Estate Planning Current Developments and Hot Topics

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Important Information Regarding This Summary
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Introduction

This summary of current developments includes observations from the 49th Annual Philip E. Heckerling Institute on Estate Planning in 2015 as well as other observations from various current developments and interesting estate planning issues.

1. Legislative Developments

a. **Transfer Tax Legislation Unlikely in 2015**. The various transfer tax proposals in the Administration's Fiscal Year 2015 Revenue Proposals (released by the Treasury on March 2, 2014) will likely proceed only as part of a general tax reform package, and not as a package of separate transfer tax legislation. There have been some indications, however, that transfer taxes are not being considered in the reform measures. With Republicans controlling both the House and Senate, legislation to enhance transfer tax measures seems highly unlikely.

b. **Fundamental Tax Reform Unlikely**. The approaches for fundamental tax reform by the Congress and President have substantial differences. The prospect of fundamental tax reform is unlikely without Congress's ability to override a Presidential veto.

c. **Transfer Tax Repeal Possibilities**. Some talk has arisen again of the possibility of the repeal of transfer taxes. In the last several years, Republicans who supported estate tax repeal were reluctant to raise the issue, for fear that the substantial decreases in transfer taxes achieved in ATRA might be lost. With Republicans controlling both houses of Congress, that is not a realistic fear at this point. There is a greater chance of estate tax repeal this year than last year, but still just "better than nominal."

   Some planners have wondered whether with the President's tax proposal to trigger capital gains taxation upon death (or when making gifts) without a basis increase under §1014, while also keeping the estate tax, might be an overture to negotiate for allowing a repeal of the estate tax if Congress would agree to the capital gains on gift or death proposal. Representative Kevin Brady (Republican-Texas), a member of the House Ways and Means Committee, almost immediately stated that the President's "reneging on the 'permanence' of the estate tax agreements" is creating a movement to have a floor vote this year on repealing the estate tax, DAILY TAX REPORT, at 22DTR GG-3 (Feb. 3, 2015), and he introduced legislation (passed by the House on April 16, 2015)) to repeal the estate and GST tax, retain the gift tax at a 35% rate with a $5 million indexed exemption, and retain stepped-up basis at death.

   Subsequently, Paul Ryan became Speaker of the House of Representatives, and Kevin Brady became chair of the House Ways and Means Committee. One noted commentator observes that Rep. Brady's becoming chair of the Ways and Means Committee may somewhat increase the chances of estate tax repeal, but "it would be wrong to jump to conclusions about that. Estate tax repeal remains a politically complex issue, and it is not at all clear that the present or future House leadership would be willing to spend its political capital on this objective rather than others, whether in packaging a repeal to avoid a presidential veto or in positioning it to get 60 votes for a Senate cloture motion." Ronald Aucutt, *Ron Aucutt's "Top Ten" Estate*

Planning and Estate Tax Developments of 2015, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2371 (Jan. 4, 2016).

d. **President's 2016 Fiscal Year Budget Proposal: Increasing Taxes on Wealth, Reducing Taxes on Middle Class, Business Tax Reform**. The Treasury on February 2, 2015 released the General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (often referred to as the "Greenbook") to provide the details of the administration's budget proposals. For a discussion of the proposals impacting estate planning in the 2014 Fiscal Year Revenue Proposals, see Item 1.c of the Hot Topics and Current Developments Summary (2013) found **here** and available at **www.Bessemer.com/Advisor**. A few summary comments about specific proposals, and in particular with comments about new provisions in the 2016 Fiscal Year Greenbook and the 2015 Fiscal Year Greenbook are included below. (The revenue estimates are from the Fiscal Year 2016 Greenbook.)

Treating Gifts and Bequests as Realization Events. A major new proposal in the Fiscal Year 2016 Plan would raise substantial income taxes by closing the "trust loophole," to cause an immediate realization of gain upon making gifts or at death (with an elimination of the basis step-up at death under §1014). The description released in connection with the State of the Union Address refers to the basis step-up under §1014 as "perhaps the largest single loophole in the entire individual income tax code." Some of the specific elements of the proposal include:

- Treating bequests and gifts other than to charitable organizations as realization events;
- For couples, no tax would be due until the death of the surviving spouse;
- Allowing an exemption from capital gains at death of up to $100,000 per individual ($200,000 per couple), which exemptions would be portable between spouses;
- Allowing an exemption for personal residences for capital gains up to $250,000 per individual ($500,000 per couple), which exemptions would also be portable between spouses;
- Exempting tangible personal property (other than expensive art) and similar collectibles;
- Allowing relief from the immediate realization of income for inherited small family-owned and operated businesses unless and until the business was sold; and
- Allowing a closely-held business the option to pay the tax on gains over 15 years.

The President's proposal calls for realization of income taxes on appreciation at death and also retains the estate tax. An example in the Greenbook describes a decedent with stock worth $50 million that has a basis of $10 million. It states that because the heir's basis in the stock is "stepped up" to $50 million, no income tax is ever due on the $40 million of gain. The example does not point out that the $50 million of stock will be subject to a $20 million estate tax (assuming the decedent had previously used her unified credit). The Greenbook makes clear that this proposal applies in

addition to the estate tax, and the income tax on gains realized at death would be deductible for estate tax purposes. For example, if the income tax is recognized as a deduction against the estate tax (to yield the same result as a deathbed sale), the estate deduction would be $40 million x 28%, or $11.2 million, saving $11.2 million x 40%, or $4.48 million of estate tax. Thus, net tax attributable to the $40 million of appreciation would be $28 million - $4.48 million, or $23.52 million.

This proposal will get no traction in the Republican-controlled Congress—but the sweeping nature of this new approach is quite interesting.

Increased Capital Gains Rates. In addition, the proposal would increase the top rate on capital gains and qualified dividends to 28% for couples with income over about $500,000 (the 2016 Fiscal Year Budget proposal makes clear that the 28% rate includes the 3.8% tax on net investment income).

Effect of Capital Gains Tax Reforms. The President's proposal states that 99% of the financial impact of raising the capital gains rate and eliminating the basis step-up would be on the top 1% of taxpayers, and 80% of the impact would be on the top 0.1% of taxpayers (those with over $2 million of income). The reforms would raise "$208 billion over the first 10 years, with larger revenue gains when fully implemented.") (Estimated ten-year revenue from the capital gains tax reforms including the realization of gains from gifts and bequests and the increased rates: $207.884 billion. Interestingly, this is *much* smaller than the revenue from the proposal to "reduce the value of certain tax expenditures," (including limiting the benefit of most deductions to 28% and limiting other tax benefits such as tax-exempt interest, which is $603.226 billion.)

Section 529 Plans. The proposal at the State of the Union Address also would eliminate the advantages of 529 plans for new contributions and would repeal the tax incentives going forward for the much smaller Coverdell education savings program (but the President no longer supports these proposals in the face of strong opposition).

Other Individual Income Tax Proposals. The proposal also continues the items in the 2015 Fiscal Year Budget Proposal to (1) limit the benefit of most individual deductions to a maximum of 28% with similar limitations of the tax benefits of tax-exempt bonds and retirement plan contributions), and (2) enact a "Buffet Rule" requiring that the income tax be at least 30% of an individual's income for wealthy individuals.

Business Tax Reform. The Fiscal Year 2016 Budget proposal would, among other things:

- lower the corporate tax rate to 28% with a 25% effective rate for domestic manufacturing, to be paid for by additional structural reforms, including accelerated depreciation and reducing the tax preference for debt-financed investment;
- provide relief for small businesses by letting businesses with gross receipts of less than $25 million (more than 99% of all businesses) pay tax based on a cash accounting method and by permanently extending and enhancing the §179 expense deductions to allow deductions for up to $1 million of

investments in equipment up front to avoid having to deal with depreciation rules; and

- reform the international tax system, with the core proposal being (i) to apply a 19% minimum tax on foreign earnings that would require U.S. companies to pay tax on all of their foreign earnings when earned "with no loopholes," after which the earnings could be reinvested in the U.S. without additional tax and (ii) to impose a mandatory repatriation tax of 14% on previously earned offshore income.
- Although business tax reform has bipartisan support, the reform is expected to be revenue-neutral, so there will be winners and losers, which will lead to intense political pressure.

Restore 2009 Estate, Gift and GST Tax Parameters, Beginning in 2016. The 2014 and 2015 Fiscal Year Plans proposed restoring the 45% rate/$3.5 million estate and GST exemption/$1 million gift exemption effective beginning in 2018. The 2016 Fiscal Year Plan moves up the effective date to 2016 (while President Obama is still in office). This proposal is not taken seriously (but who knows what could happen in the process of negotiating tax reform measures). Its continued inclusion (and acceleration) in the 2016 Fiscal Year Plan shows that its inclusion is quite intentional by the Obama Administration. (Estimated 10-year revenue: $189.311 billion, up from $118.282 billion in the 2015 Fiscal Year Plan.)

Require Consistency of Basis for Transfer and Income Tax Purposes. This proposal was enacted July 31, 2015, as discussed below. (Estimated ten-year revenue: $3.237 billion, but the Joint Committee estimate associated with the actual legislation reports estimated ten-year revenue of $1.542 billion.)

New GRAT Requirements Prior to 2016 Fiscal Year Plan. Requirements include (i) a 10-year minimum term, (ii) a maximum term of life expectancy plus 10 years, (iii) a remainder value greater than zero, and (iv) no decrease in the annuity amount in any year. Several years ago, this was included in various bills that needed revenue offset, but it has not been included in any bills over the last several years. The proposal applies to GRATs created after date of enactment; it is extremely unlikely that this will be retroactive to the beginning of the year (as was done—probably inadvertently as to this provision—in the "Trade Adjustment Assistance Extension Act of 2011" legislative proposal).

New GRAT requirements in 2016 Fiscal Year Plan. **The 2016 Fiscal Year Plan adds a requirement that the remainder interest in the GRAT at the time the interest is created has a minimum value equal to the *greater* of 25% of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed). In addition, GRATs would be prohibited "from engaging in a tax-free exchange of any asset held in the trust."** (Apparently the reference to "a tax-free exchange" would include any purchase of assets by the grantor from the GRAT if there was no capital gains tax on that purchase because the prior paragraph of the Greenbook spoke of that as a way of avoiding future capital gains taxes because of the basis step-up that would occur at death if the grantor had purchased the asset.) (**Observation: This would kill GRATs as a practical matter**.) The GRAT proposal and the grantor trust proposal were separate items in last year's proposal

but are combined in this year's Plan. Perhaps that was done thinking that the grantor trust proposal had a greater likelihood of passing if it were combined with what had been the less controversial GRAT proposal (but the GRAT proposal in this year's plan will be controversial as well). (Estimated ten-year revenue: Last year's plan broke out the estimated revenue impact of the GRAT provision and grantor trust provision separately, but in the 2016 Plan they are combined. The 10-year revenue impact of the GRAT and grantor trust proposal is $18.354 billion. Last year, the revenue impact of the GRAT proposal was $5.711 billion and $1.644 billion for the grantor trust proposal, totaling $7.355 billion. This is a substantial increase in the 2016 Fiscal Year Plan.)

Limit Duration of GST Exemption to 90 years. This proposal has not generated a groundswell of criticism. 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.)

Sales to Grantor Trusts. The 2014 Fiscal Year Plan substantially narrowed this proposal from the 2013 Fiscal Year Plan (which would have included all grantor trusts in the settlor's gross estate). The 2014 Fiscal Year Plan provides generally that if there are sales to grantor trusts, the portion in the trust attributable to the sale (net of the amount of consideration received by the grantor in the transaction) would be in the grantor's gross estate (or would be a gift from the grantor if grantor trust status of the trust terminated during his lifetime). The 2015 Fiscal Year Plan clarified that the proposal generally would not apply to irrevocable life insurance trusts. There was no further change in the 2016 Fiscal Year Plan proposal. This is a huge change and passage seems unlikely. The proposal applies to trusts that engage in a "sale, exchange or similar transaction" on or after the date of enactment. (Estimated ten-year revenue: $1.644 billion in the 2015 Fiscal Year Plan. See above regarding the GRAT proposal for the revenue estimate in the 2016 Fiscal Year Plan.)

Section 6166 Estate Tax Len. 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: $248 million.) This almost certainly will be included in any transfer tax legislation that passes.

Health and Education Exclusion Trusts. "HEET" trusts are a seldom-used strategy to create a long term trust out of which tuition and medical payments could be made for future generations without any GST tax. Unfortunately, the proposal is Draconian in approach. It would eliminate the current exclusion under §2503(e) for payments from a trust for the health or tuition payments for second generation (and more remote) beneficiaries. Furthermore, the proposal has a seldom used very harsh effective date provision—applying to trusts created after and transfers after the date of the introduction of this bill. (Estimated ten-year revenue: *Negative* $231 million)

Simplify Gift Tax Annual Exclusion. Referencing the complexity of administering *Crummey* trusts and the potential abuses, the 2015 Fiscal Year Plan first proposed deleting the present interest requirement for annual exclusion gifts, allowing the $14,000 per donee exclusion for most outright transfers, and adding a new category of gifts to which a $50,000 *per donor* annual limit would apply. The proposal applies to gifts made after the year of enactment. For a description of the details of this

rather confusing proposal, see Item 1.c of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

The 2016 Fiscal Year Plan clarifies this proposal to indicate that "**[t]his new $50,000 per-donor limit would not provide an exclusion in addition to the annual per-donee exclusion**; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion." In addition, the 2016 Fiscal Year Plan added that the $50,000 amount would be indexed. There seems to be little chance of this proposal passing Congress. (Estimated ten-year revenue: $3.446 billion)

Expand Applicability of Definition of Executor. The definition of "executor" in the Internal Revenue Code that applies only for purposes of the estate tax would be extended to all tax purposes. The proposal would be effective upon enactment, regardless of a decedent's date of death. (Estimate ten-year revenue: Negligible)

Omission of Section 2704 Proposal. In prior years the Obama Administration has proposed revising §2704 to add an additional category of applicable restrictions (to be provided in regulations) that would be disregarded in valuing transferred assets. That proposal was dropped in the 2013 and 2014 Fiscal Year plans. There are indications that new proposed regulations under §2704 may be forthcoming in the near future, as discussed below.

Reporting Requirement for Sale of Life Insurance Policies and Change Certain Transfer-for-Value Exceptions. The proposal would change the transfer-for-value rule so that the rule would not apply for transfers to the insured, or to a partnership or a corporation of which the insured is a20-percent owner. (The current exceptions to the transfer-for-value rule also apply for transfer to a partner of the insured or a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer.) Query whether 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?

Payment to Non-Spouse Beneficiaries of Inherited IRAs and Retirement Plans over Five Years. The 2014 Fiscal Year Plan added 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 2014 Fiscal Year plan did *not* specifically make this requirement applicable to Roth IRAs. But the 2015 Fiscal Year plan provided that all of the same minimum distribution rules would apply to Roth IRAs as other IRAs (applicable for taxpayers reaching age 70 ½ after 2014). Therefore, Roth IRAs would be subject to the 5-year distribution requirement. Under the 2016 Fiscal Year Plan, the proposal would be effective for plan participants or IRA owners dying after 2015, and the proposal appears to apply to Roth IRAs only if the owner reached age 70 ½ after 2015 and to owners who die after 2015 after reaching age 70½. The general five-year proposal, while a dramatic change, has significant acceptance on a policy basis of requiring that retirement plans be used for retirement. However, extending this rule to existing Roth IRAs seems very unfair. (Estimated 10-year revenue of the general 5-year proposal: $5.479 billion)

The five-year distribution requirement provision was included in the Chairman's Mark of the "Preserving America's Transit and Highways Act of 2014" (June 24, 2014). However, the House passed a measure to extend the funding of the Highway Trust Fund through May 2015, and the 5-year distribution provision not included in that extension. (This is the "Transportation Bill" that has been languishing in Congress for several years to provide funding to maintain numerous transportation projects and the nation's highway system. This issue may arise again this spring as the May 2015 expiration date nears.)

Limit Total Accrual of Tax Favored Retirement Benefits. This proposal, also added in the 2014 Fiscal Year Plan, generally 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 a particular amount ($210,000 in 2014), representing plan amounts of about $3.2 million for a 62-year old individual in 2014. The 2016 Fiscal Year Plan updates the plan amount to about $3.4 million (which amount will decrease if interest rates increase), enough to provide an annual income of $210,000. 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: $26.043 billion)

Eliminate MRD Requirements for Qualified Plans and IRAs under Aggregate Amount of $100,000 (Indexed). The minimum required distribution rules would not apply if the aggregate value of the individual's IRA and qualified plan accumulations does not exceed $100,000 (indexed for inflation). The proposal applies to individuals reaching age 70½ after 2014 or who die after 2014 before attaining age 70½.

60-Day Rollover for Inherited Retirement Benefits. Under current law, surviving spouses may receive benefits from an IRA outright and roll them over to another IRA (a "60-day rollover"), but beneficiaries other than spouses may only make a trustee-to-trustee transfer from the decedent's IRA to an inherited IRA. The 2015 Fiscal Year plan for the first time acknowledges that the trustee-to-trustee transfer requirement "creates traps for the unwary" for non-spouse beneficiaries, and allows non-spouse beneficiaries to make 60-day rollovers to another IRA. The proposal applies under the 2016 Fiscal Year Plan to distributions after 2015. (Estimated 10-year revenue: Zero)

Enhance Administrability of Appraiser Penalty. Section 6694 imposes a preparer penalty for unreasonable positions and for willful or reckless conduct. Section 6695A imposes an appraiser penalty if the claimed value of property based on an appraisal results in a substantial or gross valuation misstatement. The proposal replaces a "more likely than not" exception with a "reasonable cause" exception. In addition, the appraiser penalty would not apply if the appraiser is also subject to the preparer penalty. The proposal in the 2016 Fiscal Year Plan would apply to returns filed after 2015. (Estimated 10-year revenue: Zero).

e. **Tax Extenders**.

(1) *1974 Extenders.* H.R. 5771 was passed by the House on December 3, 2014, by the Senate on December 16, 2014, and signed by the President on December 19, 2014. Division A of H.R. 5771 is the "Tax Increase Prevention Act of 2014." It extends various items through December 31, 2014, retroactive to January 1, 2014. There were negotiations to pass a two-year extender package (through

December 31, 2015), but the President indicated that he would likely veto the two-year extension package (on the basis that it provided more benefits to businesses than individuals), so the two-year extender package was not adopted. Accordingly, the extended provisions were extended just through December 31 (or 13 days from the day they were enacted). The Tax Increase Prevention Act of 2014 is referred to as the "TIP Act." Sam Donaldson quips—"For once, the legislative acronym got it right. 'How far did Congress go in tax legislation? Just the tip.'" Sam jokes "I bought a carton of milk the day that passed and the milk is still good." Among other things, the Tax Increase Prevention Act of 2014 included extensions of the following items from January 1, 2014 through December 31, 2014:

- extension of the "IRA charitable rollover" (which allows individuals age 70 ½ or older to donate up to $100,000 annually to charity directly from their IRAs without having to treat the distributions as taxable income—see subparagraph (3) below);
- election to claim itemized deduction for state/local sales taxes in lieu of state and local income taxes;
- exclusion of home mortgage forgiveness from discharge of indebtedness income for the discharge (in whole or in part) of "qualified principal residence indebtedness" for a "principal residence";
- deductions of contributions of real property interests for conservation purposes are allowed subject to a 50% of the taxpayer's contribution base limitation (100% for qualified farmers and ranchers) and a 15-year carryover;
- accelerated depreciation of certain business property (bonus depreciation);
- shortened S corporation built-in gains holding period (5 years rather than 10 years);
- for charitable contributions of property by S corporations, the shareholder's basis is reduced only by the contributed property's basis; and
- 100% exclusion from gross income of gain from the sale of qualified small business stock.

(2) *2015 Extenders*. On December 18, 2015, Congress passed and the President signed into law the Protecting Americans from Tax Hikes (PATH) Act of 2015. The PATH Act retroactively reinstated for 2015 the tax extenders that were renewed for and then expired at the end of 2014. Unlike extenders legislation over the last several years, a number of the provisions were renewed *permanently*. These include the Provisions extended permanently include:

- Qualified charitable distribution (QCD) rules (sometimes referred to as the IRA charitable rollover—see subparagraph (3) below).
- State and local sales tax deduction;
- Enhanced American Opportunity Tax Credit ($2,500/year credit for up to four years of post-secondary education);

- Enhanced Child Tax Credit;
- Basis of an S corporation shareholder's stock is not reduced by the unrealized appreciation in property contributed to charity by the S corporation;
- Reduction from ten to five years of the period in which a newly converted S corporation's built-in gains are subject to a corporate-level tax;
- School teacher expense deduction;
- Section 179 expensing;
- Section 1202 small business stock capital gains exclusion; and
- Qualified conservation contributions.

Some of the extender provisions were extended, but just through 2016 (or longer, as noted below). These include:

- Exclusion of discharged mortgage debt on short sales;
- Deductibility of mortgage insurance premiums;
- Above-the-line education deduction of qualified tuition and fees;
- 50% bonus deprecation (extended through 2017, it is reduced to 40% bonus depreciation in 2018 and to 30% bonus depreciation in 2019); and
- Work opportunity tax credit is extended through 2019 for businesses that hire certain targeted groups.

(3) *IRA Charitable Rollover; Qualified Charitable Distributions (QCDs).* The PATH Act makes the QCD rules permanent, retroactive to January 1, 2015.

- The maximum QCD permitted annually is $100,000 per individual and is available only for individuals age 70 ½ or older who make distributions directly to charity from an IRA.
- The QCDs satisfy required minimum distribution (RMD) requirements for IRAs.
- The QCD must be made directly to a public charity; donor advised funds and private foundations are ineligible recipients.
- There can be no benefit whatsoever received from the charity.
- A QCD can fulfill a previously existing pledge.
- Previously received 2015 RMDs cannot be returned to an IRA, but taxpayers who may have already received their RMD can still take advantage of the QCD opportunity.

f. **ABLE Accounts**. The Achieving a Better Life Experience Act of 2014 (the "ABLE Act") created new Code section 529A. It allows the creation of tax-free savings accounts somewhat like 529 Plans that are used for disabled special needs beneficiaries rather than for college expenses. States are authorized to create qualified ABLE programs for individuals who qualified for SSI or SSD -- or who met similar tests of disability --

before age 26. Only a single account could be created for any individual, and contributions to the account are limited in the aggregate to $14,000/year (or the then-current gift tax exclusion figure). The account can grow tax free (like a 529 Plan). If distributions are used to pay "qualified disability expenses," they are not included in gross income. ABLE defines qualified disability expenses liberally, covering many expenses that Medicaid does not already cover. If a distribution is made that is not a qualified distribution, it is subject to a 10% penalty in addition to being included in gross income; such a distribution will also cause the ABLE Account to lose its favorable treatment for eligibility purposes.

Amounts in an ABLE account (up to $100,000) do not count as a resource for SSI qualification purposes. In the event that the account grows above $100,000, SSI eligibility will be suspended but state Medicaid eligibility will continue so long as the account stays below the state's maximum 529 Plan level. The accounts will be handled by the beneficiary directly, and will not remain under the control of the original donor(s). Account balances can in some cases be transferred to other family members who meet the disability criteria. ABLE accounts will be a nice benefit for clients with disabled beneficiaries, and may be useful in connection with special needs trust planning -- but note that all sums in the ABLE account can be claimed by the state Medicaid agency upon the death of the beneficiary, even third-party contributions from family members. The possibilities, limitations and risks will become clearer as the IRS and Social Security Administration adopt regulations implementing the new section 529A, and individual states create (or choose not to create) ABLE accounts.

(Thanks for Robert B. Fleming [Tucson, Arizona] for information included in this summary of ABLE accounts.)

Under the 2014 legislation, the beneficiary of the 529 ABLE plan would have been required to use the plan in his state of residence. The Protecting Americans from Tax Hikes (PATH) Act of 2015 (the 2015 tax extenders legislation that was enacted December 18, 2015) eliminates the residency requirement, and allows individuals to choose any state's 529 ABLE plan, which allows more control over investment options and expenses and the state-based maximum account limits.

g. **Basis Consistency Provisions in Legislation Extending Highway Trust Fund**.

(1) *Background.* For purposes of determining the basis of assets received from a decedent, the value of the property as determined for federal estate tax purposes generally is deemed to be its fair market value. Treas. Reg. §1.1014-3(a). The estate tax value is not conclusive, however, but is merely a presumptive value that may be rebutted by clear and convincing evidence except where the taxpayer is estopped by the taxpayer's previous actions or statements (such as by filing estate tax returns as the fiduciary for the estate). Rev. Rul. 54-97, 1954-1 C.B. 113; *see* Augustus v. Commissioner, 40 B.T.A. 1201 (1939). In Technical Advice Memorandum 199933001, the IRS ruled that an individual beneficiary who was not the executor of the estate and took no other inconsistent actions or statements was not estopped from trying to establish that the date of death value (and the basis) was higher than the value reported on the estate tax return. In Janis v. Commissioner, T.C. Memo 2004-117, *aff'd*, 461 F.3d 1080 (9th Cir. 2006) the court applied a duty of consistency where the

sole beneficiaries were also the sole co-executors of the estate. The court held that the discounted estate tax value of an art gallery set the basis of individual art works (proportionately), observing that the beneficiaries were not contending that the discounted value was incorrect for estate tax purposes. A duty of consistency was also applied in Van Alen v. Commissioner, T.C. Memo 2013-235, to estop beneficiaries who had signed or were deemed to have signed an agreement consenting to the special use valuation election; the beneficiaries were estopped from arguing that the basis was higher than the special use value.

The President's Budget proposal for fiscal year 2010, published on May 11, 2009 proposed various "loophole closers" to help fund a reserve for health care reform, including a consistency of basis provision. It proposed that gift transferees would be required to use the donor's basis (except that the basis in the hands of the recipient can be no greater than the value of the property for gift tax purposes). The basis of property received by death of an individual would be the value for estate tax purposes. Regulations would address implementation details, such as rules for situations in which no estate or gift tax return is required, when recipients may have better information than the executor, and when adjustments are made to the reported value after the filing of an estate or gift tax return.

The "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal" issued by the Staff of the Joint Committee on Taxation on September 8, 2009 provided further insight. As to the estoppel issue, the report stated that a beneficiary "should not be estopped from claiming a basis different from the value determined by an executor for estate tax purposes where the taxpayer did not participate in the executor's determination." In addition, the report took the position that the basis would be the value "*reported* for transfer tax purposes" (i.e., the value placed on the gift or estate tax return) and not the value ultimately determined in an estate or gift tax audit. The report says that would have "the salutary effect of encouraging a more realistic value determination in the first instance." The report adds that the salutary effect would be lost if there were a relief mechanism in case the basis used by transferees differed from the fair market value "ultimately determined for transfer tax purposes." In contrast, the Greenbook says that the basis would be "the value of that property for estate tax purposes" and that regulations would address "the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.") Finally, the report clarified that under the proposal, the basis of the recipient can be no *greater than* the value determined for estate and gift tax purposes, but the recipient could claim a lower value to avoid accuracy-related penalties under §6662 if the transferor overstated the value for transfer tax purposes.

This proposal was repeated in the Administration's Revenue Proposals for Fiscal Years 2011-2016 but the Proposals made clear that the value as finally determined for estate tax purposes would apply, not just the reported value. A legislative proposal of that approach was contained in section 6 of the Responsible Estate Tax Act in 2010 (S. 3533 and H.R. 5764), in the December

2010 "Baucus Bill, and in section 5 of "The Sensible Estate Tax Act of 2011" legislative proposal (H.R. 3467).

(2) *Legislative Provision in Extension of Highway Trust Fund.* The basis consistency provisions for property received from a decedent (but not the consistency proposals for gifts) were enacted as Section 2004 of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, which extends funding of the "Highway Trust Fund" through October 29, 2015 and which was signed into law July 31, 2015 (the "Act").

New Section 1014(f). Section 2004 of the Act adds new §1014(f), which provides that the basis of property to which §1014(a) applies (i.e., property acquired from a decedent) shall not exceed the final value determined for estate tax purposes (and there are detailed provisions governing when the tax is finally determined), or if the final value has not been determined, the value provided in a statement to the decedent's recipients. This provision applies only to property "whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11… on such estate." [Observe that if there is no estate tax because of the marital or charitable deduction and therefore inclusion of the asset in the estate does not increase the liability for the estate tax imposed on such estate—because the estate tax liability "on such estate" remains at zero—the basis consistency provision of §1014(f) apparently does not apply. There is no similar exception, however, in the information reporting requirements in new §6035, discussed immediately below. The exception would apply to the penalty under new §6662(k), because it references §1014(f), but there is no similar exception to the penalties under §§6721 and 6722). Therefore, penalties may be imposed for failure to file the information statements required under §6035 by the due date of the tax return even though no penalties may apply for failing to file the return itself in a timely manner (because the failure to file penalty under §6651 is based on a percentage of the tax due).]

Information Reporting Requirements. If the estate is required to file an estate tax return under §6018(a), the executor is required to report valuation information to both the recipients (i.e., "each person acquiring any interest in property included in the decedent's gross estate") and the IRS. §6035(a)(1). [Observe that the information reporting requirement likely does not apply to estates that file estate tax returns merely to elect portability, but that are not otherwise required to file returns. While Treas. Reg. §20.2010-2(a)(1) provides that an estate that elects portability will be "considered" to be required to file a return under §6018(a) in addressing the timely filing requirement to elect portability, the apparent intent of this provision is to determine when a return must be filed to make the portability election, and not when a return is actually required to be filed under §6018. Hopefully, the IRS will make clear in guidance regarding §6035 that estates filing returns merely to make the portability election are not subject to the information reporting requirements of §6035. Also observe that the broad description of the recipients who are entitled to receive information may indicate that the information must be provided to all current and potential future trust beneficiaries for assets in revocable trusts or for estate assets that pass to trusts.] Such statements must be furnished at the time prescribed in regulations, but no later than 30 days after the return's due date,

including extensions (or 30 days after the return is filed, if earlier). §6035(a)(3)(A). If valuation or other adjustments are made after the statements are furnished, supplemental statements must be furnished within 30 days of the date of the adjustment. §6035(a)(3)(B). Regulatory authority is granted to provide implementation details, including rules for situations in which no estate tax returns are required, or if the surviving joint tenant or other recipient has better information than the executor.

Penalties for Inconsistent Reporting. Section 2004(c) of the Act amends §6662 to provide that the accuracy-related penalties on underpayments under §6662 apply if a taxpayer reports a higher basis than the estate tax value basis that applies under new §1014(f).

Penalties for Failure to Provide Information Returns and Statements. Penalties for the failure to file correct "information returns" or "payee statements" are provided in §§6721 and 6722, respectively. The penalty is generally $250 ($100 for returns or statements required before 2016), with a maximum penalty for all failures during a calendar year of $3,000,000 ($1,500,000 for returns or statements required before 2016). If the failure to furnish the required information return or statement is "due to intentional disregard" of the requirement to furnish the return or statement, the penalty is $500 ($250 for returns or statements required before 2016) or if greater, "10 percent of the aggregate amount of the items required to be reported correctly." §§6721(e) and 6722(e). ***Thus, the penalty can be quite large for intentionally disregarding the requirement to file the information returns or statements.*** Section 6724(a) provides a waiver of the penalties imposed by §§6721-6723 if the "failure is due to reasonable cause and not … willful neglect." (Section 6723 imposes a smaller penalty for the failure to comply with "a specified information reporting requirement," but that section does not apply. The regulations to §6723 provide that the section applies only to certain specifically listed information requirements, none of which is the information required under new §6035. Treas. Reg. §301.6723-1.)

The §§6721 and 6722 penalties are extended to information returns and statements to estate recipients required under new §6035. Section 2004(b)(2) of the Act revises the definitions of "information return" and "payee statements" (as those terms are used in §§6721 and 6722) to include statements to be filed with the IRS as "information returns" and statements to be provided to estate recipients as "payee statements," by amendments to §6724(d). (Those definitions apply "for purposes of this part" (which refers to Part I of Subchapter B of Chapter 68—including §§6721 and 6722).

Effective Date. The amendments to §§1014(f), 6035 and 6724(d) described above "shall apply to property with respect to which an estate tax return is filed after the date of the enactment of this Act." (Section 2004(d) of the Act.) This means that the information returns and recipient statements (and penalties for failure to furnish such statements) apply for returns actually filed after July 31, 2015, even for decedents who died before July 31, 2015. For decedents who died long enough ago that the due date for filing the estate return has already passed, the Act literally says that the information return and recipient statements were due on the due date of the return—even though that was before the Act

was even passed, in effect imposing a retroactive due date. In addition, penalties are applicable (retroactively, in effect, if the due date for the return has already passed). This retroactive application of the Act may apply in various situations. For example, the executor may have delayed filing the estate tax return for an estate in which sufficient assets pass to the surviving spouse or charity or to a QTIP trust (the QTIP election can be made on the first return that is filed, even if it is filed late, Treas. Reg. §20.2056(b)-7(b)(4)) so that no estate tax is due for the decedent's estate. Hopefully, relief will be provided by the IRS for those "retroactive due date" situations. In particular, it would seem that the 10% penalty for intentional disregard of the requirement of filing the information returns and recipient statements under §§6721(e) and 6722(e) would not apply when the requirement to make such information returns and statements was not even known on the date that the Act now says they were due.

Extension of Due Date for Information Reports. Notice 2015-57 extends the due date for filing information reports under new §6035 to February 29, 2016. "This delay is to allow the Treasury Department and IRS to issue guidance implementing the reporting requirements of section 6035." The Notice provides that information reports should not be filed "until the issuance of forms or further guidance."

Form 8971. An early release draft of Form 8971 as of December 18, 2015 has been posted at IRS.gov/draftforms. The Office of Management and Budget (OMB) is expected to release the Form officially sometime in the first several weeks of January, 2016. Part I lists general information about the decedent and executor. Part II lists information about beneficiaries (including TIN, address, and "Date of Service"). A Schedule A is attached to provide information to each estate beneficiary. The Schedule A includes the Form 706 Item number and description of property that the beneficiary has acquired from the decedent. For each asset listed, the executor indicates whether the asset increases estate tax liability and provides the valuation date and value. Schedule A contains a "Notice to Beneficiaries" directing the beneficiary to retain the schedule for tax reporting purposes and informing the beneficiary that if the property increased the estate tax liability, the Code requires consistent reporting of basis. The executor is directed to "[s]ubmit Form 8971 with a copy of each completed Schedule A to the IRS." There is no discussion on the Form or Schedule A as to when the information must be provided to a beneficiary and how the Schedule A will be completed to be submitted to the IRS before a distribution has been made to the beneficiary.

A draft of Instructions to Form 8971 has been posted on the Office of Information and Regulatory Affairs website. (The instructions for Form 8971 are at **http://www.reginfo.gov/public/do/DownloadDocument?objectID=60262200** .) A big question has been what to report 30 days after the Form 706 is filed if distributions have not been made at that time (which is typically the case). The Instructions say:

> the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A should be filed once the distribution to each such beneficiary has been made.

Therefore, when the Form 8971 is filed 30 days after the Form 706 has been filed (and before most of the assets have been distributed), each beneficiary will receive a Schedule A reporting all items in the gross estate that "could be used" to fund the bequest to that beneficiary, "in whole or in part" (which presumably would be pretty well all of the assets in the gross estate that have not previously been distributed or sold). When distributions are later made, a revised Schedule A will be sent to the beneficiary and a supplemental Form 8971 will be sent to the IRS. There is no discussion of what to do for property that is sold by an estate and reinvested and the reinvested proceeds are later distributed to a beneficiary (which also occurs frequently as estates liquidate or diversify to minimize the risk of loss before estate taxes are paid). The Instructions provides that the Schedule A will be delivered "to the trustee(s) of a beneficiary trust." Accordingly, apparently the Schedule A need only be sent to the trustee of a recipient trust and not to each potential beneficiary of the trust.

Practical Administration and Fairness Issues. Carol Harrington pointed out several years ago 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.

In many estates, the executor will not know 30 days after the estate tax return is filed what assets will be passing to particular estate beneficiaries. In that case, the executor may need to provide the valuation information to every estate beneficiary about all estate assets except for beneficiaries receiving only specific bequests of particular property. Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only entitled to receive a general bequest that may represent a fairly small portion of the estate.

One wonders why there is a necessity of providing a statement to the IRS about values of assets reported on an estate tax return when the estate tax return itself has already been filed with the IRS. Presumably, the only point of providing a statement to the IRS would be to give the IRS information about assets passing to particular beneficiaries in case the IRS will track the basis information that may be reported by those beneficiaries on their future income tax returns. The identification of particular assets passing to particular beneficiaries will not be available, however, for many estates by 30 days after the estate tax return is filed (and obviously before an estate tax closing letter is received).

Regulations will need to provide many implementation details. For example, must information statements be provided to beneficiaries receiving specific cash

bequests? Must the information statement be provided to a beneficiary who is also the executor?

Must the information be provided for income in respect of a decedent items or for appreciated property acquired by the decedent by gift within one year of death that is left to the donor? Those items receive no basis step-up at death; they are exceptions from §1014(a) [see §1014 (c) and §1014(e)] so the basis consistency provisions do not apply to those items. Information reporting about the estate tax values of those items would at best be useless and may actually create confusion for beneficiaries (leading them to believe they may be able to use the estate tax value as the basis).

Furthermore, one wonders if the revenue raised (the Joint Committee on Taxation estimates a $1.542 billion revenue impact between 2015 and 2025) will be less than the additional expense that will be incurred by estates in complying with the information reporting measures within 30 days after estate tax returns are filed. Most planners believe the revenue estimate is wildly overblown; one planner has referred to this basis consistency and reporting concept as "cracking nuts with a sledgehammer."

h. **Social Security Claiming Options**. The Bipartisan Budget Act of 2015, signed into law on November 2, 2015, removed several important alternatives for claiming Social Security benefits. These important changes were made without any public discussion of the changes; they surprising appeared in the 2015 Budget Act without warning. They address alternatives available to married couples. A married person may elect retirement benefits based on his or her earnings record, based on the spouse's earnings record (spousal benefits are generally 50% of the other spouse's benefit), or possibly to switch between the two options. Spousal benefits (based on the other spouse's earnings record) cannot be elected until after the other spouse has filed to receive benefits.

(1) *File and Suspend Strategy*. Beginning in 2000, Social Security has allowed a participant upon reaching his or her "full retirement age" (currently age 66, increasing to age 67 for individuals born after 1960) to file and claim benefits based on that person's earnings record, which allows his or her spouse to begin collecting spousal benefits. The participant could then suspend his or her own benefit until reaching age 70 (but the spouse would continue to receive the spousal benefits). This is important because the amount of monthly Social Security benefits grows by as much as 8% per year (to a maximum increase of 32% at age 70) if there is a delay in receiving benefits. Benefits can be claimed as early as age 62, but the monthly benefit will be as much as 75% more if benefits are delayed from age 62 to age 70. This strategy is still available for persons who elect to suspend benefits (after reaching full retirement age) on or before April 29, 2016. After that time, when a person suspends his or her own benefits, all benefits payable on his or her own earnings record to other individuals (such as spousal benefits) will also be suspended.

(2) *Restricted Spousal Benefits (File and Switch Strategy).* After an individual reaches the full retirement age (currently age 66), the individual could file a restricted application to receive just spousal benefits based on his or her

spouse's earning record, but allow the individual's own retirement benefit to continue to grow (up to age 70, after which time there is no further increase in the retirement benefits). Persons age 62 or older by the end of 2015 may continue to use this strategy; otherwise, persons will no longer be able to restrict an application to spousal benefits only, but will have to claim all benefits when electing to receive benefits. Accordingly, the restricted spousal benefits election can still be a viable strategy if BOTH spouses have a Social Security earnings record entitling them to retirement benefits and their spouses to receive spousal benefits and if at least one of the spouses has reached age 62 in 2015. Otherwise, this strategy is no longer available.

2. Treasury-IRS Priority Guidance Plan

a. **Overview.** The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015 was released on July 31, 2015; it is available at **http://www.irs.gov/pub/irs-utl/2015-2016_pgp_initial.pdf**. Two items from last year's list for Gifts, Estates and Trusts have been eliminated because of the issuance of final regulations: final regulations under §67 and the final portability regulations.

The 2015-2016 Plan includes the new item in last year's Priority Guidance Plan: "Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability." This will likely make clear that QTIP trusts can be used in connection with portability planning even if the QTIP election is not needed to reduce the estate tax in the first decedent's estate, despite the provisions of Revenue Procedure 2001-38. (Rev. Proc. 2001-38 appears to give estates the option of electing to treat the unneeded QTIP election as null and void; a revenue procedure announcing the Service's administrative forbearance cannot negate an election clearly authorized by statute.) The preamble to the portability final regulations (T.D. 9725) addresses the effect of the portability election on the application of Rev. Proc. 2001-38 in a cursory fashion: "The Treasury Department and the IRS intend to provide guidance, by publication in the Internal Revenue Bulletin, to clarify whether a QTIP election made under section 2056(b)(7) may be disregarded and treated as null and void when an executor has elected portability of the DSUE amount under section 2010(c)(5)(A)." (The preamble does not mention that an example in the temporary regulation regarding the application of the exception from having to report values for certain property applies in a situation involving a trust for which a QTIP election was made, Reg. §20.2010-2T(a)(7)(C) Ex.2, was revised to omit the reference to a QTIP election.). Planners had been hopeful that this issue would be clarified in connection with the finalizing of the portability regulations by June 15, 2015 (which is the only new item on this year's list of projects in the Gifts and Estates and Trusts section of the Priority Guidance Plan for 2014-2015). One wonders why this guidance regarding Rev. Proc. 2001-38 is taking so long. Perhaps the IRS wants to craft a solution dealing with situations in which the portability election is made and QTIP assets decline in value by the time of the surviving spouse's death to keep the executor from being able to invoking Rev. Proc. 2001-38 to keep the assets from being included in the surviving spouse's gross estate in order to avoid a step-DOWN in basis under §1014.

