect to the unanimous member powers, §2514(c)(3)(B) provides that a power is not a general power of appointment if it can be exercised only "in conjunction with a person having a substantial interest in the property subject to the power, which is adverse to exercise of the power in favor of the possessor." The rulings rely on the statement in the regulations quoted above about the coholder of a power having an adverse interest if the coholder may exercise the power after the possessor's death in favor of himself, his estate, his creditors, or the creditors of his estate. Reg. §25.2514-3(b)(2). That regulation goes on to provide an example:

> "Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons which includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise of

> the power in favor of X. Similarly, if on Y's death the power will pass to Z, Z is considered to have an interest adverse to the exercise of the power in favor of Y."

For example, under the facts of the rulings, if the distribution committee directs a distribution to Son 1, the sons are considered adverse to each other as to that decision, so the power to make a distribution, held jointly with the other sons, is not a general power of appointment. If a distribution committee member ceases to serve, the remaining distribution committee members continue to serve. Contrast the reasoning as to this issue with the reasoning regarding the issue of whether the "Grantor consent power" results in an incomplete gift by Grantor. For purposes of that issue, the sons were not considered to have an interest adverse to Grantor because their jointly held powers do not continue after Grantor's death. However, as to the interests of the sons among themselves, a son's jointly held power to make distributions does not cease to exist at the death of any of the other sons.

The IRS had expressed concern in IR-2007-127 that the prior favorable DING Trust letter rulings may be inconsistent with Revenue Ruling 76-503 and Revenue Ruling 77-158 because those rulings suggest that because distribution committee members are replaced if they resign or die, they would be treated as possessing general powers of appointment over the trust corpus. PLRs 201310002-201310006 do not give any indication whatsoever how the IRS resolved that issue, or whether particular attributes of the trusts involved in the rulings were central to the IRS's favorable ruling as to this power of appointment issue.

Miscellaneous Observations in Rulings. The rulings make various miscellaneous observations in addition to the formal rulings described above. (a) The fair market value of the trust assets is includible in Grantor's gross estate for federal estate tax purposes. (b) Any distribution to any beneficiary other than Grantor will be a gift by Grantor for federal gift tax purposes. (c) The rulings specifically decline to express an opinion about the effect of the decanting authority to make distributions to other trusts.

Subsequent Ruling. The attorney who received PLRs 201310002-201310006 has received a subsequent private letter ruling dated October 21, 2013 (involving a Nevada trust). A distinction in the fact situation in the new ruling is that the trust named guardians to act for minors who are on the Distribution Committee.

38. Interest on Graegin Loan Not Deductible; Majority Interest in LLC Valued With Low Marketability Discount, *Estate of Koons v. Commissioner,* T.C. Memo. 2013-94

a. *Basic Facts.* In *Estate of Koons v. Commissioner,* T.C. Memo. 2013-94, the decedent's revocable trust owned 46.9% of the voting stock (and 51.5% of the nonvoting stock) of a company distributing PepsiCo products. The company undertook steps to sell the PepsiCo assets, and the company's remaining assets were transferred to an LLC. As part of the sale transaction, the LLC offered to redeem interests owned by the decedent's children (or trusts for their benefit). Some of the children were unhappy with the structure of the sale and redemption, but all of the children accepted the offer by February 27, 2005. (One son sent a letter to his father saying the redemption "felt punitive" but the children acknowledged the "exit vehicle" and that they "would like to be gone." The letter made various other complaints, observations, and suggestions. The father responded in a letter a few days before he died: "I am going to study your letter of February 21st and if I wish to accept any of your suggestions I will let you know at an appropriate time.")

The LLC operating agreement was amended to limit, for 15 years, the annual amounts of discretionary distributions to 30% of the excess of "Distributable Cash" over income tax distributions.

The decedent died (supposedly very unexpectedly, though the case does not say that) within days of the children's acceptance of the redemption offers, on March 3, 2005. The redemptions were completed on April 30, 2005 following the decedent's death. Following the redemptions, the decedent's revocable trust owned 70.42% of the voting interest and 71.07% of the nonvoting interest of the LLC.

The estate had about $19 million of liquid assets and the decedent's estate tax return indicated that the estate owed about $21 million of estate tax and the decedent's revocable trust (which held the LLC interest) owed about $5 million of GST tax. (The IRS position was that those liabilities were $64 million and $20 million, respectively.) The estate borrowed $10.75 million from the LLC on February 28, 2006 in exchange for a promissory note. (The LLC had over $200 million of "highly liquid assets.") The note provided for interest at 9.5% per year with principal and interest due in equal installments to be paid over 6 ½ years, but the payments would not begin for over 18 years (they would be made between August 31, 2024 and February 28, 2031). The loan prohibited prepayment. Total interest payments to be made on the note were over $71.4 million. The LLC reported interest income annually with respect to the accrued interest on the loan.

b. *Valuation Issue—Government's Appraisal Accepted, Allowing 7.5% Marketability Discount.* The net asset value of the LLC was about $317.9 million. The valuation dispute was over the amount of marketability discount that should be allowed in valuing the estate interest in the LLC.

Neither expert allowed a control premium or discount. A control premium was not permitted, even though the revocable trust owned 70.4% voting control of the LLC after the redemptions, because the holder of that interest "could not have accrued private benefits" and could not "extract value above its pro-rata claim on company assets."

The taxpayer's expert was Mukesh Bajaj (who often testifies for the government in tax cases). The court observed, without details, that his expert rebuttal report admitted as testimony was different from the report he prepared that was attached to the estate tax return. His report calculated the marketability discount based on his 2001 regression study of 88 companies, as described in Mukesh Bajaj, David J. Denis, Stephen P. Ferris & Atulya Sarin, *Firm Value and Marketability Discounts*, 27 J. CORP. L. 89 (2001). He calculated a marketability discount of 31.7%, after making adjustments for differences between the LLC and the 88 companies in the 2001 study. The court noted that his conclusion was based in large part on an assumption that the redemption of the children's interests would not occur.

The government's expert was Francis X. Burns (who also has served as the expert for the government in other tax valuation cases). He believed that it was reasonably foreseeable that the redemptions of the children's interests would occur, that the LLC would make cash distributions, and that the revocable trust's interest could force the LLC to distribute most of its assets. He thought the marketability discount should be between 5-10%, and that "7.5% would reflect a reasonable compromise between a seller and a buyer."

The court agreed with the government's position that the children's signed redemption acceptance letters were enforceable and that they wanted to have their interests redeemed (the redemption agreements provided for redeeming their interests based on the full pro rata value of the LLC's assets). The majority members could eliminate the provision in the LLC operating agreement limiting discretionary distributions to 30% of the distributable cash in excess of income tax distributions. The taxpayer's expert believed that the LLC's board of managers would not distribute most of the LLC's assets because the decedent had expressed the desire that the LLC should invest in operating businesses after his death. The court observed, however, that a hypothetical buyer would consider that the LLC could be forced to distribute most of its assets by the 70.4% voting owner in spite of the decedent's expressed desire. A majority member who could force the LLC to distribute most of its assets would not sell its interest for less than the member's share of such a distribution (citing *Estate of Jones v. Commissioner*, 116 T.C. 121, 135 (2001)). The court also concluded that the government's appraiser appropriately considered potential liabilities of the company including the possibility of a particular lawsuit against the company (which was dismissed after the decedent's death based on the statute of limitations.)

A provision in the operating agreement requiring a 75% vote to transfer an interest in the LLC to persons who were not direct descendants was given little weight because a holder of the revocable trust's interest in the LLC could eventually force the LLC to distribute most of its assets to its members or control its investment decisions.

The court agreed with the government's expert's analysis of why the taxpayer-expert's regression analysis overstated the marketability discount. The reasons included that the 88 companies in the regression analysis derived their profits mainly from active business operations, the 88 company transactions involved ownership interests of less than 50.50%, and the taxpayer's expert overstated the relationship between block size and the valuation discount because regulatory restrictions were more responsible for the valuation discounts in the 88 companies than a large block size.

c. *Graegin Loan Issue; Interest Deduction Disallowed.* The court (Judge Morrison) disallowed the $71.4 million interest deduction for estate tax purposes on the $10.75 million note. The court reasoned that the revocable trust could have forced a distribution from the LLC to pay the estate tax, and that the loan merely delayed the time for such a distribution because the estate's only ability to repay the loan was from eventual distributions from the LLC. The estate argued that a loan from the LLC was preferable to a cash distribution because a cash distribution would leave the LLC with less cash to buy businesses. However, the court noted that the loan also depleted the LLC of cash. Furthermore, the court noted that the estate would have to remain active long enough to repay the loan, and keeping the estate open 25 years "hinders the 'proper settlement' of the Estate."

The reasoning in *Koons* is similar to the analysis in *Estate of Black* v. *Commissioner,* 133 T.C. 340 (2009). In both, the court reasoned that the family entity could have simply made a distribution to the estate, that the estate had no ability to repay the loan apart from eventual distributions from the family entity, and that the loan merely deferred the eventual distribution from the entity to repay the loan. A distinction is that in *Black*, a purported reason for the loan was to avoid a forced sale of a favored asset, but the family entity sold the favored asset anyway in order to have the cash to loan to the estate. By analogy, the estate argued in *Koons* that the LLC could not make a distribution to the estate because the LLC purpose was to invest in businesses, but the loan reduced the LLC's cash that was available to invest in businesses. In *Estate of Duncan v. Commissioner*, T.C. Memo. 2011-255*,* a case in which the interest deduction was allowed, the loan kept the estate from having to sell illiquid assets (i.e. oil and gas interests).

In any event, the extreme nature of the loan in *Koons* (a 25-year loan with no payments for 18 years, generating $71.4 million of interest on a $10.4 million loan) no doubt highlighted the issue for IRS scrutiny and possibly triggered a harsh "smell test" concern with the judge. The old adage "pigs get fat and hogs get slaughtered" comes to mind.

39. Self-Canceling Installment Notes (SCINs); CCA 201330033 and *Estate of William Davidson*

a. *General Description*. A potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion, in the seller's estate, of the unpaid obligation at its fair market value on the date of the seller's death. One way to avoid this problem is to use a self-canceling installment note (SCIN), a debt obligation containing a provision canceling any future payments amounts upon the death of the holder.

If the holder dies prior to the expiration of the term of the SCIN, the automatic cancellation feature may operate to remove a significant amount of assets from what would otherwise be includible in the estate of the holder. This feature can also be useful if the seller does not want to burden the purchaser with the continued obligation to make payments after the seller's death. If the seller lives to full life expectancy, the seller will receive more payments than if a standard note had been used. If the seller dies before the note is paid, the IRS maintains that the seller's estate will recognize the amount cancelled as income on the estate's first income tax return.

b. *Seminal Case—Estate of Moss*. Planning with SCINs followed the seminal case of *Estate of Moss v. Commissioner.* 74 T.C. 1239 (1980), *acq. in result*, 1981-1 C.B. 2. The Tax Court held that the remaining payments that would have been due following the maker's death under a SCIN was not includable in the decedent's gross estate under §2033 because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock" and as such "it was an integral provision of the note." In *Moss*, the parties stipulated that the SCIN sale transactions were bona fide transactions for full and adequate consideration and that the cancelation provision was part of the bargained for consideration for the purchase price of the stock. In that case, "there was nothing to indicate that his life expectancy would be shorter than the approximate 10 years of life expectancy which was indicated by generally accepted mortality tables." (The notes had varying terms, but one of the notes had a term of 9 years and 7 months, so the term of note was very close to the seller's life expectancy.)

c. *Risk Premium to Account for Cancellation Feature*. For the value of the SCIN to equal the value of the property sold, the seller of the property must be compensated for the risk that the seller may die during the term of the note, and thus not receive the full purchase price. Since such a feature must be bargained for at arm's length to be respected, the seller must be compensated for the risk associated with the potential cancellation either by an increase in the purchase price or by a higher interest rate. To calculate the premium, an advisor must determine what stream of payments are required, taking into consideration the possible death of the seller, to have the same present value as the principal amount of the promissory note. There is not universal agreement on how payments under a SCIN are properly valued, for there is no clear answer concerning which mortality tables should be used and which discount rate should be applied to value the payments. Many, if not most, practitioners are using the higher of the §7520 rate or the AFR for the actual term of the note; the estate tax risk of using a rate that is too low is simply too great.

   The risk premium can be structured using a higher than "normal" interest rate, a higher principal face amount of the note, or a combination of the two. A principal risk premium should be treated as a capital gain to the seller and increase the basis of the property in the hands of the purchaser. Using a higher interest rate will result in higher interest income to the seller (taxed as ordinary income and subject to the 3.8% tax on net investment income) and a higher investment interest deduction for the buyer.

d. *Recognition of SCIN Transaction as Bona Fide Transaction to Recognize Note As Providing Value*. The premium feature of SCINs was addressed in *Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003), *rev'g*, T.C. Memo. 2001-128. In that case, the decedent sold real property to his son in exchange for a SCIN that was fully secured by the real property. The note was payable over 11 years. The interest rate increased by one-half percent every 24 months, beginning at 6.25 percent and ending at 8.75 percent the last 12 months of the note. The decedent died unexpectedly five months after the note was issued, after payments had been made for only three months. (He had heart disease but medical experts testified that his life expectancy at the time of the SCIN transaction was between 5 and 13.9 years.) The Tax Court concluded that the sale was not a bona fide transaction and that the SCIN provided **no consideration**. The Sixth Circuit stated that "a SCIN signed by family members is presumed to be a gift and not a bona fide transaction." *Id*. at 597. However, the presumption could be rebutted by an affirmative showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness. The court concluded that, on the facts of the case, the estate "rebutted the presumption against the enforceability of an intrafamily SCIN by affirmatively showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness." The Sixth Circuit remanded the case to the Tax Court to determine the value of the note and whether the SCIN constituted a bargain sale with some gift element. The parties settled.