There are four new items in the 2015-2016 Plan:

"1. Guidance on qualified contingencies of charitable remainder annuity trusts under §664.

…

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

…

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

…

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

Items 3, 5, and 8 all relate to sales to grantor trusts, suggesting that issues related to sales to grantor trusts are major "radar screen" issues for the IRS. These issues are discussed further in Items 2.b, 2.c, and 2.d below.

Other items in the Priority Guidance Plan carried over from prior years include:

- Final regulations under §2032A regarding imposition of restrictions on estate assets during the six month alternate valuation period (this project first appeared in the 2007-2008 plan and proposed regulations were published in November 2011);
- Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against an estate (this project first appeared in the 2008-2009 plan);
- Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP (for example, the allocation of GST exemption to trusts created under a GRAT at the end of the initial GRAT term) (this project first appeared on the 2012-2013 plan);
- Final regulations under §2642(g) regarding extensions of time to make allocations of the GST exemption (this project first appeared in the 2007-2008 plan and proposed regulations were published in April, 2008);
- Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships (this item first appeared in the 2003-2004 plan) (**there are indications that Treasury and IRS officials are currently working on this proposal, so proposed regulations might conceivably be issued at some point during 2015**); and
- Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates (this item first appeared in the 2009-2010 plan to implement the provisions of the "HEART Act" of 2008; this is consistently referred to by Treasury and IRS personnel as a top priority, but the implementation of what amounts to a transfer tax on transferees or their estates is complicated).

b. **Basis of Grantor Trust Assets Following Grantor's Death**. One of the new items on the Business Plan is the basis of grantor trust assets following the grantor's death under §1014. Some commentators take the position that the deemed change of ownership for income tax purposes at the grantor's death (from the grantor to the trust) constitutes the receipt of property from a decedent for purposes of §1014, and that there should be a basis step up even though the assets are not included in the gross estate. *See* Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. TAX'N 149 (Sept. 2002). The article observes that the basis step-up under §1014 is not limited to assets included in a decedent's gross estate for estate tax purposes. While §1014 provides for a basis adjustment to the date of death value for property included in a decedent's gross estate, there are various other situations in which property that is "acquired from a decedent" will receive a basis adjustment, detailed in nine paragraphs of §1014(b). Section 1014(b)(9) is the "included in the decedent's gross estate" section, but other subsections are far more general, including subsection (b)(1) which simply refers to "property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." (An example of an asset not in a decedent's gross estate for estate tax purposes that receives a basis adjustment is foreign property left from a foreign person to a U.S. person—that property in the hands of the U.S. person has a basis equal to the date of death value even though it was not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.) The Blattmachr, Gans & Jacobson article reasons "a good argument can be made that assets held in such a trust should be viewed as passing as a bequest or devise when the trust ceases to be a grantor trust at the moment of death." Up until the grantor's death, the assets have been treated as being owned by the grantor for income tax purposes. For further discussion of the basis of assets in a grantor trust, see Item 9.k below.

The IRS added to its "no-ruling" list earlier in the year that it will not issue rulings as to "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code." Rev. Proc. 2015-37; *see* Diane Freda, *IRS No-Rule on Basis in Grantor Trust Sales Reflects Clash of Opinions*, BNA Daily Tax Report (June 19, 2015) (noting that tax attorney Alan Lederman observes that there are conflicting private rulings; PLR 201245006 concludes that a basis step-up would be available for the grantor trust assets at the grantor's death but CCA 200937028 reasons that "since the decedent transferred the property into the trust," there is no basis step-up under §1014). Jonathan Blattmachr's reaction to the no-ruling position is that the IRS "doesn't like the result of stepped up basis, and isn't going to assist taxpayers in reducing their tax bill—even if it is legitimate." *Id*.

c. **Valuation of Promissory Notes**. The Business Plan refers to the valuation of promissory notes under §§2031, 2033, 2512, and 7872. Some examining agents have taken the position in gift tax audits that promissory notes bearing interest at the AFR should not be treated as being worth the face amount of the note, but have been reluctant to allow discounts in valuing such notes for estate tax purposes.

(1) *Gift Tax Value of Notes in Sale Transactions*.

For gift tax purposes, the IRS sometimes challenges the value of promissory notes, either arguing that the AFR is not a sufficient interest rate, or that the collateral is not sufficient and there are collectability problems. While §7872 clearly applies in valuing a cash loan for gift tax purposes, its concepts do not clearly apply for sale transactions. The taxpayer response is that §7872, the *Frazee* case, and the *True* case support using the AFR, and the note valuation issue generally falls out at Appeals. (The IRS contested the valuation of a note in a Tax Court case, *Estate of Williams*, but a stipulated decision was entered on March 19, 2015 providing an estate tax deficiency much less than that requested by the IRS.)

Section 7872(f)(8) explicitly states that § 7872 does ***not*** apply to a loan to which sections 483 or 1274 apply (and those sections apply to notes given in sale transactions). This is so even if §§ 483 and 1274 do not apply by reason of exceptions or safe harbor provisions. § 7872(f)(8). This straightforward statement is modified somewhat by the regulations and proposed regulations, and transmogrified by case law (see below).

Section 1274(c)(2) provides that for *income* tax purposes (i.e., the OID rules) the AFR is the test rate for determining if there is "adequate stated interest" for a note given in a sale transaction. *See* Treas. Reg. §§1.1274-2(c)(1)(debt instrument with interest rate equal to or greater than test rate determined under §1.1274-4 has adequate stated interest) & 1.1274-4(AFR is the general test rate for a debt instrument given in consideration for the sale or exchange of property).

Proposed regulations would clarify that using the AFR on notes in sales transactions should be sufficient interest to value the note at its face value for *gift* tax purposes (assuming there are no collectability or security problems). Prop. Treas. Reg. §25.2512-8 states that debt instruments (i.e., notes) given in sales transactions "shall be valued in accordance with the rules set forth in §1.1012-2." Prop. Treas. Reg. §1.1012-2(b)(1) addresses the value of debt instruments given in a sale or exchange and states that if the debt instrument has adequate stated interest within the meaning of section 1274(c)(2) [which uses the AFR as the test rate], the value shall be its issue price [i.e., the face amount].

In *Frazee v. Commissioner*, the court reasoned that § 7872 applies in seller financing situations. 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.") The court acknowledged the IRS concession that § 7872 applied for gift tax purposes rather than valuing the note under a market rate approach: "We find it anomalous that respondent urges as her primary position the application of Section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept." 98 T.C. at 590.

Similarly, in *True v. Commissioner*, the court held that § 7872 applies to a purchase transaction under a buy-sell agreement for a deferred payment. 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 9535026 and 9408018 confirm the IRS position that §7872 will apply to the gift tax valuation of notes issued in intra-family sales transactions, regardless of the application of Sections 1274 or 483 to the transaction for income tax purposes, and 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. P.L.R. 9535026.

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 to 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.)

Private Letter Ruling 200147028, on the other hand, concluded that a trust would retain its GST exempt status following loans to second generation beneficiaries as long as the loan were adequately secured and were subject to a *market rate of interest*.

The bottom line is that the §7872/1274/483 issue will remain submerged so long as the AFR remains below 6%, unless Congress intervenes. *See* Stephen J. Wolma, *Ambushed in a Safe Harbor*, 33 Val. U.L. Rev. 309 (1998), advocating Congressional action to resolve the conflict, short of Supreme Court intervention. When the AFR climbs above 6%, in intra-family land sales transactions, careful planners will apply the AFR unless gift taxes are not an issue. Circuit level cases have split as to whether the 6% safe harbor applies for gift tax purposes. (The 8th and 10th circuits hold that the 6% safe harbor does not apply for gift tax purposes. *Krabbenhoft v.*

Commissioner, 939 F.2d 529 (8th Cir. 1991); *Schusterman v. United States*, 63 F.3d 986 (10th Cir. 1995). The 7th circuit has held that the 6% safe harbor does apply for gift tax purposes as well. *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir. 1988).) Aggressive planners outside of the 8th and 10th circuits may always choose to use the 6% safe harbor if the AFR exceeds 6%, relying on the favorable case, common sense and fairness.

With intra-family sales transactions involving sales of personal use property (i.e., not land held for investment), at least under the § 7872 proposed regulations, §483 is not applicable and §7872 should be used. The penalty for using the §7872 safe harbor in that case, however, is not burdensome, as the §§1274 or 483 AFR (permitting the lowest of the prior three months' AFRs) is usually not substantially lower than the §7872 AFR.

Another argument made in some audits is that the note transaction is not a bona fide loan but is a gift. Cases list a variety of factors that are considered in determining whether debt is legitimate or not (in a variety of different contexts beyond just gift issues), but the fundamental issue is whether there was a reasonable expectation of repayment.

(2) *Estate Tax Value of Notes*.

While §7872 addresses gift tax issues, and subsequent authority recognizes that notes with interest at the AFR will not be discounted merely for gift tax purposes because of the interest rate, there is no such similar certainty for estate tax purposes. Does that mean that the note can be discounted for estate tax purposes because there are no regulations on point for estate tax purposes? Because there is no coordinating regulation some attorneys take the position that general valuation principles should be applicable, and it may be possible to discount the note for estate tax purposes if the note uses the AFR as the interest rate. *Be aware, however*, the IRS estate tax agent may feel that taking a discount for this reason alone 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 sale or loan transaction. Lance S. Hall, with FMV Opinions, Inc. reports one example of having appraised a note for estate tax purposes at about half the outstanding balance of the note—and having the value accepted in the estate tax audit. Lance Hall, *The FMV Solution* (September 15, 2009). (In the situation described, FMV Opinions, Inc. applied a discount rate based upon required rates of return for highly rated publicly traded debt issued by REITs, adjusted for the substantial differences between the note and the public debt. Specifically, while the trust was well capitalized as of the date of death, the note was unsecured and lacked protective covenants. Additionally, both the note and the underlying assets of the trust were not readily marketable.)

Section 7872 specifically authorizes the issuance of regulations addressing the valuation of notes in light of §7872. Section 7872(i)(2) states that "[u]nder regulations prescribed by the Secretary, any loan which is made with donative intent and which is a term loan shall be taken into account for purposes of chapter 11 [the estate tax chapter] in a manner consistent with the provisions of subsection (b) [providing for the income and gift tax treatment of below-market loans.]" Commentators observe that regardless what Congress meant, it merely authorized regulations (final

regulations have never been issued) "and did not write a self-executing rule." Ronald Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts,* ALI-CLE Planning Techniques for Large Estates 973, at 1066 (April 2015).

The IRS has issued a proposed regulation for estate tax purposes that directly addresses the estate tax value of a "gift term loan" following the issuance of §7872 and that may even address the value of notes having adequate interest. The proposed regulation conceivably purports to say that the value of the note could not be discounted for estate tax purposes except to make adjustments where the stated interest rate under the note is lower than the AFR in effect at the date of death or where the facts impacting the collectability of the note have changed "significantly since the time the loan was made." In this regard, the proposed regulation may impose a stricter standard for discounting notes for estate tax purposes because of uncollectability issues than the standards described in the general estate tax regulation for valuing notes, which do not impose the requirement of a "significant" change. Prop. Reg. § 20.7872-1 provides:

> "For purposes of chapter 11 of the Internal Revenue Code, relating to estate tax, a gift term loan (within the meaning of §1.7872-4(b)) that is made after June 6, 1984, shall be valued at the lesser of:
>
> (a) The unpaid stated principal, plus accrued interest; or
>
> (b) The sum of the present value of all payments due under the note (including accrual interest), using the applicable Federal rate for loans of a term equal to the remaining term of the loan in effect at the date of death.
>
> No discount is allowed based on evidence that the loan is uncollectible unless the facts concerning collectability of the loan have changed significantly since the time the loan was made. This section applies with respect to any term loan made with donative intent after June 6, 1984, regardless of the interest rate under the loan agreement, and *regardless of whether that interest rate exceeds the applicable Federal rate in effect on the day on which the loan was made.*" Prop. Reg. § 20.7872-1 (emphasis added).

The proposed regulation says that it applies to valuing a "gift term loan," which would be a below market loan (with interest less than the relevant AFR). However, the last sentence says that it applies to any term loan made with donative intent *even if the interest rate exceeds the AFR* on the day the loan was made. Query, does the "with donative intent" phrase simply mean that the loan was not a compensation related loan or corporation-shareholder loan as referenced in §7872(c)(1)(B)-(C), or does it refer to a loan that was intended as a gift even though it had an interest rate higher than the relevant AFR? Arguably, the note given in a sale transaction does not reflect a loan "with donative intent." In any event, this regulation has never been finalized.

d. **Defined Value Clauses.** The new item regarding *defined value formula clauses* suggests that the IRS will eventually issue regulations regarding the effect of defined value formula clauses, despite its losses in the *McCord, Christianson, Petter, Hendrix* and *Wandry* cases. Sales to grantor trust transactions may use a *Wandry* clause, providing for a sale of that number of shares equal to a given value. (That was the approach taken in the *Woelbing* sale transaction, now under litigation. Estate of

Donald Woelbing v. Commissioner, Docket No. 30261-13; Estate of Marion Woelbing v. Commissioner, Docket No. 30260-13.) Alternatively, a sale transaction may use a price adjustment clause. Either of these may be within the scope of the regulation project.

For further discussion of defined value clauses, see Item 13.e below.

e. **Items of Highest Priority**. Cathy Hughes (with the Treasury Department Office of Tax Policy) provided insight at the May 2015 ABA Tax Section meeting as to the regulation projects impacting estate planners that we might expect to see in the near future. Projects that she mentioned include: (1) Final portability regulations (the temporary regulations expire June 15, 2015); (2) Guidance under the ABLE Act allowing states to create "Section 529-type" accounts for the disabled (which has now been issued); (3) Final regulations regarding basis rules for term interests in charitable remainder trusts (which were issued on August 11, 2015); (4) Guidance regarding the §2801 tax on gifts by certain expatriates to U.S. citizens and residents (this has been a "high priority" for several years); and after that guidance is issued (5) Section 2704 proposed regulations. (The preceding information is based on a summary of the ABA Tax Section meeting by Diane Freda. Freda, *Guidance on Material Participation For Trusts, Estates May Emerge in Stages*, BNA Daily Tax Report (May 12, 2015).) Guidance on the first four of those items have been released, suggesting that the Section 2704 proposed regulations may be high on the list of projects that we will see next.

At the ABA Tax/Real Property Probate and Trust Law Section Joint Meeting on September 18, 2015 Cathy Hughes indicated that the IRS/Treasury is still working on the Section 2704 proposed regulations. They are "getting closer" but they cannot predict when the new rules will be issued. She gave no further indications regarding the scope of the rules or their effective date. Ms. Hughes acknowledged that the government is also hard at work on implementing the basis consistency and information reporting legislation. She confirmed that forms and instructions have been sent to the Office of Management and Budget for approval and could be available in early January. The government is also working on implementation regulations and updating computer systems to implement the new basis consistency legislation; that is a high priority project. In addition, the government is continuing work on implementation of the "ABLE Act" following the issuance of proposed regulations earlier this year, and IRS further guidance is expected in early 2016. An additional project receiving attention is a guidance project regarding section 6166; the government expects to issue comprehensive proposed regulations, and this project may come out "sooner rather than later." *See* Alison Bennett, *Guidance on Valuation Discounts "Getting Closer,"* BNA Daily Tax Report (September 21, 2015).

Information about the anticipated timing of the new §2704(b) guidance and the scope of the new rules was updated by a presentation by Leslie Finlow, an IRS senior technician reviewer, who said at the American Institute of CPAs Fall Tax Division Meeting on November 4, 2015 that the guidance is expected "very soon" and that the guidance will not be based on the prior Greenbook proposal (as discussed in Item 2(f)(2) below.) *See* Freda, *IRS: Forget 2013 Treasury Proposal on Valuation Discounts*,

BNA DAILY TAX REPORT 214 DTR G-6 (November 5, 2015). Persons attending the meeting report that Ms. Finlow said "I personally hope it is by the end of the year because I would like to check it off my list, but I do not know when they will be out and I cannot give you any assurances." Accounting Today website article dated November 18, 2015 by Moira A. Jabir titled *Hints on the New IRS Regulations on Family Limited Partnerships* says an IRS official recently indicated at a trusts and estates luncheon that the IRS is not expected to issue the valuation discount regulations "until the end of this year."

This summary suggests that the §2704 regulations will not be issued within the immediate near future but might conceivably be issued this fall or in 2016.

f. **Section 2704 Project**.

(1) *Overview.* Section 2704(b)(4) gives the Treasury broad authorization to issue regulations that would disregard certain "other restrictions" in determining the value of an interest in a corporation or partnership transferred to a family member if the restriction "does not ultimately reduce the value of such interest to the transferee." IRS and Treasury officials hinted about eight years ago that they were close to issuing such a proposed regulation (reflecting a §2704 guidance project that was placed on the IRS/Treasury Priority Guidance Plan in 2003), but President Obama's first budget proposal included a revenue proposal to revise §2704, and the §2704 regulation project was put on hold pending the possible passage of such legislation that might provide legislative support for the positions the new proposed regulation might take. Not a single bill was ever introduced addressing the legislative proposal, however, and the §2704 legislative proposal was omitted from the President's budget proposal released in February 2012.

IRS and Treasury officials have indicated that the §2704 regulation project is proceeding. Cathy Hughes, a Treasury official, had some comments about the §2704 regulation project at the recent ABA Tax Section meeting. The proposed regulation may have a dramatic impact on the valuation of interests in closely-held corporations or partnerships that are transferred to family members—and the proposed regulation might conceivably be effective when the regulation is finalized retroactive to the date of the proposed regulation.

(2) *Section 2704 Statutory Background*. Section 2704 was enacted in 1990 as a part of Chapter 14. The goal in particular was to limit discounts for certain family partnership or LLC interests that are transferred to family members. Section 2704(b) is titled "Certain Restrictions on Liquidation Disregarded." It provides that any "applicable restriction" is disregarded in valuing an interest in a corporation or partnership that is transferred to a family member if the transferor and family members control the entity. An "applicable restriction" is any restriction that (i) effectively limits the ability of the corporation or partnership to liquidate, and (ii) the restriction lapses (entirely or partially) after the transfer OR the transferor or family members can remove the restriction (entirely or partially), but an "applicable restriction" does not include "any restriction imposed, or required to be imposed, by

any Federal or State law" (or commercially reasonable restrictions imposed by unrelated persons in a financing transaction).

Section 2704(b)(4) includes broad legislative authority for the IRS to issue regulations that would disregard "other restrictions":

> "The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

The title to §2704(b) is "Certain Restrictions on Liquidation Disregarded." The authorization of regulatory authority in §2704(b)(4) does not specifically limit the regulations to "other liquidation restrictions" but merely refers to "other restrictions." Does this provide legislative authority for regulations limiting discounts for reasons other than merely disregarding liquidation restrictions despite the title of §2704(b)?

(3) *Significance of State Law Exception.* The exception for "any restriction imposed, or required to be imposed, by any Federal or State law" is very important. The "state law" exception is clearly integrated into the existing regulations.

> "An applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction…. Ability to remove the restriction is determined by reference to the State law that would apply but for a more restrictive rule in the governing instrument of the entity…. A restriction imposed or required to be imposed by Federal or State law is not an applicable restriction." Treas. Reg. §25.2702-2(b).
>
> "(c) *Effect of disregarding an applicable restriction.*—If an applicable restriction is disregarded under this section, the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under the State law that would apply but for the restriction." Treas. Reg. §25.2704-2(c).

The exception for restrictions imposed by State law has dramatically reduced the applicability of §2704 to partnership and LLC transfers. Some state legislatures have revised limited partnership and LLC laws after the passage of §2704 to provide various limitations on the rights of limited partners or LLC members to make transfers under default rules that apply unless the partnership or operating agreement specifically overrides those default rules. One possible approach of the new proposed regulation might be to apply the statute more literally, so that only restrictions that are mandated (i.e., "required to be imposed") would be recognized under the statutory exception.

(4) *Possible Scope of New §2704 Proposed Regulation*. Cathy Hughes said that the scope of what the new regulations might include are indicated by the §2704

legislative proposal (last included in the Fiscal Year 2013 Greenbook, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals" dated February 2012). (This suggests that the new proposed regulations may include many of the items that were being considered eight years ago. The Treasury presumably suggested the §2704 legislative project to the Obama Administration to support the provisions that it wanted to include in its new regulations.)

The §2704 legislative proposal in the Greenbooks for the Obama Administration, ending with the 2013 Fiscal Year Greenbook, includes five items. The new §2704 regulation may include some or all of these subjects.

(i) *Additional "Disregarded Restrictions*." An additional category of restrictions ("disregarded restrictions," which are in addition to the liquidation restrictions addressed in §2704) may be disregarded in determining the value of interests in "family-controlled entities" (observe, this is not limited just to partnerships and LLCs) that are transferred to family members. What are those additional restrictions? They are "to be specified in regulations." *Transferred interests would be valued by substituting for "disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations.*"

(ii) *Assignee Interests*. Restrictions on a transferee being able to become a full-fledged partner (or member of an LLC) would be a disregarded restriction.

(iii) *Third Party Involvement in Removing Restrictions*. Section 704(b)(2)(B)(ii) says that one of the general requirements of an "applicable restriction" is that the transferor or family members can remove the restriction. (The Greenbook proposal generally retains this family-removal requirement with respect to "disregarded restrictions.") The Fifth Circuit in the *Kerr* case reasoned that §2704 did not apply to the partnership in that case because charities had small limited partnership interests, and all partners had to consent to removing restrictions; thus, the family acting alone could not remove the restrictions. *Kerr v. Commissioner*, 292 F.3d 490 (5th Cir. 2002). Under the legislative proposal, "certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family."

(iv) *Safe Harbor*. The statute would provide regulation authority that would include "the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met."

(v) *Marital and Charitable Deduction*. The legislation would include provisions dealing with the interaction of the marital and charitable deductions for transfer tax purposes. Therefore, if an interest is valued higher than its actual fair market value for transfer tax purposes, the higher value might also be applied for marital deduction and charitable deduction purposes (a taxpayer-friendly provision).

To view the legislative proposal that was included in the President's budget proposals for fiscal years 2010-2013, click **here**.

Richard Dees (Chicago, Illinois) wrote a 29-page letter to the Assistant Secretary of Tax Policy in the Treasury Department and to the Commissioner of the Internal Revenue Service on August 31, 2015, in which he maintains that if the regulation implements the provisions in the statutory proposal, the regulation "would be invalid as contrary to the origin, purpose and scope of the current statute." The letter provides a detailed summary of the statutory provisions in §2704, the legislative history behind §2704, and case law interpreting §2704 to support his position. Some of his reasoning is that the origin and intent of §2704 was "only to disregard liquidation provisions and other provisions of the organizational documents that lowered the value of interests in a family business for transfer tax purposes below what would occur under state law if those provisions were not in the documents." He argues that §2704(b) only empowers the IRS to *disregard* certain restrictions in family entity organizational documents, but not to replace those disregarded provisions with IRS-invented alternatives "that would make the valuation of minority interests in a family business the same as if family attribution applied;" instead the balance of the provisions in the documents that are not disregarded and provisions supplied by the operation of state law would be considered in valuing the transferred interest.

The IRS may be changing course!! Leslie Finlow, an IRS senior technician reviewer, said at the American Institute of CPAs Fall Tax Division Meeting on November 4, 2015 that:

- The guidance is expected very soon; and
- The guidance will not be based on previous Treasury Department proposals— "We're not looking at the Greenbooks or anything President Obama said four years ago…We're looking at the statute, and the statute as it looks now is what you will see at the conclusion."

This summary of Ms. Finlow's comments is from Freda, *IRS: Forget 2013 Treasury Proposal on Valuation Discounts*, BNA DAILY TAX REPORT 214 DTR G-6 (November 5, 2015). This article observes that practitioners had been worried that the IRS was planning to issue new restrictions based on the 2013 Greenbook proposal, which added restrictions "that may extend beyond the scope of those currently addressed by tax code Section 2704(b)."

(5) *Effective Date*. Treasury regulations are typically effective on the date final regulations are issued. At least several years typically lapse from the time proposed regulations are issued until the regulations are finalized. In very limited situations, proposed regulations provide they will be effective when finalized retroactive back to the date of the proposed regulations. For example, the proposed regulations regarding the income tax effects of private annuities issued in 2006 take that approach (and interestingly, those regulations still have not been finalized, nine years after the proposed regulations were issued, *see* REG-141901-05k proposing changes to Reg. §§1.72-6(e) & 1.100(j)). The initial "anti-Kohler" proposed regulations that were issued in 2008 also took that "retroactive effect" approach, but the revised proposed regulation issued in 2011 dropped that harsh effective date provision. *See* Prop. Treas. Reg. §20.2032-1(f). Cathy Hughes suggested at the ABA Tax Section

meeting that the Treasury and IRS are still considering what should be the appropriate effective date of the proposed regulation.

(6) *Legislative History*. Some planners have expressed concern that the proposed regulation may limit the availability of minority and marketability discounts for transfers involving family-controlled entities. *See* Freda, *Guidance on Material Participation For Trusts, Estates May Emerge in Stages*, BNA Daily Tax Report (May 12, 2015) (summarizing comments of Richard Dees). The legislative history (the 1990 Conference Report) makes clear that Chapter 14 was not intended to "affect minority discounts or other discounts available under [former] law." The Senate's discussion of the former law and the impact of Chapter 14 is rather emphatic.

> "The value of property transferred by gift or includable in the decedent's gross estate generally is its fair market value at the time of the gift or death. Fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031-1(b)). This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer. Accordingly, courts generally have refused to consider familiar relationships among co-owners in valuing property. For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.
>
> . . . .
>
> *The bill does not affect minority discounts or other discounts available under present law.*
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> . . . .
>
> *. . . the bill does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally* in all items of income, deduction, loss and gain in the same proportion *(i.e.*, straight-up allocations)." (136 Cong. Rec. § 15679, 15681 (October 18, 1990) (emphasis added)).
>
> Perhaps the existence of this legislative history is the reason that the IRS beginning in 2009 sought legislative changes to §2704 before issuing its new proposed regulations.

g. **Surprises.** The IRS in 2015 released several items of interest for which there was no warning in the previous Priority Guidance Plan.

(1) *Basis of Assets Transferred to Grantor Trust at Grantor's Death.* The IRS has added to its "no-ruling" list that it will not issue rulings as to "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code." Rev. Proc. 2015-37. This issue was later included on the 2015-2016 Priority Guidance Plan. See Item 2.a above.

(2) *Closing Letters Will Be Issued Only on Request*. In a June 16, 2015 update to the "Frequently Asked Questions on Estate Taxes" on the IRS website, the IRS indicates that for all estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. Taxpayers are asked to wait at least four months after filing the estate tax return to make the closing letter request "to allow time for processing." Apparently, this change in procedure is made in light of cuts to the IRS budget and in light the fact that a closing letter does little good for returns filed solely to elect portability (because the statute of limitations on that return does not lapse until the statute of limitations lapses on the surviving spouse's return). Estates that owe estate taxes will almost routinely want to request the closing letter before making estate distributions.

This notice on the IRS website says that for returns filed before June 1, 2015, estates can expect to receive a closing letter about 4 to 6 months after the return is filed unless the return is selected for examination or reviewed for statistical purposes.

At the ABA Tax/Real Property, Trust and Estate Law Section Joint Meeting on September 18, 2015 Cathy Hughes (with the Treasury Department Office of Tax Policy) suggested that an alternative to requesting a closing letter is to request a transcript for the estate tax return. A particular code on the transcript indicates that the examination is complete (and a closing letter historically would have been issued). At some point, the regulations may state affirmatively that the transcript is the equivalent of a closing letter.

The closing letter issue was addressed at the American Institute of CPAs Fall Tax Division Meeting on November 4, 2015 in discussions with the Trust, Estate and Gift Tax Technical Resource Panel. Practitioners expressed concern that a code on the estate tax return transcript will not carry the same weight as a closing letter, and that locating a code on the transcript is too complex for the executors of small estates. Practitioners said a more convenient approach would be to include a box on Form 706 that the executor could check off requesting a closing letter. The "Frequently Asked Questions on Estate Taxes" webpage on the IRS website was revised on November 2, 2015 to add a telephone number for requesting closing letters: (866) 699-4083 (which is also listed in the 2015 Form 706 Instructions). *See* Freda, *IRS: Forget 2013 Treasury Proposal on Valuation Discounts*, BNA DAILY TAX REPORT 214 DTR G-6 (November 5, 2015).

In early December 2015, the IRS added a webpage entitled "Transcripts in Lieu of Estate Tax Closing Letters." It describes using accounts transcripts as an alternative to closing letters.

> Account transcripts, which reflect transactions including the acceptance of Form 706 and the completion of an examination, may be an acceptable substitute for the estate tax closing letter. Account transcripts are available online to registered tax professionals using the Transcript Delivery System (TDS) or to authorized representatives making requests using Form 4506-T.
>
> **Transcript Delivery System (TDS)**

For all estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. In lieu of an estate tax closing letter, account transcripts are available online to tax professionals. An account transcript from the Transcript Delivery System (TDS) reflects transactions including the acceptance of Form 706 and/or completion of an examination.

Tax professionals can register on IRS.gov to secure estate tax transcripts…. Requests for these products will be fulfilled only when a properly executed Form 2848, Power of Attorney or Form 8821, Tax Information Authorization, is already on file….

NOTE: The decision to audit a Form 706 is typically made four to six months after the filing date. Please wait four to six months after filing Form 706 before submitting a request for an account transcript.

[Details governing the mechanics of making requests under the TDS system are explained.]

Following a successful request, an **Account Transcript** will display on the screen.

- The **Transactions** section of the transcript contains details of the entire account…
- **Transaction Code 421 indicates an Estate Tax Return (Form 706) has been accepted as filed or that the examination is complete**. Please note that the Transaction Code 421 explanation will display "**Closed examination of tax return**" in all instances. If Transaction Code 421 is not present, the tax return remains under review. Allow additional time before checking again.

[In addition, details about requesting an account transcript for estate tax returns by mailing or faxing Form 4506-T, Request for Transcript of Tax Return are explained.]

Registering under the TDS system will require patience and persistence. Mickey Davis (Houston, Texas) posted a day-by-day diary on the ACTEC listserv of his experience in going through the **17-step process** of registering on the IRS's TDS system to be able to request account transcripts online. This is a classic:

Day 1

I'm going through the process [of registering on the TDS system]. PTIN isn't enough. You have to be registered as a professional tax preparer. The announcement says as much, so I was expecting that. That takes about a week or so, because you have to fill out an online form (you need to have your social, and the filing status and AGI shown on your last Form 1040). Then you have to wait to have a confirmation code mailed to your house.

But that isn't all. I had to call the IRS to figure out why I still couldn't get a transcript. The IRS person directed me to the site that told me that I had to … set up to e-file (even though you can't e-file estate or gift tax returns). Getting registered as a professional tax preparer as described in the announcement is actually step 2 of 17 (I am not kidding).

To be set up to e-file, you have to lie to the IRS (or at least to their online registration system) and tell them that you are sole proprietor (even if you are not), and that you don't have an EIN (even if you do, and even though the web site says that you MUST have an EIN to proceed). Then you have to tell them your SSN and date of birth, and that you want to file 1041s (even if you don't).

I messed up somewhere about step 14 or 15, and haven't gotten back to it. I hope to try again this weekend, but I understand that once you complete step 17, you then have to wait for approval….

So glad that accessing on-line transcripts is making our lives so much simpler.

Day 4

I spoke to the IRS today. I was having trouble getting past step 16 because I was entering my PTIN instead of my PIN (which I apparently created when I first logged in, but didn't remember doing so). The helpful and chipper IRS person with whom I spoke told me that I could request a new PIN by mail. She was genuinely excited for me when, after telling me that it would be 5 digits long, I was able to guess it! She helpfully suggested that I write down my PIN and keep it in a safe place. I got my application submitted today for which she congratulated me! The submission date is December 20, when I first started working on this particular application (I gave up on several others, and have deleted them from the site—it saves them for you in case you want to go back).

The IRS person suggested that I keep checking back on the application from time to time. Once logged in, you can click on "Application" and then go to "e-file application" and then click on the (right) pending application. From there you can scroll down to Application Summary (NOT Application Status). What you are looking for is (i) a six digit EFIN; (ii) your Application Status as "Completed." Apparently, it usually takes **about 45 days for approval**!

Day 5

As I understand it, I would have to be named on a signed Form 2848 for the client, but we'll know more when some of us get through the process.

… Of course, once the IRS investigates my character and suitability to allow me access to their electronic record, things could get dicey. We'll see.

h. **Inflation Adjustments for 2016.** Revenue Procedure 2015-53 describes inflation adjustments for 2016. Some of the adjusted figures include the following:

- Individual income tax brackets: The top bracket for married individuals begins at $466,950 of taxable income; the top bracket for single individuals begins at $415,050 of taxable income;
- Estate and trust income tax brackets: The top bracket begins at $12,400 of taxable income;
- Transfer tax exemption amount: The basic exclusion amount (i.e., the estate, gift, and GST "exemption" amount) is $5,450,000;
- Annual exclusion: The gift tax annual exclusion remains at $14,000; and
- Gifts to non-citizen spouse: The first $148,000 of present interest gifts to a non-citizen spouse are excluded from taxable gifts.

3. Overview of Estate Planning Practices in the Current Environment

a. **Stability of Estate Transfer Tax Laws**. The American Taxpayer Relief Act of 2012 ("ATRA") provides for permanent provisions in the transfer tax area, without any further phase-ins. That stability did not exist from 2001-2012.

b. **Small Percentage of Population Subject to Transfer Taxes**. Estimates are that with a $5 million indexed gift and estate exemption ($5.43 million in 2015) only 0.14% of Americans who die each year will owe any federal estate tax (or about 2 out of every 1,000 people who die). The $5 million indexed gift exemption also means that many individuals have no concern with lifetime gifts ever resulting in the payment of federal gift taxes. There are still wealthy clients, though, and the wealthy are getting wealthier. (The Dow Jones average increased 26½% in 2013 and 7½% in 2014.)

c. **Cannot Ignore GST Tax**. Even low to moderate-wealth individuals cannot ignore the GST tax. Without proper allocation of the GST exemption (also $5 million indexed), trusts created by clients generally will be subject to the GST tax at the death of the beneficiary. (Sometimes that will occur by automatic allocation, but the planner must be sure that proper GST exemption allocation is made to long-term trusts even though the purpose of the trusts is not to save transfer taxes.)

d. **Fear of Estate Tax Uncertainty Is No Longer Driving Clients to Estate Planners**. Prior to 2012, Congressional action (or inaction) was driving clients to estate planning practices to make changes to estate plans. That is no longer happening. Estate planning practitioners will need to be more proactive in communicating with clients the importance of estate planning matters.

e. **Increased Relative Importance of Income Tax Issues**. At a time when the estate and gift tax for many Americans is zero, income tax planning is more significant than transfer tax planning. Even for couples with about $11 million of assets, little or no federal estate taxes may be due at the surviving spouse's death. Achieving basis step-up at each of the spouse's deaths may be very important. The ordinary income tax rate (39.6%) is about the same as the federal estate tax rate (40%). Even the capital gains rate (23.8% including the 3.8% tax on net investment income), when combined with state income taxes, may approach the federal estate tax rate.

f. **Routinely Using Traditional Credit Shelter Trust/Marital Deduction Planning is Out Other Than For Very Wealthy Clients**. The days of automatically using traditional credit shelter trust/marital deduction planning for all clients with assets more than one exemption amount are gone. Some planners believe that planning for the $10 million estate is *more* difficult than planning for the $100 million estate, because of the balancing required between various alternatives, depending on future events, for the $10 million estate. There may be situations in which credit shelter trust planning is appropriate for the $10 million and under estates, but only with careful consideration of a wide variety of factors.

g. **Portability Approach Has Become More Predominant**. Unless strong reasons exist to use credit shelter trusts in $10 million and under estates, an approach of using portability to take advantage of the first spouse's estate exemption will become more predominant. The surviving spouse has both spouses' exemptions to cover estate taxes, but a basis step-up is achieved at both spouses' deaths. Some of the factors for favoring the creation of a credit shelter trust at the first spouse's death include if there is (i) a likelihood or significant possibility of substantial appreciation of estate assets after the first spouse's death, (ii) a state estate tax, (iii) a blended family situation, (iv) a younger client scenario (in which remarriage of the surviving spouse is

likely), (v) a situation in which the couple wants to use trusts after the first spouse's death and wants to have both the surviving spouse and descendants as discretionary beneficiaries of the trust.

Some planners refer to this as the "do no harm" approach. A fairly good tax plan is in place for couples with estates under $10 million before the client comes to the planner's office—no estate tax would likely occur at either spouse's death (although future appreciation may conceivably result in some estate taxes at the second spouse's death) and there is a basis step-up at both spouses' deaths.

h. **Planning Is More Difficult for Planners**. Tax simplification measures that permit additional planning alternatives, often make planning more difficult for planners, because the planner must review the appropriateness of each possible alternative. That has certainly happened with portability. Many attorneys report that discussing the portability alternatives with clients and the various factors impacting the decision often takes 20-30 minutes or more, and at the end of the discussion the client is often totally perplexed about what to do. Even after a decision is made, the planner must document the discussion, including the factors that were considered and the reason that the client made the decision that was made.

Twenty years later, facts may occur that mean that an alternative course of action would have been preferable, and the planner needs to be able to document that the client made an informed, reasoned decision.

i. **Transfer Planning Still Important for Wealthy Families.** Transfer planning is still important for clients who will be subject to estate taxes (individuals with assets over about $5.5 million and couples with assets over about $11 million). An initial step is to focus on strategies that use no gift exemption or that leverage the use of gift exemption (therefore, leaving the client with estate exemption so that the client can own low basis assets at death, covered by the exemption, to achieve a basis step-up for those assets). Low-interest loans, GRATs, leveraged GRATs, and sales to grantor trusts (see paragraph k below) are all strategies that may accomplish those goals. GST planning is very important; with appropriate planning a large portion of even very large estates can be left in a GST exempt manner. See paragraph k and Item 5.k below. Special more sophisticated transfer planning strategies may also address ways to minimize the effect of losing basis adjustments at the transferor's death. See Items 7 and 11 below.

Discounts for interests in partnerships and LLCs may at some point be diminished. The rumored §2704 regulations are making their way up the bureaucratic approval process. *Transfer planning with these interests might be accelerated*; the issuance of those proposed regulations may still take years, but it could happen sometime this year.

In the unlikely event that the GRAT proposal in the 2016 Fiscal Year Plan Greenbook should pass, new GRATs would effectively be eliminated. (The remainder interest would have to be valued at the greater of 25% of the value contributed or $500,000, but not to exceed the value contributed, and the grantor could not purchase assets from the GRAT. The proposal would apply to GRATs created after the date of enactment.)

j. **Be Very Careful Before Making Lifetime Gifts of Low Basis Assets**. Estate tax savings result from gifts by excluding the future appreciation in the donated assets from the donor's gross estate. The estate tax savings are offset by the loss of a basis step-up if the client dies no longer owning the donated property. For example, a gift of a $1 million asset with a zero basis would have to appreciate to approximately $2,470,000 (to a value that is 247% of the current value) in order for the estate tax savings on the future appreciation ($1,469,135 x 40%) to start to offset the loss of basis step-up ((2,469,135 x 23.8% for high bracket taxpayers). The required appreciation will be even more if there are also state income taxes on the capital gains.

k. **Grantor Trust Planning Still Advantageous**. Grantor trust planning continues to be very desirable for clients with large estates who are interested in transfer planning strategies to reduce estate taxes. See Item 11.b below. Even for more modest estates, grantor trusts afford substantial flexibility. Advantages of using grantor trusts include:

> (i) the grantor pays the income taxes on the trust income so the trust can grow faster and the tax payments further reduce the grantor 's taxable estate (studies have shown that this is the most important factor in the long-term effectiveness of transfer planning strategies—even more important than discount or freeze planning aspects of transfer planning strategies);
>
> (ii) the grantor can sell additional assets to the trust in return for a low-interest note without gain recognition on the sale (and all of the appreciation can be in a GST exempt trust if GST exemption is allocated to the initial gift to the trust); and
>
> (iii) the grantor has the flexibility to purchase back trust assets, in case the grantor prefers having assets that were transferred to the trust or if the grantor wants to reacquire low basis assets so they will receive a basis step-up at the grantor's death (the purchase should be made with cash or high basis assets because the income tax effects of purchasing low basis assets in return for a note are not certain). See Items 6.b and 11.b below.

Examples of the flexibilities of grantor trusts are that the grantor can keep the ability to end the grantor trust status when desired and distributions can be made to the grantor's spouse to pay the income taxes if desired (assuming the spouse is a discretionary beneficiary).