In *Costanza*, the IRS interestingly argued that the parties entered into the SCIN transaction because they presumed the father would die prior to the note being fully satisfied. "If they had thought [the father] would outlive the final payment due under the SCIN, ... there would have been no reason to have signed the SCIN, as opposed to an unconditional promissory note." The Sixth Circuit rejected this argument, reasoning that it effectively would invalidate all SCINs, but SCINs have been recognized (*Estate of Moss*).

An earlier case had agreed with the IRS position under the facts of that case that the SCIN was not recognized as providing any value to the seller. In *Estate of Musgrove v. United States*, 33 Fed. Cl. 657 (1995) a demand SCIN transaction was not recognized as a bona fide transaction because of the absence of a real expectation of repayment (since the seller was in poor health and the purchaser did not have other funds and the seller declared that he was not likely to demand payment on the note), and the SCIN was included in the decedent's gross estate.

e. *Impact of Note Term*. A SCIN term which is too long may raise debt/equity concerns, especially when the sale is to a trust with comparatively few other assets. The mortality component of the SCIN increases as the term of the SCIN increases, for a greater risk premium must be added to the SCIN to compensate the seller for the higher probability that the seller will die prior to the expiration of the longer term.

f. *Chief Counsel Advice 201330033*. The IRS Chief Counsel Office weighed in on the treatment of SCINs in Chief Counsel Advice 201330033. A CCA memo merely states the litigating position of the IRS for a case, the the memo gives guidance regarding the IRS's position regarding SCINs. The taxpayer entered into various estate planning transactions including transfers of stock in exchange for preferred stock, stock transfers to GRATs, and sales of stock for notes. The CCA addresses the sale transactions. The sale transactions included some "standard" note transactions and some SCIN transactions.

CCA 201330033 relates to the estate tax audit of the estate of William Davidson. The following fact summary is the description of facts in the CCA. The more detailed facts involving the *Estate of Davidson* are discussed following this summary of the CCA.

Note Transactions. (1) One sale was to grantor trusts for notes providing interest-only annual payments with a balloon principal payment at the end of a fixed term.

(2) A second sale was to grantor trusts for SCINs, providing for interest-only payments during the note term, with a balloon principal payment at the end of the note term.

The face of the note was almost double the value of the stock that was sold. "The higher value of the notes supposedly compensated the decedent for the risk that he would die before the end of the note term and neither the principal nor a significant amount, if not all, of the interest would be paid."

(3) A third sale transaction was to grantor trusts for SCINs, requiring interest-only payments during the note term, with a balloon principal payment at the end. These SCINS had an interest premium rather than a principal amount premium to account for the self-canceling feature.

On the same date as the third sale transaction, seller also funded a GRAT. The CCA does not describe the GRAT term. (Obviously, if the grantor died during the GRAT term most if not all of the GRAT assets would be included in the grantor's estate. Presumably, the grantor thought he would live throughout the GRAT term--or else he was being sneaky and created the GRAT just to make it look like he thought that he would live that long.)

The decedent was diagnosed with a serious illness "very shortly after" the third sale transaction and GRAT formation and died less than six months after the sale transactions, having received no payments at all on the notes. The CCA does not address the decedent's life expectancy at the time of the transactions in relation to the terms of the notes, but did note that "[b]ecause of the decedent's health, it was unlikely that the full amount of the note would ever be paid." (Based on the description in the CCA, it is not clear whether the decedent merely had some health issues, but would have satisfied the requirement in the §7520 regulations of having a greater than 50% likelihood of living at least one year. However, the *Estate of Davidson* facts [discussed below] appear to indicate that medical consultants selected by the IRS agreed that the decedent had a greater than 50% probability of living at least one year at the time of the sale transactions. The IRS maintains, however, that is irrelevant because §7520 does not apply at all to SCINs.)

Issues. The CCA addresses three issues.

(1) Does a portion of the transfers for the SCINs constitute a gift?

(2) How should the fair market value of the SCINs be determined?

(3) What are the estate tax consequences of the SCINs at the seller's death?

Gift Element and Valuation of SCINs. The CCA observes that the exchange of property for a promissory note is not treated as a gift "if the value of the property transferred is substantially equal to the value of the notes." [Observation: This is helpful to have an acknowledgement from the IRS, albeit not guidance that can be relied on, that a sale in return for notes "substantially equal" to the value transferred is not a gift. In light of the inherent uncertainties in valuing property and notes, an acknowledgement of a "substantial equality" standard is comforting.]

The analysis primarily is a comparison to the facts to the *Costanza* case. However, unlike the IRS's argument in *Costanza*, the CCA does not take the position that the note should be disregarded in its entirety. The CCA distinguishes the facts from the facts in *Constanza* on several grounds.

- In *Costanza*, the seller-decedent needed the note payments (of interest and principal, so they were substantial periodic payments) for retirement income and therefore "had a good reason, other than estate tax savings, to enter into the transaction."
- Under the CCA facts, the payments during the term of the note were interest-only payments and a steady stream of income was not contemplated. Also, the seller-decedent had substantial assets and did not need cash flow from the sale to cover daily living expenses.
- An indicia of genuine debt is that there must be a reasonable expectation of repayment, and the CCA suggests that the estate has not demonstrated that the grantor trusts-purchasers have the ability to repay the notes. This is particularly concerning for the SCINs that are about double the value of the stock transferred to the trusts in return for the notes (but is also a concern for the SCINs with the interest-rate premium). However, the CCA acknowledges that the estate might argue that the grantor trusts have enough seed money to cover the note payments.
- The analysis of the estate tax issue also discussed similarities with the *Musgrove* case (which held that the SCIN was included in the decedent's gross estate). The facts of the CCA were similar to the facts of *Musgrove* because the seller-decedent "was in very poor health and died shortly after the note was issued." [Observation: A distinction between *Musgrove* and the CCA facts may be that the seller may have been unaware of his serious health issue at the time of the sale transactions, even though he died within six months, because he was diagnosed after the sale transactions.] Also, there is a legitimate question as to whether the note would be repaid in each case.

As to how the note should be valued, the CCA states that the SCINs were valued "based upon the § 7520 tables." Presumably that means they were valued using the § 7520 rate as the discount rate to determine the present value of the future payments, and that the mortality tables of § 7520 were used in determining the principal and interest premium amount to account for the self-canceling feature. The CCA gives the following conclusion regarding how the notes should be valued:

> "We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986)."

The IRS position may be based in part on the general understanding that § 7520 applies to annuities, interests for a life or term of years, remainders and reversions—but does not govern debt instruments. (Section 1274—which refers to the applicable federal rate rather than the § 7520 rate and which makes no reference to mortality tables—specifically applies to "certain debt instruments issued for property.")

The IRS's conclusion that the § 7520 tables do not apply "to value the notes in this situation" raises various questions.

- The paragraph says that § 7520 applies only to value an annuity, interest for life or a term of year, or a remainder. Are the principles of § 7520 (in particular the mortality tables of § 7520) never applicable for valuing notes?
- Is the primary concern that the decedent's life expectancy was unduly short, making the valuation using the mortality tables of §7520 inappropriate? What if the decedent was in good health? Would §7520 then be applicable in valuing SCINs (i.e., using the §7520 rate as the discount rate to value future payments and using the §7520 mortality tables)? As a practical matter, the commercial programs that value SCINs (including the Numbercruncher program and Larry Katzenstein's Tiger Tables) use the §7520 approach to value SCINs. (Some commentators suggest using the AFR, rather than the §7520 rate to value SCINs; using the AFR produces a higher value for notes than using the §7520 rates. See Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,¶ 1601.3.B(1)-(2) (2000).)
- The CCA cites a prior GCM taking the same position that §7520 does not necessarily apply in valuing notes for an installment sale (although that GCM predated §7520). GCM 39503 ("unlike the private annuity, there is no requirement that the actuarial tables are to be used in determining the gift taxation of an installment sale. Thus, the taxpayer's particular health status may be considered.") In that respect, the position in the CCA is basically consistent with prior position statements from the IRS. Various commentators have noted this position of the IRS. Esperti et al., IRREVOCABLE TRUST: ANALYSIS WITH FORMS (WG&L), ¶16.06[4][A]; BNA TAX MANAGEMENT PORTFOLIO 805, ¶III(C)(3)("there is no requirement that the actuarial tables are to be used in determining the gift taxation of SCINs," quoting GCM 39503). However, other commentators have concluded that the IRS's citation of GCM 39503 is overstated as support for the proposition that § 7520 does not apply for valuing SCINs but that the decedent's actual medical history should be considered.

  > As the language clearly shows, the GCM is not rejecting the use of the mortality tables at all. The memo simply acknowledged that Revenue Ruling 80-80 required taxpayers to use the mortality tables in Treasury Regulation § 20.2031-10 to value private annuities, and reiterated that no such requirement existed for SCINs. The fact that the use of the § 7520 tables is not required, does not mean that these tables do not offer the most practical valuation system for SCINs as well. An again, this GCM was released in 1986. The subsequent Rev. Rul. 96-3 deemed Rev. Rul. 80-80 to be obsolete. Yet the CCA characterizes the GCM for the proposition

> that mortality tables should not be used and the willing buyer willing seller standard should be used instead. Simply put, the CCA mischaracterizes the GCM for standing for a much broader principle than it actually does.
>
> …
>
> By changing the valuation of a SCIN, the IRS is abandoning a mechanical valuation system for a system that practitioners can only speculate about. The need for subjective valuation was a reason for the enactment of § 7520. Congress recognized that in intra-family transactions there frequently are no comparable arm's-length transactions which could be relied on to establish the value of the transaction.

Ken Crotty, Jerry Hesch, & Alan Gassman, *Chief Counsel Advice 201330033: IRS Puts SCINs in the Sunlight, Will Taxpayers Get Burned?*, LEIMBERG INFORMATION SERVICES ESTATE PL. NEWSLETTER #2147 (SEPT. 24, 2013).

- Other commentators have suggested that the §7520 actuarial tables should apply unless there are serious health issues. *See* Zaritsky & Aucutt, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS (WG&L), ¶12.02[3](2d ed. 1997 & Supp. June 2013). This treatise provides an excellent extended analysis of this issue.

> The IRS may attempt to reject the use of the actuarial tables under Section 7520 in valuing the premium on a SCIN, but the tables appear to be the best way to value a SCIN premium. In GCM 35903 (May 7, 1986), the IRS stated that, when the term of a SCIN is less than the transferor's life expectancy (determined at the time of the transaction in accordance with Regulations Section 1.72-9, Table I), then the transaction will be characterized as an installment sale with a contingent sales price and will be treated in accordance with the installment sale rules, rather than the private annuity rules. …
>
> It should be noted, however, that GCM 35903 predated Section 7520, which states that actuarial tables must be used to value an "annuity, any interest for life or a term of years, or any remainder or reversionary interest." Section 7520 states that it must be used to value "an interest for life or a term of years," which precisely describes the payments under a SCIN. Furthermore, the IRS publication "Actuarial Values, Alpha Volume," which implements the IRS actuarial tables under Section 7520, includes an example that uses the tables to determine "the present worth of a temporary annuity of $1.00 per annum payable annually for 10 years or until the prior death of a person aged 65. . . ." This, too, appears to describe precisely the calculation of the premium for a SCIN. Thus, Section 7520 appears to apply to the valuation of a SCIN premium.
>
> Also, GCM 35903 only cites two articles [citing S. Banoff & M. Hartz, "Sales of Property: Will Self-Cancelling Installment Notes Make Private Annuities Obsolete?" 59 Taxes 499 (1981), and E. Schnee, "Cancelling a Debt Correctly Can Give Rise to Estate and Gift Tax Advantages," 8 Est. Plan. 276 (1981)] as authority for using actual life expectancies rather than actuarial life expectancies to value a SCIN. The Banoff and Hartz article provides no authority for preferring the use of actual life expectancy over actuarial life expectancy, and merely describes it as "one equitable way" of determining the SCIN premium. The Schnee article does not refer to the computation of the SCIN premium at all but states, also without authority, that the

payments on a SCIN must continue for no longer than the "taxpayer's life expectancy based on mortality tables and taxpayer's health at the time of sale."

Furthermore, it should be noted that a GCM is expressly not a binding precedent. A GCM is issued solely for internal agency use. As the Court of Appeals for the D.C. Circuit has explained:

> GCMs are memoranda from the Chief Counsel to the Commissioner written originally for the purpose of guiding the Assistant Commissioner (Technical) concerning substantive issues on proposed revenue rulings, private letter rulings, and technical advice memoranda. The . . . same qualities that make these memoranda useful to the Assistant Commissioner (Technical) recommend the memoranda to agency lawyers for legal research and to agency field personnel in need of guidance in dealing with the public on certain tax liability issues. Moreover, the fact that earlier GCMs are constantly updated to reflect the current status of an issue within the Office of Chief Counsel, . . . combined with the "reconciliation" of positions taken by the Chief Counsel in GCMs with those ultimately adopted by the decisionmaker in the formal rulings, eliminates whatever deliberative character these documents may have had prior to their being "updated" or "reconciled." In essence, after a decision has been reached, a completed GCM becomes an expression of agency policy.