Analytical studies of the financial impact of various strategies demonstrate that sales to grantor trusts can be incredibly efficient in accomplishing wealth transfer, particularly accomplishing wealth transfer in a many that is largely GST exempt. (See Item 5.k below.) In several recent cases, the IRS has taken that position that §2036 applies to sales to grantor trust transactions. Planners should take careful steps to create the best defense around a §2036 argument. (See Item 13.c below.)

l. **Undoing Prior Planning Strategies**. A number of clients will want to engage in planning to "undo" the effects of prior planning transactions if the client will not face estate taxes with the larger exemptions and does not want to lose the basis step-up at each spouse's death. This includes avoiding the funding of bypass trusts under the wills of clients who die without updating their wills, causing previously transferred low-basis assets to be included back in the donor's gross estate, and undoing prior discount planning. See Item 6 below.

m. **Basis Adjustment Planning**. Planning to leave open the flexibility to cause trust assets to be included in the gross estate of a trust beneficiary if the beneficiary has

excess estate exemption, to permit a basis adjustment at the beneficiary's death without generating any added estate tax, is increasingly important. Possible strategies include planning for the flexibility to make distributions to the beneficiary (either pursuant to a wide discretionary distribution standard or under the exercise of a non-fiduciary limited power of appointment), to have someone grant of general power of appointment to the beneficiary, to use of a formula general power of appointment, or to trigger the Delaware tax trap (by the exercise of a limited power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment). See Item 7 for a more detailed discussion of these strategies. Perhaps this type of planning is given a boost by the statement in President Obama's tax proposal that the "trust loophole" under §1014 is "perhaps the largest single loophole in the entire individual income tax code."

n. **Trust Planning**. Planning to use trusts will continue to be important, if for no other reason, for the non-tax advantages of trusts (including planning for long-term management and creditor protection or "divorce" protection for beneficiaries). However, these advantages must be balanced against the greater administrative and income tax costs for trusts. Trust structuring should incorporate planning for flexibility provisions to react to future conditions. See Item 4 below. Powers of appointment are becoming increasingly popular for various reasons in facilitating future flexibility. See Item 10.

o. **Estate and Trust Distribution Planning.** Estates and trust reach the maximum income tax bracket at only $12,300 in 2015 ($12,400 in 2016); if distributions are made that "carry out" income to the beneficiaries instead, they may be in much lower brackets. (For example, married individuals do not reach the top bracket until they have taxable income in 2015 of $464,850, adjusting to $466,950 in 2016.) This planning is particularly important for capital gains; trusts with income taxable income over $12,300 ($12,400 in 2016) are taxed on capital gains at 23.8% (not counting any state income taxes). Individuals may have a 15% or even lower rate on capital gains. Increasing attention is devoted to causing capital gains to be in distributable net income (DNI) so that distributions can result in capital gains being subject to the15% or even lower rates. See Item 18.b below.

   This does not mean that trust distributions should automatically be made to reduce the trust's taxable income below $12,300 ($12,400 in 2016). That may frustrate the reasons the trust was created. But trustees may need to consider income tax planning in making decisions of what is in the best overall interest of the trust and beneficiaries in accordance with the distribution standard in the trust instrument. See Item 18.a below.

   Trusts with business income will focus on whether they can satisfy the material participation requirements so that the resulting non-passive business income is not subject to the 3.8% tax on net investment income. See Item 19 below.

p. **State Estate Taxes**. Clients in states with state estate taxes will continue to need tax planning to minimize state estate taxes, which can be very significant. Twenty-one states and the District of Columbia have state estate taxes. New York's experience may be followed in other states (relaxation of the state exemptions but estate inclusion for gifts within three years of death).

4. Structuring Trusts and Trust Design Strategies

David Handler (Chicago, Illinois) discussed trust provisions that are important for any trust. Even highly sophisticated transfer planning strategies typically involve trusts, and the fundamental trust design issues often get short shrift. The result of the planning, however, is that the assets end up in a trust and the trust document controls the assets for many years. (Mr. Handler's article includes trust provisions for many of the issues summarized below, as well as for many other issues.) In addition, Lauren Wolven (Chicago, Illinois) discussed various interesting issues regarding the need for documents to address specifically provisions for spouses and descendants in light of changing definitions of the "modern family."

a. **Trustee Appointment**. The provisions for appointment of the initial and successor trustees are the most important provisions in the entire document. See Item 4.I of the Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor** for highlights from a recent article about this same topic. Charles A. Redd, *The Most Disrespected Decision in Estate Planning,* TRUSTS AND ESTATES 13-14 (July 2014).

   Successor Trustees. A fixed list of original and successor trustees does not work well; the settlor invariably will want to change that list at some point in the future. Alternatively, provide a list of persons who can appoint trustees, and perhaps the flexibility to add to that list of appointers. The appointers should also have the authority to specify the conditions and terms for who can be appointed as successor trustee (for example, to specify that spouses of children would not be permissible trustees).

   Trustee Removal. The trustee appointers may also be given the authority to remove trustees. If a list of removers is used, it typically includes the grantor, the grantor's spouse, and then descendants if above a certain age. (Under Revenue Ruling 95–58, the grantor can have a trustee removal power as long as the trustee must be replaced by someone who is not related or subordinate to the grantor.)

   Beneficiaries as Trustees. If a beneficiary is a co-trustee, the trust must have an ascertainable standard for distributions in which the beneficiary co-trustee participates. An independent trustee could also have a broader discretionary standard for making distributions to the beneficiary. A beneficiary-trustee who can make distributions to himself only for health, education support and maintenance could be authorized to add an unrelated co-trustee who would have broad authority to make distributions to the beneficiary.

   Adding Co-Trustees. The instrument can provide a procedure for adding co-trustees (by a settlor, beneficiary, trustee, trust protector, or others). The settlor can have the power to add co-trustees as long as the settlor cannot appoint himself or herself. *Durst v. U.S.*, 559 F.2d 910 (3d Cir. 1977) (corporate trustee had a power to control disposition, and grantor reserved right to name an individual trustee as co-trustee; court concluded that grantor could not name himself, and there was no estate inclusion).

   Administrative Trustees. The instrument can authorize the appointment of a co-trustee for certain functions, including as an administrative co-trustee who would

have the responsibility of maintaining records of the trust. An administrative trustee in a particular state may be appointed to facilitate obtaining sufficient nexus with a state to apply that state's governing law.

Investment Trustee. If permissible under state law, a particular co-trustee could be given the responsibility for making investment decisions. The grantor can be the investment trustee. *Old Colony Trust Co. v. U.S.*, 423 F.2d 601, 603 (1st Cir. 1970)(broad trustee administrative powers that could "very substantially shift the economic benefits of the trust" did not invoke section 2036(a)(2) because such powers were exercisable by the donor-trustee in the best interests of the trust and beneficiaries, and were subject to court review). Managing investments is an administrative power that will not cause estate inclusion for the grantor, as long as there is no authority over closely held stock under section 2036(b) or life insurance on the grantor's life (to avoid §2042 inclusion).

b. **Trust Protectors**. A trust protector may be given the authority to take "settlor-type" actions that the settlor cannot retain directly for tax reasons. For example, a trust protector could have the authority to amend the trust to make administrative changes (which could include such things as providing a broker with specific authorization language to implement a certain transaction, to correct scriveners' errors, to make adjustments for tax law changes, or to change the name of the trust). Be wary of authorizing broader trust amendments, for fear the settlor would constantly want to amend the irrevocable trust every time the settlor amends his or her revocable trust or will.

A problem with appointing a trust protector is deciding who should serve in that role. The trustee is the most "trusted" person from the settlor's point of view. Who can override that? The settlor needs "an even smarter and even more trusted person" to override the trust with the trust protector powers.

c. **Powers of Appointment**. The trust might give an individual (usually a family member) a non-fiduciary power of appointment to redirect who will receive assets, to change the division of assets among beneficiaries, to change the trust terms, etc. Many years later the settlor's children may be in a better position than the settlor to decide how the assets should be used for their respective children. "A fool on the spot is worth a genius two generations ago." Also, the power of appointment is a "power of disappointment," giving the powerholder a "stick" over other disgruntled beneficiaries. "I brought you into this world and I can take you out of this trust."

The power of appointment should specify the manner in which it may be exercised (for example, in further trust, the ability to grant further powers of appointment, etc). It should also specify the mechanics of exercising the power (such as whether the last exercise controls and whether an exercise is revocable until it becomes effective).

Contingent Powers of Appointment. There has been an increased interest in the last several years in granting a formula contingent testamentary general power of appointment or giving someone the authority to grant a general power of appointment to a beneficiary (to achieve a basis step-up to the extent possible without increasing estate taxes of the beneficiary and/or to make use of the beneficiary's GST exemption). Observe that achieving a basis step-up is typically not

an issue for non GST exempt trusts because a basis step-up is permitted after a taxable termination caused by the death of the beneficiary. §2654(a)(2). One planner's preferred approach is to include a general power of appointment for beneficiaries but to give the trustee or some other powerholder the authority to remove the general power. Such a provision might also direct that the trustee can exercise its discretion to remove a general power of appointment only if requested to consider exercising that discretion by a beneficiary.

Whether or not having a general power of appointment for a beneficiary is preferable may turn on a variety of facts, such as where the child is domiciled, what are the estate and income tax rates in that state, does the child have excess estate exemption, etc. Those factors can change as exemptions go up or down, as the child moves, or as the child's assets climb or decline in value.

d. **Dividing Trusts**. "Share toys, not money." Big problems erupt if all siblings are beneficiaries of the same trust and share out of the same trust account. "That does not make for good holiday dinners." They will have differing views on management, investments, and distributions. This can arise, for example, if a single trust is created after the first spouse's death for the surviving spouse and all of the decedent's children. The surviving spouse may not need distributions from the trust, and the children in effect have to share the same trust for what could be decades. Authorize the division of a trust into sub-trusts for the separate respective beneficiaries.

e. **Distributions**. Every client asks what "support and maintenance" includes. "Can I buy the fourth house?" Helpful flexibility is added by giving a third-party trustee the authority to make discretionary distributions in the trustee's sole and absolute discretion, without requiring equal distributions, considering or not considering outside financial resources, and to or for the benefit of the beneficiary. All of those could be included with perhaps the additional emphasis "and I really mean it."

Advancements. A trustee may be very reluctant to make a large distribution to an older beneficiary from a trust for multiple beneficiaries. The trustee may be more likely to do so if the trustee has the authority to treat the large distribution as an advancement of that beneficiary's share of the overall trust. Give the trustee the flexibility to treat distributions as advancements without requiring that all distributions be treated as advancements.

Use of Property. The trust may give the trustee the authority to allow a beneficiary to use real property owned by the trust, with or without rent of other charges (but requiring that any trust that qualifies for the marital deduction may not permit anyone other than the settlor's spouse to use trust property for less than fair market value).

Trustee Guidance and Incentive Provisions. Incentive provisions are difficult to draft in a manner that will make sense in the future. A simple incentive trust rule may have many exceptions that swallow the general rule. A preferable approach to using incentive provisions is to give the trustee broad discretionary distribution authority with a statement of guidance and principles. A sample clause (from David Handler) is as follows:

> I request (but do not require) that when determining whether to make a distribution to a descendant of mine from any trust hereunder and the amount of such distribution, the

trustee do so in a manner that assists, encourages or rewards such descendant for exhibiting or accomplishing the following "desired behaviors":

(a) pursue an education at least through college and/or a vocational/technical school;

(b) be gainfully employed with a view toward being financially self-sufficient;

(c) be a law-abiding member of society;

(d) be a productive member of society by making meaningful and positive contributions to family, community and society;

(e) engage in entrepreneurial and/or creative activities;

(f) handle money intelligently and avoid wasteful spending;

(g) act with empathy, thoughtfulness, kindness and consideration toward others;

(h) develop healthy and meaningful relationships;

(i) make contributions of time, money or both to charity; and

(j) maintain a healthy lifestyle, both physical and mental.

The trustee should consider the societal norms in the geographical area in which a beneficiary resides, as I do not intend for the trustee to impose his own personal beliefs on a beneficiary as to what constitutes "gainful employment," "healthy lifestyle," or other subjective notions referred to above, although the trustee's beliefs are certain to be a part of such determinations.

Of course, a beneficiary's age, health, abilities and other circumstances will affect his or her ability to accomplish one or more of the desired behaviors, and should be considered in construing and applying the foregoing to any particular beneficiary. I consider full-time parents to be productive members of society and gainfully employed, and do not intend that a beneficiary be discouraged from choosing to raise a family as his or her sole occupation.

I do not expect a beneficiary to necessarily accomplish or exhibit all of the desired behaviors, and recognize that some desired behaviors may even conflict with others. It is my hope and intent that the trust property will be used to reward and enhance the quality of life of those beneficiaries that have exhibited, accomplished or are working toward accomplishing one or more of the desired behaviors, and to encourage and assist the beneficiaries to exhibit and achieve the desired behaviors. On the other hand, I also hope and intend that the trust property will not be distributed to a beneficiary who is engaging in self-destructive, abusive or illegal behaviors ("undesired behaviors"), except for the beneficiary's health, education and basic support, which may include expenses for rehabilitation and treatment or care.

If the trustee, in the trustee's discretion, determines (1) that a beneficiary is not capable of handling money or financial affairs prudently, or (2) that a beneficiary has financial problems or marital difficulties that could result in the diversion or dissipation of trust property or

property distributed from the trust, then I recommend (but do not direct) that the trustee refrain from distributing property to the beneficiary until such problems have been resolved to the trustee's satisfaction.

The trustee shall have no duty to inquire or monitor whether a beneficiary is exhibiting or accomplishing the desired behaviors or the undesired behaviors, as the guidelines set forth in this Article are not intended to limit the trustee's discretion to make distributions to the beneficiaries, but the trustee should consider the sentiments expressed in this Article.

(This form, many other forms included in David's materials, as well as a variety of forms and David's detailed excellent estate planning analysis and discussion are in DAVID HANDLER, COMPLETE ESTATE PLANNING SOURCEBOOK (available online at wolterskluwers.com).)

As an example of other forms to assist in providing guidance to trustees regarding distribution decisions, Lauren Wolven offers the following clauses providing detail as to what is meant by "best interests" and "support."

> **Best Interests**. Whenever the Trustee is authorized or directed to pay to, or apply for the benefit of, accumulate, or otherwise administer income or principal for the best interests of a beneficiary herein, the term "best interests" shall be liberally construed by the Trustee and shall contemplate not only authorized distributions for the support of said beneficiary (if such distribution shall be deemed to be in the best interest of said beneficiary by the Trustee) but also authorized distributions for such beneficiary's comfort, happiness and convenience. By way of illustration and not in limitation thereof, the best interests of a beneficiary may include the right of the Trustee to make distributions as will permit a beneficiary to travel for business, pleasure, or educational purposes; to purchase an automobile; to purchase or furnish a personal residence; to purchase, initiate, or invest in a business interest which the Trustee personally deems to be sound or promising, even though such business might be the type of investment in which, because its risk, the Trustee could not or would not invest for the trust estate; to acquire, receive, or enjoy benefits deemed by the Trustee to be luxuries; to enable such beneficiary to celebrate his or her wedding or other commitment ceremony with a suitable reception in keeping with such beneficiary's style of living, and to enable such beneficiary to augment his or her separate income or estate as such beneficiary sees fit. In addition, if a beneficiary is a minor, the term "best interests" might also include, by way of illustration and not in limitation, the right of the Trustee to provide such sums to enable such beneficiary to attend a summer camp; to take vacation trips; to participate in social activities of interest to such beneficiary and such beneficiary's peers; provided, however, that if any person or persons have the legal obligation to support any such beneficiary, the Trustee shall endeavor to make payments which are not in satisfaction of any obligation of support; provided, further, however, that if the Trustee deems it necessary to provide support for a beneficiary the Trustee shall have full power to do so. In making any such discretionary distribution, the Trustee may consider the ability of said beneficiary to deal with and manage the money or property involved, and shall exercise the discretionary powers herein conferred primarily to benefit said beneficiary rather than the remaindermen. This Section is intended solely as a precatory guide to the Trustee and shall in no way be construed to alter, limit, or enlarge the discretions and powers conferred upon the Trustee by any other provision hereof nor to require the Trustee to make any distribution to any beneficiary.
>
> **Support**. The "support" of a beneficiary shall include said beneficiary's support and maintenance in reasonable comfort, medical care (including but not limited to dental and psychiatric care) and education (including but not limited to public or private elementary, secondary, college, post-graduate, professional, vocational, language and artistic studies). Distributions for the support of a beneficiary shall be based upon the standard of living to which such beneficiary shall have been accustomed during the five (5) year period immediately preceding any such distribution, *but may be made only if and to the extent that the other income and resources known to the Trustee to be available to said beneficiary for such purpose (including the income and resources of any person who shall be legally obligated to support said beneficiary) are inadequate [optional to have beneficiary's other resources included]*.

The author expresses appreciation to Lauren Wolven and to Horwood Marcus & Berk Chartered (Chicago, Illinois) for the use of the Best Interests and Support clauses.

Blended Family Situations; Typically Contentious Items. In a blended family scenario, disputes may arise between the settlor's surviving spouse and children of the settlor by a different marriage. To reduce the chances of litigation, Lauren Wolven suggests that instruments might address how certain typically contentious items will be paid, such as: real estate taxes on any residence owned by the trust; routine maintenance and repairs on the residence; major capital expenditure (such as a new roof) for the

residence; medical expenses and health insurance; utilities; insurance of a residence, artwork or other valuables; income taxes on distributions from the trust; vacation travel; caregivers; and automobiles and auto insurance.

f. **Divorce**. The trust may provide that in the event of a divorce from a family member of the settlor, the divorced person and his or family members will be removed as beneficiaries, trustees, and powerholders. (This may be important to avoid being stuck with grantor trust status inadvertently. Under §672(e), a grantor is deemed to hold any power or interest held by someone who was a spouse of the grantor at the time the trust was created. It is bad enough that the divorced spouse remains as a trust beneficiary; the grantor may also be struck with paying all income taxes on the trust's income.)

   The divorce clause may cover details as to when it applies such as whether it is triggered by being legally separated or upon the filing of a divorce petition.

   In structuring distribution standards, fiduciary appointments, and powers of appointment, give consideration to how those provisions might impact whether the trust assets are considered as "marital assets" of a beneficiary in the event of the beneficiary's divorce. *See Pfannenstiehl v. Pfannenstiehl*, Mass. App. Slip Op. 13-P-906 (August 27, 2015) (in a divorce action, judge considered husband's interest in discretionary spendthrift trust created by his father, which provides for distributions to husband and the father's other descendants for their "comfortable support, health, maintenance, welfare and education," where husband had received substantial distributions prior to the divorce action [distributions continued to his siblings but not to husband during the divorce proceedings], as a "vested interest" and as marital property in determining equitable distribution in divorce; trust spendthrift clause did not protect the beneficiary's trust interest in the divorce action, the court concluding that "settled trust law … holds that the mere statement of a spendthrift provision in a trust does not render distributions from a trust, such as this one, immune to inclusion in the marital estate"). For further discussion of the effect of trust structuring on the protection of a beneficiary's discretionary interest in a trust for divorce purposes, see Item 4.k of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**. [

g. **Defining Spouse.** The instrument may make clear who is included as a "spouse" for purposes of the instrument, including same-sex marriages (and whether they are recognized if living in a state that does not recognize the marriage even if the spouses were legally married elsewhere), domestic partnerships, or civil unions.

h. **Defining Children and Descendants**. Specify whether children and descendants include the settlor's children and descendants or only include children and descendants of the settlor *and the settlor's spouse*. If split gifts are made using both spouse's exemptions, the consenting spouse may not want all of the settlor's descendants from prior or subsequent marriages to be included as beneficiaries.

   Children Born Out of Wedlock. A traditional approach is to treat children born out of wedlock to a female beneficiary as a beneficiary, but to require that children born out

of wedlock to a male beneficiary to be acknowledged by the male-beneficiary in order for the out of wedlock child to be recognized as a beneficiary of the trust.

Adopted Children; Assisted Reproductive Technology (ATR). The instrument should address whether adult adoptions are recognized for purposes of the agreement. (The position of the Restatement (Third) of Property: Wills and Other Donative Transfers §14.5 is to treat an adopted child as the child of the adopting person in someone else's testamentary document only if the child was (i) adopted before he or she reached 18, (ii) or the adopting parent functioned as the parent before the child reached 18, or (iii) if the adopting parent was the foster or stepparent of the adopted child.)

The document can also address what descendants by ATR should be included. Lauren Wolven and Horwood Marcus & Berk Chartered (Chicago, Illinois) provide the following very concise ATR provision:

> A child conceived and born using the genetic material of a designated person after the death of such designated person shall be considered the child of such designated person if all of the following conditions are met:
>
> (i) The child is in gestation within two (2) years after the death of such designated person;
>
> (ii) The designated person
>
> A. signed a record evidencing consent to the use of his or her genetic material after the death of such designated person; or
>
> B. at his or her death, was the spouse of the child's surviving parent, which surviving parent caused such child to come into being, and such designated person had not signed a record evidencing lack of consent to use of his or her genetic material by the surviving spouse; ….

i. **Portability**. The default provision in many revocable trusts is to require that the portability election be made following the first spouse's death if there is unused estate exemption. See Item 5.j below.

j. **Change of Situs or Governing Law**. Trust provisions may give the trustee the authority to change the trust situs or governing law, but do not allow such a situs change to shorten or lengthen the rule against perpetuities applicable to the trust. Do not provide that a change of situs will automatically change the governing law; governing law changes should be intentional.

k. **Avoid Foreign Trust Status**. Require that all "substantial decisions" (as defined in Reg. §301.7701-7(d)(1)(ii)) be made by U.S. persons.

l. **Limitations on Non-Family Trustee's Power to Acquire Closely-Held Non-Family Entities in Which Trustee Has an Interest**. Most settlors will not want to permit a trustee who is not a family member to invest trust assets in his family's business unless the beneficiary's family has an interest in the business or consents to the investment.

m. **Waive Prudent Person Rule**. The prudent person rule for trusts may be more restrictive that the settlor wants. The trust may give the trustee the broadest possible investment discretion consistent with his or her fiduciary duties. The trust may permit the trustee, in making investment decisions, to consider the portfolio of "similar" trusts in determining overall asset allocation, risk, and diversification.

n. **Incapacity of Fiduciary.** There should specific procedures included to determine the incapacity of a fiduciary, short of having to a court declaration of incapacity (which would be very difficult for the family). For example, an incapacitated person might be someone who is a minor or under a legal disability, incarcerated, absent with unknown whereabouts for 90 days, or who does not produce a letter from a physician within 90 days of a request that the person is able to manage business affairs.

o. **Merger or Decanting Authority**. The trust may authorize the trustee to merge the trust assets with a trust for the same beneficiaries having substantially similar terms (not permitting merger with a trust that has a longer applicable perpetuities period). Alternatively the trust may have an even broader provision allowing the trustee to distribute assets, in accordance with the distribution standards, to a trust for a beneficiary (*i.e.*, a decanting provision). Even if the state does not have a decanting statute, the trust can spell out the terms of permitted decanting transactions. Such a provision should incorporate safeguards that are included in some of the state statutes; for example, that the decanting cannot be exercised in a way that would disqualify the trust for the marital or charitable deduction, that a decanting power may not be exercised by a beneficiary in a manner that would cause inclusion of the trust assets in the beneficiary's gross estate, and that a decanting power may not be exercised in a manner that causes the trust not to qualify for a "tax benefit" available to the trust. In addition, do not permit accelerating a remainder interest because that may be deemed to constitute a power to add beneficiaries that would inadvertently cause the trust to be a grantor trust.

p. **Conflicts Waiver**. The trust instrument may specifically authorize a trustee to enter into transactions with itself or an affiliate. For example, it may allow the trustee to invest in its own mutual funds or other proprietary investments that will provide additional investment flexibility for the trust. As another example, this would permit an individual trustee who is with an accounting or investment firm to use the services of those firms. (That is probably why the settlor selected that person as a trustee.)

q. **GST Provisions**. The trust may contain provisions empowering the trustee to administer trusts in a manner that most efficiently utilizes GST exemption that has been allocated to the trust. This may include the power to sever partially exempt trusts, or the power to make distributions entirely from a trust with a lower or higher exclusion ratio to the exclusion of another trust.

r. **Summary of Important Trust Provisions to Look For in Reviewing Trust Documents.** Steve Gorin (St. Louis, Missouri) offers the following list of specific trust provisions to consider in reviewing a client's existing trust documents to discuss whether further planning may be appropriate:

- Insufficient powers of appointment granted to allow the primary beneficiary to reshape the estate plan as needed;
- Insufficient flexibility regarding distributions in light of the need to get income and capital gain taxes to the beneficiary under today's punitively high trust income tax rates relative to the large majority of beneficiaries;

- Trustee succession either does not take into account a variety of contingencies or is not flexible enough to allow the primary beneficiary or trustees to modify succession in situations in which the client would like that flexibility;
- Need to get basis step-up at the beneficiary's death instead of saving estate taxes (for modest estates); and
- Forced outright distributions that ruin asset protection, when trustee provisions and powers of appointment can achieve the same result as forced distributions without compromising asset (including divorce) protection.

5. Portability

a. **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 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."

Temporary regulations were released on June 15, 2012 (§§ 20.2010-1T, 20.2010-2T, and 20.2010-3T). Those regulations expired within three years (i.e., on June 15, 2015), and the IRS issued final regulations, effective June 12, 2015. The final regulations made relatively few revisions from the temporary regulations. 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 (if the estate tax return is not timely filed and if the estate is small enough that no return would otherwise be required, Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014, and the IRS in the preamble stated that the IRS is considering whether to make these types of extensions permanent, as discussed below);
- In most cases there will be no need to list values of assets passing to a surviving spouse or charity on the "timely and complete" Form 706 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 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).

The automatic extension of time for certain estates under the filing threshold to make the portability election announced in Rev. Proc. 2014-18 expired on December 31, 2014, but the preamble to the final regulations states that "[t]he Treasury Department and the IRS continue to receive, and are continuing to consider, requests for permanent extensions of this type of relief. However, such relief is not included in the final regulations."

The preamble to the final regulations also clarifies that a complete and properly prepared return that does not compute the DSUE amount because there is no unused exclusion based on the return as filed will be deemed to have satisfied the requirements for making the portability election if subsequent adjustments result in unused exclusion amount, without the need for making a "protective" portability election.

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** and available at **www.bessemer.com/advisor**.

For a more detailed discussion of portability planning (including the advantages and disadvantages of various approaches) see Item 8 of the Hot Topics and Current Developments Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor**.

b. **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 wide variety of factors that might apply at the first spouse's death (including the surviving spouse's age and life expectancy, whether assets will likely appreciate substantially, whether assets may be sold during the spouse's lifetime, whether assets will be held long-term even after the surviving spouse's death, whether the assets are those kinds that have larger than normal capital gains rates, the states where the beneficiaries

live and their estate and income tax rates, whether there will likely be net consumption of the estate, whether it is important to use trusts that allow both the surviving spouse and children to be potential beneficiaries, etc.).

Clients living in states with state estate taxes may use a combination of a credit shelter trust (up to the state exemption amount) and portability.

c. **Portability Approach Becomes More Predominant**. Unless there are strong reasons to use credit shelter trusts in $10 million estates, an approach of using portability to take advantage of the first spouse's estate exemption will become more prominent. There are some factors favoring the creation of a credit shelter trust at the first spouse's death (discussed below), but unless one of those apply, a fairly good tax plan is in place for couples with estates under $10 million before the client comes to the planner's office—there would likely be no estate tax at either spouse's death (although future appreciation may conceivably result in some estate taxes at the second spouse's death) and there is a basis step-up at both spouses' deaths. Some planners refer to this as the "do no harm" approach.

d. **Planning Is More Difficult for Planners**. Planners must discuss the portability concepts and various factors impacting the decision of whether to rely on portability rather than using credit shelter trusts with clients and document those discussions. While the portability concept is intended to simplify planning, it has not made life simpler from the planner's standpoint.

e. **Major Factors.** Unless the couple owns assets close to double the exemption amount and still have significant growth years ahead, the couple will likely not owe any federal estate tax, whether the credit shelter approach or portability approach is used. For these clients, the major issues are:

- Use a credit shelter trust up to the state exclusion amount (if the state has an estate tax and if the state does not recognize portability [Delaware and Hawaii (and Maryland beginning in 2019) do recognize portability for their state estate taxes]);
- Leave qualified retirement plan and IRA benefits outright to surviving spouses (to take advantage of the longer-term payout opportunities afforded to spouses);
- Trust vs. no trust planning (*i.e.*, are the non-tax advantages of trusts important to the client—but trust planning can be used either with credit shelter trust or with portability and QTIP trusts);
- Blended family concerns—this is one reason to use the credit shelter trust to avoid complexities that might otherwise apply if conditions change such that estate taxes are owing at the surviving spouse's subsequent death (in which event the QTIP trust may end up substantially "underpaying" or "overpaying" the estate taxes and using a credit shelter trust would avoid that complexity);
- If trusts will be used, is it important for both the surviving spouse and descendants to be discretionary beneficiaries after the first spouse's death? (if so, use credit shelter planning unless the clients live in a "self-settled trust state" in which the surviving spouse could create a trust for himself/herself

and the descendants without opening the trust to the spouse's creditor's claims—assuming domestic asset protection trusts work);

- Remarriage possibility—a significant possible disadvantage (especially for younger clients) is that the surviving spouse may remarry and the new spouse may die before the surviving spouse, resulting in a loss of the DSUE amount from the first deceased spouse (unless the surviving spouse made a gift utilizing that DSUE amount before the new spouse predeceased the surviving spouse);
- Asset protection significance—assets that are protected from creditor claims under state law (such as retirement accounts, homestead property and life insurance) can be left in those forms to maintain the asset protected status of the assets;
- Basis issues—the second basis step up is a major advantage of the portability approach (but ways of obtaining basis step up even with credit shelter trust planning may be possible); and
- State estate and income tax impact—If there is no state estate tax for the surviving spouse and a high state income tax for the children, portability may be favored; if there is a state estate tax for the surviving spouse and no state income tax for the children, the credit shelter trust may be favored; the results may be different for particular children depending on whether they are living in a high income tax state or not (some children may prefer the CST-at least up to the state exemption amount- and some may prefer portability).

For clients with estates substantially larger than the double the exemption amount, traditional creditor shelter trust planning is still appropriate.

For a more detailed discussion of the advantage and disadvantages of the credit shelter trust approach and the portability approach, as well as a detailed discussion of complexities and inequities that can arise in a blended family situation if a credit shelter trust is not used at her first spouse's death, see Item 5.d-f of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

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 if the estate tax return was filed only to elect portability. It provides that the estate may elect a procedure under which the IRS will ignore a QTIP election "where the election was 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. This issue is on the 2014-2015 and 2015-2016 Priority Guidance Plans; unfortunately, this guidance was not issued in connection with the portability final regulations. See Item 2 above.

g. **Optimal Approach for 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) Disclaimer approach - 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) QTIPable trust approach - 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 offers more planning flexibilities in many situations.

Disclaimer Approach Disadvantages. There are several significant disadvantages of relying on the disclaimer approach. 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. *See generally* 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 Additional Flexibilities. Even though the QTIP approach may seem more complicated to clients, in many ways, the QTIPable trust approach affords greater flexibilities.

- *Fifteen months.* The executor has up to 15 months to decide whether to make the QTIP election and over what portion of the trust.
- *Formula election.* 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.
- *GST "reverse-QTIP" election*. If the QTIP election is made, the executor could make the "reverse-QTIP" election and allocate the decedent's GST exemption to the trust.
- *State estate tax.* 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.

- *Clayton provision.* Any unelected portion could pass to a standard bypass trust under a "Clayton" provision. (Some planners believe that 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. Panelists take the position that there *should* be no gift tax consequences; this should be no different than other post-death tax elections [such as where to deduct administrative expenses] that have a direct impact on the amount of assets that pass to the credit shelter trust and to the surviving spouse [or QTIP trust]). However, if the surviving spouse is the executor making the Clayton election, uncertainty would exist for years as to whether a gift results and whether that causes §2036 inclusion issues for some portion of the credit shelter trust.) (As an aside, Jeff Pennell thinks the preferable plan is generally to structure the credit shelter so that it has "QTIPable terms"—mandatory income interest for spouse as the exclusive beneficiary. That would, for example, facilitate getting a PTP credit if the surviving spouse were to die shortly after the first spouse to die. Other panelists observe that clients like being able to make transfers to children and the use of the children for income shifting purposes.)
- *Spouse can retain limited power of appointment*. The surviving spouse can have a testamentary limited power of appointment over the assets in the QTIP trust (or the Clayton bypass trust).
- *Delayed QTIP election decision (even for many years)*. A possibility suggested by some planners is the flexibility to delay making the CST/QTIP decision for many years, even until soon before the surviving spouse dies, if there are no estate tax concerns and the QTIP election would afford a basis step; the QTIP election may be made at any time on the first estate tax return that is filed late, Reg. §20.2056(b)-7(b)(4). If the trust assets have exploded in value and the surviving spouse would have to pay estate tax if the trust assets were included in his or her estate, the QTIP election would not be made at the later time. Portability would not be allowed with this strategy (because the portability election must be made by filing a timely return). This strategy might be used if the surviving spouse does not need the first spouse's exemption to avoid estate taxes at the second spouse's death; making the late QTIP election would allow a basis adjustment for all assets in the QTIP without increasing federal estate taxes.
- *Section 2519 deemed transfer.* Another possible flexibility with a QTIP trust is the ability of the surviving spouse to make a gift or release a small portion of the income interest (say 1%), and be treated as making a gift of the remainder interest under §2519. This may be a way that the surviving spouse could make a taxable gift to make use of the DSUE amount to guard against losing the DSUE amount in the event of a remarriage with the new spouse

predeceasing. Because the spouse retains 99% of the income, 99% of the QTIP assets would be included in the estate under §2036, which would mean that the §2519 gift of the remainder interest would be excluded from the adjusted taxable gifts in the estate tax calculation. §2001(b)(last sentence); Reg. §20.2044-1(e), Ex.5. (While the adjustment in the amount of adjusted taxable gifts may roughly offset the §2036 inclusion (without regard to subsequent appreciation), the surviving spouse would be able to add to his or her applicable exclusion amount the DSUE amount that was applied in the gift transaction. Reg. §20.2010-3(b).) The deemed gift would not eliminate the benefit of GST exemption allocated to the trust under a "reverse QTIP election." Reg. §26.2652-1(a)(3). (This approach does not make the most efficient use of the gift exemption because the QTIP trust (that constitutes the deemed gift) is not a grantor trust, but this §2519 approach may be all that the willing spouse is willing to do in terms of making gifts.) Additional steps may be required regarding tax allocation to make sure that the first spouse's family benefits from the first decedent's DSUE amount.

QTIPable Trust With Delayed Power of Withdrawal. If the clients want to have the flexibilities afforded by using a QTIP trust (*i.e.*, to have 15 months to decide what QTIP election to make, to make a formula QTIP election, etc.) but still wants the spouse to have an unlimited withdrawal power, consider creating a standard QTIP trust with a delayed withdrawal power. The trust is a general power of appointment trust qualifying for the marital deduction only if the surviving spouse's power of appointment exists immediately following the decedent's death. Reg. §§20.2056-5(a)(4)("must be exercisable in all events"); 20.2056-5(g)(1). For example, provide that the power of withdrawal arises sometime after the estate tax filing date. Any limitations desired on the amount of the withdrawal right could be added (*e.g.,* up to 20% each year). Prof. Jeffrey Pennell suggests that this perhaps should be the default approach for QTIP trusts, to be removed if the clients don't want the provision. (Jeff observes that most attorneys trust their own spouses after they are dead but think their clients do not trust their spouses.)

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.

Additional Creative Approaches Using Both Disclaimers and QTIP Trusts. For creative ideas of further ways to build in flexibility using both disclaimers and QTIP trusts, see Item 5.i of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

h. **Alternative Ways to Use First Spouse's Estate Exemption.** Even if a credit shelter trust is not created at the first spouse's death, there are several ways to make use of the first decedent's exemption during the surviving spouse's lifetime.

(1) *Gift by Surviving Spouse*. One possibility is for the surviving spouse to make a gift equal to the amount of the DSUE amount received from the first spouse. Under

the portability regulations, the first spouse's estate exemption is allocated automatically to cover that gift. The advantage of this approach is that the resulting trust is a grantor trust as to the surviving spouse. The first spouse's GST exemption can still be used if assets are left to QTIP trust with a "reverse QTIP" election and the surviving spouse uses other assets to make the gift to the trust. The disadvantage is that the surviving spouse cannot be a beneficiary of that trust (unless the trust is protected by the spouse's creditors by a DAPT statute).

(2) *Deemed Gift Under §2519*. Another possibility is for the surviving spouse to make a gift of a small portion of the income interest of the QTIP trust, which results in a deemed gift of the remainder interest in the QTIP trust. See the discussion of "Section 2519 deemed transfer" in Item 5.h above.

(3) *Supercharged Credit Shelter Trust*^{SM}. Another possibility is using a "Supercharged Credit Shelter Trust^{SM}." The Supercharged Credit Shelter Trust^{SM} is a strategy under which a healthy spouse (say W) creates an inter vivos QTIP trust for a spouse expected to predecease (say H). W would have a power to withdraw assets from the trust, but the withdrawal power would lapse at H's death. The gift would be complete at H's death and W would file a gift tax return making the QTIP election. At H's death, the trust assets would remain in a credit shelter trust for W up to the amount of H's estate tax exemption, and the balance would pass to a QTIP trust for W (with H's estate making the QTIP election). Even though W made the original contributions to the trust, §2036 would not apply to the credit shelter trust at W's subsequent death because the QTIP regulations make clear that H is treated as creating the trust for transfer tax purposes, not W, so that §2036 does not apply. Treas. Reg. § 25.2523(f)-1(f) Ex. 11 ("because S is treated as the transferor of the property, the property is not subject to inclusion in D's gross estate under section 2036 or section 2038"). Even though H is treated as creating the continuing trust for W for transfer tax purposes, W is still treated as the grantor of the continuing trust for grantor trust purposes, so the trust is a continuing grantor trust as to W. *See* Treas. Reg. §671-2(e)(5). *See generally* M. Gans, J. Blattmachr, & D. Zeydel, *Supercharged Credit Shelter Trust*^{SM}*,* 21 PROBATE & PROPERTY 52 (July/August 2007).

i. **Should the Portability Election be Mandated? Who Pays the Filing Expense?** This is particularly important for second or (or third) marriages. If clients are asked if the surviving spouse should be able to use any excess exclusion, most will say yes. If clients are asked whether the surviving spouse should have to pay the first-decedent's family to be able to use the unused exclusion amount, most will say no. The planner may discuss with the clients whether the spouse of the decedent's estate should bear the expense of filing the estate tax return to make the election.

David Handler (Chicago, Illinois) indicates that he typically mandates in wills that the portability election will be made following the first spouse's death. Professor Stanley Johanson (University of Texas School of Law) suggests the following clause:

> If my husband survives me and my husband or his representative requests that my executor make a portability election with respect to all or a portion of my "deceased spousal unused exclusion amount," I direct my executor to make the election in the amount and under the terms provided to my executor by my husband or his representative. The cost of preparing and filing a Form 706

federal estate tax return making the portability election shall be [charged against my estate as an administration expense] [borne and paid for by my husband].

Similarly, consider these issues in pre-marital agreements.

Walton v. Estate of Swisher, 3 N.E.3d 1088 (Ind. App. 2014) is an example of negotiations that may arise regarding the portability decision if the decedent's will does not address the portability election. In that case the surviving husband agreed with the decedent's daughter to pay some of the deceased wife's medical expenses and to pay her estate $5,000. The husband died the following year. When the daughter learned of the estate tax savings that resulted from the use of the wife's unused exclusion amount, she sued his estate for $500,000 under an unjust enrichment theory. The court concluded that no additional amount was owed, and the original agreement with the daughter was unambiguous and did not result in unjust enrichment.

The fact that this claim was even made raises interesting issues for planners:

- The importance of covering the filing/ portability issue in the couple's estate planning documents or marital agreement, including who pays for the cost of filing the return if it will be filed just to make the portability election;
- The possibility of opening a probate estate for the purpose of having an executor who can negotiate for the preparation of an estate tax return;
- Whether the surviving spouse is the appropriate person to serve as executor;
- The value of the right to file the estate tax return and make the portability election and whether the executor should negotiate to receive payment for making the election (a surviving spouse's counter argument is that the spouse may claim the available family allowance or spousal allowance that may be available to the spouse under applicable state law if the portability election is not made; the spousal allowance may be relatively small [e.g., $25,000 in Indiana] or can be fairly large [e.g., amount needed for the spouse's and minor children's maintenance for one year without regard to other resources available for the spouse's support in Texas, TEX. ESTATES CODE §353.102]); and
- The importance of the surviving spouse disclosing the potential benefits of portability when negotiating a payment for filing the return.

j. **Financial Impact**. Diana Zeydel (Miami, Florida) drew various conclusions from financial modeling (using a "Monte Carlo analysis" to take into consideration the volatility of possible outcomes) of likely outcomes with a diversified portfolio.

- A key element of any planning is to give the clients assurance that sufficient assets will be available for their lifestyle needs for life. Financial modeling can examine the effects of planning strategies if there are "down" markets in the future. Realize that for everyone, cutting back on lifestyle is extremely difficult, whether someone is used to living on $50,000 per year or $2 million per year.
- Surviving spouses typically have an "overlife" of 10 years of more. That is long enough for assets to have substantial appreciation and making the right choice can have a significant financial impact on the family.

- The financial impact to a family of doing planning vs. no planning and the effects among various different strategies is not nearly as dramatic as before ATRA—because of the large indexed exemptions.
- The credit shelter trust vs. portability decision can vary greatly depending on the state estate tax on the spouses and the state income tax that applies to the children. If there is no state estate tax for the surviving spouse and a high state income tax for the children, portability may be favored. If there is a state estate tax for the surviving spouse and no state income tax for the children, the credit shelter trust may be favored.
- For a couple with $10 million that spends 4% annually, leaving assets outright to the surviving spouse or in a QTIP trust and relying on portability will likely result in no estate tax being payable at the surviving spouse's subsequent death (the median result is that the assets will decline to about $9 million). However, there is no certainty of this. In 5% of the cases, the assets could grow to $18-20 million. Using a QTIP trust to make use of the first spouse's GST exemption means that most of the couple's assets would likely end up in GST exempt trusts.
- For a couple with $30 million (or more), the likelihood of achieving significant estate tax savings by using a credit shelter trust rather than relying on portability is very high, even if the spending level is 5%.
- For the couple with $30 million (or more), even greater amounts (and significantly more GST exempt amounts) could be transferred to descendants following the surviving spouse's death by using a "Supercharged Credit Shelter Trust℠" (described in Item 5.i above.) (This is because the credit shelter trust created for the surviving spouse is a grantor trust as to the surviving spouse, meaning that the trust can accumulate assets much more efficiently during the surviving spouse's lifetime and that the income tax payments will reduce the spouse's assets that are subject to estate tax.) For an even better result, the surviving spouse could make a gift to a grantor trust using his or her own exemption amount as well as taking steps to use the decedent's exemption amount (by a gift of the DSUE amount from the decedent or by using the Supercharged Credit Shelter Trust℠ approach).