…

Practitioners should, therefore, generally use the actuarial tables under Section 7520 to calculate the premium on a SCIN. They should, however, be aware of the possibility that the IRS may challenge this calculation to the extent that the seller's actual life expectancy is significantly different from his or her actuarial life expectancy. *Id.*

- The Zaritsky and Aucutt treatise also points out that a fairly recent case, *Dallas v. Commissioner*, T.C. Memo. 2006-212 appears to have used §7520 in valuing a SCIN. Zaritsky & Aucutt, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS (WG&L), ¶12.02[3] at n.19.8 (2d ed. 1997 & Supp. June 2013):

  > It is not possible to replicate this calculation perfectly from the facts reported in the court's opinion and in the pleadings available online. It is, however, possible to get close enough to believe strongly that the Section 7520 tables were used by the IRS in its determination of the value of the SCIN in this case.

- If the concern is that the seller-decedent in the CCA was in poor health and "unlikely" to receive the full note payments, and if § 7520 can apply if there are no health concerns, how does one determine when the poor health threshold has been crossed? Do the principles of Treas. Reg. § 1.7520-3(b)(3) apply? (Under the regulation, the §7520 tables may not be used if the person who is the measuring life has a "terminal illness" and for these purposes, "terminal illness" means that the individual has an "incurable illness or other deteriorating physical condition" which results in at least a 50% probability that he or she will die within one year. If the person lives for 18 months or longer after the relevant valuation date, he will be presumed not to have been terminally ill at the time of the transaction, unless the existence of a terminal illness can be established by clear and convincing evidence.)

- An alternative interpretation of the CCA's conclusion may be that the decedent's actual medical history must be taken into account in all SCIN valuations, even if the taxpayer has at least a 50% probability of living at least one year. For example, if an individual is in perfectly good health, but has a family history of cancer, would the "decedent's medical history" indicate that the mortality tables in §7520 could not be used? What if an individual is in outstanding good health, suggesting that he or she will have a longer than normal life expectancy. Would the SCIN be valued taking into account "the decedent's medical history" in that case as well to provide a higher value to the SCIN than the §7520 tables would suggest?
- Does the CCA mean that §7520 cannot be used in valuing "standard" notes without a self-canceling feature? The facts of the CCA give rise to some confusion about that issue, because the transaction involved the sale for standard note as well as for SCINs and this conclusory sentence does not make a distinction for the standard notes. However, the context of the statement clearly suggests that it is referring to the SCINs. The sentence refers to the "notes in this situation" and the immediately preceding paragraph was clearly addressing the SCINs.

Estate Tax Effects. The *Moss* case held that the SCIN remaining payments were not included in the decedent's gross estate and the *Musgrove* case concluded that the SCIN was included in the gross estate. The CCA noted similarities with *Musgrove*: (a) the decedent's health made it unlikely that all payments would be made; and (b) there is a legitimate question as to whether the note would be repaid. There was no further conclusion as to whether the SCINS would be included in the estate, other than the analysis treating this situation as being closer to the *Musgrove* facts than the *Moss* facts.

g. *Estate of William Davidson, Tax Court Cause No. 013748-13 (filed June 14, 2013).*

General Background. William Davidson was the President, Chairman, and Chief Executive Officer of Guardian Industries Corp., one of the world's leading manufacturers of glass, automotive, and building products. Before various gift and sale transactions in December of 2008, he owned 78% of the common stock of Guardian. He is a prior owner of the Detroit Pistons NBA team. The decedent (age 86) entered into various gift and sale transactions in December 2008 and January 2009, include large sale transactions for self-canceling installment notes. Soon after these transactions, he was diagnosed with a serious illness and he died on March 13, 2009 (before he received any payments on the notes). The IRS Notice of Deficiency alleges gift, estate, and GST tax deficiencies of well over **$2.6 billion (**although the IRS acknowledges in its answer that it "did not calculate certain deductions and credits to which [the estate] may be entitled."). The case involves a wide variety of issues, but the major issues are the valuation of the Guardian stock and whether the self-canceling installment notes constituted bona fide consideration that is considered as providing any value whatsoever, or if they are bona fide, whether they provide consideration equal in value to the stock transferred in return for the notes. The following brief summary of facts only addresses the SCIN transactions. The decedent sold about $600 million worth of Guardian stock (using the taxpayer's valuation) to trusts for SCINs and sold about $530 million of Guardian stock for "standard" notes. This summary is based on the estate's petition (filed June 14, 2013) and the government's answer (filed August 9, 2013).

Valuation. The stock sale and gift transactions were based on a value of $2,750 per share for the common stock and $531 per share for the preferred stock of Guardian. After the date of death, the estate obtained an appraisal indicating a value of $2,300 per share for the common stock at the date of the gift/sale transactions and $1,900 at the date of death.

The IRS maintains that the value of the Guardian common stock was $4,400 at the gift/sale dates and $2,999 at the date of death, and that the Guardian preferred stock was approximately $750 per share. (The government's appraiser was Francis X. Burns, who has also been the government's valuation expert in various other transfer tax cases.)

The primary difference between the taxpayer's and the government's appraisals is that the taxpayer's appraisal was based primarily on a "market analysis" whereas the government's appraisal was based 25% on a market analysis and 75% on a discounted cash flow analysis of estimated cash flows for the corporation.

Gift and Sale Transactions. There were gift, sale and substitution transactions on three dates. All of the sales were for notes providing annual interest payments and balloon principal payments after 5 years. The SCINs were secured by more Guardian shares than just the shares transferred in return for the SCINs. The summary of transactions below describes the value of Guardian shares transferred in each of the sale transactions; these values are based on the taxpayer's valuation of the stock.

December 22, 2008.

- There were gifts to various trusts of common and preferred stock of Guardian, valued at over $150 million (using the IRS's values).
- There were substitutions of stock with trusts that had been created in 1995 and 1997 (increasing the percentage of common stock owned by the trusts), which the IRS alleges also included a gift element.

January 2, 2009.

- Guardian stock was sold to trusts for the decedent's two children and his step-daughter for 5-year balloon "standard" notes, with annual interest payments at a rate of 2.06% (the AFR)(combined transfers of $210 million of stock for $210 million face value unconditional 5-year notes).
- Guardian stock was sold to GST exempt and non-exempt trusts for six grandchildren for standard notes (combined transfers of $322 million of stock for

$322 million face value, 5-year unconditional notes with annual interest payments at a rate of 2.06% [the AFR]).

- Guardian stock was sold to six grandchildren's trusts for SCINs (combined transfers of $162.3 million of stock for $305.9 million face value, 5-year balloon SCINs, with annual interest payments at a rate of 2.4% [the §7520 rate]). The SCINs reflected a risk principal premium of about 88% over the stock value.
- Guardian stock was contributed to a 5-year GRAT. The IRS answer clarifies that any unpaid annuity amount following the decedent's death and the remaining assets in the GRAT at the end of its 5-year term pass to a family foundation that is exempt under §501(c)(3).
- Further substitutions of stock were completed with the 1995 and 1997 trusts.

January 21, 2009.

- Guardian stock was sold to trusts for the decedent's children and step-daughter for SCINs (combined transfers of $432 million of stock for $432 million face value, 5-year balloon SCINs, with annual interest payments at a rate of 15.83% [reflecting an interest rate premium of 13.43% over the §7520 rate]). (Interestingly, the IRS answer "denies any allegations that such transfers were sales," but did not make that same statement regarding the SCIN transactions with the grandchildren's trusts on January 2.)
- Older trusts were merged with newly created trusts for the decedent's children and step-daughter.
- Additional Guardian stock and the SCINs from these January 21 transactions were contributed to a 5-year GRAT. The IRS answer clarifies that any unpaid annuity amount following the decedent's death and the remaining assets in the GRAT at the end of its 5-year term pass to a family foundation that is exempt under §501(c)(3).
- Further substitutions of stock were completed with the 1995 and 1997 trusts.

Mortality Information.

- *Section 7520 Tables.* The mortality tables under §7520 indicate that the life expectancy was 5.8 years at the time of the sale transactions (based on Table 90CM, which applied to transactions from May 1999-April 2009 [Table 2000CM applies to transactions from May 2009 forward]). The taxpayer's appraiser used life expectancies from Table 90CM and the 2000 National Vital Statistics Life Expectancy table to assume that the decedent had a life expectancy of about five years.
- *Decedent's Doctors*. The decedent's primary physician wrote a letter in October 20, 2008 stating: "Mr. Davidson continues an active exercise schedule, and is routinely working at home or in the Guardian Headquarters Office. Based on

regular medical assessments and oversight, I believe that Mr. Davidson is in good health commensurate with his age group, and participates in a healthy lifestyle, exercise regimens, and activities which require keen mental rigor. He has no current conditions which will impact his actuarial life expectancy."

In December 16, 2008, the primary physician wrote another letter stating that he had completed a routine medical assessment of the decedent the prior week. He concluded that "there are no changes in his health and he has no current conditions which would impact his actuarial life expectancy and continues to work in his usual capacity."

A specialist in physical medicine and rehabilitation examined the decedent in early January 2009 and wrote a letter stating: "I considered [Mr. Davidson's] prognosis for return to standing and short distance assisted ambulation within 6 months to be good." [Observe, this letter indicates that the decedent had significant ambulatory limitations in January 2009.]

- The government's answer in the case alleges that the estate did not offer any evidence demonstrating that these physicians were qualified to estimate the decedent's life expectancy.
- *IRS's Medical Expert.* One of the IRS's medical experts estimated that the decedent had a significantly shorter life expectancy, 2.5 years. He estimated that the decedent had only a 19.3% probability of surviving for five years. The expert never personally examined the decedent but based his estimates on the decedent's medical records as well as prognostic studies and statistical studies. The IRS's valuation of the SCINs was based on this medical expert's life expectancy estimate.
- *Four Medical Consultants' Review of Medical Records—Greater Than 50% Probability of Living At Least One Year.* In connection with the estate tax audit the decedent's medical records were reviewed by four medical consultants, two of whom were selected by the estate and two of whom were selected by the IRS. All four medical consultants concluded that the decedent had a greater than 50% probability of living at least one year in January 2009.
- *Possible Tax Court Guidance Regarding Valuation of SCINs*. If the *Davidson* case is not settled, the Tax Court opinion may provide the first guidance in any reported case regarding the valuation of SCINs. The IRS makes two arguments regarding the SCINs. First, the SCIN transactions are not bona fide and the notes provide no consideration. Second, in the alternative, if the SCINs are bona fide, they should be value under a hypothetical willing buyer test, not under §7520.

  One possible outcome is that the court determines that the SCINs were not bona fide loan transactions (perhaps based on whether there was a reasonable expectation of repayment-and one factor in that decision will be that the SCINs are secured by more Guardian stock than just the shares transferred in return for the

SCINs), and the SCINs may be valued at zero if they are determined not to represent bona fide loan transactions. The government's answer in the case states that the burden of proof is on the estate to prove that the SCINs were bona fide debt, that the decedent intended or expected to collect all payments due under the SCINs, and that the trusts would be able to make payments on the SCINs when due.

If the court gets beyond the "bona fide transaction" issue, because all of the medical consultants agree that the decedent had a greater than 50% probability of living at least one year on the date of the sale transactions, the court presumably will be squarely faced with addressing whether §7520 applies in valuing SCINs. The IRS maintains that §7520 applies only in valuing annuities and life estates. The estate maintains that §7520 applies in valuing "any interest for life or a term of years," and that a SCIN requires valuing an interest that involves both a term of years and an interest for life. If §7520 applies in valuing SCINs, Treas. Reg. § 1.7520-3(b)(3) indicates that the §7520 mortality tables can be used "to determine the present value of an annuity, income interest, remainder interest, or reversionary interest" even if the individual who is a measuring life is in poor health as long as he or she is not terminally ill, defined to mean the person has a greater than 50% probability of living at least one year. The government's position in the answer is that "whether or not the decedent was terminally ill within the meaning of Treasury Regulation §1.7520-3(b)(3) is not relevant." Therein lays the dispute that may be squarely before the court.

h. *Planning Implications*.

- *SCINs Will be Scrutinized If the Seller Dies "Early."* The CCA is the first guidance about the IRS's position regarding SCINs since its loss in *Costanza*. The CCA clearly indicates that the IRS continues to view SCIN transactions in a negative light, particularly if the decedent has health issues or dies soon after the SCIN transaction. We can expect to see close examination of SCIN transactions in gift and estate tax audits.
- *Backloading*. The CCA at various places highlighted that the SCINs called for interest-only payments with balloon principal payments at the end of the note term. "Backloading" SCINs in this manner appears to be a "red flag" that will draw IRS attention. Backloading SCINs raises the valuation risk—because there will be a very large payment at the end of the note term, if the discount rate or mortality assumptions are wrong, the value will be skewed significantly.
- *SCINs vs. Private Annuities*. Private annuities operate somewhat like SCINs in that no payments are required after the annuitant's death. An early death may result in the seller receiving back far less than the value that was transferred in exchange for the private annuity. The IRS scrutinizes private annuity transactions as well if the seller dies soon after the private annuity transaction. *See Estate of Kite v. Commissioner*, T.C. Memo 2013-43 (discussed in Item 35 above). However,

§7520 clearly applies in valuing private annuities, and if the client has a greater than 50% likelihood of living at least one year after the transfer and will likely live at least 18 months afterward, the actuarial tables in §7520 may be used. Treas. Reg. § 1.7520-3(b)(3). If a client is not in excellent health, but would clearly satisfy the 12-month requirement, the private annuity may be a more conservative approach (even though other tax effects of the private annuity transaction may not be as favorable as a sale for a SCIN). On the other hand, the regulations require that a purchasing trust have sufficient assets to make the annuity payments if the seller lives to age 110. Treas. Reg. §20.7520-3(b)(2)(i). The mortality factor may add such a large premium (particularly for older sellers) that the purchasing trust would be unable to satisfy that requirement. *See e.g., Kite v. Commissioner,* T.C. Memo. 2013-43 (private annuity was bona fide and not illusory; individual purchasers had ability to pay annuity payments for full life expectancy); *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278 (§2036 applied to a transfer of limited partnership interests to children in return for a private annuity, in part because the parties intended to ignore the agreements, and the children-purchasers did not have assets of their own to make the annuity payments). Some planners suggest avoiding the exhaustion test by having individuals or other trusts guarantee the annuity payments. Other planners suggest structuring the annuity to be payable for the shorter of life expectancy or a term of years that exceeds life expectancy by a year or so; this is treated as an annuity for purposes of the valuation rules (GCM 39503), but the term of years element would eliminate the requirement to have assets to pay an annuity to age 110.

- *§7520 Application*. The CCA raises an ambiguity regarding the manner in which SCINs are valued. The commercial programs (which anecdotal evidence suggests are typically used by IRS agents in audits regarding SCINs where there are no particular health issues) generally use the §7520 discount rate and mortality tables to value SCINs. If §7520 cannot be used at all to value SCINs, those commercial programs may be suspect. What approach should be used?
- *Ability to Repay*. The CCA at various points emphasized that the ability to repay a note is a central element of recognizing the note as a valid debt instrument rather than as a continuing equity interest of what was transferred in return for the note. In planning SCIN transactions, consider the ability of the obligors on the note to repay the note (as well as evidence suggesting that the seller may not demand payment if payments are not made timely). If sales are made to trusts, consider their ability to make the note payments. The CCA suggests that this concern is exacerbated if there is a large principal premium to account for the cancellation feature, resulting in a note with a face value of double the value of assets transferred. Having the SCINs secured by assets in addition to the assets transferred in return for the SCINs may be helpful in establishing the reasonable expectation of repayment and the ability to repay the note.

This is a particularly problematic issue for older clients, for whom the risk premium (especially for backloaded "balloon" payments) may result in an inordinately large principal premium or interest premium, making it unlikely that the full amount can be paid if the seller lives to a full life expectancy.

- *Using AFR as Interest Rate for Standard Notes.* While the conclusion of the CCA is somewhat frustrating in light of the confusion of how far it meant to go in saying that §7520 did not apply to the "notes in this situation" (which included standard notes without a cancellation provision), the CCA does not discuss the standard notes at all, other than to note their existence. The CCA raises no concerns about the interest rate that is used on the standard notes. The CCA does not give any indication of the interest rate that was used on the standard notes, and whether the AFR, the §7520 rate or some other rate was used. (As discussed above, the *Estate of Davidson* facts indicate that the AFR was used for the standard notes, but the CCA made no mention of that fact.)

  As a practical matter, many intra-family sale transactions use notes having an interest rate equal to the AFR rather than the higher §7520 rate. Sections 1274 and 7872 were enacted soon after the *Dickman* case and address valuing gifts from below market loans. Those sections (which constitutes the basis for the AFR) seems to contemplate cash loans, but there is authority that AFRs under §7872 can also be used for sale transactions. *See Frazee v. Commissioner*, 98 T.C. 554, 588 (1992)("Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply the provision as drafted."); *True v. Commissioner*, T.C. Memo. 2001-167 ("We concluded in Frazee v. Commissioner, supra at 588-589, that section 7872 does not apply solely to loans of money; it also applies to seller-provided financing for the sale of property. In our view, the fact that the deferred payment arrangement in the case at hand was contained in the buy-sell agreements, rather than in a separate note as in Frazee, does not require a different result."), *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004).

  Private letter rulings have also taken the position that using an interest rate that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. Private Letter Ruling 9535026 involved an installment sale of assets to a grantor trust in return for a note that paid interest annually at the § 7872 rate (i.e., the AFR), with a balloon payment of principal at the end of 20 years. After summarizing the provisions of § 7872 and the *Frazee* case, the ruling concludes

> "that, if the fair market value of the stock transferred to the [trust] equals the principal amount of the note, the sale of stock to the [trust] will not result in a gift subject to gift tax. This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to their terms; and (ii) the [trust's] ability to pay the notes is not otherwise in doubt."

Private Letter Ruling 9408018 addressed whether redemption of a mother's stock by the corporation for a note, where her son was the remaining shareholder, constituted a gift. The note had an interest rate equal to the greater of (i) 120% of the applicable federal mid-term rate, or (ii) the rate sufficient to provide the note with "adequate stated interest" under § 1274(c)(2) (which is tied to the AFR). The ruling employed reasoning similar Private Letter Ruling 9535026, and concluded that because the interest rate on the note will be at least equal to the AFR for the month during which the note is executed, the fair market value of the note for federal gift tax purposes is the face value of the note. (That ruling similarly was conditioned on (i) there being no indication that the note would not be paid according to its terms and (ii) the corporation's ability to pay the notes is not otherwise in doubt.)

- *"Substantially Equal" Acknowledgement*. As noted above, in light of the inherent uncertainties in valuing property and notes in sale transactions, an acknowledgement that "substantially equal" values are sufficient to avoid gift consequences is comforting. (This same statement was in GCM 35903.)

- *Income Tax Consequences of SCINs.* If the seller dies before all payments have been made, the planner must understand that while this may result in a decrease in the amount included in the seller's gross estate, there are factors that may offset some or all of that advantage. If the seller dies before the SCIN matures, the IRS maintains that the deferred gain will be recognized for income tax purposes on the estate's first return. *See Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993). (This reversed the Tax Court's holding that the deferred gain was recognized on the decedent's final return. 98 T.C. 341 (1992).) Some commentators (supported by the Tax Court dissent in *Frane*) maintain that the cancelled gain should not be recognized as income by anyone. In addition, if the sale for the SCIN was made to a grantor trust, there may be no recognition of income on the grantor's death. There are also uncertainties regarding the purchaser's basis in the purchased assets. In any event, just be aware that there are income tax issues that may offset some of the advantages of avoiding estate inclusion for the cancelled payments. *See generally* Akers & Hayes, *Estate Planning Issues With Intra-Family Loans and Notes,* ¶517-4-517.6, 47th ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2013).

- *Contribution of SCINs to GRAT.* Under the *Davidson* case facts, the SCINs from the January 21 transactions were contributed to a 5-year GRAT in which any unpaid annuity amount following the decedent's death and the remaining assets in the GRAT at the end of its 5-year term pass to a family foundation that is exempt under §501(c)(3). At first blush this may seem to "undo" the effects of the SCIN transaction. The contribution of SCINs to a GRAT, however, may have important economic effects that are based on the anticipation that the decedent will live to his full life expectancy. As mentioned above regarding the general description of SCINs, a possible disadvantage of SCIN transactions is that if the seller lives to (or near) his full life expectancy, the seller will receive more payments than if a standard note had been used (because of the risk premium that is built into the principal or interest payments), thus increasing the amount included in the seller's gross estate for estate tax purposes. Contributing SCINs to a GRAT reduces that risk. If the seller dies early, the trust that purchased the assets may experience a valuation increase by reason of having the note liability cancelled. On the other hand, if the seller lives to his full life expectancy and if the SCIN has been contributed to a GRAT, the increased value represented by the risk premium will generally represent the GRAT appreciation that will pass to the GRAT remaindermen. *See* Steven Oshins & Kristen Simmons, *The SCIN-GRAT,* TRUSTS & ESTATES 18 (June 2008).

A further wrinkle in the *Davidson* case is that the beneficiary of the GRAT unpaid annuity payments and remainder is a family foundation. Perhaps the decedent wanted to leave any degree of the excess risk premium actually received to the family foundation, but the amount of that premium that is actually paid by the purchasing trust obviously depends on how long the decedent lives after the sale. Using the GRAT is a way to isolate that amount of risk premium to pass to the family foundation rather than using a formula in the will designed to leave a bequest to the foundation based on the amount of the risk premium actually received by the seller. (But it does seem to be a rather complicated way to achieve that result.) In any event, using a GRAT with a family foundation as the remainder beneficiary is unusual. (It is not a qualified charitable annuity remainder trust; if for no other reason, the *Davidson* facts indicated that the GRAT was not designed with a remainder value of at least 10% of the initial value contributed to the GRAT, which is a requirement for charitable remainder annuity trusts. §664(d)(1)(D).)

40. Decanting—Massachusetts Court Recognizes Common Law Decanting Authority Based on Trust Instrument, *Morse v. Kraft et al.*

An interesting development regarding decanting is that a Massachusetts opinion has held that the trustee had the authority to decant trust assets to new trusts similar to the existing trusts but adding the settlors' sons as trustees. *Morse v. Kraft et al.*, SJC-11233 (Supreme Judicial Court Suffolk County July 29, 2013).

Having the common law authority to decant without approval of beneficiaries or the court is critically important for GST purposes. The application to the court in Morse specifically noted that determining whether the trustees had the authority to decant under Massachusetts common law principles (without approval of beneficiaries or a court) was important because the GST regulations provide that a distribution of a GST exempt trust to a new trust will not destroy the trusts exempt status if the terms of the trust authorize the distribution to a new trust "without the consent or approval of any beneficiary or court," even if the new trust extends the term of the trust, as long as it is not extended beyond lives in being at the creation of the old trust plus 21 years. Reg. §26.2601-1(b)(4)(i)(A)(i). (A judicial or non-judicial modification of a trust will not destroy the trust's exempt status if the modification does not shift a beneficial interest to a younger generation beneficiary and if the modification "does not extend any beneficial interest in the trust beyond the period provided for in the original trust." Reg. §26.2601-1(b)(4)(i)(D). That alternative is not nearly as attractive, because it does not allow shifting more benefits to younger generation beneficiaries or extending the term of the trust in any manner whatsoever beyond the term in the original trust.) Florida and New Jersey cases have previously concluded that trustees had "decanting" powers where the trust instruments gave the trustees broad distribution powers. *Phipps v. Palm Beach Trust Co.*, 142 Fla. 782 (1940); *Wiedenmayer v. Johnson*, 106 N.J. Super. 161, 164-65 (App. Div.), *aff'd sub nom. Wiedenmayer v. Villanueva*, 55 N.J. 81 (1969).

In *Morse*, the court noted that a trustee's decanting authority "turn[s] on the facts of the particular case and the terms of the instrument creating the trust" (quoting *Phipps*). The trust instrument gave the trustee broad discretion to make distributions to a beneficiary or to apply distributions "for his or her benefit." The trustees' discretion regarding distributions included "full power" to dispose of property "in their discretion, without order or license of court." In addition, the settlor and the draftsman of the trust submitted affidavits stating that they intended the trust to allow distributions to new trusts without the consent or approval of any beneficiary or court." The new trusts were for the benefit of the same beneficiaries as the beneficiaries of the existing trusts. (The only change noted by the court was to add the settlor's sons as trustees of the new trusts.) The court reasoned that the trusts

> "give the disinterested trustee discretion to distribute property directly to, or applied for the benefit of, the trust beneficiaries, limited only in that such distributions must be 'for the benefit of" such beneficiaries. We regard this broad grant of almost unlimited discretion as evidence of the settlor's intent that the disinterested trustee have the authority to distribute assets in further trust for the beneficiaries' benefit."

In addition, the court noted that the affidavits from the settlor and draftsman evidence that the settlor's intent was to give the trustees decanting authority. Also, the trust instrument gave the trustee the "full power" to exercise discretion "without order or license of court." The court concluded: "For these reasons, the terms of the 1982 Trust authorize distributions to the new trust for the benefit of the 1982 trust beneficiaries without the approval of any beneficiary or court."

Planning Implications.

- The Boston Bar Association submitted an amicus brief requesting the court to "extend the decanting power to purely discretionary trusts where the trustee has the power to distribute assets 'to' the beneficiary, but not 'for the benefit of' the beneficiary." Joan Di Cola, Joan Di Cola on Morse v. Kraft – Massachusetts Supreme Judicial Court Allows Decanting, LEIMBERG ESTATE PLANNING NEWSLETTER #2125 (August 2, 2013). The court expressly declined to adopt that position of recognizing "an inherent power of trustees of irrevocable trusts to exercise their distribution authority by distributing trust property in further trust, irrespective of the language of the trust."