  A key result of using these approaches is that substantially more of the wealth passes to descendants in a GST exempt nature. As a practical matter, the portion of the estate that is non-exempt will likely be consumed by the children-generation (as discussed below).

- For clients with a diversified portfolio with typical turnover for a diversified portfolio, whether or not a basis step-up is available at the second spouse's death is not overly significant. (Gains are realized significantly during the surviving spouse's lifetime, and there is not a great deal of unrealized appreciation that would lose the benefit of a basis step-up.)
- The modeling shows that sales to grantor trusts are substantially more effective in transferring wealth than GRATs (as expected).

- For very large estates, doing "garden variety" sales to grantor trust planning can achieve huge transfer tax benefits—and a substantial part of the benefit is that much more of the estate will pass to the family in GST exempt trusts. For example, with a $100 million estate, if the spouses each currently make gifts of their $5.43 gift exemption amounts to GST exempt grantor trusts and annually make gifts of the additional indexed exemption amounts, and if W sells $48.9 million of assets to her grantor trust (9 to 1 debt to equity ratio), with reasonable assumptions on consumption rates, approximately 85-90% of the estate will be in GST exempt trusts at the second spouse's death assuming H dies in 5 years and W dies in 20 years. (Probably all of the estate, even for very large estates would pass for grandchildren in GST exempt trusts because the children will likely consume much if not all of the assets from the non-exempt trusts that are left after the deaths of both spouses. Children will want to live in the same lifestyle as their parents, and if there are multiple children, the assets get divided too much to really permit that—leaving the conclusion that children will likely consume most or all of the non-exempt trusts.)

6. Unwinding Transactions Post-ATRA

The large indexed gift and estate exemptions under ATRA with portability means that most Americans will have no federal gift or estate tax concerns. (Estimates are that less than 0.14% of decedents who die each year will owe federal estate tax). Many clients did planning in prior years to reduce estate taxes when the exemptions were much lower (for example, $600,000 in 1997), and some of that planning is no longer needed, and indeed may be counterproductive. The clients may want to reverse transactions that generated valuation discounts or that removed assets from the client's gross estate so that the full value of those assets will be entitled to a basis adjustment at the client's death. John Bergner (Dallas, Texas) discussed possible strategies.

a. **Avoiding Discounts.** If assets were contributed to or acquired in entities or were held in co-ownership, valuation discounts may apply. For example, if a $1.0 million asset is discounted by 40%, that $400,000 discount may result in no estate tax savings (if the client does not have an estate large enough to generate estate taxes with the large indexed/portable exemptions), but the $400,000 discount may result in losing a basis step-up of $400,000, which may cost $400,000 x 23.8%, or $95,200 (or more if here are also state income taxes). Indeed, the IRS may argue in income tax audits for high discounts, and taxpayers may argue that the discounts should be lower.

   Possible strategies include the following.

   Redemption of Partnership or LLC Interest. The redeemed partner generally does not recognize gain except to the extent that any money received exceeds the partner's basis in his partnership interest. (Distributions of marketable securities are treated as distributions of cash unless one of the exceptions to §731(c) applies.) Non-cash assets are received with a basis equal to his basis in the partnership interest. The individual would then own the assets outside the entity and would not be discounted at death. (This may result in giving up centralized management/asset protection features of the partnership or LLC.)

Liquidate Entity With Discountable Interests. As with redemptions, the partners generally recognize gain on their liquidating distributions only to the extent that money received exceeds the basis in their respective partnership interests. A partner's outside basis is reduced by any money received and is next allocated to unrealized receivables and inventory items, and finally to other distributed properties. (The partner's outside basis becomes his substituted basis of the assets received in liquidation.) Other distributed properties that may have a low basis would receive a basis adjustment at the partner's death. (Centralized management/asset protection features of the partnership or LLC would be lost.) **Before liquidating, make sure that no partner has contributed appreciated property within 7 years**; otherwise a partner may recognize gain if property is distributed to someone different than the contributing partner. §§704(c)(1)(B) & 737.

Purchase General Partner Interest. The client might purchase general partnership interests held by others so that the client has control of the entity to minimize discounts.

Convert Limited Partnership to General Partnership. General partnerships typically do not have limitations on the ability to withdraw or force dissolution of the partnership that results in discounts for limited partners. Conversion of a limited partnership to a general partnership should not have income tax consequences.

Amend Entity Documents To Eliminate Features That Cause Discounts. Entity agreements may be amended to remove features that generate discounts, such as removing limitations on the right to withdraw (perhaps allow all limited partners to withdraw for "net asset value" or for "fair value" determined as going concern value without discounts), requiring the distribution of all income, revising how the agreement is amended (permit majority vote to control for amendments and liquidation), or being able to compel a liquidation of his interest based on net asset value. Some degree of transfer restrictions will still be desired in order for the family to have some control over who can become a partner (example, they will not want creditors to be become partners).

Merge Discounted Fractional Interests. Fractional interests in real estate often yield discounts in the 20%-40% range. The client might purchase undivided interests held by others, so the client would die owing 100% of the property without any discount, or the parties might divide multiple co-owned properties so that the respective parties own 100% of certain properties. If the co-owners are the grantor and his or her grantor trusts, this could be done without realizing taxable gain.

Co-Ownership Agreement. The co-owners might agree to a co-ownership agreement that would remove some of the features that result in a discount, such as allowing co-owners to force a sale of the asset at its undiscounted value.

b. **Cause Inclusion of Assets in Settlor's Estate**.

Exercise Swap Power to Acquire Low Basis Assets Held by Grantor Trust. The grantor may pay cash to the grantor trust to acquire low-basis assets (so that the assets will achieve a basis adjustment at the grantor's death). If the grantor purchases the assets for a note, it is uncertain what basis the trust will have in the note—and whether future payments may generate gain to the trust. If the grantor does not have sufficient cash to make the purchase, the grantor may borrow cash

from a third party lender to make the purchase. See Item 11.b below. Consider using a defined value clause in exercising the substitution power to minimize possible gift issues. Advise the client of the possibility of disclosing this "non-gift" transaction on a gift tax return and making adequate disclosure to start the statute of limitations on gift tax assessments. (Interestingly, the adequate disclosure regulations do not require that an appraisal be attached to a return reporting a "non-gift" transaction.)

If No Swap Powers, Negotiate Sale With Trustee. If the grantor does not have a substitution power, the grantor could negotiate to purchase low basis assets from the grantor trust.

Convert to Grantor Trust. If the trust is not a grantor trust, consider taking steps to convert the trust to a grantor trust so that the grantor can acquire the low basis assets from the trust in a non-taxable transaction. Possible strategies include a court modification to include a substitution power of other grantor trust "trigger" power, decanting to a grantor trust, or borrowing from the trust.

Section 2036/2038 Inclusion. The settlor might become the custodian of an UTMA account or the trustee of a trust that does not have determinable standard for distributions. Alternatively, multiple settlors might invoke the reciprocal trust doctrine. Missteps in the correct operation of a transfer planning strategy (which can happen with the best of intentions) may support an argument of an implied agreement of retained enjoyment. This could include such things as continuing to use the trust assets without paying fair market rental value or making installment payments on sales transactions with a grantor trust with entity distributions that match the note payment amounts. However, the intention of the grantor at the time of the original transfer is what is determinative under §2036. If at that time the grantor did not intend to retain use of the asset, subsequent intentional "missteps" should not trigger §2036. *See Estate of Riese v. Commissioner*, T.C. Memo. 2011-60 (lease payments were not made for settlor's continued use of residence after termination of QPRT term within the 6-month period from the termination date to the date of her death; IRS argued that reflected an implied agreement of retained enjoyment; court determined that she had intended to pay rent but the attorneys had merely not determined rental payments and prepared a lease prior to her death and "[t]there was no understanding, express or implied, at the time of transfer that decedent could occupy the residence rent free").

This issue of looking back to intent at the time of the original gift does not apply to §2038 inclusion. Therefore a court modification to add the grantor as a co-trustee (if there is not a "determinable interest" standard on distributions) or to give the grantor a limited power of appointment among the class of beneficiaries would trigger §2038 inclusion.

Beneficiary Argue for Estate Inclusion. If a decedent did not include on the estate tax return an asset that had been transferred, can a beneficiary later make the argument (for income tax purposes) that the decedent should have included that asset on the estate tax return (because he used the asset without paying rent, because there was a sale to a grantor trust in which every dollar of income was used to make note payments, etc.)? Presumably so. The beneficiary certainly can claim that the actual value at the date of death was different than the value reported on the estate tax

return (as long as the beneficiary was not the executor that filed the estate tax return). Rev. Rul. 54-97.

Purchase Remainder Interest in GRAT. If a GRAT has substantial value in highly appreciated assets that will ultimately pass to a remainder trust following the GRAT term, the grantor might purchase the remaindermen's interest in the GRAT (if there is not a spendthrift clause prohibiting that sale of the remainder interest). The grantor will own all assets in the trust, so the GRAT will terminate by merger. The GRAT regulations prohibit a "commutation" of the grantor's interest, but this is the opposite of that. The grantor will own the appreciated assets at death to achieve a basis adjustment. For further details, see Item 28.k of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

Move Trust Situs to State Without Domestic Asset Trust Protection. The grantor may have created a trust with the grantor as a discretionary beneficiary that is sitused in a state with a domestic asset protection trust statute (so that the grantor's creditors cannot reach the trust, which likely prevents the grantor from having a retained enjoyment under §2036). Change the situs and applicable governing law so that the trust is no longer protected from the grantor's creditors, which may cause §2036 to apply.

c. **Avoid Funding Bypass Trust**. Countless situations will arise in which a spouse dies with a traditional formula bequest in a will that has not been reviewed in years that creates a bypass trust when the couple has no federal estate tax concerns at the surviving spouse's subsequent death. Creating the bypass trust will create administrative complexity that the surviving spouse wants to avoid and, perhaps more importantly, will eliminate any basis step-up for trust assets at the surviving spouse's death (because he or she would not own the trust assets). Strategies include (i) reading the will closely to see if there are provisions that could justify not funding or immediately terminating the trust (such as a small termination provision, etc), (ii) using a court reformation or modification to authorize not funding the trust, (iii) negotiating a family settlement agreement to avoid funding the trust, or (iv) decanting to a trust with broader provisions that would authorize terminating the trust.

There are significant transfer tax issues that may arise—the children may be deemed to have made a gift to the surviving spouse if they consent to disbanding the credit shelter trust. That gift may be very difficult to value, especially if the surviving spouse has a lifetime or testamentary limited power of appointment. Furthermore, the assets passing to the spouse at the first spouse's death will not qualify for the marital deduction unless there is a legitimate dispute (because they do not pass from the decedent but rather pass pursuant to the settlement agreement, *see Ahmanson Foundation v. U.S.,* 674 F.2d 761 (9th Cir. 1981)), so the decedent's full exemption will not be available for portability. Also, there would be no use of the first spouse's GST exemption if the assets do not pass to a QTIP trust (for which the "reverse QTIP election" could be made).

If the bypass trust is not funded, there may still be theories on which it would be recognized. *See Estate of Olsen v. Commissioner,* T.C. Memo. 2014-58 (court determined amount that should have been in bypass trust and excluded that amount

from surviving spouse's gross estate); *see generally* Mickey Davis, *Funding Unfunded Testamentary Trusts*, 48TH ANNUAL HECKERLING INST. ON EST. PLANNING ch. 8 (2014). See Item 27 of the Heckerling Musings 2014 and Other Current Developments Summary (February 2014) found **here** and available at **www.Bessemer.com/Advisor**.

d. **Life Insurance Trust That Is No Longer Needed**. The client may have created a life insurance trust that is no longer needed to avoid paying federal estate taxes. Planning strategies include surrendering the policy if it is no longer needed (which can raise income tax and fiduciary concerns), selling the policy to a third party (which may generate a greater return than surrendering the policy), or having the grantor exercise a swap power to acquire the policy or purchase the policy from the trust for the policy's fair market value.

e. **Turning Off Grantor Trust Status.** The client may want to take steps to "turn off" grantor trust status to avoid paying income taxes on the income of existing trusts if that achieves no estate tax savings. Furthermore, grantor trust status may cause the grantor to dispose of assets to pay the trust's income taxes that if held until death would have received a basis adjustment. However, keeping grantor trust status may be very helpful if the client wishes to substitute illiquid assets into the trust in return for liquid assets for living expenses or to purchase low-basis assets from the trust prior to the grantor's death to achieve a basis step-up at death. If the grantor decides that terminating the grantor trust status is preferable, possible strategies (depending on what causes the trust to be a grantor trust) include (i) releasing a swap power, (ii) releasing a power to add beneficiaries, (iii) changing trustees, (iv) releasing a power to remove and replace trustees if the replacement could be someone who is related or subordinate to the grantor, (v) relinquishing a power to make distributions to the grantor's spouse, (vi) ceasing to pay life insurance premiums (at least not paying premiums with trust income). Once the grantor trust status is terminated, the trustee should consider income tax effects in future distribution decisions; making distributions to low-bracket beneficiaries may reduce the income tax, rather than having all of the trust income (in excess of $12,300, changing to $12,400 in 2016) from being taxed at the trust's top income tax rates.

f. **Causing Inclusion of Assets in a Beneficiary's Estate**. If a trust beneficiary has excess estate exemption, causing assets to be included in the beneficiary's estate, up to the point that no federal estate tax is generated, will allow low basis assets to receive a basis adjustment at the beneficiary's death. For a more detailed discussion of planning strategies, see Item 7.f below.

g. **Causing Inclusion of Assets in a Third Party's Estate.** A beneficiary may exercise a limited power of appointment to appoint trust assets in further trust for a third party (such as a modest-wealth parent or grandparent). The third party would have a testamentary general power of appointment in the new trust (perhaps just exercisable in favor of a creditor of the person and perhaps only with the consent of a third party (someone other than an adverse party)). In default of exercise of the general power of appointment, the assets would return to a trust for the benefit of the beneficiary or someone in the beneficiary's family. The assets would receive a basis adjustment at the third party's death (and the third party's GST exemption could be allocated to the assets). For a similar strategy, see Item 7.g below.

7. Basis Adjustment Flexibility Planning

a. **Consider Importance In Each Particular Situation**. In many situations, clients will have no federal estate tax concerns, and a key tax planning item will be to take advantage of the basis adjustment under §1014 that occurs at the client's death (that generally applies to assets owned by the client at death, but it can apply even more broadly than that, as discussed in Item 9.e below.) This can apply to assets that a client owns or to assets in a trust of which a client is a beneficiary. For some clients, this will be a key part of the tax planning to take advantage of what President Obama's tax proposal called "perhaps the largest single loophole in the entire individual income tax code."

In other cases, however, basis adjustments will not be particularly important. For example, if an individual has a diversified managed investment portfolio, traditional turnover in the portfolio will mean that gains realized through the years, and there will not be a great deal of unrealized gain from appreciation in the portfolio. In those cases, basis adjustment planning will not be a priority. The discussion below applies to situations in which basis adjustment planning is determined to be important in a particular client situation.

b. **Consider Using Zeroed Out Transfer Planning.** Consider using transfer planning strategies that minimize the use of the client's gift and estate tax exemption amounts. Leaving estate tax exemption available allows the client to retain appreciated assets until death to receive the benefit of a basis step-up under §1014. For example, consider using GRATs (or "leveraged GRATs") to transfer future appreciation without using any of a client's exemption amount, or making leveraged use of estate and GST exemptions with gifts and much larger sales to grantor trusts. Various transfer planning strategies that may make very efficient use of exemptions amounts are discussed in Item 11.c below.

c. **Consider Using Third Parties' Exemption Amounts for Basis Adjustments.** A client may give/sell assets to a grantor trust for a third party (such as a modest-wealth parent of the client) who will have a testamentary general power of appointment in the trust. At the parent's death, the inclusion of the assets in his or her estate may generate no estate taxes but the assets would receive a basis adjustment (although issues could arise if the parent dies within a year of when the client creates the trust) and the parent could allocate his or her GST exemption to the assets. The assets might pass by default into a trust for the client's benefit but that would not be in the client's estate for estate tax purposes. Melissa Willms (Houston) has referred to the planning as the creation of the "Accidentally Perfect Grantor Trust," with this example:

> Jenny owns the stock in a closely held business that she thinks is about to explode in value. Her mom Mary's net worth is perhaps $10,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. She then sets up an IDGT for Mary's benefit, and sells the non-voting stock to the trust for its current appraised value of $1 million. She uses a combination of seed money and a guarantee by Mary to make sure that the sale is respected for tax purposes. The trust has language that grants Mary a general testamentary power to appoint the trust property to anyone she chooses. Mary signs a new will that leaves the trust property to a dynasty trust for Jenny and her descendants, naming Jenny as the trustee. (Just in case, the IDGT contains the same type of dynasty trust to receive the property if Mary fails to exercise her power of appointment.) When Mary dies four years later, the stock has appreciated to $2 million in value. Because the trust assets are included in Mary's estate, the stock gets a new cost basis of $2

> million. The trust assets, when added to Mary's other assets, are well below the estate tax exemption of $5 million. Mary's executor uses some of Mary's $5 million GST exemption to shelter the trust assets from estate tax when Jenny dies. Despite the fact that Jenny has the lifetime use of the trust property, (i) it can't be attached by her creditors, (ii) it can pass to Jenny's children, or whomever Jenny wishes to leave it to, without estate tax, (iii) principal from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants without gift tax, and (iv) if the trust isn't a grantor trust as to Jenny, income from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants, thereby providing the ability to shift the trust's income to taxpayers in low income tax brackets.

Mickey R. Davis and Melissa J. Willms, *Trust and Estate Planning in a High-Exemption World and the 3.8% 'Medicare' Tax: What Estate and Trust Professionals Need to Know*, UNIV. OF TEXAS SCHOOL OF LAW 61ST ANNUAL TAX CONFERENCE (December 2013). For additional information about this general planning alternative (and potential applications) see Austin, Beaudry & Law, *The Power of the Power of Appointment Support Trust*, TRUST & ESTATES 2 (Dec. 2015) (referring to this strategy with the acronym "POAST").

Gift Tax Issues. The trust is a gift by the client, using the client's gift exemption. But the sale to the trust and the payment of income taxes by the grantor may leverage the appreciation of assets in the trust, making use of the client's gift exemption advantageous.

Estate Tax Issues–Parent's Estate. The trust assets contributed to the trust will be included in the parent's gross estate under §2041. The assets that are sold to the trust may also be included in the parent's gross estate, although issues can arise as to whether merely the *net* value of those assets (i.e., net of the debt that the trust owes to the client) is included in the estate. *See Reg.* §20.2053-7 ("if the decedent's estate is not so liable [for the amount of the mortgage or indebtedness], only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need by returned as part of the value of the gross estate"). Having the parent guarantee the trust indebtedness would create a stronger argument for including the full value of the trust assets in the parent's gross estate (to receive a basis adjustment for the assets). The client anticipates that the parent will have plenty of estate exemption so that the parent will pay no estate tax. (If the client thinks that the trust assets may grow to the point that the assets exceeds the parent's estate exemption, the trust could include a formula general power of appointment for the parent, to the extent that inclusion of the trust assets in the parent's estate would not cause the parent's gross estate to exceed the exemption amount. If that is done, the trust would also have to provide that only assets subject to the general power of appointment would remain in trust for the benefit of the client.)

Estate Tax Issues–Client's Estate. The parent will be treated as the transferor of the trust after his or her death, so the client can be the trustee, a discretionary beneficiary (as long as the client cannot make distributions to himself beyond amounts needed for health, education, support and maintenance), and can have a testamentary limited power of appointment over the trust—all without causing inclusion in the client's gross estate—as long as the client's state has passed legislation providing that the client is not treated as the settlor of the trust for creditor purposes (i.e., overriding the traditional "relation back" doctrine—see Item 15.d of the Hot Topics and Current Developments Summary (December 2013) found **here**

and available at **www.Bessemer.com/Advisor** for a detailed discussion of the "relation back" issue). A variety of rulings involving "joint spousal trusts" have made this clear. PLRs 200604028, 200403094, 200210051, 200101021. *See* John Bergner, *Waste Not Want Not—Creative Use of General Powers of Appointment to Fund Tax-Advantaged Trusts*, 41st Annual Heckerling Inst. on Est. Pl. ch. 14 (2007).

Income Tax—Grantor Trust. The client will likely create the trust as a grantor trust as to the client. Following the parent's death, there is a strong argument that the trust continues as a grantor trust as to the client under Reg. §1.671-2(e)(5) if the parent does not exercise the general power of appointment. *See generally* M. Gans, J. Blattmachr, & D. Zeydel*, Supercharged Credit Shelter Trust*SM*,* 21 PROBATE & PROPERTY 52, 55 (July/August 2007). If the parent exercises the general power of appointment, the deemed grantor of the trust changes for purposes of the grantor trust rules, and the trust would no longer be a grantor trust as to the client. *See* Mickey Davis, *Basis Adjustment Planning*, 2014 STATE BAR OF TEX. ADV. EST. PL. & PROB. COURSE ch.10 at 21 (2014).

Income Tax—Basis. The assets should receive a basis adjustment at the parent's death because the assets are included in the parent's gross estate (but see the discussion above about the estate tax consequences for the parent as to whether only the net value of trust assets are included in the estate). Mickey Davis points out that if the testamentary general power of appointment is not exercised by the parent, the basis adjustment arises under §1014(b)(9) instead of §1014(b)(4). Section 1014(b)(9) (but none of the other 1014 subsections) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent prior to the decedent's death. Because the "accidentally perfect trust" is usually designed to be a grantor trust, the junior family member is presumably "the taxpayer" for this purpose. The §1014(b)(9) limitation would appear to apply to any depreciation deductions taken by the junior family member prior to the death of the senior family member. As a result, if the trust remains a grantor trust as to the junior family member after the senior family member's death, the amount of the basis adjustment might be reduced by the amount of the depreciation deductions allowed to the junior family member prior to the senior family member's death. See Treas. Reg. § 1.1014-6.

If the parent dies within a year of when the client makes the gift to the trust and if the assets pass back to the client, §1014(e) would prevent a basis adjustment. If the assets merely pass to or remain in a trust of which the client is a discretionary beneficiary (or may be added as a discretionary beneficiary by a third person after some point in time), §1014(e) may not apply, in which event a basis adjustment would be allowed, as discussed in Item 8.c below.

GST Tax Issues. The client could allocate GST exemption to the trust, but alternatively, the client might allocate no GST exemption initially and allow the parent to allocate his or her GST exemption at the parent's death. The parent will be treated as the transferor to the trust for GST tax purposes. §2652(a)(1)(A); Reg. §26.2652-1(a)(1).

Creditor Issues. Under the laws of some states, assets that pass to a trust for the client (either by the exercise of a general power of appointment or upon the unexercised lapse of a general power of appointment) will generally be protected from claims of the client's creditors. *E.g.,* TEX. PROP. CODE §112.035(g)(3)(B) (trust

spendthrift protection applies to irrevocable trust for the benefit of the settlor "to the extent that the property of the trust was subject to a general power of appointment in another person").

Practical Uses. Having a "permanent" $5 million indexed estate tax exclusion amount makes this type of planning realistic; the client can feel very comfortable that the parent will not have estate tax concerns even with the general power of appointment over the trust assets.

Similarly, a beneficiary of a trust who has a limited power of appointment might appoint the assets to a trust in which a third party (such as a modest-wealth parent) has a testamentary general power of appointment. The assets would receive a basis adjustment at the parent's death, hopefully no estate taxes would be payable by the parent, and the parent could allocate his or her GST exemption to the assets. See Item 6.g above.

d. **Preserving Basis Adjustment Upon Death of Donor/Settlor.** For a detailed discussion of basis adjustment planning for donors, see Item 10 of the Hot Topics and Current Developments Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor**. Various strategies for causing inclusion of assets in the settlor's estate to achieve basis adjustments at the settlor's death are summarized in Item 6.b. above.

e. **GST Impact.** Basis adjustment planning considerations for trusts is important particularly for GST-exempt trusts. For non-exempt trusts, if a taxable termination occurs at a beneficiary's death (for example, when the last non-skip person dies), a GST tax is imposed and a basis adjustment is allowed. §2654(a)(2).

f. **Causing Inclusion of Assets in a Trust Beneficiary's Estate**. If a beneficiary has substantial excess estate exemption, causing inclusion in the beneficiary's estate (up to the beneficiary's excess estate exemption) may afford a basis adjustment at the beneficiary's death without resulting in any federal estate taxes. For example, if a credit shelter trust is used at the first spouse's death and the surviving spouse has excess estate exemption amount, these strategies could be used to cause some or all of the credit shelter trust assets to be in the surviving spouse's gross estate to achieve a basis adjustment at his or her subsequent death. The same strategies could apply to any other beneficiary of a trust who has excess estate exemption. Strategies that may be considered for these purposes are briefly summarized below. Each of these strategies is addressed in considerably more detail Item 7.c-g of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

Distributions to Beneficiary. There are fiduciary concerns as to whether the distribution (especially a large distribution made primarily to achieve a basis adjustment at the beneficiary's death) can be justified within the standard for distributions. If a trustee makes distributions beyond what is authorized in the instrument, the IRS may take the position that it can ignore the distribution. *See Estate of Lillian L. Halpern v. Commissioner*, T.C. Memo. 1995-352.

Exercise of Limited Power of Appointment. Another possible way of addressing the potential reluctance of exercising broad distribution powers because of fiduciary concerns is to grant someone a non-fiduciary power of appointment to appoint trust

assets to the beneficiary. However, gift tax concerns with the exercise of such a power of appointment may arise if the powerholder is a beneficiary of the trust. *See* Treas. Reg. §§25.2514-1(b)(2), 25.2514-3(e) Ex.3; PLRs 9451049, 8535020.

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 beneficiary. 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 beneficiary's unbridled ability to redirect where the assets will pass. The power could be limited to the ability to appoint the assets to the beneficiary's creditors. Preferably this power would be held by someone other than the trustee. Because of the trustee's fiduciary duty to all beneficiaries, a trustee may be reluctant to grant any particular beneficiary a general power of appointment except in special circumstances (for example if the beneficiary was the only beneficiary and held a broad testamentary limited power of appointment in any event). Perhaps provide that the independent party cannot grant a general power until requested to consider exercising its discretion (to avoid a continuing duty to monitor). One planner's approach is to include a general power for beneficiaries but give the trustee or some other party the power to remove the general power. Query whether a beneficiary may be deemed to have a general power of appointment for tax purposes even before it is actually granted? See Item 10.e below.

Formula General Power of Appointment. To avoid the risk that the third party never "gets around" to granting the general power of appointment, consider granting it by formula in the trust from the outset under a formula approach. The formula could start by giving the beneficiary a general power of appointment up to the amount that would not generate estate taxes in the beneficiary's estate, and could further detail by formula which trust assets would be subject to the general power of appointment.

A very simple formula approach, if the beneficiary clearly does not have to pay estate taxes even considering the trust assets, is to give the beneficiary a testamentary general power of appointment over non-IRD appreciated property. (Only non-IRD appreciated property benefits from a basis adjustment under §1014.) Another very simple formula approach would be to grant the general power of appointment over a fractional share, the numerator of which fraction is "the largest amount which, if added to the beneficiary's taxable estate, will not result in or increase the federal estate tax payable by reason of the beneficiary's death."

Issues may be raised as to whether the limitations under this type of "conditional" general power of appointment would be recognized for tax purposes (so that the beneficiary would not automatically have a general power of appointment over all of the trust assets). However, *Kurz v. Commissioner*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995) reasoned that if a decedent's general power of appointment was contingent on the occurrence of certain events, 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. If the formula grants a general power of appointment up to the amount of the beneficiary's remaining exemption amount less the value of the beneficiary's taxable estate, the beneficiary has a great deal of control to increase the amount subject to the general power of appointment by reducing the size of his

taxable estate—for example by consuming assets, by making terrible investment decisions, or by leaving assets to a spouse or charity—which would increase the amount of the formula general power of appointment. However, those would all seem to be acts of independent significance. The risk of such an argument could be minimized

> 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.

The formula could also specify which assets are subject to the general power of appointment (and therefore would be entitled to a basis adjustment at the beneficiary's death). Perhaps a trustee or other third party could have the authority to determine which assets are subject to the general power (but would that be recognized for tax purposes?). Alternatively, the formula could specify objectively which particular assets are subject to the general power of appointment formula amount. The formula might allocate the general power first to the assets that if sold immediately prior the beneficiary's death would generate the greatest aggregate amount of federal and state income tax, or it might be customized to apply first to low-basis assets that are the most likely to be sold after the beneficiary's death. Be wary of using a formula that is so complicated to apply that substantial expense would be incurred in applying the formula. For a discussion of general considerations in crafting a formula general power of appointment, see Leonard & Schingler, *Using a "Formula General Power of Apportionment* [sic] *to Resolve Income Tax Basis "Step-Up" Issues in the Age of Portability and a Request for Clarification Regarding Revenue Procedure 2001-38*, CALIF. TAX LAWYER, at 24-32 (Fall 2014). For a much more detailed discussion of the validity of such formula general powers of appointments, with references to various articles discussing them in detail with sample forms, and for examples of formula general powers of appointment see Item 7.e and Exhibits A and B of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

Delaware Tax Trap. The beneficiary who would like to have the asset included in his gross estate, to achieve a basis step-up at the beneficiary's death, could exercise a limited power of appointment that he has under the trust by appointing the assets to another trust in which some person has a withdrawal right or other presently exercisable general power of appointment. That may trigger §2041(a)(3) to cause the assets to be included in the beneficiary's gross estate. (In addition, the trust assets so appointed would be in the other person's gross estate as well, but that person may have modest wealth so that no estate tax would be owed at that person's death.)

Generally, 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 appoint 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. Arizona has changed its state law (and other states are considering similar changes) so that the Delaware tax trap could be triggered by a beneficiary (to cause the beneficiary to include the assets in his or her estate under §2041) by merely exercising a power of appointment in a manner that gives another person a *nongeneral* power of appointment. For a further discussion of the complexities of the Delaware tax trap, see Item 7.f of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

Asset Protection Impact. Distributing assets to a beneficiary obviously subjects the assets to the creditors of that beneficiary. The law is unclear (and developing) as to whether merely granting a general power of appointment to a beneficiary subjects the assets to the claims of that beneficiary's creditors. (It does under the position of the Restatement (Third) of Property, which position has been adopted in various states, including California, Michigan and New York.) A possible solution is to require the consent of a third person (who would need to be a nonadverse party in order of the power of appointment to cause estate inclusion under §2041). For a detailed discussion of the creditor impact of powers of appointment, see Item 10.m below.

8. Achieving Basis Adjustment At First Spouse's Death Regardless Which Spouse Dies First; Limitations Under Section 1014(E) If Donee Dies Within One Year

a. **Community Property.** Spouses in community property states get a basis step-up on all community property regardless of which spouse dies first. §1014(b)(6). The rationale of the basis step-up for both halves of community property goes back to 1948 when the marital deduction was instituted. The general thinking was that husbands would likely own all of the marital assets and husbands were likely to die first, so a full basis step-up would be available for all marital assets for most couples at the first spouse's death. If only the decedent's one-half of community property received a basis step-up, community property states would be disadvantaged compared to common law states. The rule for community property is now based on outdated assumptions, but it continues.

Any separate property could be converted to community property (through a "transmutation agreement"). *See, e.g.*, TEX. FAM. CODE §4.202; TEX. CONST. Art. XVI, Sec. 4.202. But a question arises as to whether that is a transfer that might trigger §1014(e) if the "recipient" spouse dies within one year.

For couples that do not live in community property states, the spouses might create community property by conveying assets to a "Community Property Trust" under Alaska or Tennessee law. See the discussion in Item 1.l of the ACTEC 2013 Fall Meeting Musings found **here** and available at **www.bessemer.com/advisor**. If real estate is involved, contribute the real estate to an LLC and transfer interests in the LLC to the Alaska or Tennessee Community Property Trust. The trustee in Alaska or Tennessee should preferably have possession of trust assets to minimize possible disputes with the IRS over the application of appropriate conflicts of laws principles.

Some planners have reported audits of such trusts in which no questions were raised about the community property treatment of the assets.

Owning assets as community property vs. separate property has real life consequences, including (1) ownership and disposition on death or divorce, (2) management rights, and (3) what property is liable for debts of a spouse.

b. **Joint Spousal Trusts.** (1) Joint spousal trusts have been used as a strategy for assuring that the first decedent's spouse has sufficient assets in his or her gross estate to fully utilize the estate exclusion amount. This is not as important now that we have portability. (2) The joint trust has also been used in the hope that it would secure a basis step-up at the first spouse's death for all of the marital assets

(mirroring what happens with community property). (3) As a practical matter, many couples view their assets as joint assets, and using a joint trust coincides with that perception (even if doing so may cause complexities later on).

Several private letter rulings, and in particular PLR 200101021, provide that giving the first decedent-spouse a general power of appointment over all of the joint trust assets is workable to facilitate funding the credit shelter trust at the first spouse's death. This is not as important now that portability is available to avoid wasting the first decedent-spouse's unused estate exclusion. In PLR 200101021, the joint trust was funded with tenancy by the entireties property. Each spouse could terminate the trust, causing the trust property to be delivered to the grantors as tenants in common. Upon the death of the first grantor, he or she had a testamentary general power of appointment over the entire joint trust. In default of exercise of the power of appointment, a credit shelter trust was to be funded with the trust assets, with the balance of the trust assets passing to the surviving spouse.

The IRS ruled that (1) there was no completed gift on creation of joint trust, (2) all of the trust assets were included in the gross estate of the first decedent-spouse, (3) the assets passing to a credit shelter trust at the first spouse's death were not included in the surviving spouse's estate under §2036, (4) there was a gift from the surviving spouse to the first decedent-spouse immediately before the moment of death, but the gift qualified for the gift tax marital deduction, and (5) there is no basis adjustment for assets passing to the surviving spouse because of §1014(e). (Some commentators have questioned whether the deemed gift and gift tax marital deduction ruling is correct [for example, some question how one can make a gift to a deceased spouse that qualifies for the marital deduction when they are not married after the death], and some planners are uncomfortable using this technique without further clarification. The IRS is not attacking them, however.) These rulings and the reasoning of the IRS are discussed in great detail in John Bergner, *Waste Not Want Not—Creative Use of General Powers of Appointment to Fund Tax-Advantaged Trusts*, 41st ANNUAL HECKERLING INST. ON EST. PL. ch. 14 (2007) (the marital deduction issue in particular is discussed in ¶1404.5).

c. **Section 1014(e) Limitation if Donee of Gifted Appreciated Assets Dies Within a Year and the Assets Pass Back to the Donor.** Another goal of the joint spousal trust is to achieve the result that applies to community property—to obtain a basis step-up on all assets in the trust, regardless which spouse contributed assets to the trust and regardless which spouse dies first.

Section 1014(e) Statutory Provision. Section 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 and if the property passes back to the original donor (or his or her spouse). In applying §1014(e), though, the devil is in the details—it is a poorly worded statute with many ambiguities. For an excellent analysis of §1014(e) and planning ramifications, see Jeff Scroggin, *Understanding Section 1014(e) & Tax Basis Planning,* LEIMBERG EST. PL. EMAIL NEWSLETTER #2192 (Feb. 6, 2014). Here is §1014(e) in its entirety (emphasis added):

> (e) Appreciated property acquired by decedent by gift within 1 year of death.
>
> (1) In general. In the case of a decedent dying after December 31, 1981, if--
>
> (A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and
> (B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.
>
> (2) Definitions. For purposes of paragraph (1)—
>
> (A) Appreciated property. The term "appreciated property" means any property if the fair market value of such property on the day it was transferred to the decedent by gift exceeds its adjusted basis.
>
> (B) Treatment of certain property sold by estate. In the case of any appreciated property described in subparagraph (A) of paragraph (1) sold by the estate of the decedent or by a trust of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale.

If property is given to an individual in hopes of getting a basis increase at the individual's death, several initial planning steps are in order. (1) Make sure the individual does not have creditors who would take the property. (2) Having a medical directive for that person is better than having a living will, so there is more flexibility for keeping the individual alive past the one year date if the property will return to the original donor. (3) There is no risk of §1014(e) applying if the donor is happy with the asset passing to someone other than the original donor at the individual's death.

Application to Joint Spousal Trust. The IRS ruled in PLR 200101021 that §1014(e) applied to the joint trust that gave the first decedent-spouse a general power of appointment over all of the trust assets. The IRS reasoned that assets are given from the surviving spouse to the decedent-spouse at the instant of the decedent-spouse's death and then returned to the surviving spouse—obviously within one year of the gift—therefore no basis adjustment is permitted under §1014(a). *See also* PLRs 200604028, 200413011, 200403094, 200210051 & TAM 9308002. Some commentators question the IRS's reasoning that the surviving spouse makes a gift at the instant of the first spouse's death as a result of relinquishing control to the decedent-spouse. *E.g.,* John H. Martin, *The Joint Trust: Estate Planning in a New Environment*, 39 REAL PROP. PROB. & TR. J. 275 (2004). Furthermore, §1014(e) arguably does not apply if the assets do not return "to" the donor (*i.e.*, the surviving spouse) but remain in trust for the benefit of the surviving spouse. In any event, the

IRS position is clear that a basis adjustment is allowed only for the portion of the joint trust assets attributable to the first decedent-spouse's contributions to the trust.

Refinement: "Joint Exempt Step-Up Trust "("JEST"). This planning strategy, with various adjustments, has been referred to as the "Joint Exempt Step-Up Trust (JEST). *See* Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1,* 40 EST. PLAN. 3 (Oct. 2013); Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 2,* 40 EST. PLAN. _ (Nov. 2013). The authors suggest that the assets passing from the share of the surviving spouse on the death of the first dying spouse based upon the power of appointment exercisable by the first dying spouse should go into a separate trust of which the surviving spouse may not be a beneficiary (or only addable as a beneficiary by independent trust protectors), or which may be less likely to provide benefits to the surviving spouse based upon restrictive language or the need to receive consent from an adverse party. The authors note that, if challenged by the Service, this approach of restricting distributions to the surviving spouse should provide a higher probability of success for receiving a stepped-up income tax basis if the Service were to challenge this. The authors also note that the separate credit shelter trust funded from the assets coming from the share of the surviving spouse will be considered as an incomplete gift by said spouse if the IRS can show that the surviving spouse was the actual contributor, since he or she has retained a testamentary power of appointment. The authors also point out that the credit shelter trust funded from the assets owned by the surviving spouse might be considered to be a gift by said spouse, and that said spouse could disclaim the testamentary power of appointment described above so that the gift would not be incomplete. Further, the surviving spouse may be given the power to replace trust assets with assets of equal value so that the intended second credit shelter trust (funded from assets owned by the surviving spouse) would instead be operated as a grantor trust. The authors report that some planners have indicated that they are using this system, and expect to consult carefully with the surviving spouse and family after the first death in order to determine how to proceed with this flexible design trust system.

If the approach of using a trust protector to add the donor as a discretionary beneficiary at some later time is used, consider delaying the addition until after the statute of limitations has run on the determination of gain from a sale of the property in question. One approach may be to sell the asset soon after if it is acquired from the decedent (which should generate very little gain) and later repurchase similar (or even identical) assets (there are no wash sale rules for recognition of gain purposes). That would start the 3-year statute of limitations on assessment of additional income tax.

Application of §1014(e) If Assets Pass Into Discretionary Trust for Donor. Whether the assets pass to a QTIP trust or a credit shelter trust for the surviving spouse, arguably §1014(e) would not apply on the theory that the asset did not pass back to the donor for purposes of this income tax statute but into a trust for the benefit of the donor (even if the assets pass to a QTIP trust that is included in the surviving spouse's gross estate 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 QTIPable trust for wife if husband predeceased her. 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.

The legislative history to §1014(e), which was passed in 1981 as a part of ERTA, discusses that §1014(e) applies if the property passes to the donor directly or indirectly. It applies if the inclusion of the gift property in the decedent's estate "affected the amount that the donor receives under a pecuniary bequest." H.R. Rep. No. 97-201, at 188-89 (July 24, 1981). Therefore, if the gift property passes to a credit shelter trust but other property passes to the donor, this suggests that §1014(e) would apply. But if the entire estate passed to a credit shelter trust, this indirect argument in the legislative history might not apply.

Professor Mark Siegel points out that the legislative history to ERTA also states that the rules under §1014(e) apply on a pro-rata basis if the donor-heir is only entitled to a portion of the property, and the portion of the property that does not pass back to donor receives a stepped up basis. He suggests that this pro rata rule should apply to trust interests:

> As applied to dispositions in trust, the pro-rata rule should recognize the split interests between income beneficiary and remainder beneficiary. The trust agreement may direct the trustee to pay all the income to the donor. If that is the case, the donor possesses the right to the income and would be entitled to receive only the value of that portion of the property. Actuarial principles would be used to determine the value of the income interest and § 1014(e) would apply to that portion to prevent a step up in basis. However, the income beneficiary is not entitled to receive the value of the trust remainder so that the remainder portion should receive a step up in basis under § 1014(a). The portion attributable to the remainder interest should be valued according to actuarial principles. The terms of the trust income interest must be examined to ascertain whether the donor-income beneficiary is entitled only to a portion of the property. For example, if the trustee were authorized to pay the income or accumulate it, the discretionary nature of the income interest would prevent the donor from having the right to the income and being entitled to receive the value of that portion of the property. Therefore, the valuation tables would not apply to value the discretionary income interest. As a result, there is no portion of the trust property the donor is entitled to and section 1014(e) would not apply. Consequently, the entire property would receive a section 1014(a) step up.

Mark R. Siegel, I.R.C. Section 1014(e) and Gifted Property Reconveyed in Trust, 27 AKRON L.J. 33, 49 (2012).