- The court viewed this as a matter of interpreting the trust instrument, and pointed several times in its opinion to the broad discretion of the trustee in making distributions and the specific authorization in the trust instrument that a payment to a beneficiary could be "applied for his or her benefit" and that distributions could be made "for the benefit of" the beneficiaries. Many trust instruments merely authorize distributions "to" beneficiaries and do not explicitly include the phrase "for the benefit of" beneficiaries. The case leaves in greater question whether those trusts have a decanting authority without court approval.
- By focusing the analysis on the specific terms of the trust, there may be more necessity of obtaining a judicial order that the trustee has the authority to make distributions in further trust without court approval in order to be assured that the decanting will not have adverse GST consequences, particularly if there is any shifting of benefits to younger generation beneficiaries or any extension of the trust term, whatsoever.
- Query whether the IRS may at some point take the position that having to get a court order that the trustee has decanting authority without approval of the court means that, in fact, court authorization was necessary for purposes of the limitation in the GST regulations?
- For future drafting purposes, the court noted that trusts created in the future may need to authorize decanting specifically if that is intended:

  > "In the absence of express authorizing legislation, … practitioners are including express decanting provisions in standard trust agreements with increasing frequency….The 2012 Trust [i.e., the newly created trust under the decanting power], for example, twice states expressly that the trustee has decanting power. In light of the increased awareness, and indeed practice, of decanting, we expect that settlors in the future who wish to give trustees a decanting power will do so expressly. We will then consider whether the failure top expressly grant this power suggests an intent to preclude decanting."

- For an excellent discussion of *Morse* and structuring decanting provisions in trust instruments, see Zeydel, *Zeydel on Morse v. Kraft,* LEIMBERG EST. PL. NEWSLETTER #2139 (Sept. 10, 2013).

41. Social Security and Medicare Basics—What One Needs to Know When Approaching Mid-60s

a. *Social Security Administration Website; Personal Earnings Record of Workers.* The Social Security Administration website has recently been changed to www.socialsecurity.gov. (It was previously www.ssa.gov. Some have joked that it was changed because the Social Security Administration realized that was "ass backwards.")

   Personal Earnings Record statements previously were mailed to participants in the Social Security system. (For convenience, this summary refers to participants in the system with earnings records as "workers." The more official Social Security lingo is to refer to a participant as a "number holder" or "NH." At least "worker" seems a little more personal than "NH.") The Personal Earnings Record statements are now only available online at the website (saving an estimated $70 million per year). Individual statements are available at www.socialsecurity.gov/mystatement. An worker's top 35 years are used to determine the retirement benefits. The website includes "Estimated Benefits" together with the Earnings Record.

b. *Full Retirement Age.* The full retirement age is 65 for those born in 1937 or earlier, increasing from age 65 to 66 for those born in 1938-1942, age 66 for those born in 1943-1954, and increasing from age 66 to age 67 for those born in 1955-1959, and age 67 for those born in 1960 and later.

c. *Collecting Early.* Retirement benefits can be started as early as age 62, but a permanent reduction in benefits will apply. For example, the percentage of benefits for an worker collecting early whose full retirement age is 66 is as follows: 62-75%, 63-80%, 64-87%, 65-93%, 66-100%.

   The breakeven age for a single person waiting until age 66 (versus age 62) and taking full benefits is age 78. The chance of a 62 year old male living beyond age 78 is 78% and for a 62 year old female the chance is 85%. Waiting till age 66 is a no brainer for most people, unless they cannot obtain work or have serious health issues AND are single.

d. *Deferring Starting Benefits Beyond Full Retirement Age.* If benefits do not begin before or at the full retirement age, the annual benefits will permanently be increased, as follows: 66-100%, 67-108%, 67-116%, 69-124%, 70 (or later, but there is no reason to defer to a later age)-132%. These are called "delayed retirement credits."

   At age 70, the maximum benefit is reached. If a worker defers receiving benefits, the benefits go up 8% per year, so from age 66 to age 70, the benefit would increase by 32% to about $40,000 per year.

e. *Deciding When to Apply for Benefits.* Factors in the decision of when to begin receiving benefits include the person's health status and life expectancy (e.g, if the person will die at age 64, it would be better to begin receiving benefits at age 62), the need for income, whether the worker plans to work, and the needs of survivors.

   The COLA adjustments are made based on the initial base level of payments, so the COLA adjustments magnify the impact of the reduction for early payments. Taking early payments also impacts the level of survivor benefits following the worker's death.

   The vast majority of people choose to begin receiving Social Security benefits at age 66.

   Foregoing the early payment option at age 62 dramatically impacts the level of benefits that will be paid for the rest of the worker's life. For example, benefits beginning at age 62 will be about $1,850/month vs. $3,255 per month if the benefits do not begin until age 70. As discussed in paragraph c above, waiting until age 66 is a no brainer for most people, unless they cannot obtain work (and are desperate for cash flow for basis support) or have serious health issues AND are single.

   In making the decision to delay receiving benefits from age 66 to age 70, observe that it takes about 12½ years to recover the four lost years of benefits--14 years taking into account the time value of money. Therefore, the decision to defer benefits means that the worker thinks he or she will live to age 82.5 (or age 84 taking into account the time value of money). Another factor to consider is that if the worker is likely to continue working until age 70, the individual will have a higher base for computing benefits as his or her 35 highest years, this increasing the "principal insurance amount" even before the "delayed retirement credits" are applied.

The decision of when to apply for benefits also involves other issues, discussed below, such as spousal benefits. Commercial resources that can assist in maximizing Social Security benefits include reasonably priced software from MaximizeMySocialSecurity.com and Social SecurityChoices.com and the "AARP Social Security Calculator" available for free at http://www.aarp.org/work/social-security/social-security-benefits-calculator/.

Deborah Tedford (Mystic, Connecticut) points out that counter intuitively, some studies show it is more important for those with fewer savings to delay Social Security than those with substantial assets (and other income). As average Americans age, their savings tend to diminish, and the higher monthly benefits become increasingly important.

f *Changing One's Mind*. There is a procedure to change the election to receive benefits by filing a "Request for Withdrawal of Application." This can be filed if the recipient has not received more than 12 checks. (The reason for limiting the number of checks is to prevent someone from electing to receive benefits at age 62, then at age 70 changing the election to receive benefits at age 70—by paying back the principal amount of payments received in the meantime, but not the income earned on those payments.)

g. *Retirement Benefit Amounts.* For someone who has an earnings record reaching the earnings limit for 35 years, the retirement benefits are currently about $2,400-2,500/month if the benefits begin at the full retirement age. COLA adjustments apply and the amount may change in future years.

Stated differently, at age 66, a worker can receive benefits without retiring. Benefits are based on the highest 35 years of earned income (up to a maximum amount each year) in years the worker participated in the Social Security program. If a worker has always earned the maximum for 35 years, Social Security benefits will be about $30,000 per year at age 66. If both spouses have worked and reached those maximum levels for 35 years, they would get about $60,000 per year.

h. *Impact of Continuing to Work After Receiving Benefits.* If the worker begins receiving benefits before the full retirement age, the person can earn up to $15,120/year (in 2013) without any reduction in benefits. Earnings above that will reduce the benefits by $1 for every $2 earned above that limit.

When the full retirement age is reached, the person can earn up to $40,080/year (in 2013) without any reduction in benefits. Earnings above that will reduce the benefits by $1 for every $3 earned above that limit.

After the full retirement age, there is no reduction for earnings.

These same earnings limits apply to a spouse or child who works and receives benefits on the worker's record.

i. *Spousal Benefits.* The worker's spouse is entitled to spousal benefits after the worker "files" to receive benefits if the spouse is at least age 62, even if the spouse does not have a work record. (If the spouse is entitled to benefits based on his or her own work record, the spouse can receive benefits based on his or her own work record or 50% of the worker's benefits, whichever is higher.) The spouse does not receive any benefits until after the worker files to begin receiving benefits (or "files and suspends" after reaching the full retirement age, as discussed below). When the spouse reaches the full retirement age, the spousal benefits are 50% of the "primary insurance amount" (the amount of retirement benefits if they were to begin at the full retirement age) of the worker. If the spouse begins receiving spousal benefits before the spouse reaches his or her full retirement age, the spousal benefits are reduced.

j. "*File and Suspend" Strategy.* The worker may "open his file" at his or her full retirement age, but then suspend the collection of benefits (so that when the worker's actual benefits begin they will be increased by the "delayed retirement credits;" as discussed above, the increase is 8% for each year past the full retirement age, up to age 70). This permits the spouse to receive the spousal benefits (50% of the worker's "primary insurance amount" at full retirement) even though the worker is not yet receiving benefits. (The Social Security lingo is that the spouse can claim spousal benefits on the worker's "opened but suspended record.") The spouse must be at least age 62 to receive spousal benefits, but benefits will be reduced if they are elected before the spouse reaches his or her full retirement age. For example, the higher earning spouse may file for benefits at the full retirement age but suspend payments so that the lower earning spouse can receive spousal benefits. The file and suspend strategy is not available prior to the worker's full retirement age. When the spouse elects to begin receiving spousal benefits, the spouse does not have to begin payments on his or her own worker account. For example, the spouse might elect to begin receiving full spousal benefits upon reaching age 66 but not begin taking payments on his or her own account until age 70 to receive the maximum delayed retirement credits (the 32% bonus).

   Deborah Tedford (Mystic, Connecticut) offers the following is an optimal approach that is often used by two-income spouses. Assuming husband turns 66. He files for benefits which would entitle him to receive $30,000 per year, but he "suspends" receiving benefits (to take advantage of the 8% per year increase in benefits if receipt is deferred). When wife turns age 66, she can claim under her own work benefits or the spousal benefit. She elects to claim the spousal benefit, or 50% of what husband was eligible to receive at age 66 (i.e., about $15,000). At age 70, husband and wife each claim their own benefits ($40,000 for each of them). Wife gave up four years of benefits, but she only gave up $15,000, not $30,000 per year. With this approach, wife only needs to survive 8-9 years after reaching age 66 to come out ahead by deferring the receipt of her own benefits to age 70.

k. *Survivor Benefits.* Following the worker's death, survivor's benefits may be available to the deceased worker's spouse (and child if the child is not married and under age 18, increased to 19 if the child is still in high school). If the worker had not started collecting benefits, the widow or widower benefit is 100% of the worker's "primary insurance amount" when the widow or widower reaches his or her full retirement age. If the worker was receiving benefits at the time of his or her death, the widow or widower benefit will be equal to those actual benefit amounts, assuming the widow or widower has reached his or her full retirement age.

The widow or widower can receive reduced survivor benefits beginning as early as age 60. (If the collection begins at age 60, the benefits will be reduced by up to 28.5%.)

The widow or widower will lose the survivor benefits if he or she remarries before age 60 unless the subsequent remarriage ends. Remarriage after age 60 does not impact the entitlement to survivor benefits.

l. *Divorced Spouses.* Prior divorced spouses are also entitled to spousal benefits. Requirements are that the person was married to the worker for at least 10 years, the divorced spouse has not remarried, both are at least age 62, and they have been divorced at least 2 years. Payments made to a divorced spouse will not impact the amount of benefits payable to the worker or the worker's current spouse (or other divorced spouses of the worker who qualify for divorced spousal benefits).

A prior divorced spouse of a deceased worker is entitled to survivor benefits if the individual was married to the deceased ex-spouse for at least 10 years, if the individual is unmarried or married after age 60, and if the individual is at least age 60.

The spousal benefits and survivor benefits for divorced individuals do not appear on the "Earnings Record" and "Estimated Benefits" statement, and many divorced individuals are not aware of these benefits.

m. *Taxation of Retirement Benefits.* A portion of Social Security benefits may be subject to federal income taxes. The portion is based on the worker's "combined income" level, and whether the person files individually, files a joint return, or files married filing separately. The "combined income" is adjusted gross income + nontaxable interest (so investing in tax-free bonds does not help for this purpose) + ½ of Social Security benefits.

For persons filing a joint return, if the combined income of the worker and spouse is between $32,000 and $44,000, income tax is paid on up to 50% of the benefits, and if the combined income is more than $44,000, up to 85% of the retirement benefits are taxable. If some of the benefits are subject to income taxes, the worker can choose to make quarterly estimated payments or to have federal income taxes withheld from the benefits.

If a person will not begin taking distributions from IRAs or qualified before reaching age 70 ½ (when the required minimum distributions must commence), that may be a factor in deciding to start receiving Social Security benefits at age 66 if the worker would not have sufficient "combined income" between ages 66-70 to have to pay income tax on 85% of the benefits. (But if a worker has income at that low of a level, it is likely that the worker will have to begin taking distributions from IRAs to have sufficient income for basic support needs.)

n. *Medicare.* Medicare is a federally subsidized health insurance program, enacted in 1963 as part of the Great Society of President Johnson.

An individual first qualifies for Medicare at age 65 (there are several exceptions allowing benefits at an earlier age). At age 65, the individual should go online and apply for Medicare, even if not claiming benefits.

Resources. An excellent summary of Medicare (the "official U.S. government Medicare handbook") is available at

http://www.medicare.gov/Pubs/pdf/10050.pdf. The Social Security Administration website has excellent information about Medicare (as well as Social Security) and the "search" function works very well for this website. The Center for Medicare Advocacy is another excellent resource of information about Medicare. Another outstanding resource for Social Security and Medicare information is the website for the Boston College Center for Retirement Research. The information described below about Medicare is publicly available, and older individuals will find this information on the Internet. However, if the attorney does not know these facts, the individual will not trust the attorney about other elder law issues.

Key Resource for Individualized Advice: The Area Agency on Aging Network (referred to as "AAA") for the particular area where an individual lives can provide personal customized information and advice regarding Medicare and what Plans and providers may be best for a particular individual. To find out how to contact the AAA Network in a particular area, dial "211."