This analysis suggests that the extent to which a basis adjustment is denied under §1014(e) may depend on the extent of the original donor's interest in the trust that receives property from the decedent. To the extent that there is a mandatory income or principal interest, the actuarial value of that interest would presumably be subject to §1014(e), but what if there is a Clayton provision converting a mandatory income interest to a discretionary interest to the extent the executor does not make a QTIP election? What about discretionary standards for such discretionary interests; how does a fully discretionary or extremely restrictive standard impact the portion deemed to pass to the individual? What if the individual is the trustee with the discretion to make distributions to him or herself within a standard? Does having a limited power

of appointment make a difference (even though the assets cannot be appointed to the individual)?

Application of §1014(e) If Donee-Decedent's Estate Sells the Gift Assets. Further uncertainties arise if the decedent's estate sells the assets received by gift within a year. Section 1014(e)(2)(b) provides that in the case of a sale by the estate, §1014(e) applies only "to the extent the donor … is entitled to the proceeds from such sale." If the assets pass to a trust in which the individual has only an income interest, there would not seem to be any interest in the "proceeds" except to the extent that capital gains are allocated to income under the decedent's will or perhaps to the extent that the trustee is given the discretion under the instrument or state law to allocate capital gains to income.

Administrative Difficulties of Joint Spousal Trust. If the taxpayer loses the argument that all of the trust assets receive a new basis, using the joint trust may create a difficult administrative problem. Some portion of the assets in the trust have a new basis (i.e., those assets attributable to contributions from the deceased spouse when the trust was created—and more than one year before death), and some assets have the same basis.

Application to Non-Spousal Transfers. The planning ideas discussed above also apply to gifts to donees other than spouses. In light of the indexed large estate exemption, most decedents will pay not estate tax. Gifts to a donee will receive a basis adjustment at the donee's death without causing any estate taxes to be paid (assuming the exemption covers all of that decedent's assets) unless the donee dies within a year and leaves the asset back to the donor. Even if the donee dies within a year, leaving the assets to a trust of which the donor may eventually become a beneficiary or in which the donor is only a discretionary beneficiary may still receive a basis adjustment at the donee's death.

d. **Section 2038 Marital Trust.** Another possible strategy to achieve a basis step-up for all marital assets at the death of the first spouse is a "Section 2038 Marital Trust." As an example, H creates an irrevocable trust for W as a discretionary beneficiary (H could be the trustee) providing that on W's death the assets pass to her estate. H retains the power to terminate the trust prior to W's death; if the trust is terminated, the assets would be distributed to W. The gift is complete when the trust is created (unlike the joint revocable trust) but the gift qualifies for the gift tax marital deduction (even though the trust is not a QTIP trust) because W is the only beneficiary so her interest is not a "nondeductible terminable interest," Reg. §25.2523(b)-1(a)(2). If W dies first, the assets are in her estate under §2031 and if H dies first the assets are in his estate under §2038. For a more complete discussion, see Item 8.e of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

e. **General Power of Appointment Trust Funded With Cash Followed by Sale.** An idea attributed to Jonathan Blattmachr is for the donor to fund a grantor trust with cash for the donee-spouse, in which the donee-spouse has a testamentary general power of appointment. The donor would subsequently sell appreciated property to the grantor trust (with no income recognition under Rev. Rul. 85-13). The trust assets will be included in the donee-spouse's estate because of the general power of

appointment, and a basis step-up is generally allowed under §1014(b)(9). Even if the donee-spouse dies within one year and appoints the trust assets to the donor or to a trust for donor's benefit, §1014(e) arguably does not apply. Section 1014(e) only applies if "appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death." §1014(e)(1)(A). In this situation, cash was gifted to the trust for the donee-spouse; appreciated property was not gifted to the trust. See Jeff Scroggin, Understanding Section 1014(e) & Tax Basis Planning, LEIMBERG EST. PL. EMAIL NEWSLETTER #2192 (Feb. 6, 2014).

9. Basis Background

In light of the increased importance of income tax issues and basis issues in particular, Howard Zaritsky (Rapidan, Virginia) and Lester Law (Naples, Florida) discussed a wide range of fundamental issues regarding basis matters.

a. **Significance and General Description.** Basis is a taxpayer's investment in property. It impacts a variety of tax issues including depreciation and the amount of gain realization upon the sale or exchange of an asset. An asset's initial basis or original basis is its cost (sometimes referred to as "cost basis"). Adjustments can be made to the initial basis for a variety of things including additions to basis for capital improvements and capitalized expenditures, and reductions to basis for depreciation and depletion.

   Basis is especially important for wealthy people—they may not have much ordinary income but will have a lot of capital gains. A taxpayer's basis in assets often dictates financial decisions. "It is hard to convince clients to pay a capital gains tax that they don't absolutely have to pay today."

b. **Brief History**. After ratification of the 16th amendment, the Revenue Act of 1916 introduced the concept of basis. For assets acquired before March 1, 1913, basis was equal to value on that date. Regulations added that for assets acquired after that date the basis or property was its cost and this was codified in the Revenue Act of 1918.

   Gifts and Bequests. The Revenue Act of 1921 provided a transferred basis approach for gifts and bequests. The Revenue Act of 1928 changed this to a date of death value basis rule for bequests. That was changed various times during the years 1928-1934, ending up with the date of death approach for bequests.

   Carryover Basis. The major modification to the basis rules, for estate planning and administration purposes, was the adoption of a carryover basis approach in 1976 (quickly repealed) and the one year experiment allowing an elected carryover basis instead of estate tax in 2010.

c. **Carrying Charges.** A little used rule is that carrying charges (such as real estate taxes or mortgage interest), may be capitalized and added to basis rather than being deducted in a particular year. §266. This can be helpful if the taxpayer does not have income to be offset by a deduction in a particular year. However, the election to capitalize carrying charges to be added to basis must be made on the return for the year; it cannot be elected on an amended return.

d. **Property Acquired by Gift**. Basis transfers on the date the donor relinquishes dominion and control over property, not necessarily the day on which title passes. For appreciated property, the donee's basis is equal to the donor's basis increased by gift tax paid on the appreciation (but not to exceed the asset's fair market value) at the time of the gift. (The gift tax attributable to the appreciation can be added to basis regardless of whether the donor or donee pays the gift tax.) The rule is different for depreciated property, to prevent low-bracket donors from transferring their losses to high-bracket donees. For depreciated property (i.e., the fair market value is less than the adjusted basis of the property), the donee's basis is the donor's basis for purposes of determining the amount of gain on a later sale but is the lower fair market value of the property on the date of the gift for purposes of determining the amount of loss on a later sale. (The Code does not specifically address a sale that is made at a price between the FMV at the date of the gift and the adjusted basis, but there is neither gain nor loss recognized in that event.)

Gift Tax Returns. The gift tax return has a column to list the basis of donated property. That column is often left blank, but the return preparers should include the basis information to keep track of the basis for the donor and donee. Indeed, some planners report that on occasion the IRS has returned gift tax returns that do not have the basis column completed.

Giving Depreciated Property Is Discouraged. These basis rules discourage gifts of depreciated property (perhaps other than if the depreciation arises because of discounts of partnership interests). A preferable approach is for the taxpayer to sell the property to recognize the loss and give the proceeds. Furthermore, there is no adjustment in the basis for gift tax paid when giving depreciated property because only gift tax attributable to appreciation can be added to basis.

Danger of Giving Highly Appreciated Property. The estate tax savings that result from excluding future appreciation in the donor's gross estate are offset by the loss of a basis step up. Appreciated property with a zero basis would have to appreciate to about 247% of its date of gift value before the estate tax savings (at a 40% rate) on the appreciation that is removed from the estate would start to outweigh the capital gains cost (at a 28% rate) of not getting a stepped up basis at the donor's death (if the donor had kept the property) when the property is ultimately sold. See Item 3.j above and Item 11.a below.

e. **Property Acquired From a Decedent**. Howard Zaritsky (who I have always assumed knew everything—and I'm still sure that he knows just about everything) indicated he was surprised in preparing this information how different the text of §1014 is compared to what he thought the rules were. While §1014 provides for a basis adjustment to the date of death value for property included in a decedent's gross estate, there are various other situations in which property that is "acquired from a decedent" will receive a basis adjustment, detailed in nine subsections of §1014(b). (Section 1014(b)(9) is the "included in the decedent's gross estate" section, but other subsections are far more general, including subsection (b)(1) which simply refers to "property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." An example of an asset not in a decedent's gross estate for estate tax purposes that receives a basis adjustment is foreign property left from a foreign person to a U.S. person—that property in the hands of the U.S. person has

a basis equal to the date of death value even though it was not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.)

If any property that was transferred during life is still included in the decedent's gross estate (the regulations use the example of gifts in contemplation of death because the regulations are old) and the property is depreciable, the depreciation deductions taken by the transferee are subtracted from the date of death value basis. (Howard Zaritsky commented: "That had never crossed my mind. Fortunately, it had not crossed my desk.")

For community property, the community property interest of the surviving spouse as well as the community property interest of the decedent gets a basis adjustment. §1014(b)(6).

f. **Generation Skipping Transfer Tax**. Property transferred from a non-exempt trust in a taxable termination that occurs at the same time as, and as a result of, the death of an individual receives a basis adjustment in the same manner as provided in §1014 (i.e., the value of the property on the date of the transfer). If the trust is partially exempt from the GST tax, the basis adjustment is limited to the adjustment times the inclusion ratio. For a taxable distribution or direct skip or taxable termination occurring other than at and by reason of the death of an individual, the basis is increased, but not above fair market value, by the portion of the GST tax attributable to appreciation in the value of the transferred asset immediately before the transfer. (A special rule in §2612(a)(2) characterizes distributions to skip persons that occur on the death of a lineal descendant of the transferor as a taxable termination; therefore the basis adjustment would be permitted except to the extent that GST exemption is allocated to the direct skip resulting in an inclusion ratio of less than one.)

g. **Holding Period.** An asset's holding period determines whether a gain or loss will be long-term or short-term. A holding period of more than one year results in long-term gains/losses. §1222(3)-(4). The holding period for getting long term capital gain treatment is really a year and a day. If an asset is bought on January 1 and sold on January 1 of the following year, that is not a long-term holding period. (Whether or not the year is a leap year makes no difference for this purpose.)

Tacking. An individual's holding period generally starts upon acquiring the asset. In some transactions, the new owner's holding period includes the holding period of the prior owner (called "tacking").

For gifts, tacking applies if the new owner's basis is determined in whole or in part by the donor's basis. §1223(2). Therefore, tacking applies to gifts of appreciated property (because the donee's basis is the same as the donor's basis). For gifts of depreciated property, if there is a subsequent sale at a gain, tacking applies (because the basis is

the donor's basis in that event), but if there is a subsequent sale at a loss there is no tacking (because the donee's basis is the fair market value of the property at the date of the gift and is not determined by the donor's basis in the property).

For a part gift, part sale transaction, the holding period of the portion that is a deemed sale starts on the date of the sale; for the gift portion, the tacking rules for gifts (described in the preceding paragraph) will control.

For property acquired from a decedent, the general rule is that the inherited property receives long-term gain or loss treatment. Section 1223(9) and (10) provide that even if the property is sold within a year, the property will be deemed to have been held for more than one year. However, for this deemed one-year rule to apply, the person who sells the property must be the person who received the property from the decedent. If the recipient of a bequest gives the property to a donee who later sells it within a year, the deemed one-year holding period rule does not apply and the sale will generate a short term capital gain/loss. (For decedents who died in 2010 and made the election for carryover basis to apply under §1022, the automatic one-year holding period rule does not apply, but the decedent's holding period generally becomes the beneficiary's holding period. *See* Rev. Proc. 2011-41.)

h. **Uniform Basis Rules**. Property acquired from a donor or decedent has a single or uniform basis, even if multiple persons acquire an interest in the property. Reg. §§1.1014-1(b), 1.1015-1(b). For example, this would apply if the property is left in a life estate or trust. The basis of the property is apportioned among the various beneficiaries based on the values of their interests in the life estate/remainder or in the trust. For interests subject to a life estate or mandatory income interest, the value of the income interest is based on the person's age and the §7520 rate. Therefore, the proportionate values of the beneficiaries' interests change from month to month. There are no clear rules as to how to value interests of beneficiaries under ascertainable standards or of discretionary beneficiaries.

The uniform basis rules are particularly important in two situations: (1) for depreciation deduction allocations (and the way that accountants allocate the deductions in that case is often wrong); and (2) when a beneficiary sells his or her interest in the trust. If a term interest is sold, the seller is deemed to have a basis of zero unless it is sold in a transaction in which *all* interests in the trust are sold to a third party. (For example, if the holder of the annuity interest in a CRAT sells his annuity interest, the seller's basis is zero and all of the proceeds are gain.)

The IRS deems the commutation of a trust, in which the term and remainder interest holders receive their proportionate shares of the underlying assets, as a sale of each beneficiary's interest and the seller of the term interest gets no basis. The IRS will not rule on a commutation of a CRT. Rev. Proc. 2015-3. On the other hand, if the trust is terminated by selling both the term and remainder interests to a *third person*, the seller of the term interest can apply his or her basis to determine gain.

i. **Proving Basis.** This is another aspect of determining basis that is somewhat surprising. If the donee of a gift does not have facts to determine the basis in the hands of the donor, §1015(a) requires the IRS "if possible" to obtain the information from the donor or anyone else who may know the facts. If finding the facts becomes impossible, the basis shall be the fair market value of the property as of the date or approximate date that the donor had acquired the property. Reg. §1.1015-1(a)(3). Various cases have allowed approximating the basis. *Cohan v. Commissioner*, 39 F.2d 540 (2nd Cir. 1930) is cited as stating a "close is good enough" rule. The Sixth Circuit in the *Caldwell v. Commissioner* case (234 F.2d 660) indicates that if there is some evidence to prove basis, the IRS cannot ignore it and must make an effort to determine the basis. (In that case, the court determined that there was sufficient

evidence to find the fair market value of the stock around the time that the donor [or the last prior owner] acquired the property.)

j. **Part Gift/Part Sale Transaction**. In a *non-charitable* part gift/part sale, the transaction is treated as a sale to the extent the consideration received exceeds the transferor's adjusted basis. Reg. §1.1001-1(e). The transferor's basis is allocated entirely to the sale portion of the transaction (which is very taxpayer friendly— reducing the gain that the seller recognizes.) The transferee's basis is the greater of the consideration paid or the transferor's adjusted basis at the time of the transfer plus any gift taxes paid. Reg. §1.1015-4.

For a *charitable* part gift/part sale, in which all or part of the gift portion is deductible as a charitable deduction under §170, the transferor's adjusted basis is allocated between the sale and gift portions—which increases the gain that is recognized by the seller as compared to the noncharitable part gift/part sale situation.

k. **Sales to Grantor Trusts**. *Revenue Ruling 85-13.* The fundamental underpinning of the sale to grantor trust concept is Rev. Rul. 85-13, which ruled that the grantor is the deemed owner of the grantor trust assets for income tax purposes (so the grantor trust did not get a new cost basis in the asset that it acquired from the grantor for a promissory note). While this conclusion may be questionable, there have now been five other published revenue rulings, two notices, and over 125 private letter rulings, chief counsel advisories, field service advice and technical advice memoranda supporting this same position. Even so, this sobering thought puts the underlying rationale of this favorable treatment of grantor trusts in perspective:

> The fountainhead of modern grantor trust law is Rev. Rul. 85-13. Nevertheless, lest it be thought that the technique addressed in this article is iron-clad, it is good for one's perspective to be reminded from time to time that the most serious authority in this area is an IRS ruling that defies the holding of a respected U.S. Court of Appeals.

Ronald Aucutt, *Installment Sales to Grantor Trusts*, 2 BUS. ENTITIES 28 (April/May 2002).

Basis Adjustment for Gift Tax Paid. Is a basis adjustment for gift tax paid allowed if there was no gift for income tax purposes because the grantor is deemed to still own the property? PLR 9109027 says there is a basis adjustment for gift tax paid but only when the grantor trust status terminates. (But that does not help if the asset is sold before the grantor trust status terminates.) Howard Zaritsky believes there should be a basis adjustment for gift tax paid, but acknowledges that neither he nor the IRS have any real authority for their respective positions. Howard believes accountants typically report gifts to grantor trusts by making the basis adjustment for gift tax paid.

Trust's Basis in Note from Grantor. Howard believes that the note the grantor receives from the grantor trust in a sale transaction has no basis. If the note and the property transferred to the trust both have a basis equal to the grantor's basis in the property prior to the sale, there would be double counting of the basis.

Termination of Grantor Trust Status During Grantor's Lifetime—Effect on Gain Recognition and Basis. Termination of grantor trust status during the grantor's lifetime can result in recognition of gain and, logically, the increase in the basis of assets held by the then-nongrantor trust. *See* Rev. Rul. 77-402, 1977-2 C.B. 222; Reg. §1.1001-2(c)Ex. 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985).

Termination of Grantor Trust Status at Grantor's Death—Effect on Gain Recognition and Basis. There is no answer on which everyone agrees. The IRS has not expressed a precedential position. Under Rev. Rul. 85-13, the grantor is the deemed owner of the grantor trust's assets for income tax purposes. The death of an individual is not itself a recognition event. Testamentary transfers of encumbered assets do not themselves result in recognition of gain, so the grantor's death should be treated for income tax purposes as if the grantor owned the encumbered assets and disposed of them by traditional testamentary transfer at death. Howard believes strongly the answer should be that no gain is recognized on death.

What about the basis of the assets in the trust? For income tax purposes the grantor owned the property on the date of death, not the trust. The trust becomes the owner upon the grantor's death. There is a "not bad" argument that the deemed change of ownership for income tax purposes at the grantor's death constitutes the receipt of property from a decedent for purposes of §1014, and that there should be a basis step up even though the assets are not included in the gross estate. *See* Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. TAX'N 149 (Sept. 2002). "BUT good luck getting an accountant to take that position on an income tax return." Howard would be willing to take that position on a return, advising the client that the IRS will fight the issue if it spots the issue. He believes there is no risk of penalties for taking that position because it is not contrary to any existing law and is supported by some law. CCA 200923024 draws a distinction between the effects of a grantor trust status terminating during the grantor's lifetime and of a lapse of grantor trust status "caused by the death of the owner which is generally not treated as an income tax event." *But see* CCA 200937028 (questioning whether basis adjustment is allowed under §1014 for assets transferred to grantor trust if assets are not in decedent's gross estate). A response to that CCA is that foreign property left from a foreign person to a U.S. person receives a basis step-up even though the assets in not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.

l. **Private Annuities.** The basis of the purchaser in a sale of assets for a private annuity varies at different times and for different purposes. Rev. Rul. 55-119, 1955-1 C.B. 352; Rev. Rul. 72-81, 1972-1 C.B. 98.

During Annuitant's Lifetime. For computing depreciation on the property purchased, or for calculating gain if the annuitant resells the property *while the annuitant is still alive*, the basis is the present value of the annuity agreement on the date of the sale. (If the purchaser makes annuity payments in excess of that amount, the additional payments may be added to basis for these purposes.) If the property is sold at a loss during the annuitant's lifetime, the basis is the amount of payments actually made. If the sale is for more than the payments made but less than the present value of the annuity at the time of the sale, neither gain nor loss is recognized.

Following Annuitant's Death. At the annuitant's death, basis is adjusted down to the amount (if less) that has in fact been paid less any depreciation deductions allowable with respect to the annuity property.

m. **Self-Canceling Installment Note**. *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993) adopted the IRS position that the portion of the note that is canceled at death is recognized as gain by the estate as IRD under §691(a)(5)(iii). That is consistent with the IRS position discussed in GCM 35903. A strong five-judge dissent in the Tax Court opinion (98 T.C. 341) authored by Judge Halpern took the position that there was no cancellation of indebtedness income, because that indebtedness never existed—the SCIN was negotiated with the understanding that no payments were due after the seller's death. (Judge Halpern included sample language to avoid the result reached by the majority in *Frane.* He suggested that every payment be subject to the precondition that the transferor is alive—and he offered sample language to accomplish that result.)

If assets are sold to a grantor trust for a SCIN, the arguments regarding sales to grantor trusts discussed above would be applicable at the grantor's death.

n. **Special Use Valuation**. If property is valued for estate tax purposes under §2032A, and if there is subsequently a recapture tax that must be paid if the qualified use of the property ends within ten years of the decedent's death, the qualified heir can elect (in an irrevocable election) to increase the basis of the property by the amount of the estate tax value reduction allowed under §2032A, *but* the heir would have to pay interest on the recapture tax, running from the original estate tax return due date to the date the recapture tax is paid. §1016(c)(5)(B).

o. **Life Insurance**. The income tax effects of sales or surrenders of life insurance policies were recently addressed in Rev. Ruls. 2009-13 and 2009-14. The IRS position is that the basis of a life insurance policy is generally the total premiums paid reduced by the "cost of insurance protection" provided throughout the policy's existence and further reduced by nontaxable dividends the insured has received. Rev. Rul. 70-38; ILS 200504001.

10. Powers of Appointment

a. **Significance and Uses.** A great deal of attention over the last several years has focused on using general powers of appointment to cause estate inclusion in order to achieve a basis adjustment at a beneficiary's death. State law issues regarding powers of appointment have been under review recently. A Uniform Powers of Appointment Act (referred to in this Item as the "Act") was promulgated by the Uniform Law Commission in July 2013. Turney Berry was the Chair of the Drafting Committee. Colorado has adopted the Act and several other states (including California) are considering it. State law regarding powers of appointment is remarkably thin. The information in this Item generally discusses positions taken by the Act regarding powers of appointment.

Powers of appointment are widely used in trusts for a variety of reasons.

(1) *Basis Adjustment.* A general power of appointment may force estate inclusion to allow a basis adjustment at the beneficiary's death. If a general power is used for this purpose, it might be limited to appreciated assets (i.e., assets with fair market value exceeding basis) other than IRD items (those are the only assets that could benefit from a basis adjustment).

(2) *"Second Look" Changes*. Powers of appointment provide a great deal of flexibility by giving other persons the ability to adjust how assets will pass from the trust taking into account conditions that exist at that time. The powerholder can consider changes in family dynamics (including marital issues, creditor issues, substance abuse issues, or bad attitudes that are detrimental to family harmony). "A fool on the spot is better than a genius two generations ago."

(3) *Control; Stop Meddling*. Powers of appointment give desired "arm twisting" influence to powerholders under Professor Halbach's old rubric that the "power to appoint is the power to disappoint." For example, powerholders can make sure that charitable beneficiaries continue to support the settlor's desired activities and beliefs. Powerholders who are current beneficiaries can stop "meddling" by remainder beneficiaries. To make this even stronger, give the powerholder the right by an inter vivos power of appointment to exclude certain persons as beneficiaries of the trust. That would remove their right to receive information from the trustee and take away their standing in court proceedings.

(4) *Prevent Completed Gifts*. A donor's retained power of appointment may keep a transfer from being a completed gift for gift tax purposes. For example, transfers to a DING or NING trust to save state income taxes typically employ retained powers of appointment to keep the contribution from being a completed gift for gift tax purposes. (Under CCA 201208026, the grantor may need to retain an inter vivos power, rather than just a testamentary power of appointment, if the trustee is authorized to make distributions to persons other than the grantor. *See* Reg. §25.2511-2(b).)

b. **Non-Fiduciary Powers**. Powers of appointment are non-fiduciary powers. Decanting authority is a fiduciary power. If an instrument says that a trustee holds a power of appointment, it is not really a power of appointment– it is a normal trustee power subject to fiduciary duties.

c. **Nomenclature Change**. The "powerholder" is the person who can exercise a power of appointment (the traditional term for that person was "donee"). To satisfy some academics on the drafting committee, special powers of appointment are referred to as "non-general powers of appointment."

d. **General Power Presumption**. The presumption is that a power of appointment is a general power of appointment unless it is limited. For example, "Fred may appoint the asset as Fred determines" is a general power.

e. **Ability to Grant General Power; General Power Does Not Exist Until Actually Created**. Section 2041(b)(1)(C) provides that a power exercisable "in conjunction with" another person will be a general power unless the other person is the creator of the power or is an adverse party (for example, another beneficiary). Some planners have raised the question of whether there is a real difference between a power that is conferred by a third party vs. a power exercisable in conjunction with a third party. *See* Ronald Aucutt, *When is a Trust a Trust?,* at 17, printed as part of *It Slices, It Dices, It Makes Julienne Fries: Cutting Edge Estate Planning Tools,* STATE BAR OF TX. 20th ANN. ADV. ESTATE PLANNING STRATEGIES COURSE (2014). This raises the possible IRS argument that the beneficiary may be deemed to hold a general power of appointment even if it is never formally granted by the third party. A possible counterargument is the provision in Reg. §20.2041-3(b) that if a power is exercisable

only on the occurrence of an event or contingency that did not in fact take place, it is not a general power of appointment. If the independent party never grants the general power of appointment, arguably that is a contingency that never took place within the meaning of that regulation.

The Uniform Act cannot change tax consequences but attempts to "nudge the law;" a Comment to the Uniform Act supports the view that the ability to create a general power of appointment ought not to be viewed as the equivalent of the ability to exercise the power with another. The Comment to §102 notes that if a person can change a general power into a nongeneral power or vice versa, the power is either general or nongeneral depending on the scope of the power at any particular time. For state law purposes, the power is what it is at the time it is being looked at, not what it has been or could be.

f. **Choice of Law.** The traditional rule is that the law where the power of appointment was created controls regardless where it is exercised. As an example of the importance of governing law, assume that a powerholder can appoint the assets to specified persons or their spouses. Would same-sex spouses be included? That may depend on the state law that governs. Or the term "descendants" may depend on the law of a particular state with respect to artificial reproduction technology or other state law issues (such as the recognition of adult adoptions). The Uniform Act changes the governing law provision to what the Commissioners think is the uniform practice of practitioners in exercising powers of appointment—and that is to apply the law of the domicile of the powerholder.

g. **Important Exception to Avoid Inadvertent General Powers**. Section 204 of the Uniform Act presumes that a power is nongeneral if it is exercisable only at the powerholder's death and permissible appointees are a defined and limited class excluding the powerholder's estate, creditors and creditors of the estate. For example, a power to appoint to descendants of the powerholder's parents would not include the power of the powerholder to appoint to himself, his estate or creditors.

h. **Substantial Compliance With Donor Imposed Formal Requirements**. Traditionally, there has been no doctrine of substantial compliance recognizing substantial (but not precise) compliance with the formal execution requirements imposed by the creator of the power. Section 304 provides that substantial compliance with a formal requirement imposed by the donor, including a requirement that the instrument make specific reference to the power, is sufficient if: (1) the powerholder knows of and intends to exercise the power; and (2) the manner of attempted exercise of the power does not impair a material purpose of the donor in imposing the requirement. For example, a testamentary power of appointment that can be exercised by will can also be exercised by a revocable trust that is functionally equivalent to a will. However, a specific reference requirement would not be satisfied by an exercise of "any appointment that I might have" or by a residuary clause purporting to exercise any powers that the testator has—because a material purpose of the specific reference requirement was to avoid inadvertent exercises. In that situation, the exercise of the power would at least need to reference who created the power that is being exercised.

i. **Permissible and Impermissible Appointees.** *Power to Appoint to Powerholder or Powerholder's Estate*. A power to appoint to the powerholder or the powerholder's

estate is extremely broad, allowing the appointment in favor of anyone and without restrictions (even if the power states that it is subject to restrictions). There is no need that the powerholder first appoint to himself or to his estate and then make a distribution to others or make a bequest to others. *See* Comment to §305 of the Act.

Power to Appoint to Creditors. The effect of a power to appoint to the powerholder's creditors or to creditors of his estate is unclear. For example, assume that the powerholder owes $100 to Bob. If the powerholder can appoint assets to his creditors, can he appoint all of the trust assets to Bob or only up to $100? After he distributes $100 to Bob, Bob is no longer a creditor. A power to appoint to creditors of the estate is more troubling, because Bob is clearly a creditor of the estate at Bob's death, and subsequent events (such as paying $100 to Bob) do not change the fact that as of the date of the powerholder's death, Bob was a creditor of the estate.

The issue is important because planners sometimes draft a general power of appointment as a power to appoint to creditors, thinking that this is the most limited general power possible. If the power is not limited to the extent of a creditor's debt, this type of general power is not limited at all.

What is the answer? "Everyone knows the answer—but everyone knows a different answer." For example, a BNA Portfolio takes the position there is no limit on the amount that could be appointed to a creditor, but Professor John Langbein says that the power to appoint to creditors can be exercised in favor of a creditor only up to the amount of the debt to the creditor. When asked if he has authority for his position, he responded "You might as well look for authority that the sun rises in the east. This question is so stupid that everyone knows the answer." When told that a lot of people think the answer is different, Prof. Langbein responded "There are a lot of stupid people."

j. **Fraud on Exercise.** The Comment to §307 of the Act explains the "fraud on the power" concept as follows:

> Among the most common devices employed to commit a fraud on the power are: an appointment conditioned on the appointee conferring a benefit on an impermissible appointee; an appointment subject to a charge in favor of an impermissible appointee; an appointment upon a trust for the benefit of an impermissible appointee; an appointment in consideration of a benefit to an impermissible appointee; and an appointment primarily for the benefit of the permissible appointee's creditor if the creditor is an impermissible appointee. Each of these appointments is impermissible and ineffective.

k. **Contract to Exercise a Power.** A powerholder cannot contract to exercise a power of appointment in a certain manner unless it is currently exercisable. §405 of the Act. The policy reason for this position is that the person who created the power wanted to leave flexibility for the powerholder to change his or her mind before it is exercised taking into account current conditions. Such a contract to exercise a power of appointment in a particular manner could not be enforced.

This issue is particularly important for testamentary powers of appointment. The drafting committee struggled with whether to allow contracts to exercise a testamentary power of appointment because many lawsuits could be settled if someone who had a testamentary power of appointment could agree in the settlement to exercise the appointment in a certain manner. The committee ultimately concluded that there were too many ripple effects of allowing such contracts.

As an example, assume A has the power to appoint to his descendants. He really wants to give $1 million to the opera. He clearly cannot just appoint $1 million to the opera. Furthermore, he cannot appoint $1 million to his daughter because the daughter has agreed to give the $1 million to the opera. Difficult situations can arise regarding such indirect transfers. Suppose the daughter does not agree directly to give the appointed assets to the opera, but instead simply makes an enforceable $1 million pledge to the opera and A appoints $1 million to her. Is that a fraud on the power?

Another example illustrates how difficult this issue can be. Assume that a father appoints assets to his children "so they will take care of their mother." Few would think that is abusive. But if the father said to a child "if you will fund an irrevocable trust with $1 million for your mother today so that I know she will be taken care of, I will appoint $1 million to you," that would be inappropriate.

l. **Condition Exercise on Consent of Nonadverse Party.** A classic solution to prevent these types of potential abuses is to condition the exercise of a power on someone else's consent.

m. **When Can Creditor Reach Assets of Holder of General Power?** The mere existence of the authority of someone to create a general power of appointment does not of itself create creditor concerns for the person who might be granted a general power of appointment.

If a beneficiary is actually granted a general power of appointment (either by a third party or by formula at the beneficiary's death), the traditional rule has been that would not by itself allow creditors to reach the assets. However, the beneficiary's creditors could reach the assets if the beneficiary actually *exercised* the general power of appointment (although a 1935 Kentucky case said that creditors could not reach the assets even if the power was exercised as long as it was not exercised in favor of creditors). That traditional rule (dating back to a 1879 Massachusetts case) was the position of the Restatement (Second) of Property (Donative Transfers) (§§13.2, 13.4, 13.5). The Restatement (Third) of Property, however, takes the position that property subject to an *unexercised* general power of appointment can be reached by the power holder's creditors if his or her property or estate cannot satisfy all of the powerholder's creditors. Restatement (Third) of Property (Donative Transfers) §22.3 (2011). Some states (such as California, Michigan, and New York) have specific statutory measures adopting the position of the Third Restatement. The Uniform Trust Code applies the Restatement (Third) position to inter vivos general powers of withdrawal in §505(b)(1) (presumably that would also apply to inter vivos general powers of appointment); it does not address property subject to a testamentary general power of appointment, but refers to the Restatement Second position—suggesting that creditors could not reach property subject to an unexercised testamentary general power of appointment.

Section 502 of the Act provides that creditors of the holder of a general power may reach the assets subject to the power to the extent the powerholder's property (if the power is presently exercisable) or the powerholder's estate is insufficient. (This wording [and the Comment to §502] suggests that the creditors of a person who holds a *testamentary* general power of appointment would not be able to reach the trust assets until after the powerholder dies.) The Comment to §502 clarifies that

the rationale of this position is that a presently exercisable general power of appointment is equivalent to ownership. Whether the powerholder has or has not exercised the power is not relevant to this issue. **This is the biggest change from traditional law principles under the Act, and this is the provision that states are most likely to consider changing. As discussed above, traditionally the creditors of a powerholder with a testamentary general power could not reach the property unless the powerholder exercised the power, but the uniform act changes that result to allow the creditors of the powerholder to reach the assets and some states may want to change that result.** There is an exception in the Act for property subject to Crummey withdrawal rights in §503; upon the lapse, release, or waiver of a withdrawal power, it is treated as a presently exercisable general power only to the extent that it exceeds the annual exclusion amount.

Creditors of a powerholder of a *nongeneral* power of appointment generally cannot reach the assets subject to the power. §504 of the Act.

A possible solution to keep from making assets subject to a general power of appointment available to the powerholder's creditors is to require the consent of a third person (who would need to be a nonadverse party in order for the power of appointment to cause estate inclusion under §2041). *See* Bove, *Using the Power of Appointment to Protect Assets—More Power Than You Ever Imagined*, 36 ACTEC L.J. 333, 337-38 (Fall 2010).

Greg Gadarian (Tucson, Arizona) suggests a very interesting planning strategy that exists for lapsed withdrawal powers in two states (Arizona and Michigan) that treat the lapsed powerholder as not being the settlor of the trust for creditor purposes. *See* ARIZ. REV. STAT. §14-10505(B). A number of states have similar provisions that limit creditors' access to assets over which a power of withdrawal has lapsed to amounts described in §§2041(b)(2), 2514(e), or 2503(b), but Arizona and Michigan apply this protection to the entire amount of the lapsed withdrawal. For example, the trust might give a Trust Protector the authority to grant a withdrawal power over the entire trust assets to a beneficiary; the withdrawal power would lapse 30 days after it is granted. The assets would be included in the powerholder's gross estate (to the extent the lapsed power exceeds the "5 or 5" amount in §2041(b)(2)), and the powerholder would (according to various IRS letter rulings) be treated as the owner of the trust for income tax purposes under §678, but the entire trust would continue to have spendthrift protection. This could be used to cause estate inclusion for a surviving spouse to allow a basis adjustment at his or her death and to cause the trust to be a grantor trust as to the surviving spouse, all without subjecting the trust assets to the spouse's creditors following the lapse of the withdrawal power.

The *possibility* that creditors of the powerholder of a general power of appointment can reach the appointment assets (in light of the uncertainty of the development of state law regarding this issue) is an important factor that planners should consider before creating general powers of appointment. Even if an individual has no creditor concerns, the individual is just one auto accident away from a financial disaster.

11. Transfer Planning Strategies Considering Both Income and Estate Tax Savings

a. **Danger of Giving Highly Appreciated Property**. The estate tax savings that result from excluding future appreciation in the donor's gross estate are offset by the loss of a basis step up. Appreciated property with a zero basis would have to appreciate to about 247% of its date of gift value before the estate tax savings (at a 40% rate) on the appreciation that is removed from the estate would start to outweigh the capital gains cost (at a 28% rate) of not getting a stepped up basis at the donor's death (if the donor had kept the property) when the property is ultimately sold. See Item 3.j above.

To determine the growth rate required to overcome the loss of the basis adjustment at death, one planner suggests the following formula:

(Capital Gain Rate x (Gift Value - Basis]) + (Gift Tax Rate x [Gift Value – Remaining Gift Tax Exemption]) – (Estate Tax Rate x [Gift Value – Estate Tax Exemption at Death])

Value of Gift x (Estate Tax Rate – Capital Gains Rate)

Formula by Kelly Hellmuth (McGuire Woods) as reported by Stacy Eastland (Houston, Texas).

There may be various reasons why the loss of basis step-up is not particularly important. Investment considerations for many individuals may suggest the wisdom of selling particular assets classes and investing in other classes to maintain a diversified portfolio—meaning that the low basis assets will likely be sold in any event during the donor's lifetime. On the opposite end of the planning spectrum, the assets may be family assets that will likely be held in the family long after the grantor's death with an anticipated long delay in any capital gains income tax cost. (Beware though: A client may be adamant that a particular asset will never be sold, but the heirs secretly cannot wait to sell it.) If the assets are held in the family until the death of the next generation, a basis step-up may be available at that time; in any event, the income tax cost upon selling the asset may be long in the future.

b. **Grantor Trusts.** "The grantor trust is the leveraged plan of choice, leaving substantial flexibility." There are three significant advantages of using grantor trusts.

- *Income Tax Payments.* The grantor pays the income taxes attributable to the trust income so the trust assets can grow faster (and the tax payments further deplete the grantor's assets that would otherwise be subject to estate taxes).
- *Grantor Sales to Trust*. The grantor can sell assets to the trust without causing realization of income. Rev. Rul. 85-13. There should be no gain realization even if the note is not paid by the time of the grantor's death (although there is some uncertainty about this matter). See Item 9.k above.
- *Flexibility for Repurchases*. There is substantial flexibility in the planning, because the grantor can repurchase low-basis assets from the grantor trust. The grantor could purchase the assets by exercising a swap power or, if there is no swap power, by a negotiated sale. The purchase could be made with a high interest rate note from the grantor to achieve more wealth transfer. The best approach would be to pay off the note before the grantor's death because the trust may have a low (or zero) basis in that note. The grantor may need to borrow funds from a third party lender to be able to pay off the note

to the grantor trust. This could be prearranged so that the borrowing and payment could be accomplished very quickly if the grantor determines that death is imminent. If the grantor's estate does not have sufficient cash to repay the third party lender (and does not want to sell the assets that the grantor purchased from the trust), the grantor trust could purchase the receivable from the bank so that the grantor's estate would owe the payment to the trust (which it might satisfy with the asset that received a basis adjustment at the grantor's death).

Another way of using grantor trusts is for a trust beneficiary to sell S corporation stock to a trust for which the QSST election trust beneficiary. *See* Item 11.e.(3) below. Alternatively, to avoid having a high amount of unrealized appreciation, for which there is no basis step-up at the grantor's death because the trust assets are not owned by the grantor, consider adjusting the asset allocation of the trust. Some passive equity investments have more current income and less unrealized appreciation than others.

c. **Strategies to Save Exemption to Preserve Exemption for Basis Step-Up; Leveraged GRAT**. Various strategies can transfer wealth without using gift exemption, or by leveraging the gift exemption. This approach can leave the client with estate exemption at death, so that low basis assets could be owned until death to receive a basis step-up. These strategies include GRATs and cascading sales to grantor trusts. Using defined value clauses can assist in minimizing the use of gift exemption.

A leveraged GRAT can be quite efficient. 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 an FLP with financial/private equity assets.

(1) The client might contribute 10% of the LP units to a wholly owned 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 10% LP units.

(3) The capital interest in the LLC (having a net value, without considering 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-to-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 (or other financial/private equity assets) 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-to-1 ratio). Transferring both the carry and investment interests avoids the application of §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).

d. **Using Parent's Exemptions.** Many wealthy clients are self-made and have modest-wealth clients who they support. The client may give/sell assets to a grantor trust for the modest-wealth parent who will have a testamentary general power of appointment in the trust. At the parent's death, the inclusion of the assets in his or her estate may generate no estate taxes but the assets would receive a basis adjustment and the parent could allocate his or her GST exemption to the assets. See Item 7.c above.

e. **Post-Mortem Strategies That Lower the Net Income and Transfer Tax**.

(1) *Charitable Lead Trust.* A typical testamentary charitable lead annuity trust (CLAT) provides for annuity payments to charity over a 20-year term, with the remainder passing to family members. The annuity amount is set so that the remainder interest has a very low actuarial value, so there is an estate tax charitable deduction for almost the full amount passing to the CLAT. The math works much like GRATs—if the assets have combined income/appreciation above the §7520 rate, the excess will pass to family member at the termination of the 20-year CLAT. Planners like CLATs; the math works. Clients do not like them because family members do not want to wait 20 years to receive benefits

(the "Prince Charles Syndrome"). One way of avoiding this concern and to maximize the efficiency of the CLAT is to fund the testamentary CLAT with a partnership interest, and have the partnership redeem the CLAT's partnership interest during the estate administration in a manner that meets the "estate administration" exception from the self-dealing rule as described in the regulations to §4941. Reg. §53.4941(d)-1(b)(3); *see* PLRs 200207029, 200124029. Requirements include that (i) the personal representative for the estate (or trustee of a revocable trust) has the power to sell, (ii) the transaction is approved by the court having jurisdiction over the estate or revocable trust, (iii) the sale occurs before the estate is terminated, (iv) the estate receives an amount that equals or exceeds the fair market value of the foundation's interest in the property at the time of the sale, and (v) the transaction either (a) results in the estate receiving an interest as liquid as the one it gave up, or (b) is required under the terms of any option that is binding on the estate or trust. The partnership CLAT assets in return for a 20-year interest-only balloon note, with an interest rate much higher than the §7520 rate so that it is high enough to be able to make the annual charitable annuity payments. *See* Daniels & Leibell, *Planning for the Closely Held Business Owner: The Charitable Options*, 40TH ANN. HECKERLING INST. ON EST. PLANNING, ch. 12 (2006).

(2) *Simulated Credit Shelter Trust Using Portability.* The surviving spouse could fund an LLC (wholly owned by the spouse so it is a disregarded entity). The spouse could give interests in the LLC to a trust (structured to be a grantor trust as to the spouse) to utilize the DSUE amount received from the decedent. (The spouse generally cannot be a beneficiary of this trust - unless the planner and spouse are willing to rely on the laws of a DAPT state apply to keep the trust assets from being subject to the claims of the spouse's creditors.) The spouse could then sell the remaining LLC units to the trust in return for a note. The note payments could provide assets for the spouse's support. The tax-free growth within the trust (because the grantor pays the income taxes) drives substantial tax efficiencies in the wealth transfer, and the grantor has substantial flexibility to later repurchase assets from the trust. (This general type of strategy is discussed at Item 5.i above.)

(3) *Credit Shelter Trust Invests in S Corporation and Surviving Spouse Sells Assets to S Corp.* Using a grantor trust by the surviving spouse to utilize the first decedent's spouse's exemption generally produces a better result than just using a credit shelter trust—because of the surviving spouse's payment of the trust's income taxes. If a credit shelter trust is used, there are several ways of simulating the advantage of using the grantor trust approach. One approach is to use an S corporation. The credit shelter trust created at the first spouse's death and the surviving spouse might contribute assets to an S corporation in return for voting and non-voting interests. The surviving spouse, as the sole beneficiary of the credit shelter trust, would make the QSST election for the trust, which causes the credit shelter trust to be treated as a grantor trust as to the spouse with respect to the S corporation stock in the trust. §1361(d)(1)(B); Reg. §1.1361-1(j)(8). (After making the QSST election, all of the credit shelter trust income would have to be distributed annually to the surviving spouse—but the S corporation does not have to distribute all of its income.) The surviving

spouse could sell much of his or her remaining non-voting stock in the S corporation to the credit shelter trust. That stock would have a high basis at that point, because the S corporation was funded with high basis assets received from the decedent's estate. This permits the benefits described above for grantor trusts to some degree—but the trust is only treated as a grantor trust with respect to the S stock and the spouse's purchases from the QSST are not treated as disregarded sales. In addition, there is a potential §2036 risk if the sales are not treated as bona fide sales for full and adequate consideration. For this reason, Ellen Harrison points out that it is preferable for any sales by the surviving spouse to be made to the surviving spouse's own grantor trust and not to a QSST.

(4) *Credit Shelter Trust Using Preferred Partnership to Simulate Advantage of Grantor Trust*. Another method of simulating the advantage of a surviving spouse's grantor trust if a credit shelter trust is used involves the use of a preferred partnership to shift more of the income tax burden to the surviving spouse. The credit shelter trust and a separate grantor trust created by the surviving spouse could form a preferred partnership creating qualified preferred interests under §2701. The preferred interests would generally be held by the grantor trust and the growth interests would be held by the bypass trust. The grantor would end up paying most of the income taxes attributable to the partnership interests because only income in excess of the preference amount each year will be taxable to the growth interest held by the credit shelter trust. All of the appreciation will pass free of transfer taxes at the surviving spouse's subsequent death in any event. (If the surviving spouse needs cash flow for living expenses, the spouse could retain some of the preferred interest.) If the cash flow is not sufficient to fund the preference, the spouse could sell some high basis assets to the partnership in return for an AFR interest-only note or the partnership could borrow cash from the spouse's grantor trust. If the spouse has no exemption to fund the grantor trust, the spouse could fund a GRAT with the preferred interest, and the excess of the preferred rate over the §7520 rate would cause assets to accumulate for creating a grantor trust at the termination of the GRAT.

If there is enough taxable income that significant income is allocated to the growth interest, and if the surviving spouse is the only current beneficiary of the credit shelter trust, a further strategy is for the credit shelter trust to contribute the growth interest to an S corporation and for the credit shelter trust to make the QSST election (similar to the transaction described in Item 11.3(3) above). The QSST would be treated as a grantor trust as to the surviving spouse under §678, and the surviving spouse would pay the income tax on the credit shelter trust income from the S corporation.

f. **Transfer Planning With Parent Retaining Cash Flow for Living Expenses**. Clients may be unwilling to engage in transfer planning because they need to keep all of the cash flow they have currently for living expenses. Planners explain that they cannot make a gift and retain the income from the gift asset or else §2036 will apply. The following strategy allows the parent to keep the current cash flow—which both provides living expense to the parent and shifts the income tax burden to the parent

rather than to family trusts to allow the trust to grow faster. Client and client's grantor trust contribute assets to a preferred partnership (or LLC). The client receives the preferred interest and the grantor trust receives the growth interest. (Perhaps the entity is initially a single member LLC owned entirely by the client [or perhaps it is an LP and the grantor trust only has a small interest], but the client later gives the growth interest to the grantor trust.) The preferred interest is structured to satisfy §2701. The preferred interest has a high coupon rate (perhaps 8-10%) that as a practical matter equals about all of the cash flow from the entity's assets. The client is able to make a transfer, shifting the growth interest to the grantor trust, while continuing to receive all of the cash flow from the assets.

g. **Planning Idea to Help Preserve Discount.** If a client is paying estate tax and wishes to minimize the likelihood of an IRS audit about discounts and if transfers have been made by only one spouse, consider having the grantor-spouse transfer enough assets to the other spouse so the grantor-spouse does not have to file an estate tax return. In that manner the grantor-spouse would not have to "check the box" that he or she made a transfer or sale of an interest in a partnership, limited liability company, or closely held corporation (Question 13e of Part 4 on the Form 706).

12. Planning Issues With QTIP Trusts

Planning for surviving spouses who are beneficiaries of substantial QTIP trusts is complicated. 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). Several possible strategies are discussed below.

a. **QTIP Investment in Assets With Discounted Values**. One possible alternative is for the QTIP trust to invest in assets that may result in discounted values, such as an investment in a limited partnership or LLC with standard transfer and management restrictions. In *Kite v. Commissioner*, T.C. Memo 2013-43, a QTIP trust invested assets in a limited partnership. The IRS did not argue that the investment of QTIP trust assets in the limited partnership (in return for discounted partnership interests) was 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.

Fiduciary Duty Issue. The strategy would involve the fiduciary issue of whether the fiduciary is breaching its duties to beneficiaries by investing assets in a manner that causes the assets to decrease in value. (Lou Mezzullo was an expert witness in a case in which a trustee of QTIP trust was sued for investing QTIP trust assets in an FLP.) This strategy may entail getting beneficiary consents, but consents should not be worded to reflect that the primary (or sole) reason is so that the QTIP assets can eventually pass to the beneficiaries with reduced estate taxes.

Section 2519 Issue. 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*

PLR 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.

Gift Issue. 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).

Similarly, do the remainder beneficiaries face possible gift issues for consenting to actions that have the effect of reducing the value of their interests in the trust as remaindermen?

Section 2036 Issue. Consider this example. Assume the spouse makes a gift of 1% of the income interest of a QTIP trust, retaining the other 99%. The spouse is deemed to make a gift of the entire remainder interest under §2519. At the spouse's subsequent death, 99% of the trust assets would be included in the spouse's estate under §2036(a)(1), and an adjustment will be made in the spouse's adjusted taxable gifts that are added to the estate tax calculation under §2001(b). Reg. §20.2044-1(e), Ex. 5. A possible planning approach would be for the spouse to sell the income interest, rather than making a gift of it, to avoid §2036(a)(1) inclusion. The spouse would continue to receive payments on that note (rather than a fluctuating income entitlement). That could result in freezing the value of the QTIP trust assets for transfer tax purposes. This was the fact situation in Letter Ruling 201024008, but a ruling on the §2036(a)(1) issue was not requested or given. (A *sale* of the income interest may result in the spouse having a zero basis in the income interest under §1001(e)(1) for purposes of determining how much gain is recognized on the sale transaction. Section 1001(e)(1) should not be triggered by a *gift* of some or all of the income interest.)

As discussed in Item 5.h in the discussion of "QTIPable Trust Approach Additional Flexibilities" above, a surviving spouse following a portability election might make a gift of a small portion of the income interest to make a deemed gift of the remainder under §2519 to make a gift utilizing DSUE amount received from the predeceased spouse. In that case, while the adjusted table gifts may roughly offset the §2036 inclusion (without regard to subsequent appreciation), the surviving spouse would be able to add to his or her applicable exclusion amount the DSUE amount that was applied in the gift transaction. Reg. §20.2010-3T(b).

b. **Strategy to Make Gift While Keeping Current Cash Flow Without Triggering §2036**. PLR 201426016 illustrates an ingenious strategy that allows a surviving spouse to keep all of the current cash flow from a QTIP while making a deemed gift of much of the QTIP without causing §2036 estate inclusion of all of the QTIP assets. Under the facts of the ruling, the taxpayer proposed that a single QTIP trust would be divided into three separate QTIP trusts: Trust 1-same terms as original; Trust 2-unitrust interest of between 3-5%; Trust 3-same terms as original. Presumably the plan was that the unitrust amount in Trust 2 would be determined so that the surviving spouse continued to receive all of the income (assuming the total income was less than 3-5% of the trust value). The trustees would obtain a court order terminating Trust 3, with provisions that the children would reimburse the spouse for any gift taxes payable as a result of the gift of Trust 3. The IRS ruled that the termination of Trust 3 would constitute a gift by the surviving spouse of the income interest and a deemed gift of the remainder interest in Trust 3 under §2519. The Trust 3 assets would no longer be included in the surviving spouse's gross estate under §2044. The IRS further ruled that the termination of Trust 3 would have no effect on the continued qualification of Trust 1 and 2 as QTIP trusts. The conversion of Trust 2 to a unitrust would not be a deemed disposition under §2519, would not cause the children to make a gift to the surviving spouse, and would not trigger gain or loss under *Cottage Savings*. The overall effect was that mother would make a gift of Trust 3, to remove that trust's assets from her gross estate, but would retain all of the income that she had originally been receiving from the entire single QTIP trust. (The division of the QTIP was needed to create the unitrust interest and to prevent the gift of any portion of the trust from being a deemed gift of the remainder interest in *all* of the trust—there was only a deemed gift of the remainder interest of Trust 3.)

13. IRS's Radar Screen

John Porter discussed trends of issues that taxpayers are seeing in IRS examinations and in court proceedings.

a. **Kitchen Sink Approach.** There is a growing trend of the IRS to add every conceivable argument in the Notice of Deficiency—even though the arguments may not have been addressed in the course of the examination. In addition, there is a growing trend of the IRS alleging penalties seemingly routinely. (As an example, the recently pending *Williams* case makes about all of the arguments against a family limited partnership that the IRS has raised over the last decade, but a stipulated decision was entered in that case on March 20, 2015 providing for a stipulated estate tax deficiency much less than the amount alleged by the IRS and not applying penalties. See Item 27 below. In *Woelbing*, the IRS is alleging that §2702 and 2036

apply to a note sale when it appears that the primary matter at issue is the valuation of property that was sold to a grantor trust. See Item 14 below.)

b. **Appeals.** The IRS announced in a memo to estate and gift tax employees on September 3, 2014 that at least 270 days must remain on the statute of limitations before Appeals will accept an estate tax case, and 365 days must remain on the statute for a case involving gift or fiduciary income taxes. Previously, the rule of thumb was that 6 months had to remain on the statute before appeals would accept the case. The IRS acknowledges that more Tax Court petitions will be filed. Many families will be unhappy with that result because they do not want the publicity of a public fight with the IRS. The Tax Court typically allows docketed cases to go back to Appeals, but many taxpayers will be aggravated with the additional time, expense, and publicity.

A substantive change is that Appeals will not be allowed to raise new issues. If issues are not properly developed before the case goes to Appeals, the Appeals officer will send the case back to examiners. Appeals does not want to be the entity reviewing documents for the first time—that is the function of examination. In the estate and gift tax context, this means particularly that if the taxpayer is securing a new appraisal, it should be presented at the exam level, not at Appeals.

c. **Installment Sales to Grantor Trusts**. The IRS is closely examining sale to grantor trust transactions, from both a gift and estate tax standpoint.

- *Gift tax*. The major *gift tax* issue is the value of the property that is sold. That IRS may also question the value of the note (see Item 13.f below). Alternatively, the IRS may argue that the note is valued at zero for gift tax purposes under §2702 (or perhaps under §2701) or because it is not a bona fide transaction.
- *Valuation-Step transaction*. A valuation issue that arises is the *Pierre* step-transaction argument. *Pierre v. Commissioner* (T.C. Memo 2010-106) required that interests given and sold on the same day had to be aggregated for valuation purposes (but in that case, aggregating the gifted and sold limited partnership interests only decreased the discount from 38% to 35%) The sale should be made some time after the "seed gift." How long? John suggests 30 days should suffice, but 60 days is better, and the next tax year is better yet.
- *Estate tax*. The IRS sometimes also makes an estate tax argument—that §2036 applies and the assets that were sold should be brought back into the estate rather than including the remaining value of the note in the estate. Traditionally, the IRS has not argued that §2036 applies to sales to grantor trusts (and many sale transactions have been through audits without the IRS making that argument). However, the IRS made the §2036 argument in the pending *Woelbing* case (see Item 14 below), a case in which there may have been concerns about the amount of equity in the trust to support the sale since several of the decedent's sons gave personal guarantees for 10% of the purchase price. John Porter reports that he tried another case in December

2013 (*Estate of Beyer v. Commissioner*) in which the IRS also made the §2036 argument; the IRS argued that all of the assets of a family limited

partnership are included in the estate under §2036 and it also argued that partnership interests that were sold to a grantor trust should also be brought back into the estate under §2036.

- *Step transaction issue regarding §2036*. The *Pierre* step transaction argument may come into play with the §2036 issue—if the IRS argues that the gift and sale should be treated as a single transaction so that the transfer for full consideration exception of §2036 could not possibly apply (though the IRS does not appear to have made that argument directly in any case.)
- *Planning regarding §2036*. To help in defending against a §2036 argument for sales to grantor trusts, John suggests (1) that the partnership distributions should not be made at the same time and in the same amounts as the note payments, and (2) separating the gift and sale so that the taxpayer can argue that the sale transaction is for full and adequate consideration so that the full consideration exception to §2036 applies. John predicts that the IRS will not prevail in its §2036 or §2702 arguments in *Woelbing*.

  Further planning ideas to avoid §2036 argument. Avoid the §2036 issue by having the grantor's spouse or another grantor trust loan funds to the trust that will purchase the assets from the grantor, so that note payments will not thereafter be made to the grantor/seller. *See Jo*nathan Blattmachr, *Protecting an Estate Tax Plan from Turner, Trombetta, Davidson, Woelbing, Etc.,* ANNUAL NOTRE DAME ESTATE PLANNING INST. (2014).

d. **Family Limited Partnerships and LLCs.** The most litigated issue is whet*her* assets contributed to *an FLP/LLC should be included in the estate under §2036 (without a discount reg*ARDING RESTRICTIONS APPLICABLE TO THE limited partnership interest). There have been about 37 reported cases. The IRS typically argues that assets should be included under §2036(a)(1) as a transfer to the FLP/LLC with an implied agreement of retained enjoyment. In a few cases, it has also made a §2036(a)(2) argument, that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the property contributed to the entity. The government wins about 2/3 of those cases. (In some of those cases, the FLP/LLC assets have been included in the estate under §2036 even though the decedent had transferred the partnership interests during life (*Harper, Korby*).)

   Bona Fide Sale for Full Consideration Defense. Almost every one of these cases that the taxpayer has won was based on the bona fide sale for full consideration exception to §2036. (The two exceptions are *Kelly* and *Mirowski,* which held there was no retained enjoyment under §2036(a)(1) as to gifts of limited partnership interests.) The key is whether there were "legitimate and significant nontax reasons" for using the entity. There is nothing wrong with having tax reasons for creating entities, but the test is whether there was "A" legitimate and significant nontax reason as well. John Porter summarizes factors that have been recognized in particular situations as constituting such a legitimate nontax reason.

- Centralized asset management (Stone, Kimbell, Mirowski, Black, Purdue [recent case discussed in Item 13.h below])
- Involving the next generation in management (Stone, Mirowski, Murphy)
- Protection from creditors/failed marriage (Kimbell, Black, Murphy, Shurtz)
- Preservation of investment philosophy (Schutt, Murphy, Miller)
- Avoiding fractionalization of assets (Church, Kimbell, Murphy)
- Avoiding imprudent expenditures by future generations (Murphy, Black)

Section 2036(a)(1) Implied Agreement of Retained Enjoyment. Courts have considered the following factors in determining that there was an implied agreement of retained enjoyment (as summarized by John Porter).

- Non pro-rata distributions (*Harper, Korby, Thompson*)
- Personal expenditure with partnership funds (*Strangi, Hurford, Rector*)
- Personal use assets in partnership (*Strangi*)
- Payment of estate tax and expense when assets were transferred to the FLP/LLC close to death (*Miller, Strangi, Erickson, Jorgenson, Bigelow*)
- Accurate books and records not kept (*Harper*)
- Insufficient assets outside of FLP/LLC for living expenses (*Thompson, Miller, Strangi, Rector*)

Section 2036(a)(2). The §2036(a)(2) issue impacts whether the client can serve as the general partner of an FLP or manager of an LLC. There are three relevant cases, two of which held that §2036(a)(2) applied, but in unique fact situations. Traditionally, planners have relied on the *Byrum* Supreme Court case for the proposition that investment powers are not subject to §2036(a)(2).

In *Strangi* (T.C. Memo 2003-145), the decedent owned 47% of the stock of an S corporation that was the 1% general partner. The court held that the decedent, in conjunction with others, could designate who could enjoy or possess the FLP property. However, the decedent was the 99% limited partner, so the court could reason that any fiduciary duties owed as GP were not significant because there was no one with an interest to enforce those duties.

In *Turner II* (T.C. Memo 2011-209), the court acknowledged that a transferor's retention of the right to manage transferred assets does not necessarily require inclusion under §2036(a)(2), citing *Byrum* and *Schutt v. Commissioner.* However, the court gives no further analysis whatsoever of limits imposed by *Byrum.* One of the reasons given by the court for applying §2036(a)(2) was that the decedent effectively was the sole general partner. In addition, the court mentioned three powers that the general partner had, two which were the sole and absolute discretion to make pro rata distributions of partnership income (in addition to distributions to pay Federal and State tax liabilities) and the power to amend the partnership agreement at any time without the consent of the limited partners.

Estate of Cohen v. Commissioner (79 T.C. 1015) involved a decedent who was co-trustee of a Massachusetts business trust. The co-trustees had broad management powers including whether to declare dividends. The court observed the *Byrum* Supreme Court's emphasis on the fiduciary obligations that the decedent owed in that case to shareholders and concluded that §2036(a)(2) did not apply because the trustees of the business trust did not have unlimited authority regarding distributions but had to act within a fair standard of conduct made in good faith in the exercise of a bona fide business judgment. The court stated that if the trustees had unlimited discretion, "so that dividends could be arbitrarily and capriciously withheld or declared, then the dividend power would constitute a 'right' under section 2036(a)(2); if, on the other hand, the power is circumscribed by cognizable limits on the exercise of discretion, then no such 'right' exists."

If a client wants to serve as the GP of an FLP or manager of an LLC, John thinks that §2036(a)(2) could be avoided if a business judgment ascertainable standard is imposed on distributions. He recommends in that case that the entity agreement should mandate that distributions be made in accordance with that standard (including the ability to maintain reserves as determined in the exercise of his or her fiduciary obligation and reasoned judgment to be necessary for future investments and expenses).

Other Issues--§2703 and Indirect Gift. Other issues that the IRS sometimes raise in audits regarding FLP/LLCs are (1) whether specific restrictions in partnership agreements should be ignored for tax purposes under §2703 (*Holman* and *Fisher II*)

and (2) whether contributions to an FLP/LLC immediately followed by gifts or interests in the entity should be treated as indirect gifts of the underlying assets of the entity (*Holman, Gross, Linton,* and *Heckerman*).

Chart of FLP/LLC Discounts. John Porter has prepared a helpful chart summarizing the discounts that have been recognized in cases involving FLP or LLC interests. The chart is attached as Appendix A.

In addition to the FLP/LLC cases listed in that chart, the recent *Estate of Richmond* case (T.C. Memo 2014-26) addressed discounts for the decedent's 23.44% interest in a C corporation investment holding company. It allowed a 7.75% lack of control discount, a 32.1% lack of marketability discount, and a built-in gains discount of about 43.16% of the tax liability if all of the assets in the corporation had been sold immediately at the date of the decedent's death. See Item 24.a for a brief summary of *Richmond.*

e. **Formula Transfers With Defined Value Clauses**

(1) *Types of Defined Value Formula Approaches.* John Porter reports that he has had a lot of success over the last few years in upholding transfers made under defined value formulas. There are five basic types of these clauses:

- Formula allocation clause, allocating portions of a transferred asset between taxable and non-taxable transfers based on the subsequent agreement of the parties (*McCord, Hendrix*)

- Formula allocation clause, allocating portions of a transferred asset between taxable and non-taxable transfers based on values as finally determined for federal gift tax purposes (*Christiansen, Petter*)
- Clause defining the amount transferred based on values as finally determined for federal gift tax purposes (*Wandry*)
- Price adjustment clause (*King;* but *McLendon* and *Harwood* did not recognize price adjustment clauses)
- Reversions to donor of excess over a specified value (*Procter*)—this condition subsequent approach does NOT work. The clause in *Procter* provided that any amount transferred that was deemed to be subject to a gift tax was returned to the donor. It trifles with the judicial system, because any attempt to challenge the gift or raise gift tax defeats the gift. The *Procter* doctrine does not invalidate all formula transfers. Since the 1944 *Procter* case, many other types of formula clauses have been blessed by the IRS and the courts (marital deduction clauses, GST formula allocations, split interest charitable trust clauses, GRATs, formula disclaimers, etc.).

(2) *2015-2016 Treasury Priority Guidance Plan Project*. The 2015-2016 Priority Guidance Plan (sometimes referred to as the IRS's "Business Plan") adds the following item: "Guidance on the gift tax effect of defined value formula clauses under §2612 and 2511." See Item 2.a. above. Apparently, the IRS is adding a regulations project to address defined value formula clauses.

(3) *Recent Discussion of Procter in Belk*. *Procter* was recently discussed by the Fourth Circuit (the same circuit that decided *Procter)* in *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. December 16, 2014). *Belk* was not a valuation case but involved a violation of one of the substantive requirements to obtain a conservation easement. The contribution agreement allowed substituting other land as long as that did not harm the conservation purpose. The IRS contended that violated one of the requirements for a conservation easement, that there be a restriction in perpetuity on specific real property. The contribution agreement included a "savings clause" providing that the charity (a land trust)

> shall have no right or power to agree to any amendments … that would result in this Conservation Easement failing to qualify … as a qualified conservation contribution under Section 170(h) of the Internal Revenue Code and applicable regulations.

The taxpayer argued that even if the substitution provision causes the contribution not to satisfy the statutory requirements for a deductible easement, "the savings clause nonetheless renders the Easement eligible for a deduction." The taxpayer acknowledged that the courts have rejected "condition subsequent" savings clauses that alter a gift following an adverse determination by the IRS or a court, but tried to distinguish *Procter* (without arguing that it was incorrectly decided), arguing that the substitution clause was not a "condition subsequent savings clause" but was merely an interpretive clause to make clear there could be no amendment inconsistent with the overriding conservation

intention of the parties. The court disagreed with the attempt to apply this clause as a broad savings clause in this fashion:

> [In *Procter*] [w]e explained that the taxpayer's attempt to avoid tax, by providing the gift "shall be void" as to property later held "subject to the tax," was "clearly a condition subsequent," and involved the "sort of trifling with the judicial process [that] cannot be sustained." Id.
>
> So it is here. The Belks' Easement, by its terms, conveys an interest in real property to the Trust. The savings clause attempts to alter that interest in the future if the Easement should "fail[] to qualify as a ... qualified conservation contribution under Section 170(h)."
>
> …
>
> If the Belks' "overriding intent[]" had been, as they suggest, merely for the Easement to qualify for a tax deduction under § 170(h), they would not have included a provision so clearly at odds with the language of § 170(h)(2)(C). In fact, the Easement reflects the Belks' "overriding intent[]" to create an easement that permitted substitution of the parcel -- in violation of 170(h)(2)(C) -- and to jettison the substitution provision only if it subsequently caused the donation to "fail[] to qualify ... as a qualified conservation contribution under Section 170(h)." Thus, the Belks ask us to employ their savings clause not to "aid in determining [their] intent," Rev. Rul. 75-440, but to rewrite their Easement in response to our holding. This we will not do.
>
> Indeed, we note that were we to apply the savings clause as the Belks suggest, we would be providing an opinion sanctioning the very same "trifling with the judicial process" we condemned in *Procter*. 142 F.2d at 827. Moreover, providing such an opinion would dramatically hamper the Commissioner's enforcement power. If every taxpayer could rely on a savings clause to void, after the fact, a disqualifying deduction (or credit), enforcement of the Internal Revenue Code would grind to a halt.

While *Belk* is not relevant to valuation formulas and does not address the continuing validity of *Procter*, its discussion is interesting in the context of savings clauses generally. Ron Aucutt draws the following conclusions from *Belk:*

> [T]he issue in Belk was a substantive requirement of the conservation easement statute, not valuation….But meanwhile, Belk provides an occasion to reflect on the "savings clauses" that are routinely used in estate planning documents (and all kinds of other documents) apart from a valuation context. While each case will bring its own facts and attract its own analysis, Belk suggests that such clauses that are intended to protect against inadvertent or incidental violations of applicable requirements are fine. But they would not save a trust, for example, from such a violation that is part of the core structure of the trust. For example, the Belks' ability to shift their conservation easement from property to property appeared to be such a core element of their conservation easement arrangement – and such a flagrant violation of the "perpetuity" requirement of section 170(h)(2)(C) – that the savings clause could not save it.

Aucutt, *Recent Developments – 2014,* 49th ANNUAL HECKERLING INST. ON EST. PL. (2015).

(4) *Structuring Allocation Clauses*. Formula allocation clauses are supported by more judicial authority if the portion passing as a non-taxable transfer passes to charity. John's preferred defined value approach is using a formula allocation approach with the "excess" value passing to a public charity-donor advised fund. The public charity directors have independent fiduciary obligations, and the charity is subject to private inurement and excess benefit rules. (Private foundations create complex self dealing and excess business holdings issues.) Other possible "pour-over" non-taxable recipients could include QTIP trusts or

GRATs. If a public charity is not used, John thinks the IRS argument is weakest if the GRAT is used, because the §2702 regulations support using an approach of defining the annuity amount based on the value contributed. (The IRS may argue that a GRAT results in assets passing back to the donor and invokes *Procter*.) If a QTIP trust or GRAT is used for the non-taxable portion of the transfer, John prefers that there be different trustees and somewhat different beneficial interests than the trust that receives the taxable portion of the transfer.

(5) *Compliance Best Practices.* The IRS will "nibble around the edges" of these clauses and try to find pitfalls to show that the clauses were not respected. If a clause is used that is based on values as finally determined for federal gift tax purposes, a federal gift tax return must be filed reporting the formula transfer, or else there will never be a final determination of the gift tax value. The transaction should be reported on the gift tax return consistent with the formula transfer, providing that all that was transferred is the amount determined by the formula, but the units are initially allocated based on values as reflected in an attached appraisal.

(6) *Wandry Clauses.* John has negotiated several favorable settlements with *Wandry* type clauses. He has a case under examination currently with a *Wandry*-type clause that is going to Appeals.

There were likely a number of *Wandry* transfers made in late 2012. Gift tax returns for many of them were likely filed in the late summer-early fall of 2013, and gift tax audits are beginning to emerge regarding those transfers.

Some commentators suggest that the issue more important than whether the *Wandry* clause is respected to determine the *amount* that is transferred, is whether the gift tax audit/case causes a final determination of the *extent* of property transferred. They suggest that there is a risk that years after the gift tax audit, the IRS might contend that the gift tax audit/case merely determines a gift tax deficiency and does not preclude the IRS from later claiming that the donor/seller continued to be the owner of a larger fraction of the property. *See* Austin Bramwell & Brad Dillon, *Not Another* Wandry *Article: Real Issue With* Wandry *Formulas*, 41 EST. PLANNING (May 2014).

The IRS informally has indicated that it has not given up on its opposition to *Wandry*-type clauses and is still looking for "the right case."

For a detailed discussion of *Wandry* and planning considerations in using defined value clauses, see Item 27 of the Hot Topics and Current Developments Summary (December 2013) found **here** and Item 12 of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

(7) *Sample Price Adjustment Clause*. Ron Aucutt offers the following for consideration as a possible sample price adjustment clause:

> The face amount of the Note shall be the fair market value of the Interest on <Date> as determined by an appraisal by <Appraiser>. To the extent it is finally determined for federal gift tax purposes that the fair market value of the Interest on <Date> exceeds the fair market value determined by <Appraiser>, the face amount of the note shall be increased by an amount equal to 99.9997 percent of that excess, rounded down to the nearest whole dollar.

Ronald Aucutt, *Sales to Grantor Trusts (Best Practices in Light of Concerns Raised by Woelbing and Trombetta Cases)* (January 30, 2015). Ron observes that the clause will result in at least a minimal taxable gift if there is an adjustment.

(8) *Sample Defined Transfer Clause.* Ron Aucutt offers the following for consideration as a possible defined value clause that merely defines the amount of an interest that is transferred:

> I transfer that number of units in <Entity> that has a fair market value on the date of the transfer, as finally determined for federal gift tax purposes, of $<Appraised Value> plus 0.0003 percent of the amount, if any, rounded up to the nearest whole dollar, by which the fair market value of <Target Number> units in <Entity> on the date of the transfer, as finally determined for federal gift tax purposes, exceeds $<Appraised Value>.

Ronald Aucutt, *Sales to Grantor Trusts (Best Practices in Light of Concerns Raised by Woelbing and Trombetta Cases)* (January 30, 2015). (Ron is not suggesting any assurance that these clauses will be recognized by the IRS or the courts, or even recommending that they be used, but he merely offers them for consideration by planners who are considering using a price adjustment approach or a defined value transfer approach.)

f. **Challenges of Promissory Notes.** The IRS challenges the value of promissory notes, either arguing that the AFR is not a sufficient interest rate, or that the collateral is not sufficient and there are collectability problems. The taxpayer response is that §7872, the *Frazee* case, and the *True* case support using the AFR, and John said the note valuation issue generally falls out at Appeals. (The IRS contested the valuation of a note in a Tax Court case, *Estate of Williams*, but a stipulated decision was entered on March 19, 2015 providing an estate tax deficiency much less than that requested by the IRS, as discussed in Item 27 below.)

Another argument made in some audits is that the note transaction is not a bona fide loan but is a gift. Cases list a variety of factors that are considered in determining whether debt is legitimate or not (in a variety of different contexts beyond just gift issues), but the fundamental issue is whether there was a reasonable expectation of repayment.

The IRS sometimes challenges note refinancings (to lower interest rates). John thinks the IRS position is very weak; notes are often renegotiated in commercial transactions. John has resolved several of these cases, and he has one case at Appeals currently regarding a note refinancing. **Clearly document any refinancing of an existing note to a lower interest rate. Recite the prepayment clause, that the debtor is willing to prepay, that the lender is willing to exchange a new note for the prior note, and recite the revised terms.**

The 2015-2016 Priority Guidance Plan (sometimes referred to as the IRS's "Business Plan") adds the following item: "Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872." See Item 2.a. above. Apparently, the IRS is adding a regulations project to address promissory note valuation issues. Regulations currently address the valuation of notes (Treas. Reg. §§ 25.2512-4 and 25.2512-4); presumably focus of the new regulations will be to address the valuation impact of using the AFR as the interest rate.

g. **GRATs.** There is significant audit activity of GRATs, typically to confirm that the terms of the GRAT are being satisfied and that the annuity payments are being made properly and timely. If not, the IRS makes an argument under *Atkins v. Commissioner* that the GRAT should be disqualified ab initio.

On occasion, the examining agents scour the trust instrument to confirm that all of the requirements of the GRAT regulations are included in the instrument.

If there have been substitution transactions with the GRAT, the examining agent closely reviews the values of property involved in the exchange. If hard-to-value assets have been used to make annuity payments, the IRS reviews that proper valuations have been used. John suggests using a *Wandry* formula transfer of hard-to-value assets that are used to satisfy annuity payments.

h. **Recent Case Addressing Various "Radar Screen" Issues; *Estate of Purdue v. Commissioner*.** This recent Tax Court case addresses three of the issues "on the IRS radar" that frequently arise in estate tax audits. The decedent and her husband transferred marketable securities, an undivided interest in a building, and several other assets to an LLC in 2000. The decedent made annual gifts of LLC interests to a Crummey trust in 2002-2007. Following the decedent's death in 2007, some of the estate beneficiaries made a loan to the estate to pay the estate taxes and the estate deducted the interest payments as an administration expense for estate tax purposes.

Section 2036. The case is an excellent summary of principles announced in prior §2036 FLP/LLC cases. The court held that the assets in the LLC were not included in the decedent's estate under §2036 because the contribution to the LLC satisfied the bona fide sale for full consideration exception to §2036. The court focused on the management of the consolidated family assets as a legitimate and significant nontax reason for the LLC (and also noted that the parents were not financially dependent on distributions from the LLC, there was no commingling of LLC and personal assets, formalities were respected, and the parents were in good health at the time of the transfers to the LLC).

Annual Exclusion. Gifts of interests in the LLC were present interest gifts that qualified for the annual exclusion because the donees received income from the interests. The court reasoned that (1) the LLC generated income, (2) some of the income flowed steadily to the donees (they received almost $2 million from 2000 through 2008), and (3) the anticipated income could be estimated. (This is similar to the analysis in *Estate of Wimmer v. Commissioner*, T.C. Memo. 2012-157.)

Deductibility of Interest on Loan to Pay Estate Tax. Interest on the loan from the LLC to the estate to pay estate taxes was deductible as an administration expense for

estate tax purposes. The loan was bona fide and it was "necessary" because one of the decedent's daughters (who was a member of the LLC) refused to consent to a large distribution from the LLC to pay the decedent's estate taxes, and the operating agreement required the LLC members to act unanimously in making decisions. *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249 (December 28, 2015) (Judge Goeke).

14. Sale to Grantor Trust Transaction Under Attack, Estate of Donald Woelbing v. Commissioner and Estate of Marion Woelbing v. Commissioner

a. **Overview.** A very effective method of "freezing" an individual's estate for federal estate tax purposes is to convert the appreciating assets into a fixed-yield, non-appreciating asset through an installment sale to a family member. Selling the appreciating assets to a grantor trust avoids the recognition of income on the initial sales transaction and as interest and principal payments are made on the note (at least as to payments made during the grantor's lifetime). See Item 9.k above regarding income tax effects if the note is not paid during the grantor's life. The grantor's payment of the trust income taxes allows the trust to grow much faster (and depletes the grantor's estate that would otherwise be subject to estate tax). See Item 5.k above for a discussion of how incredibly successful these transactions can be in moving wealth in a GST exempt nature to the family.

The IRS and Treasury have expressed their discomfort with sale to grantor trust transactions by making dramatic legislative proposals in the 2013 and 2014 Administration's Revenue Proposals (narrowed in the 2014 Proposal to target sale to grantor trust transactions specifically), as described in Item 1.d above.

In order for the sale transaction to be effective for estate tax purposes, it is important that the note that is given to the seller is recognized as "debt" rather than "equity." If the seller transfers assets to a trust and retains a beneficial interest in those assets, as opposed to merely being recognized as a creditor of the trust, the assets transferred will be included in the seller's gross estate for estate tax purposes. Also, the IRS takes the position that if the sale is not recognized as a "bona fide transaction," the IRS may treat the sale transaction as a gift by the seller and afford little or no value to the note that the purchaser gives to the seller to offset the amount of the gift.

Estate and gift tax examiners on occasion have questioned whether sales for notes bearing interest at only the meager AFR should be recognized. (There are some indications that the *Karmazin* case [discussed below], which received a great deal of attention in 2003, initially arose because of the examiner's concern over use of the AFR as the interest rate on an intra-family sale transaction.)

b. **Woelbing Estates Cases.** The IRS is attacking sale to grantor trust transactions in two companion cases that were filed December 26, 2013 in the Tax Court. *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13. (These are pronounced "WELL-bing.")

In 2006, Mr. Woelbing sold all of his non-voting stock in Carma Laboratories (a closely-held company located in Wisconsin) to a trust (presumably a grantor trust) in

return for a promissory note having a face value of about $59 million, bearing interest at the AFR. The purchase price was determined by an independent appraiser. The sales agreement contained a defined value provision stating that shares having a value of $59,004,508.05 were being sold and that if the value of the stock is later determined by the Internal Revenue Service or a court to be different than the appraised value, the number of shares purchased shall automatically adjust so that the fair market value of the stock purchased equals the face value of the note.

The sale was made to an "Insurance Trust" that owned three life insurance policies on the lives of Mr. and Mrs. Woelbing. (The policies were subject to an "economic benefit regime" Split-Dollar Insurance Agreement, under which the trust was obligated to eventually repay Carma for its advances of premium payments.) Two Woelbing sons (who were beneficiaries of the trust) executed personal guarantees to the trust for 10% of the purchase price of the stock. The estate's position is that the trust-purchaser had substantial financial capability to repay the note even without considering the stock itself, and that this financial capability exceeded 10% of the face value of the promissory note. (It is not clear whether the 10% cushion included the personal guarantees or whether the trust's financial capabilities other than both the stock and the personal guarantees exceeded 10% of the note face amount.)

Mr. and Mrs. Woelbing filed gift tax returns for 2006, 2008 and 2009 making the split gift election; therefore, if the 2006 sale transaction had a gift element, the gift was treated as having been made one-half by each of the spouses for gift and GST tax purposes.

Mr. Woelbing died in July 2009 and Mrs. Woelbing died in September 2013 (interestingly, only two days after receiving the IRS's Notice of Deficiency for almost $32 million against Mrs. Woelbing for her gift tax). In the estate tax audit of Mr. Woelbing's estate, the gift tax returns for 2006 and several other years were also audited.

Gift Tax Issues. The IRS asserts that the note should be treated as having a zero value for gift tax purposes and is contesting the underlying value of the stock in 2006 (asserting a value in 2006 of $116.8 million compared to the $59 million purchase price). The IRS Notice of Deficiency asserts that for gift tax purposes, "Section 2702 requires inclusion of the entire value of nonvoting shares … as gifts when they were sold… in exchange for a note." Thus, the IRS position is that the note should be treated as having a zero value under §2702. (The §2702 argument seems to depend on the same general issue as the §2036 argument, discussed below—was the right to note payments a retained equity interest in the stock that was transferred or was it a separate debt obligation? That may depend on there being sufficient cushion in the purchasing trust to support the note as a separate debt obligation and not as necessarily being a retained interest in the transferred stock.) Alternatively, if §2702 does not apply, the Notice of Deficiency alleges that "the donor made a taxable gift equal to the difference between the fair market value of the Carma Laboratories, Inc. shares transferred to the … Trust, and the note received in exchange." (That wording raises the interesting issue of what shares of stock were transferred. Under the terms of the sales agreement, only that number of shares equal to the face amount of the note was transferred.)

Estate Tax Issues. For estate tax purposes, the IRS position is that the note should not be included as an asset of Mr. Woelbing's estate, but the stock that was sold should be included in the estate under both §§ 2036 and 2038 at its date of death value. The value of the stock, according to the IRS, had increased to $162.2 million at the time of Mr. Woelbing's death. Perhaps the IRS raised the §2068/2038 issue because of a lack of "cushion" in the trust prior to the purchase. Having sufficient net value in the trust to support the purchase and payment of the debt obligation seems to be a critical element in avoiding the application of §2036/2038. *See Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958) ("the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made"). Why did the guaranties not provide that "cushion"? It seems that guaranties *should* meet the *Fidelity-Philadelphia* test, but they did not help in *Trombetta v. Commissioner*, T.C. Memo. 2013-234 (strange facts case, including that grantor retained enjoyment over all the trust assets, not just retained periodic annuity payments).

Tax and Penalties Deficiency. The Notices of Deficiency for both estates in the aggregate allege gift and estate tax liabilities over $125 million and penalties over $25 million (asserting both gift and estate tax understatement 20% penalties). There were a few other relatively minor valuation issues involved for other properties in addition to the stock sale transaction.

Gift Tax Arguments Similar to Those in Karmazin and Dallas. In *Karmazin v. Commissioner,* the IRS made similar §2702 arguments in attacking a sale of FLP units to a grantor trust. T.C. Docket No. 2127-03, filed Feb. 10, 2003. The IRS argued that the note payments should be treated as an equity interest in the trust, that the obligation of the trust to make the payments did not constitute a guaranteed annuity under the GRAT exception in §2702, and that the note should be treated as having a zero value for gift purposes. In addition, the sales agreement in that case conveyed "that number of units having an appraised value of $x million." (The examiner also claimed that the FLP was a sham and should be ignored.) The *Karmazin* case was settled later in 2003 on terms very favorable to the taxpayer. Under the settlement, the transaction was not characterized as a transfer of units followed by the reservation of an annuity from the trust, the interest payments paid by the trust were characterized as interest and not as an annuity, neither §§2701 nor 2702 applied, the valuation discount was reduced from 42% to 37%, and the defined value clause in the sales agreement was not given effect.

Current Status; February 29, 2016 Trial Date. There were reports that these cases had settled in March, 2015 on the eve of the first trial setting; if so, apparently that settlement fell through (or they did not resolve everything quickly enough for the judge, and the judge re-set the case to put pressure on the parties to finalize the settlement). On September 29, 2015, the judge set a new trial date of February 29, 2016.

c. **Estate of Beyer.** John Porter reports that the IRS made a similar §2036 attack on a sale of limited partnership interests to grantor trusts. That case was tried in the Tax Court in December 2013 and is still awaiting decision. See Item 13.c above.

d. **Using AFR as Interest Rate for Notes in Intra-Family Sale Transactions**. IRS examiners sometimes question whether the AFR under §7872 is the appropriate interest rate for intra-family sale transactions. While §7872 does not clearly apply to sale transactions, there has been support for using the AFR as the interest rate. *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); PLRS 9535026 and 9535026. For a further discussion of these authorities, see Item 13.c of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

The valuation of promissory notes for transfer tax purposes is a new item on the Department of Treasury 2015-2016 Priority Guidance Plan, as discussed in Item 2.a above.

e. **Planning Implications.** *Highly Significant Issues for Court Consideration.* If the *Woelbing* cases do not settle but are resolved by the courts, very significant planning issues will be addressed. "[A]mong other things, if the case does not settle, the Tax Court might be obliged to address the effectiveness of the value adjustment clause, the substance of the notes, the appropriate interest rate and value for the notes, and the possible reliance on life insurance policies and/or guarantees to provide 'equity' in the trust to support the purchase." Ronald Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2015,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2371 (Jan. 4, 2016). "

Careful Planning Required. The *Woelbing* cases are a reminder that sale to grantor trust transactions require careful planning (and there was detailed planning in the sale transaction involved in that case). Planners should be aware (and advise clients) that the IRS is alleging in some cases that the note has a zero value and that the seller makes a gift of the entire value that is transferred. Whether the IRS will prevail is another question altogether, but sales transactions with grantor trusts are clearly sophisticated transactions requiring careful detailed planning considerations. Some planners are reluctant to utilize sales to grantor trusts until there is more authority regarding the §2036 issues, but many other planners are continuing to use sales to grantor trusts with explanations to clients as described above.