Medicare has four parts. *Part A* pays for hospitals for "in-patient" services; this is funded by the Medicare tax on wages (2.9% before 2013, 3.8% beginning in 2013 for individuals earning over a $250,000/$200,000 threshold) and the 3.8% tax on net investment income beginning in 2013 for individuals earning over that same threshold amount. (When people say Medicare will go bankrupt they are talking about Part A. But realize that people were saying the same thing 15 years ago.) Part A costs the individual nothing (if the individual or the individual's spouse paid FICA taxes at least 10 years) and it does not impact the amount of other benefits available to the individual. Generally, there is no need to sign up for Part A as long as a worker has qualifying health plan coverage. Indeed, if the employer offers a high deductible plan and the worker elects to contribute to an HSA, the worker should *not* sign up for Part A, because that will disqualify eligibility for the HSA. The worker may wish to confirm with his or her specific health care coverage to confirm that the failure to qualify for Part A will not allow the health insurance plan to take the position that it will not pay for anything that the patient could have received under Medicare Part A.

Part B pays for doctors (generally for "out-patient" services), funded by general tax revenues. The monthly premium depends on the individual's income level. For example, if the individual files a joint return and has income of $170,000 or less, the monthly premium in 2013 is $104.90; for income above $428,000, the monthly premium is $335.70.

Part C is called Medicare Advantage. An individual can elect to join a Medicare Advantage Plan in his locality. It operates like an HMO-the provider agrees to pay all healthcare costs. The Medicare Advantage Plan pays all Part A, B, and D coverage. (Political campaigns have talked about $500 billion being cut from Medicare. The Affordable Care Act reduces payments to Advantage Plans if an individual opts to use Medicare Advantage.) Make sure that the plan provides needed services if the individual travels. Because these plans operate like HMOs, they may not provide coverage, or only temporary coverage, if the insured leaves the plan area. This can be a trap for sick elderly people. The older person may need to move to a new location to be nearer to children who can help in taking care of the older person. If the person moves to where the child lives, the patient may have no Medicare coverage at all or only very expensive coverage, because the individual is “out of network.” There are some complicated rules that allow a Part C person to switch to traditional Medicare midstream, should that be needed, but this concern is an issue to take into account before deciding to opt for Plan C coverage.

Part D is a prescription drug plan. If not covered by other medical insurance, persons reaching age 65 should enroll in a Part D drug plan, which is heavily subsidized by the government so that the individual is not paying market rates. Individuals must choose among plans, to match their particular drug needs. The national base beneficiary monthly premium for Part D is $31.17 in 2013, but prices vary significantly among plans, and the premium increases for higher income individuals. Part D plans have four stages of payment (2013 figures). (i) Initial deductible of $325. (ii) Plan pays 75% of prescriptions up to $2,970. (iii) More limited coverage from $2,970 up to $4,750 – the coverage gap or “doughnut hole.” In 2013, in the coverage gap the enrollee pays 47.5% of the cost of brand name drugs and 79% of the cost of generic drugs. This is gradually reduced until 2020, when payments will not exceed 25% for any drug in the gap. (iv) Plan pays 95% of all costs above $4,750.

Penalty for Late Enrollment in Part B and Part D. If the individual is not covered under a group health plan for the individual or the individual’s spouse, there is a late enrollment penalty for not enrolling in Part B upon reaching age 65. The penalty is 10% more for each full 12-month period, and this penalty will apply for the remainder of the individual’s lifetime. Beware that receiving COBRA benefits following employment is not treated as group health coverage for purposes of this exception from the time requirement for timely enrollment in Part B. An individual could get stuck with a permanent penalty if the individual does not enroll in Part B and D until after the COBRA group coverage ends.

There is also a penalty for Part D premiums for the drug prescription plan after the initial enrollment period if there is a period of 63 or more days in a row when the individual does not have Part D or other creditable prescription drug coverage. The penalty is an additional 1% of the base beneficiary premium for each month the person was eligible for Part D and not covered by a creditable drug prescription plan, and lasts as long as the person has Part D drug coverage.

***Key Pointer*: This penalty is huge and lasts for life. It is extremely important to enroll timely for Part B and Part D. For Part B, this is at age 65 if the person is not covered by a group health plan, or within an 8-month “special enrollment period” after the individual is no longer covered by a group health plan.**

Enrollment in Medicare. Individuals should enroll online (at the Social Security Administration website, www.socialsecurity.gov) for Part A and Part B about 3 months before reaching age 65, but the enrollment can be delayed as long as the individual is covered by a qualifying health insurance plan. (See the discussion above regarding considerations for possibly enrolling for Part A coverage even when the individual is covered by a qualifying health plan.) The individual can enroll in Medicare even if the individual does not plan to retire or receive Social Security benefits at age 65. If the person elects to file to receive Social Security Benefits, he or she is automatically enrolled in Part A and Part B. Others must enroll themselves. The website makes clear how to enroll just in Part A and not Part B (if that is desired). If the individual is already enrolled in Part A and later wishes to enroll in Part B, call 1-800-772-1213. Enrollment in Part B after the initial enrollment period is available from January 1 – March 31 of each year.

o. *Supplemental Medicare Policies; Medigap.* These are commonly referred to as "Medigap" policies. Part A pays only a limited number of days, and Part B has a 20% co-pay. There are eight different kinds of supplemental plans, labeled A-J. Every A plan is identical, every B plan is identical, etc. Shop around plans, because the same benefits are available regardless of the provider. Generally, buy the cheapest plan in the class that is needed. Some plans cover foreign medical treatment (at least for a limited time to deal with emergencies while traveling internationally) but most of the Plans do not. Some providers will write policies that will cover foreign medical treatment during foreign travel during a specified limited time period. The Area Agency on Aging ("AAA") Network for the particular area where an individual lives can provide personal customized information and advice regarding particular Medigap and Part D alternatives and providers that may be best for a particular individual based on the individual's health needs and prescription drugs used by the individual. To find out how to contact the AAA Network in a particular area, dial "211."

p. *Initial Decision May be a Life-Long Decision.* **When an individual signs up for a particular plan under Medicare or a Medigap policy, consider that as possibly being a decision for life. The plan provider may consider pre-existing conditions if the person later changes the plan or provider. Upon initial enrollment, pre-existing conditions do not affect the level of premiums. If a Plan change is desired, changing to a lower coverage Plan is easier than changing to a higher coverage Plan.**

42. Net Gift Offset by Donee's Assumption of Potential § 2035 Estate Tax Liability if Donor Dies Within Three Years, *Steinberg v. Commissioner*

a. *Synopsis.* The donor made gifts in 2007 to her four adult daughters, with the donees agreeing to pay two separate liabilities of the donor (hence, these types of gifts have been referred to as "net, net gifts"): (1) the federal gift tax imposed as a result of the gifts, and (2) any federal or state estate tax liability imposed under § 2035(b) if the donor died within three years of making the gifts. The only issue in this summary judgment action requested by the IRS is whether the second element, the assumption of any estate tax liability under § 2035(b) if the donor died within three years, may constitute consideration in money or money's worth that can be subtracted in determining the amount of the gift under § 2512(b). Section 2035(b) requires that if a donor dies within three years of making a gift, any federal gift tax paid regarding the gift must be added to the gross estate (effectively removing the advantage of the "tax exclusive" calculation of the gift tax as compared to the "tax inclusive" calculation of the estate tax). The donor's gift tax return had calculated the net, net gift after subtracting both the gift tax and the present value of the potential estate tax liability, taking into consideration the likelihood of the donor's death at some point within three years of the date of the gift. The Tax Court had previously rejected allowing an offset for this potential estate tax liability in *McCord v. Commissioner* (120 T.C. 358), but that holding was reversed by the Fifth Circuit Court of Appeals (461 F.3d 614). The majority opinion (written by Judge Kerrigan [who is also currently assigned as the trial judge for the case], joined by seven other judges) denied the IRS's summary judgment motion. The majority reconsidered and reversed the Tax Court's position in *McCord*, reasoning that the potential estate tax liability was not too speculative to consider and that the § 2035(b) liability assumption satisfied the estate depletion theory because it would replenish the estate by relieving it of such estate tax liability. The majority concluded that there are genuine disputes of material fact as to whether the donees' assumption of potential §2035(b) estate tax liability constituted consideration in money or money's worth, and that the court would no longer follow its prior position in *McCord.* The majority opinion was not clear as to what issues would be decided following trial as a matter of law and what issues would be decided as a matter of fact. For example, the majority stated that the donees' assumption of potential § 2035(b) liability "could meet the requirements of the estate depletion theory" as a matter of law.

A concurring opinion (joined by six judges) believed that the IRS did not raise, and the court should not have addressed, whether the potential § 2035(b) liability was too speculative to be considered, but that the potential liability may satisfy the estate depletion theory. The concurring opinion took a more restrictive view, however, in its analysis of the estate depletion theory. It believed that the IRS might be able to establish at trial that the § 2035(b) liability assumption, under the surrounding facts of the case, was merely a method of apportioning estate taxes among the estate beneficiaries, or might be considered as merely adding some additional enforcement mechanisms beyond the state apportionment statute that apportions § 2035(b) liability to donees of gifts that give rise to such liability. A separate concurring opinion (joined by two judges) pointed out that if the donor dies within three years of making the gift, the contractual obligation to pay a portion of the estate's tax liability might possibly be considered an asset of the estate, and that possibility should be recognized in determining that the present promise to pay the contingent estate tax may be consideration to the donor.

A dissenting opinion (by Judge Halpern) believes that allowing an offset for the assumption of potential estate tax liability under § 2035(b) would frustrate the purpose of § 2035(b), which is to mitigate in part the disparity between the tax bases subject to gift tax and estate tax. In support of his thesis, Judge Halpern included a detailed example of the complicated interrelated calculations required in determining the net, net gift amount and the combined gift and estate tax effects of a net, net gift if the donor dies within three years of the gift. [However, his calculations do not consider that the contractual liability assumption may be an asset that is included in the gross estate in that circumstance.]

b. *Basic Facts and Issue.* The donor made gifts to her four daughters under binding gift agreements in which the daughters agreed to pay two of the donor's liabilities: (1) the federal gift tax imposed as a result of the gifts, and (2) any federal or state estate tax liability imposed under § 2035(b) if the donor died within three years of making the gifts (which is referred to as the "potential § 2035(b) estate tax liability"). The gift tax return subtracted both of these liabilities in reporting that there were net gifts of about $71.6 million (after subtracting about $5.8 million as the present value of the potential § 2035(b) estate tax liability) and reporting gift tax of about $32.0 million. The IRS objected to the subtraction of the potential § 2035(b) estate tax liability to determine the amount of the net gift and sent a notice of deficiency increasing the gift tax by about $1.8 million.

The only issue in this opinion is the IRS's motion for summary judgment that the donees' assumption of the potential § 2035(b) estate tax liability "did not increase the value of petitioner's estate and therefore did not constitute consideration in money or money's worth within the meaning of section 2512(b) in exchange for the gifts."

c. *Brief General Background.* Section 2512(b) provides that the amount of a gift is determined after subtracting any "consideration in money or money's worth."

Courts (and now the IRS) recognize that if, as part of a gift conveyance, the donee contractually assumes the donor's gift tax liability imposed as a result of the gift, that assumption of liability is consideration in money or money's worth that can be subtracted in determining the amount of the "net gift" on which the gift tax is imposed. Rev. Rul. 75-72, 1975-1 C.B. 310 (gift tax paid by the donee may be subtracted from the value of the transferred property if the payment of tax by the donee is a condition of the transfer; formula for determining gift tax for net gift is tentative tax/[1 + rate of tax]).

The § 2035(b) "gross-up" provision states that if a donor dies within three years of making a gift, the gross estate is increased by the amount of gift taxes paid on the gift. The purpose is to remove the advantage, if the donor dies within three years of making a gift, of the lower tax system that applies in calculating the gift tax as compared to the system for calculating the estate tax. The gift tax is imposed just on the gift amount that passes to donees (a "tax exclusive" system), whereas the estate tax is imposed on the entire estate, including the amount that is paid in estate tax (a "tax inclusive" system). By adding the amount of the gift tax back into the taxable estate, the combined gift and estate tax is the same whether or not the gift is made—thus removing the federal transfer tax advantage of making "deathbed" gifts.

d. *Majority Opinion.* The majority opinion was joined by 8 judges (including the author, Judge Kerrigan, who is also currently assigned as the trial judge for the case, but that could change).

   (1) *IRS Position.* The IRS position was that the donees' assumption of the potential § 2035(b) estate tax liability "is worthless"; it provides no benefit to the donor other than peace of mind and fails to satisfy the "estate depletion" theory of the gift tax. The estate depletion theory is that there is "consideration in money or money's worth," which can be considered to offset the amount of the gift under § 2512(b), only to the extent the donor's estate has been replenished (which may be different than the amount of detriment to the donee).

(2) *McCord v. Commissioner.* The Tax Court had previously rejected allowing an offset for this potential estate tax liability in *McCord v. Commissioner* (120 T.C. 358), but that holding was reversed by the Fifth Circuit Court of Appeals (461 F.3d 614).The majority primarily reviewed the position that the Tax Court took in *McCord v. Commissioner,* 120 T.C. 358 (2003), *rev'd and remanded sub nom. Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006). (Although the Fifth Circuit reversed that holding, the majority observed that the case was not appealable to the Fifth Circuit, so the court was not bound to follow *McCord*.) In *McCord*, the Tax Court reasoned that (1) the potential § 2035(b) estate tax liability is too speculative to be considered, and (2) the assumption of such liability did not satisfy the estate depletion theory because the assumption of that potential estate tax liability would benefit the donor's estate and its beneficiaries rather than the donor.

(3) "*Too Speculative" Issue.* As to the "too speculative" issue (which the concurring opinion said should not have been addressed because the IRS was not making the "too speculative" argument on its summary judgment motion), the majority distinguished prior cases that had found agreements to be too speculative to be considered as a gift offset, reasoning that the other cases involved situations with considerably more speculative contingencies. It concluded that the major contingency is merely whether the donor dies within three years of the gift, but mortality tables can be used to estimate that contingency. Another factor is the fluctuation of estate tax rates and exemption amounts, but those uncertainties are less speculative than all the factors involved in determining the amount of "built-in gains discount" for C corporation stock, which has been allowed. *E.g., Estate of Jelke v. Commissioner*, 507 F.3d 1317 (11th Cir. 2007).

(4) *Estate Depletion Theory.* The majority reasoned that its prior distinction between the donor and the donor's estate regarding the estate depletion theory was incorrect; they are "inextricably bound." The majority suggested that the assumption of the potential § 2035(b) liability may satisfy the estate depletion theory as a matter of law: "A donee's assumption of potential section 2035(b) estate tax liability may provide a tangible benefit to the donor's estate, and therefore *as a matter of law* it could meet the requirements of the estate depletion theory." (Emphasis added). The majority rejected the IRS's contention that the assumption of the § 2035(b) estate tax liability did not replenish the donor's estate because it was a family-type transaction, was outside the ordinary course of business, and was not "bona fide."

(5) *Conclusion of Majority; Matters of Law vs. Matters of Fact.* The majority concluded that "[t]here are genuine disputes of material fact as to whether the donees' assumption of petitioner's potential section 2035(b) estate tax liability constituted consideration in money or money's worth," so the IRS was not entitled to summary judgment. The majority opinion did not provide any additional guidance as to what specific "material facts" would be relevant and to what extent the assumption of the potential § 2035(b) liability would be determined to satisfy the estate depletion theory either as a matter of law (having stated specifically that the assumption of such potential liability "could" meet the requirements of the estate depletion theory as a matter of law) or as a matter of fact.

e. *Concurring Opinions*. In contrast, six judges joined in a concurring opinion written by Judge Lauber that took a considerably more restrictive approach as to the amount of "money or money's worth" gift offset from the assumption of the potential § 2035(b) estate tax liability. The concurring opinion posited that the majority should not have addressed the "too speculative" argument because the IRS "reserved" the issue as to whether the potential § 2035(b) estate tax liability is too speculative as a matter of law, and the *McCord* case should not have been overruled to the extent it embraced the too speculative theory.

The concurring opinion's analysis of the estate depletion theory is significantly more restrictive than the majority opinion. The concurring opinion states that the IRS's argument is that the donees' assumption of the potential § 2035(b) estate tax liability does not increase the value of the donor's gross estate because the assumption of such potential estate tax liability does not affect the size of the *taxable estate* and therefore cannot constitute consideration as a matter of law. The concurring opinion does not agree with that position, but is sympathetic with the IRS's further refinement of its estate depletion theory argument—that the estate tax liability assumption operates merely as an "agreement to apportion the burden of the tax within the estate and, in effect, among the estate's beneficiaries." If the four daughters who are donees "are also the beneficiaries of the . . . estate they will bear the burden of the estate tax either way . . . . In neither case is the estate 'replenished.'" Furthermore, New York state law apportions the estate tax attributable to § 2035(b) to the donees who benefited from those gifts. (Very few state apportionment statutes address apportionment of the estate tax due to the gross-up of gift taxes under §2035(b); New York may be the only state statute to apportion that tax to the donees.)

The donor responded to the IRS apportionment argument by pointing out that (1) whether the donees are also the estate beneficiaries is entirely speculative until the donor dies, and (2) the contractual assumption of the potential § 2035(b) estate tax liability provides an effective enforcement mechanism that does not exist under the state law apportionment statute.

The concurring opinion's view is that the material facts relevant to the apportionment argument might dramatically reduce the amount of gift offset attributable to that assumption of liability.

> "Indeed, the proper disposition at trial of respondent's 'apportionment clause' argument may determine not only whether the donees' agreement to pay the section 2035(b) tax constitutes 'consideration,' but also the nature and outcome of the valuation exercise. If the only benefit accruing to petitioner and her estate from the donees' agreement to pay the section 2035(b) tax is the incremental benefit the executor derives from having a contractual as well as a statutory enforcement against the daughters, the actuarial value of their assumption of the contingent section 2035(b) liability becomes essentially irrelevant. The thing to be valued in that event—the 'consideration' received by petitioner's estate—will be this incremental enforcement capacity enjoyed by the executor. As Judge Ramm noted 50 years ago, we should be cautious in treating as statutory 'consideration' obligations assumed in 'an intrafamily transaction' under 'colorable family contracts." [citing *Estate of Woody v. Commissioner*] Assuming arguendo that the actuarial value of the daughters' assumption of the contingent section 2035(b) liability is $5,838,540, as petitioner contends, the value of the incremental enforcement capacity enjoyed by the executor may be substantially less than that.

> In sum, the Court properly leaves the evaluation and disposition of respondent's 'apportionment clause' argument for a postttrial opinion after all the evidence in this case has been heard. Respondent's motion for summary judgment should be denied, not because his 'estate depletion' theory is wrong, but because the proper resolution of the 'apportionment clause' argument underlying his 'estate depletion' theory hinges on disputed issues of material fact."

A separate concurring opinion written by Judge Goeke (joined by Judge Lauber) points out that the taxpayer recognizes that the assumption of the donor's estate tax liability "is a new asset of the donor that must be included in her gross estate like any other contract right," and that the court should recognize that issue in considering whether the assumption of the contingent estate tax may be consideration to the donor that offsets the amount of the gift being made.

f. *Dissenting Opinion*. A dissenting opinion (written by Judge Halpern) concludes that the assumption of the potential § 2035(b) estate tax liability as a matter of law should not be treated as consideration in money or money's worth that can be subtracted in determining the net gift. It reasons that allowing the potential § 2035(b) estate tax liability as an offset frustrates the purpose of § 2035(b), which is "to mitigate in part a disparity between the tax bases subject to the gift tax and the estate tax." The dissent goes through a detailed numerical analysis in an attempt to demonstrate that the donor could save combined gift and estate tax by making the gift even if the donor dies within three years if the potential § 2035(b) estate tax liability can be subtracted in determining the amount of the net gift. The dissent's detailed description of the process for calculating the net, net gift, after subtracting both the gift tax liability and the potential § 2035(b) estate tax liability, and the impact on the estate tax if the donor dies within three years, is enlightening.

The dissent's analysis, however, does not take into account that the donee's assumption of the potential § 2035(b) liability may itself be an estate asset that is included in the donor's gross estate. As pointed out by Judge Goeke's concurring opinion, the potential estate tax liability may have an actuarially low value as a gift offset (because of the low probability at the time of the gift of the donor dying within three years), but may be included in the donor's gross estate at the full amount of the § 2035(b) liability if the donor actually dies within three years. Taking into account this factor, if the donor dies within three years of the gift the donor's estate typically would be *much* worse off by making the gift in this manner than if the donees had not assumed the potential § 2035(b) estate tax liability.

g. *Observations.*

(1) *Donee's Assumption of Potential § 2035(b) Estate Tax Liability Is Not Typical.* Having the donee assume the potential § 2035(b) estate tax liability typically results in a relatively small gift offset (depending on the age of the donor). Unless the donor is quite elderly, the actuarial likelihood of dying within three years is small enough that the present value of this assumption of potential liability results in a relatively low offset of the gift amount. (However, for an 89 year old individual—as in *Steinberg*—the gift offset can be significant; it was an offset of $5.8 million for a $71.6 million net, net gift in *Steinberg*.) For a younger donor, it

would be a much lower gift offset, but the estate inclusion might still be the full § 2035(b) liability if the donor in fact dies within three years. The donor may not want to take that potential estate tax risk in return for a relatively small gift tax reduction.

Whether the contractually assumed estate tax liability will be included in the donor's gross estate if the donor dies within three years is not a given. Conceivably, the estate in that situation would make the similar argument that the IRS is making in *Steinberg*—that the agreement is merely a matter of apportioning the estate tax among estate beneficiaries and does not really add anything to the gross estate.

(2) *Restrictive Concurring Opinion Approach.* The concurring opinion's discussion of the IRS's estate depletion theory and "apportionment argument" hints that the 6 judges joining in that opinion might find very little gift offset by reason of the donees' assumption of the potential § 2035(b) estate tax liability. The IRS's apportionment argument (as well as the position of the dissent) was presaged in an article discussing how to value the net, net gift:

> "It's important to note that under most circumstances the donee's assumption of the IRS Section 2035(b) liability does not actually increase the donee's tax exposure. If the donee is the residuary beneficiary of the donor's estate and the donor's will directs that all estate taxes be paid out of the residue, the Section 2035(b) liability would be borne by donee regardless of his assumption of the liability pursuant to the net gift agreement. Likewise, in the absence of a direction under the donor's will, most state tax apportionment statutes would allocate the Section 2035(b) liability to the donee [citing the New York apportionment statute]." Michael S. Arlein & William H. Frazier, *The Net, Net Gift*, TRUSTS & ESTATES (August 2008), 25, at 33.

John Porter, one of the attorneys for the taxpayer in *Steinberg*, in informal comments and in arguments in a brief points out that the concurring opinion's restrictive view of the estate depletion/replenishment issue, which might permit very little if any gift offset, is inappropriate. First, he notes that whether the obligation is contractual or imposed by statute should not matter. Absent a contract (or statute), it is an obligation that would have otherwise rested with the donor. Second, he observes that the actual recipients of the gifts should not be relevant under the hypothetical buyer/seller approach to valuation, and that the concurring opinion approach is really a family attribution argument. Whether the daughters are the beneficiaries of the estate under the current will should be irrelevant for valuation purposes. The concurring opinion looked at not only the property rights exchanged, but made assumptions about other rights possessed by the daughters (i.e., an expectancy under the will). As an analogy, Mr. Porter points out that the concurrence's view would be like saying that no lack of control/lack of marketability discounts should be applied to limited partnership interests gifted by Mom because the daughters own the remaining interests in the entity. Or even worse, that no discounts should be applied because Mom is leaving the rest of the partnership interests to the daughters under her will. Those examples violate the willing buyer/seller test.

The concurring opinion (joined by six judges) says that this restrictive approach may be applied in a "posttrial opinion after all the evidence in this case has been heard." The majority opinion (joined by eight judges) gives no hint at all that it would view the amount of gift offset so restrictively, and indeed suggests that the court might even find as a *matter of law* that the assumption of potential § 2035(b) estate tax liability satisfies the estate depletion theory.

(3) *Calculation Methodology.* The Fifth Circuit in *McCord* upheld the appraiser's use of actuarial life expectancy factors used in the § 2031 regulations (Table 80CNSMT effective from 4/30/89 to 5/1/99) and the § 7520 rate in effect on the date of the gift as the discount factor for discounting the potential future liability to a present value. (Table 90CM applied to transactions from May 1999-April 2009, and Table 2000CM applies to transactions from May 2009 forward. Table 2000CM is at the end of Treas. Reg. §20.2031-7(d)(7).)

The methodology for making the calculations of a net, net gift is rather complex, involving both an application of actuarial and discount factors as well as interrelated calculations. The calculation process is described in Michael S. Arlein & William H. Frazier, *The Net, Net Gift*, TRUSTS & ESTATES (August 2008), 25, at 31, modification of analysis described in Letter to the Editor and Response (Nov. 2008) 12-13. The process is summarized as follows.

(i) *Netting of gift tax liability*. The gift is calculated net of the gift tax. The formula for the actual gift tax paid is: tentative tax/(1+rate of tax). (For example, if the "tentative tax" based on the full amount transferred is $10,000, and if the rate is 40%, the actual gift tax paid is $10,000/1.4, or $7,143.)

(ii) *Determine present value factor of potential liability for an individual dying in the following three years.* The easiest way to approach this calculation is to use the procedure described in Publication 1457 (Version 3A) (Rev. 5-2009), Example 10. That example describes the procedure to determine the present worth of $1.00 due at the death of a person of a specified age who dies within a specified term. The example uses the "M-factors" and "D-factors" on Table H to determine the present value. That approach could be used to determine the present value of the potential estate tax liability based on the probability of death occurring sometime during the three years following the date of the gift for a donor of a specified age.

For example, assume the gift is made an individual age 65 when the §7520 rate is 2.0%.

Initial age =	65
Plus Term of years =	3
Terminal age=	68

M-factor, Table H (2.0), age 65=	16,208.97
M-factor, Table H (2.0), age 68=	15,092.22
Difference=	1,116.75
D-factor, Table H (2.0), age 65=	22,697.99
Required Remainder Factor	
(1,116.75/22,697.99)=	0.04920

Therefore, for a donor age 65, the present value of the potential estate tax liability is 4.92% of the estate tax liability due to the gift tax gross-up under §2035(b) if the donor dies within three years. (That factor conceivably could be further adjusted to reflect that the estate tax is not due until 9 months after the death of the individual.)

A more complicated approach is described in the Arlien and Frazier article, which is to determine the probability of dying in each of the following three years, and to determine the present value of the potential estate tax liability for each of those three years. That approach might be necessary if the estate tax rates were changing during those periods. (The analysis described in the article should be adjusted based on a Letter to the Editor by Dan Hastings, a consultant on the "NumberCruncher" software, and the response by Will Frazier.)