Bona Fide Transaction. The planner should pay particular consideration to taking steps to cause the transaction to be treated as a "bona fide transaction" so that the note will be respected as debt rather than being treated as a retained equity interest in the trust. (If the note is treated as an equity interest in the assets that are transferred, the IRS argues that §2702 applies for gift tax purposes and that §§2036 and 2038 apply for estate tax purposes because those Code sections all involve interests retained in the transferred property itself.) Cases have listed a variety of factors that are considered by courts in determining whether intra-family loan or notes transactions are respected. E.g., *Miller v. Commissioner*, T.C. Memo. 1996-3. (As an analogy, there are debt/equity principles that are applied under §385 in the context of shareholder loans.) There are no "safe harbor" regulations for intra-family sale transactions like there are for GRATs.

Defined Value Feature. The defined value feature of the sales agreement may become more common, especially following the *Wandry* case (T.C. Memo. 2012-88).

Two prior cases (*Petter* and *Hendrix*) have recognized sale transactions with a defined value element in which "excess value" over a stipulated amount passed to charity. The clause in *Woelbing* does not involve an excess amount passing to charity but, like the gift transaction in *Wandry* (though the 2006 transaction happened long before the *Wandry* case was decided in 2012), merely defines the amount transferred in terms of a specified value amount. *Woelbing* could be the first Tax Court case addressing the validity of a "*Wandry*-type" clause in sales transactions. (*King*, *McLendon*, and *Harwood* addressed the validity of "price adjustment" clauses in sales transactions.)

Danger of Gift Splitting With Potential §2036 Issue. This case illustrates the danger of making the gift splitting election when there is a possibility that §2036 (or one of the other "string" statutes) may apply to the transfer. If the IRS is successful in its position that §2036 applies to the sale (part gift, under the IRS's position) transaction, all of the transferred stock will be included in Mr. Woelbing's estate, and §2001(b)(last sentence) provides that the gift element in his transfer will not be included as an adjusted taxable gift in his estate. However, there is no such provision that will "undo" the taxable gift of one-half of the gift element by Mrs. Woelbing.

In effect, all of the transferred asset is included in Mr. Woelbing's estate (at its date of death value) and one-half of the date of gift value is treated as a gift by Mrs. Woelbing.

Ultimately Just a Valuation Case? Is this primarily just a valuation case? (The IRS contends that the value of the transferred units was $116.8 million compared to the $59 million purchase price). Time will tell whether the IRS settles (as it did in *Karmazin*) or drops the §§2702, 2036 and 2038 arguments (it dropped a §2702 argument before trial in *Dallas*). If the case proceeds as an attack on whether the note is disregarded for gift tax purposes under §2702 and whether the sold assets are included in the seller's estate under §§2036 and 2038, this case will break new ground and provide court guidance on the requirements for a valid sale to grantor trust transaction.

Using Lifetime QTIP Trusts to Minimize §2036 Risk. Richard Franklin (Washington D.C.) suggests that a client might make a gift to a lifetime QTIP trust (making the QTIP election). The QTIP could loan cash to a grantor trust that will purchase assets from the client. Section 2036 would seem not to apply, because the client has retained no note from the grantor trust and appears to have no retained interest whatsoever in the assets that are sold to the grantor trust. Richard points out that even if an attempt were made somehow to apply a step-transaction analysis, the donor is not treated as the donor of the QTIP trust for purposes of determining whether §§2036 or 2038 applies to the QTIP trust assets at the donor's death. See Reg. §25.2523(f)-1(f) Ex. 10-11 (QTIP trust assets not included in donor spouse's estate under §§2036 or 2038 even if donor had an interest in the trust after the donee spouse's death).

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

a. **Brief Background.** 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 upon the death of the holder. Planning with self-canceling installment notes (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 cancellation provision was part of the bargained for consideration for the purchase price of the stock.

Mortality Premium. 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. There is not universal agreement as to 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. 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.

Cases. There have been few cases addressing SCINs. 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. *Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003), *rev'g*, T.C. Memo. 2001-128 recognized that a SCIN should not be ignored (the IRS argued that the sale was not a bona fide transaction) for gift tax purposes reasoning that 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 income tax consequences of the cancellation of note payments were addressed in *Estate of Frane v. Commissioner.* The Tax Court agreed that gain should be recognized upon the death of the seller reportable by the seller on the seller's final return, not by the seller's estate. The Eighth Circuit changed the result, adopting the IRS's alternate position that the decedent's estate recognizes the deferred gain on its initial income tax return as an item of IRD. 998 F.2d 567 (8th Cir. 1993), *rev'g* 98 T.C. 341, 354 (1992). A strong 5-judge dissent in the Tax Court decision believed that no gain results to either the decedent or the decedent's estate, reasoning that there was no cancellation of any obligation because there was never any obligation to make any payments after the decedent's death under the terms of the agreement.

b. **Chief Counsel Advice 201330033.** The IRS Chief Counsel Office weighed in on the treatment of SCINs in Chief Counsel Advice 201330033. CCA 201330033 announces the IRS position that §7520 should not apply in valuing SCINs, but the valuation should be "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." For a more detailed discussion and analysis of CCA 201330033, see Item 39.f of the Hot Topics and Current Developments Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor**.

c. **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, including 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.

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 due in 5 years. The SCINs were secured by more Guardian shares than just the shares transferred in return for the SCINs. These transactions included sales of stock for hundreds of millions of dollars in two different SCIN transactions. One was for a sale to Grandchildren's Trusts on January 2, 2009 for SCINs with an 88% principal premium and principal payments not being payable until the end of the five-year term (thus putting *all* of the principal risk premium at the actuarial risk of Mr. Davidson's survival for five-years). The other was for a sale on January 21, 2009 to Children's Trusts for five-year "principal balloon" SCINs with an interest rate premium (13.43% over the §7520 rate). On that same day, Mr. Davidson gave the SCINs that he received from the Children's Trusts to a five-year SCIN-GRAT; at the end of the five-year GRAT term, if Mr. Davidson were still living, the balance of the SCIN-GRAT would be distributed to the Children's Trusts (the same trusts that owed the SCIN notes.),

Mortality Information. The mortality tables under §7520 indicate that Mr. Davidson's 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 estate and IRS disagreed over

the actual life expectancy of the decedent at the time of the sale transactions. 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.

Bona Fide Transaction Issue. 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.

Applicability of §7520 in Valuing SCINs. 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, 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 its 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." That is precisely the dispute that may be squarely before the court.

Settlement of Tax Case. The parties have settled in *Davidson.* A stipulated decision was entered on July 6, 2015. The total federal estate and GST tax stipulated deficiency with respect to the Form 706 was about $152 million, which is a small fraction of the amount of deficiency alleged in the Notice of Deficiency (over $2.6 billion). The SCIN sale transactions were in January 2009; the additional gift and GST tax deficiencies for 2009 were about $178 million. (This was compared to the combined gift and GST tax deficiency asserted by the IRS of almost $876 million. There were issues other than just whether §7520 applies to the calculation of the SCIN value (including the value of the underlying Guardian Industries closely-held stock).

Subsequent Malpractice Lawsuit. The Estate of William Davidson has sued Deloitte Tax LLP to recover $500 million in taxes, fees and penalties relating to the sale transaction. The complaint was filed in the New York Supreme Court in *Aaron v. Deloitte Tax LLP*, N.Y. Sup. Ct., No. 653203/2015 (filed September 24, 2015). The

complaint indicates that the estate paid an additional $457 million in taxes, penalties and interest in the settlement with the IRS, the Estate seeks to recover approximately $500 million. The complaint is quite interesting in that it describes in detail the arguments made by the IRS in the audit and settlement discussions, and describes in detail the reasons that each accounting firm and the law firm that handled the tax litigation (Skadden Arps, Slate, Meagher and Flom, in New York) recommended that the estate accept the settlement, highlighting the weaknesses in the estate's tax case with the IRS.

A "Preliminary Statement" at the beginning of the complaint summarizes generally the failures of the accounting firm, being

> the failure to: (i) disclose all material risks and information; (ii) provide reasonable and appropriate advice given the then-existing state of estate and tax planning knowledge; and (iii) design and implement a *bona fide* and defensible plan that could withstand the inevitable IRS scrutiny that would occur.

The preliminary statement summary also states that "Mr. Davidson would 'win if he lived, or win if he died'—a phrase that Deloitte Tax repeated often." The statement also summarizes detailed failures (suggesting that these were arguments that the IRS emphasized in rejecting the plan's effectiveness):

> Besides failing to disclose the many risks, Deloitte Tax created an Estate Plan replete with flawed structures and inherent defects. These errors were so profound and so numerous that they reflect reckless indifference and gross negligence. They include failures to:

- Design and implement bona fide economic transactions, conducted at arms' length – as opposed to purely tax driven transactions;
- Properly structure the SCIN transactions with appropriate capitalization, interest rates, and repayment terms;
- Use Mr. Davidson's actual anticipated life expectancy in creating the term for the SCINs, as opposed to the five (5) year term from mortality tables under Internal Revenue Code §7520 (the "§7520 mortality tables"), which could not be relied on, particularly in light of Mr. Davidson's poor health;
- Calculate the appropriate "risk premium" for the SCINs -- instead of improperly relying upon the §7520 mortality tables;
- Provide for the actual payment of at least a portion of the risk premium to Mr. Davidson during the term of the SCINs;
- Provide appropriate amortization for the repayment of the SCINs, as opposed to, among other things, the use of a "balloon payment" due at the end of the SCINs' five (5) year term -- which created the impression that there was no realistic expectation of repayment to Mr. Davidson;
- Fund the trusts that were obligors under the SCINs with sufficient assets in order to be able to repay the holders of the SCINs upon maturity of the SCINs;
- Create defensible and acceptable transactions, instead of creating circular, illusory arrangements by which certain obligors under the SCINs would in effect owe themselves, in the event that Mr. Davidson survived their five (5) year term; and
- Separate out the various transactions in a manner that gave independent significance to each transaction -- as opposed to effectuating all the various transactions within less than a month, and in some instances on the same day, making the Plan subject to challenge under the "step-transaction doctrine."

More Detailed Summary. For a more detailed discussion of the facts and legal issues in *Estate of Davidson* and planning implications for SCINs, see Item 39.g of the Hot Topics and Current Developments Summary (December 2013) found **here** and Item 14 of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

d. **Planning Implications for SCINs.**

- *Chill Effect.* Until there is some resolution of the IRS's position that §7520 does not apply in valuing SCINs, there is considerable uncertainty about SCIN transactions. At a minimum, the CCA and *Davidson* have placed a "chill" on SCIN transactions.
- *SCINs Will be Scrutinized If the Seller Dies "Early."* The CCA 201330033 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.

  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). Some commentators (supported by the Tax Court dissent in *Frane,* 98 T.C. 341 (1992)) maintain that the cancelled gain should not be recognized as income by anyone; the five-judge *Frane* dissent reasoned that there was never any obligation to make payments after the seller's death so no indebtedness was cancelled. 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).

16. Private Annuities—Renewed Interest In Private Annuities in Light of Uncertainties With SCINs

a. **Overview of Uses.**

(1) *Poor Health*. An individual who is in poor health (but not "terminally ill" under the government regulations) may sell assets in return for a private annuity. If the individual dies before his life expectancy, value is effectively removed from the individual's gross estate because he or she will not receive payments equal

to the value of what was transferred. In extreme cases, the individual may receive very few payments, resulting in a massive wealth shift.

(2) *Additional Risks With SCINs.* In dealing with clients with shortened life expectancy, SCINs have additional risks in light of the IRS's position that §7520 does not apply in valuing SCINs (see Item 15 above). Clients with shortened life expectancies may be more inclined to use private annuities than SCINs.

(3) *Desire for Cash Flow for Life.* A client may be unwilling to engage in transfer planning, for fear that the individual eventually will run out of money for living expenses. With proper planning, however, an individual can sell assets in return for a private annuity and be assured of receiving continued cash flow for life (assuming the buyer has the ability to make the payments for the seller's life) without having the transferred assets included in the individual's gross estate.

(4) *Cash Flow From Wealthy Child to Parent*. A wealthy child who wants to provide cash flow to a healthy parent with a modest estate for the parent's life could purchase illiquid assets from the parent for a private annuity. This may result in a substantial wealth shift to the parent without any taxable gifts by the wealthy child.

(5) *Favorable Transfer Tax Consequences.* The transfer is not a taxable gift (assuming the annuity is structured so that its value is the same as the value of the assets that are sold for the annuity). Estate tax advantages include that future appreciation is removed from the estate and if the client dies "early," the payments that are received will be far less than the value transferred (and the payments may be consumed for living expenses). The wealth shift can be accomplished in a GST exempt trust.

(6) *Possible Disadvantages.*

- If the annuitant outlives his or her actuarial life expectancy under the §7520 mortality tables, the amount paid may exceed (indeed, may *far* exceed) the value of the property transferred.
- Proposed regulations (effective retroactively to 2006 when they are finalized) require immediate realization of capital gain from the asset that is sold. In addition, some portion of the payments will be ordinary income with no offsetting interest deduction for the buyer. (For this reason, if substantially appreciated property is sold for an annuity, the transaction will probably be with a grantor trust to avoid the gain recognition and ordinary income recognition.) See paragraph c below.

  Biggest hurdles are (i) establishing that the seller is not "terminally ill" so that the government's mortality tables can be used, (ii) if an annuity is paid from a limited fund, it must be able to fund the payments to age 110, or else the present value of the annuity will be reduced, and (iii) defending against an IRS attack that §2036 applies to assets transferred to a trust in return for an annuity from the trust.

b. **Valuation of Annuity**. Section 7520 clearly applies to annuities, and the mortality tables under §7520 can be used unless the seller is terminally ill. A person who has "an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year." Reg. §25.7520-3(b)(3).

Exhaustion Test. If the annuity is payable from a trust or other limited fund, regulations stipulate that the standard annuity tables may be used only if the fund is sufficient to make the annuity payments if the annuitant lives to age 110. Reg. §1.7520-3(b)(2)(i). The value of the annuity is reduced if the limited fund cannot make the annuity payments to age 110 (assuming the assets grow at the §7520 rate).

c. **Income Tax Treatment.** Historically, if an annuity was unsecured, gain recognition on the sale was deferred over the seller's life expectancy. Each annuity payment has three possible components: (i) a recovery of capital element, (ii) a capital gain element, and (iii) the balance, which is an ordinary income element. The first two elements are pro rated over the seller's life expectancy (using mortality tables under §72, which assume longer life expectancies than the §7520 tables). After the seller reaches life expectancy all future payments will be entirely ordinary income. The buyer has no offsetting interest deduction for the ordinary income element of the payments.

Proposed regulations issued on October 18, 2006 provide that all of the gain will be recognized immediately. Under this approach, the first two elements described above of payments would be tax-free over the seller's life expectancy. The regulations are effective retroactive to Oct. 18, 2006 when (and if) they are finalized. Unless the asset being sold has little unrealized gain (or unless the seller has a large capital loss to offset any gain recognition), the proposed regulations **create a strong incentive for future private annuity transactions to be exchanges with grantor trusts.**

There are two big disadvantages from the buyer's perspective. (i) There is no interest deduction for the "deferred payment" element of the payments. (ii) Following the annuitant's death, the buyer's basis in the purchased assets is the total of all payments actually made (so if the annuitant dies "early" before many payments have been made, the buyer may have a very low basis in the purchased assets). As to the basis issue, the 2006 proposed regulations do not address the purchaser's basis or the effect of a premature death. The reasonable approach is that because the gain is recognized by the seller at the outset, the buyer in the private annuity sale transaction would acquire a basis in the purchased assets equal to the fair market value of the annuity obligation on the date of sale, regardless of when the annuitant dies.

Installment Sale vs. Annuity Treatment. Historically, the income tax treatment of annuities was favorable in many situations—because the gain was recognized over the seller's lifetime rather than just over the life of note payments, and the gain recognition was deferred over the seller's lifetime even if the buyer resold the purchased assets. However, following the 2006 proposed regulations, installment sale treatment may be better—gain would be recognized pro rata with each payment rather than being recognized all up front. A 1986 IRS General Counsel Memorandum,

GCM 39503, addressed how payments apply to payments with life-based contingencies such as payments until a specific monetary amount is reached or until the seller's death. It concluded that if the specific monetary amount will be received within the seller's life expectancy, it is taxed as an installment sale; if the specific monetary amount would not be received until after the seller's life expectancy, it is taxed as an annuity. **Treating the transaction as an installment sale for income tax purposes does not mean that the payments are still not treated as "annuities" for transfer tax (and valuation) purposes.**

d. **Section 2036 Risks**. A common IRS attack on private annuities with trusts is that §2036 applies to cause the transferred property to be included in the seller's gross estate. Most of the cases that have addressed the potential §2036 issue have involved transfers of property to trusts (a few have also addressed private annuities given by individuals), particularly if the trust consists of little more than the transferred property, if the annuity payments approximate the amount of anticipated trust income, if the purchaser did not have the ability to make annuity payments apart from the assets sold in the annuity transaction or to satisfy any deficiency in annuity payments, or if the formalities of an independent trust are not honored.

The Supreme Court, in a 1958 case, suggested in a footnote that §2036 can be avoided if (i) the obligation to make annuity payments is the buyer-obligor's personal obligation; (ii) the obligation to make annuity payments is not chargeable to the transferred property; and (iii) the size of the annuity payments is not dependent on the amount of income from the transferred property (i.e., the annuity payment amounts are not matched by the income from the property). *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958).

The most recent case to discuss §2036 in the context of a sale to a trust for a private is *Trombetta v. Commissioner*, T.C. Memo. 2013-234. The case involved a rather complicated fact situation (with some significant "bad facts"). The court concluded that the transaction was

> more akin to a transfer with a retained interest than to a sale in exchange for an annuity. Decedent continued to control the transferred properties.… The transferred properties were the only source for the funds for the periodic payments, and decedent intended that the periodic payments would be made from the annuity trust's income rather than the trust corpus.… The periodic payments simply were a "conduit" for payment to decedent of the income from the Tierra Plaza and Black Walnut Square properties.

An interesting aspect of *Trombetta* is its refusal to recognize *guaranties* as allowing the trust to satisfy the *Fidelity-Philadelphia* elements (described in the preceding paragraph). The court listed three reasons: (1) the guarantors never actually paid anything on the guaranties; (2) the guarantors were unlikely to be called upon to make payments because of "the structure of the annuity trust;" and (3) the guaranties only covered the annuity payments but under the unusual facts of this case Ms. Trombetta had an implied agreement of retained enjoyment over all of the trust assets, not just the periodic payments.

Even if §2036 applies, there is an argument that the amount included under §2036 should be offset by the value of the annuity at the time of the annuity sale. *See* §2043. If the taxpayer is successful in making that argument, the effect is that only

the post-transfer appreciation would be added to the estate under §2036, even if the annuitant dies long before his or her life expectancy.

Best practice strategies to avoid §2036 for private annuity transactions with trusts include the following.

- Transfer assets to a trust with substantial corpus to satisfy the annuity in addition to property transferred in the private annuity transaction.
- The prior transfer should occur clearly before the private annuity transaction.
- The sale transaction should be negotiated between the buyer (who owns property before the sale) and seller.
- The annuity should be payable from the entire corpus of the trust, not just the property transferred in the private annuity transaction.
- The annuity payment amounts should not be tied to the performance of the trust assets.
- The annuity amount should not be equal or be tied to the income generated by the trust property, to counter an implication that the transaction is just a transfer with a retained income interest.
- Do not permit the trust to make any distributions to the annuitant other than the annuity payments.
- The annuitant should not keep direct or indirect controls over the trust.
- All formalities should be followed, including property transfers, making timely annuity payments, and assuring proper tax reporting.
- If payments are not made timely, the annuitant should enforce its rights.
- Use guarantees to provide the "substantial cushion" only if essential, but if so, use individuals who have the ability to make annuity payments.

e. **Strategies For Dealing With Exhaustion Test.** Satisfying the exhaustion test for a private annuity transaction with a trust can require a substantially seeded trust. For example, for a private annuity sale by a 70-year old, the trust would need to have an amount over 125% of the value that would be sold to the trust for the annuity. If that test is not satisfied, the present value of the annuity may be reduced significantly. For example for a sale by a 70-year old individual with no other assets, the value of the annuity would be reduced by about 20%.

Planning strategies to minimize problems with the exhaustion test include, among others, (i) taking the position that the regulation is invalid, (ii) making the transfer to a pre-funded trust so that the existing trust assets plus the assets transferred in the private annuity transaction will be sufficient to satisfy the exhaustion test, (iii) using guarantees of the annuity by individual beneficiaries of the trust, or (iv) using an annuity with a maximum term. If an annuity with a maximum term that is slightly longer than the individual's actuarial life expectancy is used, the annuity amount is not increased significantly. For example, for a 70-year old, the annual annuity amount would be increased by about 12%. To satisfy the logic of the exhaustion test, the

trust fund would need to have assets sufficient to make the payments through the stated

term (rather than all the way to age 110). For example for a 70-year old, the pre-seed amount would need to be about 35% of the amount transferred for the private annuity (compared with the 125% pre-seed amount if the annuity is not limit to a maximum term).

f. **Deferred Annuities.** The annuity can be structured to begin only after some delayed period. The annual annuity amounts thereafter would be larger than if they had begun immediately in order for the annuity to have the same present value. The IRS may view a significantly deferred private annuity as abusive for an individual with some health concerns. For example, in *Kite v. Commissioner*, a 75-year old individual in deteriorating health who had enough health issues that she was having 24-hour medical care at home sold substantial assets in return for a 10-year deferred annuity. While she had a greater than 50% probability of living more than 1 year, she was unlikely to live 10 years (and indeed she died three years after the sale, long before receiving any payments). Even so, the court ruled that the §7520 mortality payments could be used because the individual met the "terminally ill" test laid out in the regulations (she had a greater than 50% probability of living at least one year). If IRS examiners are troubled by taxpayers' ability to "self-select" by deciding to use private annuities only in situations in which they are unlikely to live to their full life expectancies, one can only imagine their reaction to the "doubling down" aspect of providing that annuity payments would not even begin for a period of years. Deferred annuities would also have greater difficulty satisfying the exhaustion test.

g. **Best Practices for Private Annuity Transactions.**

- Consider private annuity transactions (or SCINs) generally only for individuals with shortened life expectancies (but with at least a 50% probability of living at least one year).
- Do not use private annuities (or SCINs) if the client has been diagnosed with a terminal illness.
- If the individual is merely in poor health but does not have a terminal illness, obtain a letter from one of more doctors saying that the physician has no knowledge that the person has less than a normal life expectancy, and in particular that the individual is expected to live at least one year.
- Sales for private annuities may also be helpful for individuals who want to "assure" a cash flow for life before being willing to engage in transfer planning strategies.
- Unless assuring a cash flow for life is an important factor, consider using a private annuity for the shorter of a fixed term of years (which term is longer than the individual's life expectancy under the appropriate mortality tables) or life. This guards against a "reverse" transfer if the individual outlives his or her life expectancy and also helps in satisfying the exhaustion test if the private annuity sale is with a trust.

- Use a grantor trust as the purchaser in the private annuity transaction. Otherwise, there will be immediate recognition of all capital gain, and a significant "phantom gain" to the family because the "interest" element of annuity payments is not treated as deductible interest.
- Section 2036 presents a significant risk in selling assets to a trust rather than to individuals who clearly have the ability to make the annuity payments from their other assets. Follow best practice strategies, as discussed in Item 16.d above, to minimize §2036 arguments.
- Take steps to avoid or satisfy the exhaustion test (which generally requires that the trust have sufficient assets to fund the annuity payments if the individual lives to age 110). Alternatives include (i) implementing the private annuity transaction with a pre-funded trust with sufficient assets to satisfy the exhaustion test (and for older individuals, this can required substantial pre-funding); (ii) using guarantees of the annuity by individual beneficiaries of the trust; or (iii) using a private annuity for the shorter of a term of years (that is longer than the individual's life expectancy under the appropriate tables) or the individual's life (which increases the annuity payments somewhat, but not substantially).
- Carefully follow all formalities. Clarify who is responsible for making sure that payments are made on time and for proper income and gift tax reporting. If any annuity payments are made in-kind, prepare appropriate valuations. Add calendar "ticklers" for the due dates of annuity payments. Monitor that payments are made timely from the proper payor to the proper payee. The failure to follow formalities has been an issue that some §2036 and "no bona fide debt" cases have mentioned.
- Consider using a deferred annuity or graduated annuity. However, each of these may heighten IRS scrutiny and may result in substantially larger annuity payments if the individual lives to his or her life expectancy (and may make meeting the exhaustion test much more difficult).
- Realize that there will be substantial IRS scrutiny (and skepticism) if the individual dies "early."

Considering using a "*Wandry*" provision in the sale agreement specifying that the seller is selling that number of shares equal to the value of the private annuity, as finally determined for federal gift tax purposes.

17. Resurrection of "De Facto Trustee" Concept—*Securities Exchange Commission v. Wyly*

a. **Summary**. Long ago, the IRS tried to make a "de facto trustee" argument, treating a settlor as holding the powers of the trustee if the settlor exercised persuasive control over the trustee. Courts (including a U.S. Supreme Court case) rejected that "de facto trustee" argument. *SEC v. Wyly* raises concerns for estate planning advisors by

treating settlors as the de facto trustee of a trust (albeit in an extreme fact situation in which the trustees always followed the settlors' directions for over a decade).

SEC v. Wyly, 2014 WL 4792229 (S.D.N.Y. September 25, 2014) (Judge Scheindlin), is the determination of the "disgorgement" remedy in a securities law violation case by the billionaire Wyly brothers. The court based the amount of disgorgement largely on the amount of federal income taxes that the defendants avoided from the use of offshore trusts, after finding that the trusts were grantor trusts and that the defendants should have paid federal income taxes on all of the income from those trusts. The court determined in particular that the "independent trustee" exception in §674(c) did not apply even though the trustees were various Isle of Man professional management companies. Three close associates of the Wylys (the family attorney, the family office CFO, and the CFO of one of the Wyly entities) were trust protectors who had the power to replace the trustees. Throughout the trust administration, the Wylys expressed their requests to the trust protectors, who relayed them to the trustees, who always complied.

The SEC (not the IRS—this is not a tax case) argued that independent trustees *always* followed the wishes of the grantors regarding investment decisions (including some very questionable investments with close relatives, unsecured loans to relatives, and investments in real estate, artwork, jewelry, collectibles, and furnishings used by family members). The court noted that the Tax Court had previously rejected this theory in *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1976-238, which held that whether the independent trustee exception under §674(c) applies turns on "a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee who is receptive to his wishes." (The Tax Court's rejection of the theory was grounded in the U.S. Supreme Court's decision in *U.S. v. Byrum,* an analogous determination that retained powers to cause gross estate inclusion under §2036(a)(2) must be "ascertainable and legally enforceable powers.") The court disagreed with that long-standing analysis, pointing to the substance over form doctrine, reasoning that the trustee always followed the grantors' directions, and observing that "tax law deals in economic realities, not legal abstractions."

For a more detailed discussion of the facts, analysis, and planning implications of SEC v. *Wyly,* See Item 30 of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

b. **Primary Issue and Basis Relevant Facts**. The Wylys claimed that they had no beneficial ownership or control over interests in companies that had been transferred to offshore trusts and were not required to disclose their activities regarding those interests. After a six-week trial in the spring of 2014, a jury found that the Wylys always had beneficial ownership over options, warrants, and securities that were held by the [offshore] trusts, and found the Wylys liable on all counts alleged by the SEC. The court in August held a one-week bench trial to determine appropriate remedies. The SEC sought disgorgement of about $620 million. The court discussed that it had very broad discretion to determine the measure of and amount of appropriate disgorgement and decided to base the disgorgement amount primarily on the amount of income taxes that the Wylys avoided improperly by the offshore trust

structure. This turned on whether the trusts were grantor trusts; if so, the Wylys should have been reporting the income from the trusts on their U.S. income tax returns.

The trustees of all of the trusts were professional management companies located in the Isle of Man. In addition, there were three trust protectors of each trust, the Wylys' family attorney, the family office CFO, and the CFO of a Wyly-related entity. The trust protectors had the power to add or substitute charitable beneficiaries of the trusts and had the power to remove and replace trustees of all of the trusts.

After the trusts were created, the Wylys told the trust protectors what transactions they wanted the trusts to enter, the trust protectors discussed those recommendations with the trustees, and the trustees always followed those directions. There was no evidence of a single investment that ever originated with the independent trustees or that the trustees ever rejected *any* Wyly recommendation. There were several situations in which the Wylys directed the sales of certain assets, bypassing the trustees entirely.

c. **Court Analysis**.

(1) *Substance Over Form.* The analysis as to whether the trusts were grantor trusts started with a review of the substance over form doctrine. As applied to trusts, the substance over form doctrine looks to, among other things, "whether the taxpayer's relationship to the transferred property differed materially before and after the trust's creation," and "whether the taxpayer respected restrictions imposed on the trust's operation as set forth in the trust documents or by the law of trusts." The court concluded that the substance over form doctrine applies to the grantor trust provisions:

> The substance over form doctrine is applicable to the entire body of federal tax law, including the grantor trust provisions. Thus, even when a trust is not a "sham" – that is, where it has legitimate economic substance – it may still be taxable as a grantor trust because it satisfies an exception within the grantor trust provisions only in form. [citations omitted]

(2) Grantor Trusts; §674 Analysis.

Section 674 Statutory Provisions. The general rule is that a trust is a grantor trust if the beneficial enjoyment is subject to a power of disposition exercisable by the grantor or a nonadverse party, without the approval of any adverse party. Therefore, the general rule is that most trusts are grantor trusts. There are various exceptions under §674(b)-(d).

Section 674(c) is the independent trustee exception. A trust is not a grantor trust if the power of disposition over the trust is "solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor."

The court reasons that the only open question regarding the application of the independent trustee exception under §674(c) is whether the independent trustees were able to exercise their powers "solely" or "without the approval or consent of any other person."

Rejection of De Facto Trustee Argument in Estate of Goodwyn v. Commissioner. The court acknowledged the 1976 case that rejected the IRS's "de facto trustee" argument—that the grantor in effect was the trustee in light of the actual operation of the trust. The court acknowledged the holding in Estate of Goodwyn v. Commissioner (T.C. Memo. 1976-238) that §674(c) refers to "an ascertainable and legally enforceable right, not merely the persuasive control which [the grantor] may exercise over an independent trustee who is receptive to his wishes." To this 38-year old doctrine, which planners have assumed to be well established, the court responds "I disagree."

Economic Realities Control. The court reasons that the economic realities are that the Isle of Man trustees were acting at the direction of the Wylys, so the independent trustee exception of §674(c) did not apply. The court reached this conclusion with strong language that conceivably could be extended broadly to other contexts:

> I disagree. "Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that 'tax law deals in economic realities, not legal abstractions.'" [citing *PPL Corp. v. C.I.R.*, 133 S.Ct. 1897, 1905 (2013) (quoting *CIR v. Southwest Exploration Co.*, 350 U.S. 308, 315 (1956))] As Professor Danforth, the defendants' own expert, writes in his treatise, "[i]t would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person." The Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wylys expected that the trustees would execute their every order, and that is exactly what the trustees did.
>
> The evidence amply shows that the IOM trustees followed every Wyly recommendation, whether it pertained to transactions in the Issuer securities; making unsecured loans to Wyly enterprises, or purchases of real estate, artwork, collectibles, and other personal items for the Wylys and their children. The trustees made no meaningful decisions about the trust income or corpus other than at the behest of the Wylys. On certain occasions, such as the establishment of the Bessie Trusts [with their nominal foreign grantors], the IOM trustees actively participated in fraudulent activity along with the Wylys. The Wylys freely directed the distribution of trust assets for personal purchases and personal use. Because the Wylys and their family members were beneficiaries, the IOM trustees were thus "distributing" income *for* a beneficiary at the direction of the grantors—the Wylys.

d. **Planning Observations.**

(1) *Significant Even Though Not a Tax Case*. This is not a tax case, but this decision by the federal district court (and by a very respected federal district court judge) would have reached the same conclusion if this had been a tax refund case arising from claims by the IRS rather than a case arising from SEC allegations. In light of this federal district court opinion, will the IRS be more inclined to raise the "de factor trustee" argument in the future—and beyond just the §674(c) grantor trust context?

(2) *Goodwyn and Byrum Broadly Relied on By Planners.* Planners for years have been comfortable naming close relatives of grantors or beneficiaries as trustees without fear that a court would later determine that the grantor or beneficiary should be treated as holding the powers of the trustee because of the close relationship, even if the grantor or beneficiary had a significant amount of persuasive influence with the trustee. This reliance has been grounded, in substantial part, on cases like *Goodwyn*¸ as well as the *Byrum* Supreme Court

case—cases that have looked to who held the "ascertainable and legally enforceable power."

The U.S. Supreme Court made this position clear in *United States v. Byrum ,* reasoning that gross estate inclusion under §2036(a)(2) requires that the settlor held "an ascertainable and legally enforceable power…. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to 'regulate the flow of dividends' to the trust. That 'right' was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term." 408 U.S. 125 (1972). *See also Estate of Goodwyn v. Commissioner*, T.C. Memo. 1973-153 (separate *Goodwyn* case relying on *Byrum* for its conclusion that settlor's actual administration of the trust did not result in the settlor being treated as holding the powers of the trustee to cause inclusion of trust assets in the settlor's gross estate under §2036(a)(2)).

(3) *Possible Extension of Wyly Analysis to Other Contexts.* The analysis in *Wyly* could be extended beyond just the independent exception to the grantor trust rules in §674(c). The analysis might conceivably be extended to treat the grantor (§§2036(a)(2) or 2038) or beneficiary (§2041) as being deemed to hold the powers of the trustee based on the individual's persuasive influence over the trustee. Planners have not worried about those concerns in the past in selecting trustees.

While the specific facts of *Wyly* involved settlors acting through trust protectors, the fact that trust protectors were involved is not central to the court's decision.

(4) *Persuasive Control of Being Able to Remove and Replace Trustees Does Not Cause the Person Holding the Removal Power to Hold the Trustee Powers.* In Revenue Ruling 95-58, 1995-2 C.B. 1 the IRS conceded that trustee removal powers would not cause the remover to be treated as holding the trustee powers as long as the remover had to appoint a successor who was not a related or subordinate party. (Various private letter rulings have extended the logic of Rev. Rul. 95-58 to concluded that removal powers by beneficiaries will not trigger estate inclusion in the beneficiary's estate under §2041 if the removed trustee must be replaced with an independent trustee. *E.g.,* Ltr. Rul. 201432005.)

This history regarding removal powers and the ultimate concession by the IRS in Rev. Rul. 95-58 is a further indication of the extent to which the courts and even the IRS stipulate that legally enforceable powers control, not the power to persuade (or brow beat) a trustee with the constant threat of removal hanging over the trustee's head.

(5) *Planning—Pay Attention to Actual Administration of Trusts*. Trustees should have a process for making investment and distribution decisions, and should *document* their reasons for decisions that they make. Seeking the input of the settlors or beneficiaries of a trust is not a problem (and indeed is often encouraged). The *Wyly* opinion noted the testimony of one of the defendants' attorneys that the trustees followed the settlors' recommendations "when it

came to the four securities that were in companies that the Wylys were more familiar with than anyone in the world." (Footnote 73). Even so, trustees should document their reasons for decisions on behalf of the trust—particularly distribution decisions. (Indeed, an occasional "no" to requests by the settlor or a beneficiary may help evidence the trustee's independence.) The *Wyly* court emphasized that the trustees *never* said no, but *always* followed the Wylys' directions.

(6) *Trust Protectors With Broad Grantor-Like Powers.* There is a growing trend toward naming trust protectors with very broad powers, including the broad ability to amend trusts, change beneficial interests, veto or direct distributions, modify powers of appointment, change trustees, or terminate the trust—all in the name of providing flexibility to address changing circumstances, particularly for long-term trusts. See Item 21 below. The *Wyly* case points out how that could backfire if a pattern of "string-pulling" by the settlor occurs in practice with respect to the exercise of those incredibly broad powers. Planners will not stop using trust protectors in the future in light of *Wyly* but should be aware of potential tax risks that can arise if the broad trust protector powers are abused by overbearing settlors.

18. Distribution Planning New Paradigms

a. **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). The top brackets are reached for estates and trusts at $12,300 in 2015 ($12,400 in 2016). 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 ($464,850 joint/$413,200 unmarried in 2015, adjusting in 2016 to $466,950 joint/$415,050 unmarried). In addition, distributions can save the 3.8% tax on net investment income if the beneficiary does not have AGI exceeding a $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.

In making decisions about the tax impact of distributions, keep in mind that if the trust is in a state that does not have a state income tax on the trust, making the distribution to a beneficiary who lives in a state with a state income tax may generate enough state income tax to the beneficiary to more than offset the federal income tax savings to the trust by making the distribution.

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.

b. **Capital Gains in DNI**. Capital gains ordinarily are excluded from DNI (so that capital gains are ordinarily taxed at the estate or trust level). Reg. §1.643(a)-3(a). However, the regulations provide that 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)—Capital Gains Allocated to Income.

Consider providing in the trust instrument that capital gains are allocated to income (but do not do this for mandatory income trusts—so that the capital gains would not necessarily have to be distributed annually).

- Consider providing in the trust instrument that the trustee has the *discretion* to allocate capital gains to income; **there is no consistency requirement in Reg. §1.643(a)-3(a)(1) regarding allocating capital gains to income,** so the trustee could exercise its discretion each year whether to allocate capital gains to income. *See* Reg. §1.643(b)-1 ("an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.").
- Distributions from flow-through entities are typically treated as fiduciary accounting income rather than principal unless the distribution is part of a liquidating distribution. Under UPAIA cash distributions from a flow-through entity with capital gains that are taxed 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.) 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).

- There is an interesting argument that Schedule K-1 capital gains allocated to a trust from a partnership but that is not distributed is still included in the trust's DNI. Section 643(a) starts with taxable income in defining DNI and then describes several modifications. Section (a)(3) says that capital gains are excluded from DNI to the extent they are allocated to corpus and are not paid or required to be distributed to a beneficiary or for charitable purposes. If the capital gains are not allocated to corpus, there are no provisions in the statute removing them from DNI. If the partnership does not make distributions of

  the capital gain, the trust has no receipts that are characterized as either income or corpus. As long as the K-1 capital gains are not allocable to corpus, they are not excluded from DNI.

- Net short term capital gain from a mutual fund is treated as fiduciary income under the Uniform Principal and Income Act. Comments to Section 401 of the Act include the following:

  > Capital gain dividends. Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act.

Exception (2)—Capital Gains Allocated to Corpus and Consistently Treated as Part of Distributions.

- 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. Reg. §1.643(a)-3(e) Exs. 2-3.
- Trust agreements may specifically grant the trustee the discretion 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).
- 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)—Capital Gains Allocated to Corpus But Actually Distributed or Considered in Determining Amount to be Distributed.

- There is no requirement in the regulation that this be exercised consistently. *See* Frederick Sembler, *Including Capital Gains in Trust or Estate Distributions After ATRA,* TRUSTS & ESTATES 23 (March 2013)(suggesting that the trustee "make a record, before the distribution if possible, of the decision to do so") .
- 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).
- However, the examples in the regulations for Exception (3) are rather narrow and do not include an example with that rationale.

***Example Clause.* An example clause giving the trustee discretion to utilize the flexibilities afforded by the regulation to cause capital gains to be in DNI is as follows**:

> The Trustee may allocate realized short term capital gains and/or realized long term capital gains to either trust income or trust principal, and such gains shall be includable in distributable net income as defined in I.R.C. § 643 and the regulations thereunder (1) to the extent that such gains are allocated to income and distributed to the trust beneficiary; or (2) if such gains are allocated to principal, to the extent they are consistently treated as part of a distribution to the trust beneficiary, actually distributed to the trust beneficiary, or used by the Trustee in determining the amount distributable to the trust beneficiary.

Gregory Gadarian, *Including Capital Gains in DNI,* ACTEC 2014 Fall Meeting of Fiduciary Income Tax Committee.

For a more detailed discussion of these strategies, see Item 9.n of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

c. **The 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). (For a non-leap year, this is March 6.) 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 $12,300 in 2015, $12,400 threshold for the high rates and §1411 tax).