(iii) *Determine Applicable Tax Rate.* Particularly in light of the fact that the estate and gift tax rates are permanent (until changed by Congress), the 40% marginal estate tax rate is used as the tax rate.

(iv) *Determine Tentative Present Value of Potential Estate Tax Liability.* The present value of the additional estate tax liability attributable to the §2035(b) gross up is calculated by multiplying the added estate tax attributable to §2035(b) times the discount factor determined in step (ii). For the example of a 65-year old donor, this is: Gift tax paid x 40% estate tax rate x 0.04920.

(v) *Interrelated Calculations.* Interrelated calculations are repeated using these various factors. Subtracting the present value of the potential estate tax liability that is determined under step (iv) reduces the gift amount, so steps (i)-(iv) must be repeated. Eventually, the net, net gift is determined by subtracting the calculated gift tax and potential § 2035(b) estate tax liability from the amount transferred—and the result is that amount of net, net gift.

43. Interesting Quotations

a. *Great Expectations?* Larry Frolik observed that older clients are more likely to use trusts "That is because they know more about their kids." Larry calls raising children "the long glide path of descending expectations." – Larry Frolik

b. *Procrastination.* ATRA rewarded procrastination. "Those clients who did not act did not lose anything. For those who did act we may hear about buyer's remorse." – Dennis Belcher

c. *Laziness.* "Hard work pays off in the long run, but laziness pays off now." – Despair.com (as quoted by Dennis Belcher)

d. *We Sue.* We previously called the deceased spousal unused exclusion amount the DSUEA. The regulations use the term "DSUE amount. "This is because if we don't tell clients about portability going forward, what do de do? De sue. – Sam Donaldson

e. *Husbands First.* "Let's do as all Lifetime movies teach us — let's kill the husband." – Sam Donaldson

f. *Georgia PowerPoint.* Holding up fingers to make a point: "This is what we call PowerPoint in Georgia." (Sam also pointed out that his hand was not indexed for inflation and he could not illustrate $5.25 million with his fingers.) – Sam Donaldson

g *Legislation and Razors.* "Sleek and sexy ATRA. It'll cut ya like the razor."– Sam Donaldson

h. *HIT.* "High Income Taxpayers are the persons 'hit' by the new maximum rate." – Beth Kaufman

i. *The Longest Day.* In noting that the American Taxpayer Relief Act of 2012 passed the Senate shortly after midnight on January 1, 2013 and by the House later that day, Ron Aucutt quips that the American Taxpayer Relief Act of 2012 was signed on "December 32, 2012."– Ron Aucutt

j. *Rating the Wealthy.* In discussing the three different thresholds of high income taxpayers for purposes for the new maximum ordinary and capital gains rates, the Pease and PEP limitation, and the 3.8% Medicare tax, Professor Sam Donaldson observed "there are various definitions of high income: the super-rich, the rich, the well-off--and academics." – Sam Donaldson

k. *I Want Only Two Things.* "Beneficiaries just want to know two things. What do I get and when do I get it."– Dennis Belcher

l. *The Best Laid Plans.* There is an old Yiddish proverb: "Man plans and God laughs." – Dennis Belcher

m. *Never Use One Word When Two Will Do*. "The typical assignment says 'I hereby assign and transfer …' If you only 'assign' you are screwed."– Sam Donaldson

n. *Greed*. “The really greedy are among us. I'm not saying you are but you’re probably sitting next to one of them."– Sam Donaldson

o. *True Love*. “Nothing says I love you like a gift of an interest in an LLC.”– Sam Donaldson

p. *Geography Lesson*. In referring to the differences in the states regarding the treatment of same sex couples, Sam Donaldson observed, “the states are all over the map. True —literally they are all over the map.”– Sam Donaldson

q. *Marriage Penalty*. In referring to the income tax marriage penalty, Sam Donaldson observed that “everyone should bear the penalty of marriage.” Looking to his wife in the audience, he quickly added “but realize it is not a penalty for me.”– Sam Donaldson

r. *Waffle House*. “The Waffle House is a hangover cure available to many in the Southeast part of the country.” – Sam Donaldson

s. *D.C. at Its Finest*. “The fiscal cliff is not something that we can go out and admire as scenery. It is not a work of nature, it is a work of human nature that strives definitively and unambiguously to assign blame to someone else. It is a pervasive governing principle, basic premise, summum bonum, in Washington D.C. to annoy, impede, embarrass and blame the other folks. That makes it hard to predict or even analyze.” – Ron Aucutt

t. *More of the Beltway at Its Finest*. “If the goal was for each side to embarrass the other, I would say well done, mission accomplished. Both sides were successful.” – Carol Harrington

u. *Legislative Predictions*. “Prediction can take the form of applying known principles, policies and preferences to a known environment, and then predicting the outcome. When the only known principle, policy or preference is to annoy, impede, embarrass or blame the other folks--that looks not so much to the outcome as to the blame for the outcome--it is not easy at all to predict.” – Ron Aucutt

v. *Development of ATRA*. “It’s like we were looking at a drunk javelin thrower. You don’t want to look, you don’t want to watch, but you have to watch because you just don’t know where things will end up.” – Ron Aucutt

w. *Monday, Monday*. “On December 31, the fifth Monday of December and the 53rd Monday of the year, a legislative compromise seemed to be coming together.” – Ron Aucutt

x. *Need More Time?* “Remember how busy you were a month ago? Remember how you wish you could just add a few days to the year? Just run for Congress; you get the privilege of doing that. The Senate debated this into the New Year and passed it in the first couple of hours in the New Year ….”– Ron Aucutt

y. *Congressional Football*. "Those of us accustomed to spending New Year's Day watching football now watched political football with the fumbles, the punts, the dives and fouls, the end-arounds and reverses, even the fiscal scores and the calendar overtime late on New Year's Day." – Ron Aucutt

z. *They're Not Worth It*. "When you are preparing a tax return, always remember that while you're representing a client, the first thing you have to worry about is yourself. We never do anything that might be considered fraud or misleading or anything that would put us in jail; jail is really bad. We don't wish to go to jail. We don't wish to be hit with any kind of fraud penalties and don't want to be disbarred from practice. Those are really bad results. You don't have a single client who is worth taking those risks." – Carol Harrington

aa. *Wondering About Wandry*. "I can't resist 'wandering' about defined value gifts." – Ron Aucutt

bb. *The Wandry Quandry. "Wandry* is a quandary; *Petter* is better." – Skip Fox

cc. *PacMan*. "We sometimes call grantor trusts 'Pac Man trusts' — they eat the grantor alive if there's too much income tax." – Carol Harrington

dd. *Annual Exclusion Indexing*. Observe an interesting difference in the indexing of the annual exclusion. "Under most of the indexing provisions, the number is rounded to the nearest relevant number. For example the estate tax exemption is rounded to the nearest $10,000 under §2010(c)(3). However the gift tax annual exclusion is rounded down to the nearest $1,000. §§2503(b)(2). Even so, the annual exclusion has increased by 40%, from $10,000 to $14,000 over 11 years, since the indexing was added in 2001." – Observations by Sam Beth Kaufman and Sam Donaldson.

ee. *Millionaires*. "I don't want to be a millionaire — I just want to live like one." W.C. Fields, as quoted by Stacy Eastland

ff. *Wink-Wink*. "Don't write anything you can phone. Don't phone anything you can talk. Don't talk anything you can whisper. Don't whisper anything you can smile. Don't smile anything you can nod. Don't nod anything you can wink." – Gov. Earl Long of Louisiana (as quoted by Stacy Eastland)

gg. *No Winking Allowed*. "Neither the Majority Opinion nor any of the four other opinions filed in the Tax Court found evidence of any agreement —— not so much as an implicit, 'wink-wink' understanding —— between the Taxpayers and any of the donees to the effect that any exempt donee was expected to, or in fact would, accept a percentage interest in MIL with a value less than the full dollar amount that the Taxpayers had given to such a donee two months earlier." *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006)

hh. *Get Over It*. In the pre-mortem planning context, consider marrying a long-term partner to qualify for the marital deduction. "Suck it up, no matter how unprincipled you think marriage is." – Josh Rubenstein

ii. *That One Word*. "There is one word in America that says it all, and that one word is, 'You never know.'" – Jouquin Andujar, St. Louis Cardinals baseball pitcher, who is known for his Yogi-isms (as quoted by John Porter)

jj. *Now That's an In Terrorem Clause!!* "He that bereaves my will, which by God's permission I have now made, let him be bereaved of these earthly joys; and may the Almighty Lord -- cut him off from all holy men's communion in Doomsday; and be he delivered to Satan, the Devil and all his cursed companions to hell's bottom, and there be tortured, with those whom God has cast off or forsaken, without intermission, and never trouble my heirs." – Will of Wolgith from 1046 (as quoted by Ben Pruett)

Ben says — "If you think you can do better than that, be my guest."

kk. *Guns.* "Guns are dangerous for fiduciaries…The first rule is: Never give a gun to an angry beneficiary." – Allen Venet

ll. *Whose Old?* "Who is old? Anyone who is five years older than me." – Larry Frolik

mm. *Higher Math.* "So what is the compromise between $3.5 million and $1 million? It is, of course, $5 million indexed for inflation." – Ron Aucutt

nn. *Love Boring.* "I can't think of a worse gift tax return than an interesting one."– Ron Aucutt

oo. *Losers.* Portability may come in handy if the surviving spouse adopts a retirement philosophy of Powerball or marries up and now, shed of you and your loser ways, can "Ditch the zero and hitch the hero." – Sam Donaldson

pp. *Scholars. "*There is an article coming out in a Law Review 'Death and Taxes and Zombies' — relating to zombies and how werewolves may not be covered by DOMA… If it doesn't matter, an academic wrote it." – Sam Donaldson

qq. *Tired Preparers.* "Form 706s often have no Schedule R (the generation-skipping transfer tax schedule). Why? Do you get to 'R' and you're tired?" – Diana Zeydel

rr. *Memories*. "Indexing the annual exclusion makes it hard for planners—it's always changing. What was the annual exclusion in 2011? That was just two years ago and we can't remember." – Barbara Sloan

ss. *Vocabulary Lesson Needed.* "We only get to use the DSUE amount of the 'last deceased spouse.' Which of those three words is not clear? But we have definitions for those terms." – Barbara Sloan

tt. *Same Boat.* "We've looked forward to the day when the law was permanent and we could lock in plans. The law is now supposedly fixed, but I'm still saying Flexibility, Flexibility, Flexibility." – Barbara Sloan uu. *What Clients Hate the Most.* "Perhaps no professional shortcoming is more widely despised than procrastination."– Skip Fox

vv. *Don't Get Comfortable.* "The most functional family is just one divorce and one remarriage away from disaster." – Randy Johnston

ww. *Document Retention Policies.* "Most firms have a 'document retention policy' — but it is really a 'document destruction policy.'" – Stanley Wakshlag

xx. *Jury View*. Randy says to realize how conflict waivers will appear to the jury: "I'll be damned. The lawyer knew she was not supposed to do that but got the client to agree to do it anyway." – Randy Johnston

yy. *No Whining Allowed.* "We lawyers get sued. Don't whine about it. Don't make it worse." – Randy Johnston

zz. *Deadlines.* "Do not practice law by your calendar. If you work by deadlines, you will end up getting sued. The deadlines established by the court are not the deadlines in the best interest of your client. Do not wait until the last minute. Do things early — when they need to be done, not when the deadline is."– Randy Johnston

aaa. *What the Nightmares Are Telling Us.* "Do not over commit. That is easier for me to say as an older lawyer because as a young lawyer I did not do it. I would wake up in the middle of the night with a nightmare — that I've discovered is a common nightmare. You are back in college taking a class you didn't know you were enrolled in and you've got to take a final exam the next day. That is your sub-conscious telling you there is something to do you haven't done. You have too much on your plate."– Randy Johnston

bbb. *Worst Pun.* GRATs can have unusual assets. One attorney told of a GRAT with valuable violins in it. Sam Donaldson noted "there were strings attached." – Sam Donaldson

ccc. *Vultures.* "Wealth shifting always brings the vultures off the telephone lines." – Randy Johnston

ddd. *Tax Conference Pimping.* Bruce Stone mentioned Sam Donaldson's DNA in the context of persons who might want to acquire superior DNI. Sam's wife posted this message on Facebook: "Another speaker at the conference speaking about assisted reproduction just told the entire conference that people searching for designer DNA should go no further than to buy Sam's superior genes. My question is how much would they really pay? Now accepting bids." One mutual friend replied "The rest of us had no idea that sperm donor pimping is what goes on at a tax law conference." Sam's brother-in-law posted "Was that other speaker also wearing a sweater vest?" – Sam Donaldson

eee. *Best IRS Audit Question.* In audits of Form 8939 Carryover Basis Election forms, the IRS has included this request of some estates: "Provide a list of assets not owned by the decedent." REALLY? – Beth Kaufman

fff. *Congress.*

"Suppose you were an idiot. And suppose you were a member of Congress. But then I repeat myself." – Mark Twain

"In my many years I have come to a conclusion that one useless man is a shame, two is a law firm and three or more is a Congress." – John Adams

"Talk is cheap...except when Congress does it." – Anonymous

"There is no distinctly native American criminal class...save Congress." – Mark Twain