19. Material Participation by Trusts

a. **Significance**. Whether a trust's losses are subject to the passive loss rules depends on whether the trust materially participates in the activity that generates the losses. §469. More importantly, there is a non-passive trade or business income exception from the 3.8% tax on net investment that applies if the taxpayer materially participates in the business, as determined under the §469 rules. For a considerably more detailed discussion of the issues regarding material participation by trusts,

including the *Aragona Trust* case, See Item 9.g-h of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

b. **General Rules for Material Participation**. 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. Reg. §1.469-5T(a). In addition, there is a separate exception for real estate professionals (if the taxpayer performs more than 750 hours in real property trades or businesses). §469(c)(7)(B). The section 1411 regulations indicate (in an extremely round-about way) that a **100-hour test** may generally apply, with some exceptions, for purposes of the active business interest exception. Reg. §1.1411-5(b)(2). *See* Richard Dees & Jeffrey Ekeberg, *Participation of 100 Hours May Be Sufficient to Generate Active Income Exempt from the 3.8 Percent Health Care Tax on Net Investment Income*, McDermott Will & Emory Website, On the Subject Newsletter (April 14, 2014). (If the 100-hour test applies, there may be complications if the business has associated tax credits; they may be suspended until the company has passive income at some point (i.e., a year in which the taxpayer flunks the 100-hour test). *See* Steve Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications* (2015) (available from author). For a detailed discussion of the 100-hour test, See Item 9.f of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

Various cases have addressed whether particular activities rise to the level of material participation. As an example, *Leland v. Commissioner*, T.C. Memo. 2015-240 discussed whether a landowner (a practicing attorney) who leased farmland under a cropshare arrangement materially participated in the conduct of the business for purposes of §469. The landowner leased the land to a Mr. Pigg, and the landowner had to spend time controlling the wild hog population on the land as well as maintaining farm equipment. The court determined that the taxpayer met the 100-hour test. In supporting his activities in maintaining the farmland, the taxpayer offered the following explanation:

> Wild hogs are a continuing problem at the farm. They dig underneath fences to get to edible crops and have dug up and broken water lines on the farm. In a year before the tax years 2009 and 2010, wild hogs ate 250,000 pounds of peanuts that petitioner and Mr. Pigg had grown on the farm. As a result, petitioner has to spend significant time controlling the wild hog population, which he accomplishes through hunting and trapping. Petitioner usually hunts hogs for three hours each morning and afternoon while at the farm, for a total of six hours per day. In addition, he spends time building traps and baiting them with corn millet and Kool-Aid to lure hogs to a specific area, where he waits in a tripod stand with semiautomatic weapons in order to eradicate them.

(Who says the material participation rules are dry and boring?)

c. **Authority Prior to Aragona Trust Regarding Material Participation by Trusts or Estates.** There is no guidance regarding how a trust or estate "materially participates" in a trade or business, under either the §469 or §1411 regulations. The

IRS is considering regulations to address this issue; the Treasury Priority Guidance Plan for 2014-2015 issued August 26, 2014 includes the following new item: "Guidance regarding material participation by trusts and estates for purposes of §469."

(1) *IRS Position*. 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), and that the real estate professional exception does not apply to trusts. 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.

(While these have been the historic positions of the IRS, Service personnel have indicated informally that they are not necessarily taking that same approach in new regulations that they are considering.)

(2) *Activities of Non-Trustee Agents of Trust Constituted Trust Material Participation, Mattie K. Carter Trust v. U.S.* A 2003 federal district court was the first to address in a reported case what activities can qualify as material participation under the passive loss rules for trusts and estates. *The Mattie K. Carter Trust v. U.S.*, 256 F. Supp.2d 536 (N.D. Tex. 2003). The District Court concluded 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. *Aragona Trust* (discussed below) in footnote 15 said that it was not faced with and did not address whether activities by non-trustee employees are considered in determining a trust's material participation.

(3) *Technical Advice Memorandum 200733023; Rejection of Carter Trust Reasoning, Treatment of Special Trustee.* The IRS disagreed with *Carter Trust* in Technical Advice Memorandum 200733023, concluding that notwithstanding the *Carter Trust* decision, the sole means for a trust to establish material participation is by its fiduciaries being involved in the operations, relying primarily on the legislative history that made specific reference to "an executor or fiduciary, in his capacity as such" clause. The ruling also reasoned that because a business will generally involve employees or agents, a contrary approach would result in a trust invariably being treated as materially participating in the trade or business activity, rendering the requirements of §469(h)(1) superfluous. The ruling also reasoned that Special Trustees having responsibility for the trust's business interest were not fiduciaries for purposes of §469, because they gave recommendations but they were not able to commit the trust to any course of action or control trust property without the Trustees' express consent.

(4) *PLR 201029014; No Strict Application of "In Such Capacity" Clause in Legislative History.* The issue was whether a trust could materially participate in the business of a subsidiary (Sub 2) of a subsidiary (Sub 1) owned by a partnership in which the trust owned an interest. In light of the trust's remote

relationship with Sub 2, a strict application of the "in such capacity" clause in the legislative history would seemingly have prevented the trustee from being able to materially participate, because any actions of the trustee in the business of Sub 2 would have been taken in some capacity other than as trustee. In PLR 201029014, the IRS did not apply this strict approach, but concluded that the trustee could materially participate in Sub 2 through the trustee's regular, continuous and substantial involvement in the operations of Sub 2.

(5) *TAM 201317010; IRS's Most Recent Strict Attack—Activities of Co-Trustee Who Was President of Business Not Counted in Determining Trust's Material Participation*. 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, and a Special Trustee, who was also the president of a qualified Subchapter S subsidiary of the S corporation held the authority regarding 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. 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.

d. **Frank Aragona Trust v. Commissioner**. In a case of major importance, the Tax Court recently issued a case addressing the requirements for material participation by a trustee for purposes of the passive loss rules. *Frank Aragona Trust v. Commissioner,* 142 T.C. No. 9 (March 27, 2014) (Judge Morrison). This case directly addresses the "real estate professional exception" in §469(c)(7), but one of the requirements of that exception is material participation by the taxpayer. The case states that (1) trusts can qualify for the real estate professional exception and (2) activities of three of the six co-trustees as employees of the manager of the business are counted in determining material participation by the trust. The case, which is a "regular" Tax Court decision, repudiates the "hard-nosed" position taken by the IRS in TAM 201317010.

*Synopsis***.** The Frank Aragona Trust qualified for the "real estate professional exception" under §469(c)(7) so that rental losses were not disallowed as passive activities for purposes of the passive activity loss rules of §469. The IRS raised and

the court addressed two major issues. First, the court rejected the IRS's contention that a trust can never qualify for the real estate professional exception even though the regulations refer to personal services "performed by an individual." The court concluded that if the trustees are individuals, their work can be considered "work performed by an individual" and that a trust is capable of performing personal services and therefore can satisfy the §469(c)(7) exception.

Second, the court ruled that the trust materially participated in the real estate business, which is one of the requirements to satisfy the §469(c)(7) real estate professional exception. Three of the six co-trustees were full time employees of an LLC that managed the rental properties. The court concluded that the activities of the trustees, including their activities as employees of the LLC, are considered in determining material participation. The court reasoned that their activities as employees counted because (1) Michigan statutory law requires trustees to administer the trust solely in the interests of the beneficiaries, and (2) a Michigan case makes clear that trustees are not relieved of their duties of loyalty by conducting activities thorough a separate entity controlled by the trust. Also, the court rejected the IRS argument that two of the co-trustees owned minority interests in some of the entities that conducted the rental operations and that some of their activities were attributable to their personal portions of the businesses. The court gave several reasons, including that their interests as individual owners were generally compatible with the trust's goals for the jointly held enterprises to succeed. The IRS did not appeal the case.

Activities of Trustees as Employees Are Counted. The portion of the opinion most relevant to planners' decisions in structuring trusts is the court's conclusion that the activities of the trustees, including their activities as employees, should be considered in determining whether the trust materially participated in real-estate operations (which requires material participation). The court reasoned that state law requires trustees to look out solely for the interests of trust beneficiaries, and that trustees are not relieved of their duties of loyalty by conducting activities through an entity controlled by the trust.

> The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also In re Estate of Butterfield, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302).
>
> Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. Cf. In re Estate of Butterfield, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who
>
> are exercising their business judgment concerning matters of corporate policy.") Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.

e. **Planning Considerations Following Aragona Trust.**

(1) *Important Case.* There has been only one other case (*Carter Trust*, a federal district court case) addressing how a trust materially participates in a business. *Aragona Trust* is the first case exhibiting how the Tax Court will address the issue—and it is a "regular" Tax Court case, not just a memorandum opinion.

(2) *Planners Can Rely on Aragona Trust.* Prof. Sam Donaldson's summary of the material participation by trusts issue is as follows: **"Until we get regulations that codify the Service's litigation position, to which the courts must give deference, the only authority that we have is *Aragona*. It is very helpful authority. It's right. It's the correct result. Fortunately, we have authority that we can rely on without risk of penalty."**

(3) *Specific Facts of Aragona Trust Involved Wholly Owned Management Entity.* The court's reasoning in *Aragona Trust* was related to the specific facts of the case. The court reasoned that state law requires trustees to look out solely for the interests of trust beneficiaries, and that trustees are not relieved of their duties of loyalty by conducting activities through an entity wholly owned by the trust (citing *In re Estate of Butterfield*, which refers to trustees who are directors of a corporation controlled by the trust). The court's reasoning is understandable in light of the fact that it specifically addressed the fact scenario presented by the Aragona Trust. The court gave no indication that it would necessarily limit its reasoning to that situation. Indeed, the first rationale (that the trustee must look out solely for the interests of trust beneficiaries) seems to acknowledge that any activities of a trustee must be consistent with the trustee's duties to the beneficiaries.

(4) *Can Trustee Ever "Take Off Its Hat" As Trustee?* Some commentators have described this issue in terms of whether a trustee can ever "take off its hat" as a fiduciary. Under this approach, all activities of a trustee should be considered in determining material participation by the trust.

> A review of the existing tax guidance supports considering all of a trustee's actions in a trust-owned business in whatever capacity the trustee acts in determining whether the trust materially participates. The non-tax authorities support this conclusion too: the trustee is unable to completely remove her trustee "hat" when donning a different "hat" in a different capacity in the business. Where a trustee also acts in a potentially managerial role (e.g., for an entity the equity interests of which are trust assets), the trustee's fiduciary duties extend to her managerial activities. A trustee cannot disregard her fiduciary obligations to the beneficiaries when acting in another capacity, for example, as an employee or director, in a business owned by the trust. Because the trust will be a shareholder, the fiduciary duties a trustee owes the beneficiaries will not conflict with the fiduciary duties a director owes the shareholders. If they do, however, the director/trustee will have to recuse herself. Thus, all of the actions undertaken by an individual trustee with respect to any activity owned directly or indirectly by the trust are subject to her fiduciary obligations to the trust beneficiaries and, therefore, relevant to determine whether the trust materially participates under Code sections 469 and 1411.

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) (Question 10)* and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2*, TAX NOTES 785 (Aug. 19, 2013).

In support of his analysis, Mr. Dees cites (and quotes) the Restatement (Third) of Trusts §78 & §86 cmt. e, Bogert on Trusts and Trustees §543 (Dec. 2012),

and *In re Schulman,* 165 A.D.2d 499, 502 (N.Y. App. Div. 3d Dep't 1991) (citing various other New York cases).

(5) *Rejection of IRS Position in TAM 201317010*. *Aragona Trust* goes a long way toward rejecting the IRS's strict position in TAM 201317010. The IRS's arguments in *Aragona Trust* were very similar to its reasoning in TAM 201317010 for not considering the activities by the LLC employees/trustees in the business operations:

> [The IRS] reasons that the activities of these three trustees should be considered the activities of employees and not fiduciaries because (1) the trustees performed their activities as employees of Holiday Enterprises, LLC, and (2) it is impossible to disaggregate the activities they performed as employees of Holiday Enterprises, LLC, and the activities they performed as trustees.

The court's rejection of the IRS's reasoning calls into question the basic tenets of the TAM. Furthermore, the court rejected the same type of reasoning with respect to its refusal to consider separately the activities attributable to the trust portion and the individual portion of the business by the trustees who also owned personal interests in the business.

Query whether the distinction of serving as employee of the wholly owned LLC in *Aragona Trust* vs. serving as employee of the corporation in the TAM is significant?

f. **Treasury Project.** There is no guidance regarding how a trust or estate "materially participates" in a trade or business, under either the §469 or §1411 regulations. The IRS is considering regulations to address this issue; the Treasury Priority Guidance Plan for 2014-2015 issued August 26, 2014 includes the following new item: "Guidance regarding material participation by trusts and estates for purposes of §469." Various groups have submitted comments to the IRS regarding material participation by trusts and estates.

ACTEC filed comments on September 24, 2015. Among other things, the ACTEC comments suggest that (i) work done by fiduciaries should count as work of the trust or estate even if done in another capacity as long as the person is bound by fiduciary duties, (ii) activities of fiduciaries whose responsibilities for the trust or estate are solely ministerial (e.g., transmitting information concerning claims) or unrelated (e.g., management of a trust's non-business assets) would not count as material participation of the trust or estate, (iii) the fiduciary's power with respect to the business need not be a controlling power, (iv) the activities of multiple fiduciaries would generally be aggregated, (v) whether the fiduciary is an individual or an entity is generally not relevant in determining the trust or estate's material participation, (vi) work done by independent contractors generally would not count but work done by employees would count as work of the trust if the fiduciary-employer is responsible to the beneficiaries for the employees' work under the same fiduciary obligations that apply to work performed directly by the fiduciary, (vii) for grantor trusts, ignore the trust and look to whether the grantor materially participates, and (viii) characterization of the trust as materially participating or not generally carries through to the beneficiary level, but if the trust or estate does not materially participate but makes a distribution to a beneficiary who is active, "fairness requires that the beneficiary's

participation in the business count and serve to recharacterize the income as nonpassive."

20. Important Tax Administration and Procedural Rules for Estate Planners

a. **Tax Returns.** Determining what is a valid tax return and when it is filed is important for avoiding failure to file penalties and for determining the statute of limitations on additional assessments by the IRS or for claims for refund.

A document filed with the IRS is a valid return if it meets three requirements: (i) it is filed on the proper form (some forms change year to year), (ii) it provides sufficient information for the IRS to compute the tax owed, and (iii) it is signed under penalties of perjury.

Sufficient Information. If a gift is to a trust, the trust agreement must be attached to gift tax returns or the IRS may not be able to determine the correct tax. The IRS sometimes returns gift tax returns because the taxpayer left the income tax information blank in Schedule A. The adequate disclosure rules, for determining when adequate disclosure has been made on gift tax returns for statute of limitations purposes, are discussed in Item 20.c below.

Proper Signature Under Penalties of Perjury. For a return filed by e-filing, there is a signature protocol; the taxpayer must sign an e-file authorization and use a PIN to file the return with the IRS.

For a decedent's estate, there are differing signature rules for income tax returns (executor, administrator or other person charged with property of the decedent), gift tax returns (executor or administrator) and estate tax returns (executor or administrator or if none, "any person in actual or constructive possession of any property of the decedent"-referred to as a statutory executor, §§6018(a) & 2203, Reg. §20.2203-1). There is no definition of "executor" for income or gift tax purposes; one of the Greenbook proposals is to provide a definition of executor that would apply for all tax purposes. For estate tax returns, if there is no appointed executor or administrator, there could be multiple statutory executors; each should file a return disclosing information of which each is aware.

When can an agent sign for the taxpayer? For income tax returns, there are provisions for an agent or spouse to sign the return for a taxpayer in certain circumstances. Reg. §1.6012-1(a)(5). For gift tax returns, an agent can sign the return if the taxpayer cannot do so because of "illness, absence, or nonresidence" (which does not include inconvenience). Reg. §25.6019-1(h). For estate tax returns, there are no provisions for an agent to sign on behalf of the executor.

b. **Amended Returns.** There is no procedure for filing an amended estate tax return, but practitioners sometimes file "Supplemental" returns if necessary to provide the IRS with additional information. A procedure for filing amended gift tax returns if the prior return did not adequately disclose a gift is described in Rev. Proc. 2000-34.

Amended Return to Correct Mistakes. There is general agreement that there is no duty to file an amended return if a mistake on a return is discovered. *See* Pollack, *What Obligations Do Taxpayers and Preparers Have to Correct Errors on Returns?,* 72

J. TAX'N 90 (Feb. 1990). But if there is a mistake on a gift tax return, subsequent gift or estate tax returns would have to include the correct information; filing an amended gift tax return may be the easiest and cleanest way to correct the wrong information on the prior return.

Effect of Amended Return. If the amended return is filed before the due date, it becomes the real return. If it is filed after the due date, the original return is still the "return" for purposes of statutes of limitations on additional assessments and refunds.

c. **Adequate Disclosure Rules for Gift Tax Returns**. Before 1997, gift tax had to be paid on a gift tax return in order to start the statute of limitations for gift tax purposes (§2504(c)). The statute of limitations ran on gift tax returns even for gifts not reported on the return, but unreported gifts could have an impact on subsequent gift or estate reporting. Gifts could be revalued on the estate tax return (although there was a subtraction of the gift tax that would have been payable with the higher valuation, so the net result was only important if the added value pushed the estate into higher tax brackets. *See Estate of Smith v. Commissioner*, 94 T.C. 872 ((1990).)

Important changes were made in the Taxpayer Relief Act of 1997. For gifts made in 1977 or later, there is no requirement that gift tax be paid in order for the gift tax statute of limitations to begin, but a gift of a particular item must be disclosed in a manner adequate to apprise the IRS of the nature of the item to start the limitations period. §§2504(c); 6501(c)(9). (This means that the IRS at any time can impose gift tax, interest and penalties on gifts that were inadvertently or even for good cause

omitted from a gift tax return.) Once the gift tax statute of limitations has run on a disclosed item, that item will not be revalued either for purposes of determining the gift tax on later gifts or for estate tax purposes.

This system is somewhat like the system adopted in 1990 for transactions covered by §§2701 or 2702. Section 6501(c)(9) (before it was amended in 1997) provided that if the value of any gift is determined under §§2701 or 2702, additional gift taxes may be assessed at any time unless the item is disclosed on a return or statement attached to a return "in a manner adequate to apprise the Secretary of the nature of such item." Section 6501(c)(9) was amended in 1977 to apply to gifts generally, not just gifts valued under §§2701 or 2702.

Adequate Disclosure—Safe Harbor Approach. "Adequate disclosure" regulations issued in 1999 provide a safe harbor, but they are not the exclusive way to satisfy the statutory requirement of adequately disclosing a gift. If a technicality is missed, the taxpayer can argue that the IRS was put on notice of sufficient information. Prior case law regarding an analogous provision in the 6-year substantial omission statute of limitations (§6501(e)(2), which refers to an item "disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the [Service] of the nature and amount of such item") suggested a "clue" rule—the return must provide a clue but more than "a clue which would be sufficient to intrigue a Sherlock Holmes." *Estate of Williamson v. Commissioner*, T.C. Memo 1996-426. The proposed regulation had stated that a gift would be adequately disclosed "only if" certain information were included in the return. This was changed in the final regulations, which require that a gift be reported "in a manner adequate to apprise

the Internal Revenue Service of the nature of the gift and basis for the value so reported." Reg. §301.6501(c)-1(f)(2). The next sentence says that gifts "will be considered adequately disclosed" if the return provides the information listed in five subparagraphs. The preamble to the final regulations notes that "it is not intended that the absence of any particular item or items would necessarily preclude satisfaction of the regulatory requirements, depending on the nature of the item omitted and the overall adequacy of the information provided." CCA 200221010 confirms that the IRS will consider whether a disclosure adequately informs the IRS even if all of the technical requirements of the safe harbor are not met. Therefore, the approach appears to provide a safe harbor to show that a gift has been adequately disclosed.

In Field Attorney Advice 20152201F the IRS determine that the adequate disclosure requirements had not been satisfied. The gift tax return included a one-paragraph supplement entitled "Valuation of gifts" describing the valuation of various partnership interests but: (i) partnerships were not identified correctly, (ii) one digit was left off each partnership's taxpayer identification number, (iii) the description said that the land owned by the partnership was appraised by a certified appraiser, but the appraisal was not attached and the appraisal did not value the partnership interests, and (iv) the description summarily stated that "Discounts of __% were taken for minority interests, lack of marketability, etc., to obtain a fair market value of the gift."

Safe Harbor Requirements. The safe harbor has five requirements: (i) a description of the transferred property and any consideration received by the transferor, (ii) the identity of, and relationship between, the transferor and the transferee; (iii) if the property is transferred in trust, the trust's tax ID number and either a brief description of the terms of the trust or a copy of the trust instrument [*OBSERVE: merely providing a summary risks that the summary is insufficient*]; (iv) unless a qualified appraisal is submitted, a detailed description of the method used to determine the fair market value of property transferred; and (v) a statement describing any position taken that is contrary to any proposed, temporary or final regulation or revenue ruling published at the time of the transfer. Reg. §§301.6501(c)-(1)(f); 20.2001-1; 25.2504-2.

Some have described this approach as setting out two safe harbors—an "Appraisal Safe Harbor" and a "Description Safe Harbor." *See* Ronald Aucutt, *The Statute of Limitations and Disclosure Rules for Gifts*, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 833, 844 (April 2014).

Description Safe Harbor. Using the Description Safe Harbor (i.e., supplying the description of the valuation method rather than a qualified appraisal) requires the submission of very specific financial data (including among other things, the rationale for any discounts and the value of 100% of the entity). Reg. §301.6501(c)-1(f)(2)(iv).

Appraisal Safe Harbor. For the "Appraisal Safe Harbor" the regulations have very detailed requirements of what must be included in any "qualified appraisal." The appraisal must describe the appraiser's background and confirm that the appraiser is not the donor or donee or a family member, and must contain detailed information described in eight separate requirements—one of which is that the date of the transfer and the date on which the transferred property was appraised must be

stated. Reg. §301.6501(c)-1(f)(3). Planners must closely review appraisals to confirm that they contain all of the information listed in these eight requirements.

Non-Gift or Incomplete Transfer Disclosures; Ordinary Course of Business Exception. The regulations also permit disclosing completed transfers that are not gifts. The return must include an explanation of why the transfer is not a gift. A completed transfer to a member of the family made in the ordinary course of operating a business will be deemed to be adequately disclosed even if the transfer is not reported on a gift tax return, if the transfer is property reported by all parties for income tax purposes. For example, this could apply to compensation paid to family members from a family business that is reported on their income tax returns. Reg. §301.6501(c)-1(f)(4)-(5).

Curing Inadequate Disclosures. Because there is no specific provision in the Code for filing amended gift tax returns, how is an inadequate disclosure cured in later years? Rev. Proc. 2000-34 clarifies that the disclosure requirements may be met by filing an amended gift tax return with a specific caption added at the top of the return. The statute of limitations begins running from the date of filing the amended return with adequate disclosures. Rev. Proc. 2000-34 makes clear that the amended return procedures do not apply to fraudulent returns or to willful attempts to evade tax.

Separate "Adequately Shown" Requirements for Gifts Valued Under §§2701 or 2702. The adequate disclosure and safe harbor rules described above do not apply to gifts valued under §§2701-2702. Reg. §301.6501(c)-1(f)(1). Instead, Reg. §301.6501(c)-1(e) has separate rules for what must be disclosed regarding any transfer subject to §§2701 or 2702. The statute of limitations does not run unless the transfer is "adequately shown" on the return, and there are three separate requirements for the "adequately shown" test, including (i) a description of the transaction and the method used to value any retained interest, (ii) the identity and relationship between the transferor, transferee, all persons participating in the transactions, and all related parties holding an equity interest in any involved entity, and (iii) a detailed description (including all actuarial factors and discount rates used) of the method used the determine the amount of the gift and for any equity interest that is not actively traded, financial data must be included which "should generally include" specifically listed financial data for each of 5 years before the valuation date. (This means that transfers to GRATs must contain all of that information in order to meet the adequately shown" requirement to start the statute of limitations on the amount of the gift.)

d. **Due Dates**. There is a special rule for gift tax returns of a decedent—the due date is the earlier of the gift tax or the estate tax return due date.

The Form 3520-A, Report of Foreign Grantor Trust, is due March 15.

The FBAR Form (FINCen Form 114) to report foreign financial accounts is due June 30 of the year following the year for which the return is filed (and this date cannot be extended).

Individuals can obtain automatic 6-month extensions to file income tax returns by filing Form 4868 (which also automatically extends the gift tax return due date). A taxpayer who does not extend the income tax return can obtain the automatic 6-

month extension of filing the gift tax by filing Form 8892. Nonresident aliens automatically get two additional months (to June 15) to file income tax returns without requesting an extension.

An automatic 6-month extension is also available for estate tax returns by filing Form 4768 (and a longer extension may be requested if the executor is abroad). Otherwise, no extensions are possible for estate tax returns past the 6-month automatic extension date.

Extensions of payment dates are also possible. Section 6166 discretionary extensions apply to gift and income tax returns for decedents in addition to applying to estate taxes. Section 6166 extensions are available for estate taxes for estates with closely-held business interests that meet certain requirements.

e. **Statute of Limitations on Claims for Refund.** The general statute of limitations on filing claims for refund is the later of three years from when the return was filed or two years from the time the tax was paid. §6511. If the claim is not filed within the three-year period from filing, the amount that may be claimed is limited to the tax paid within the two years prior to filing the claim. A return filed before the regular due date is considered as filed on the regular due date for purposes of this rule. A return filed during an extension period is treated as filed on the actual date of filing. §6513(a).

Payment vs. Deposit. If a payment to the IRS is not specifically designated as a deposit, it is treated as a tax payment—which would start the 2-year rule on refunds as to that payment. If the remittance is designated as a deposit, the 2-year statue for refund claims does not start to run on that payment.

f. **Statute of Limitations for Additional Assessments**. Taxpayers should not be embarrassed or hesitant to assert statutes of limitations as a defense where applicable. Statutes of limitations and their application are part of the advice that planners give clients regarding managing the risk of their transactions.

General Rules. There is a basic *three-year* rule—an assessment of tax (including tax, interest and penalties) generally must be made within three years after the return was filed. 6501(a). There is a *six-year* period for substantial omissions—if gift items (or estate items on an estate tax return) are not reported on gift (or estate) tax returns that exceed 25% of the total amount of gifts (or estate assets) reported on the return. §6501(e)(2). There is *no period* of limitations for a false or fraudulent return or if no return is filed. A return filed before the regular due date is considered to be filed on the regular due date.

Fiduciary or Transferee Liability. Additional time may exist for assessments against a fiduciary liable under 31 U.S.C. §3713, under which the executor may have personal liability if the executor makes a distribution which results in insufficient funds to satisfy the decedent's tax obligations. (For a recent case regarding fiduciary liability under the Federal Priority Statute, see *United States v. Marshall*, 116 AFTR 2d 2015-5694 (5th Cir. August 19, 2015), *substituted opinion in place of prior opinion at* 771 F.3d 854 (5th Cir. 2014) (executors liable for amounts paid to charities and for payments of various expenses without preserving funds to pay the IRS in case its gift tax claim proved valid; executors had sufficient notice of gift tax claim to put a

reasonably prudent person on notice because they were told the IRS might assert a claim for unpaid gift tax; erroneous legal advice about how to address the claim was not a valid defense to liability under §3713)). In addition, there is additional time for assessments against a transferee under §§6901; 6324(a)(2). See Item 14.h regarding transferee liability, including a discussion of cases in which claims first made against transferees over a decade after the decedent's death were upheld.

There is an infinite time for assessments if a taxpayer has any foreign related items of income but did not file the proper information return (Form 3520 or 8938). The statute of limitations does not run on the *entire* tax return until the information return is filed. §6501(c)(8).

There is no statute of limitations on assessment of penalties for failure to file information returns. *See* IRM 20.1.9.1.3.

Extension of Limitations Period. The limitations period for the assessment of income and gift tax (and GST taxes other than those imposed at the same time and as a result of the death of an individual) may be extended by agreement before the expiration of the period of limitations. §§6501(c)(4), 2661(1). However, the period of limitations for estate taxes (and GST taxes imposed at the same time and as a result of the death of an individual) may not be extended. §§6501(c)(4), 2661(2).

When the IRS issues a notice of deficiency (the 90-day letter), the statute of limitations on assessments is suspended until the completion of Tax Court proceedings or the failure of the taxpayer to file a Tax Court petition in response to the 90-day letter. Reg. §301.6503-1(a)(1).

g. **How to File a Return**. There have been a variety of cases about the date of filing return; the issue in many of them is that the return was one day late.

E-filing. E-filing eliminates much of the uncertainty about when returns are filed, but gift and estate tax returns cannot be filed by e-filing. Almost all Tax Court petitions have to be e-filed (except for pro se petitions).

Mailbox Rule. The general rule is that a return is filed the day it is received by the IRS. However, the "mailbox" rule provides an important exception. The official U.S. postmark is the date of delivery if (a) the postmark date is on or before the due date (including extensions), (b) the return is actually delivered to the IRS after the due date, and (c) the return is deposited in the U.S. mail before the due date in an

envelope postage prepaid, properly addressed to the appropriate IRS office. Taxpayers can prove they physically mailed a return by the required date by using registered or certified mail. §7502, Reg. §301-7502-1(c)(2).

Private Delivery Service. A private delivery service can be used with particular services listed on the IRS website (the list now includes DHL, FedEx, and UPS). The label supplied by a FedEx employee or the date recorded electronically by DHL and UPS are treated as the postmark date for purposes of the mailbox rule. §7502(f), Rev. Proc. 97-19.

Postage Meters. If an office postage meter is used, the post office typically does not postmark the envelope (but if the post office does postmark the envelope, that official postmark controls). As long as the date on the postage meter is legible and

the IRS receives the envelope within the normal delivery period, the date on the meter controls. Reg. §301.7502-1(c)(1)(iii)(B)(i). The document is received outside the normal delivery time the mailbox rule will still apply if the taxpayer can prove the document was actually deposited in the U.S. mail before the last collection of the day from the place the taxpayer sent the document, the delay was due to a delay in the transmission of the U.S. mail, and the cause of the delay. (That obviously can be difficult to prove; using a private postage meter is risky.)

h. **Transferee Liability**. The beneficiaries of an estate have personal liability for unpaid estate taxes. §6901(a)(1); §6324(a)(2) (non-probate assets [more specifically, assets included under §§2034-2042] included in the decedent's gross taxable estate). The general rule is that the IRS has an additional year to make assessments for transferee liability under §6901, after the statute of limitations has run on the tax against the transferor. §6901(c)(1). Accordingly, for gift or estate transfers, this would generally mean four years after the date of the return. However, there is a separate personal liability provision for transferees under §6324(a)(2) for non-probate property that is included in the gross estate that is not so limited (as discussed below).

There is a limit on the amount of the liability. For transferee liability under §6901, federal courts have generally held that the transferee's liability is the value of the transferred assets on the date of transfer. *E.g., Commissioner v. Henderson's Estate*, 147 F.2d 619 (5th Cir. 1945). For non-probate transfers, §6324(a)(2) limits the liability to "the extent of the value, at the time of the decedent's death, of such property, received from the decedent."

Transferee liability applies to the donee of a gift within three years of the decedent's death under §2035(c)(1)(C) even though the gifted asset itself is not brought back into the decedent's estate under §2035. *E.g., Armstrong v. Commissioner,* 114 T.C. 94 (2000). Personal liability arising from this provision only applies to estate tax under §6324(a)(2) as opposed to gift tax under §6324(b).

It is clear that interest on unpaid estate tax is subject to the transferee liability rules. However, the cases have not been consistent with respect to whether the limit on liability to the value of property at the time of the decedent's death applies to interest as well as the unpaid principal of the tax itself. Some cases have held that the liability for interest when added to the tax can exceed the amount transferred at the time of the transfer. *Richard M. Baptiste v. Commissioner*, 29 F.3d 1533 (11th Cir. 1994) (estate tax). The Eighth Circuit has reached the opposite result in a case involving Richard Baptiste's brother, Gabriel (who was an equal beneficiary of the same life insurance policy). *Gabriel Baptiste, Jr. v. Commissioner*, 29 F.3d 433 (8th Cir. 1994), *cert. denied*, 513 U.S. 1190.

There has been an interesting history as to the interest issue in the Fifth Circuit. A 2014 opinion sided with the 11th Circuit in concluding that interest for gift tax transferee liability, when added to the gift tax, can exceed the value of the gift. *United States v. Marshall*, 771 F.3d 854 (5th Cir. 2014)(gift tax) (dissent by Judge Owen). The Fifth Circuit withdrew that opinion on August 19, 2015, and substituted a new opinion concluding that the transferee liability for gift tax plus interest is limited to the value of the gift. *United States v. Marshall*, 116 AFTR 2d 2015-5694 (5th Cir. August 19, 2015) (dissent by Judge Prado). (Apparently, on this three-judge panel,

Judge Reavley changed his position; Judges Owen and Prado maintained the same positions as in the prior opinion).

For estate tax purposes, there is no "transferee," and therefore no transferee liability unless the transfer occurs within the statute of limitations period for assessing additional estate taxes against the estate. If no transfers are made to beneficiaries within the 3-year statute of limitations on additional assessments, there will be no transferee liability if there had been no assessment of estate taxes against the decedent's estate during that 3-year period. *See Illinois Masonic Home v. Commissioner*, 93 T.C. 145 (1989) ("Section 6901 does not create a separate liability for the transferee. Instead, it merely provides for a secondary method of enforcing the liability of the transferor [citation omitted]. The transferee cannot be held liable for the transferor's tax if the expiration of the period of limitations has extinguished the transferor's liability before the assets ware transferred.") Query whether this applies to the liability of a transferee under §6324(a)(2)(estate tax with respect to assets included in the gross estate under §§2034-2042) or §6324(b)(gift tax)? *Illinois Masonic Home* was premised on §6901 not creating a separate liability for the transferee, but §6324(a)(2) and §6324(b) specifically provide that the transferee from an estate or of a gift is "personally liable for such tax" (referring to estate tax or gift tax).

Observe that the transferee liability for gift tax attaches even as to annual exclusion property. The donee is personally liable up for gift tax up to the value of the donee's gift even if the donee received only an annual exclusion gift that did not contribute to the unpaid gift tax. *See Bauer v. Commissioner*, 145 F.2d 338 (3d Cir. 1944).

Fiduciaries may be *personally* liable for payment of transfer taxes under similar concepts. *See generally* Tractenberg, *Transferee Liability Can Reach Trustee as Well as a Beneficiary*, 21 EST. PL. 259 (1994). Fiduciaries can be liable as "trustees" under §6324(a)(2), not as "transferees," which is a separate category under that section. Trustees under §6324(a)(2) are included within the definition of "transferee" for purposes of §6901. §6901(h)(cross referencing persons who are personally liable under §6324(a)(2)).

Even if the IRS fails to assess a tax deficiency against beneficiaries within the general four-year period that would be allowed under §6901(c)(1), a transferee may nevertheless be liable for transfer taxes in some situations in which §6324(a)(2) applies (keeping in mind that it applies only to assets included in the decedent's gross estate under §§2034-2042). Various cases have reasoned that § 6901(c) and § 6324(a)(2) are "cumulative and alternative — not exclusive or mandatory." Therefore, the IRS may proceed against a transferee under §6324(a)(2) even if an assessment is not made against the transferee within 4 years as required under the §6901(c) alternative. The rationale for the longer time under §6324(a)(2) is that it has no time limits (the special estate tax lien under §6324(a)(1) lasts for 10 years, but §6324(a)(2) has no time limits specified), so the general collection provisions of §§6501 and 6502 control. Section 6502 requires that an action to collect tax must be commenced within 10 years after the assessment of the tax, and that period can be suspended or extended. *See U.S. v. Kulhanek,* 106 AFTR2d 2010-7263 (W.D. Pa. 2010) (collection action filed against recipients of retirement account and life insurance policy almost 9

1/2 years after the §6166 deferral period ended by reason of the sale of the stock, which was 17 years after decedent's death); *Estate of Mangiardi v. Commissioner*, T.C. Memo. 2011-24, *aff'd in unpublished opinion*, 108 AFTR 2d 2011-6776 (11th Cir. 2011) (collection action against an IRA beneficiary eight years after the IRA owner's death, within 10 years after estate tax was assessed against decedent's estate), *validity of collection action confirmed sub. nom,*; *United States of America v. Mangiardi and Mangiardi*, 112 AFTR 2d 2013-5344 (S.D. Fl. 2013); *United States v. Geniviva*, 16 F.3d 522, 525 (3d Cir. 1994); *United States v. Russell*, 461 F.2d 605, 607 (10th Cir. 1972). The harsh unfairness of this was noted in one of the reported cases.

> [W]e express a certain sorrow that what seems inherently unfair is also quite in accordance with the law, and note a compassion for the equitable position of the appellants. They received their inheritance apparently believing that the affairs of their late mother's estate had been competently represented both professionally and personally, and handled in accordance with the law. Years later they found out that the estate had been poorly advised and represented, and had an unresolved, serious tax problem. Now they find themselves defendants in a lawsuit for the collection of those taxes, and under circumstances amounting to a forfeiture of their entire inheritance.

United States v. Geniviva, 16 F.3d 522, 525 (3d Cir. 1994).

i. **Special Automatic Estate Tax Lien**. The general estate tax lien arises under §6324(a) on all property includible in the decedent's estate for 10 years. The general estate tax lien does not have to be recorded; it is automatic. If the collateral for the lien is property of the estate, the automatic estate tax lien under §6324(a) on that property is extinguished by the special estate tax lien for §6166 deferred tax under §6324A.

For PROBATE assets, property that is purchased or transferred is still subject to the lien in that person's possession, except that if property is transferred to a purchase or holder of a security interest and if the executor has been discharged from personal liability for the estate tax under §2204, the lien no longer applies to the transferred property but the lien attaches to the consideration received from the purchaser. §6324(a)(3). For that reason, any purchaser of probate property should request documentation that the executor has been discharged from personal liability under §2204 or request that the IRS release the lien. A release of lien is requested by filing Form 4422, and can be allowed if—

> (i) the remaining property in the estate is double the value owed the IRS,
>
> (ii) payment is made to the IRS equal to the value of the property being discharged,
>
> (iii) the government does not have a valuable interest in the specific property, or
>
> (iv) sale proceeds are to be substituted for the discharged property.

The general estate tax lien divests when the sale proceeds are "for the payment of charges against the estate and expenses of its administration, allowed by any court having jurisdiction thereof." This exception was addressed in *First American Title Insurance Company v. United States*, 95 AFTR2d 2460 (W.D. Wash. 2005), aff'd 520 F.3d 1051 (9th Cir. 2008). The court applied a strict tracing requirement described in *Northington v. United States*, 475 F.,2d 720 (5th Cir. 1973). The court granted the IRS's motion for summary judgment because it determined that the title company could not affirmatively demonstrate that the payments were used for charges against the estate, and that the taxpayer must petition a court for allowance and that non-

intervention powers do not qualify as allowance. *See generally* Note, 59 TAX LAWYER 901 (2006).

For NONPROBATE assets, the rules are quite different, as illustrated in Legal Advice Issued by Field Attorneys (LAFA) 20061702F. Nonprobate property transferred to a purchaser or holder of a security interest is no longer subject to the lien; however a like lien attaches to all of the transferor's property. §6324(a)(2). The specific issue in LAFA 20061702F was whether pledging property was a "transfer" for purposes of this special rule that divested transferred property of the lien. The LAFA held that it was. It pointed out, though, other special rules that apply for nonprobate property under §6324(a): (1) The beneficiary is personally liable for the estate tax; (2) The lien remains to the extent that the value of the collateral exceeds the balance of the loan to the lender; and (3) There is a lien against the beneficiary's property.

21. Trust Protectors

a. **General Description.** Offshore trusts have historically used trust protectors, leading to growing use in the United States. A "trust protector" may be given "grantor-like" powers that can be very limited or very broad to make changes regarding the trust. The trust protector is a third party (not the settlor, trustee, or a beneficiary) who is given power in the trust instrument designed to assist in carrying out the settlor's intent. A wide variety of powers are possible—but they must be specifically described and granted in the trust instrument.

b. **Trust Protector vs. Trust Advisor**. Trust protectors and trust advisors have very different functions. Trust advisors have powers that are subsumed within the power of the trustee—they hold powers in a fiduciary capacity. Trust protectors are not fiduciaries, and they only have powers specifically granted to them in the trust instrument. Trust protectors do not have the general responsibility of "protecting" the trust—the "trust protector" term is simply the terminology used historically.

c. **State Statutes.** Section 808 of the Uniform Trust Code is entitled "Powers to Direct." Section 808(d) provides that "a person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interest of the beneficiaries." Comments to §808 provide that the section ratifies the "use of trust protectors and advisers." It explains that "Advisers" have been used for certain trustee functions and distinguishes trust protectors:

> "Trust protector," a term largely associated with offshore trust practice, is more recent and usually connotes the grant of greater powers, sometimes including the power to amend or terminate the trust. Subsection (c) ratifies the recent trust to grant third person such broader powers.

The Comments have no further discussion specifically about trust protectors.

The Uniform Code has been adopted in 29 states; some of them adopted §808 verbatim and others made slight changes. Some states also have separate statutes governing trust advisors and trust protectors, or sometimes just trust protectors.

A variety of the state directed trust statutes have language broad enough to apply to trust protectors as well. *E.g.,* 12 DEL. C. §3313(f) ("For purposes of this section, the

term 'advisor' shall include a 'protector'"; a non-exclusive list of example powers includes removing and appointing fiduciaries, modifying or amending the instrument for tax or other efficiency reasons, or modifying powers of appointment). A few states have enacted statutes addressing the powers of trust protectors specifically (including, among various others, Alaska, Delaware, Idaho, Illinois, Nevada, New Hampshire, South Dakota, and Wyoming) that list example powers that trust protectors could hold.

E.g., 760 ILL. COMP. STAT. §16.3(d) (non-exclusive list of 10 example powers that trust protectors could hold); NEV. REV. STAT. §163.5553 (non-exclusive list of 12 example powers that trust protectors could hold).

Almost all of the state statutes are default statutes—providing a list of possible powers but stating specifically it is not an exclusive list. Most of the statutes make clear that trust protectors only have powers that are specifically granted in the trust instrument. Only one state—Virginia—says that the trust protector is a fiduciary and that the document cannot override that fiduciary status.

d. **Case Law.** So far, there is little case law regarding the powers, liabilities or duties of trust protectors. *See generally* Richard Ausness, *The Role of Trust Protectors in American Trust Law,* 45 REAL PROP., TR. & EST. L.J. 319 (2010); Larry Frolik, *Monitoring Trustees: When, Why and How to Use a Trust Protector*, UNIV. OF NOTRE DAME EST. PLAN. ANN. SEMINAR (2013).

Shelton v. Tamposi (N.H.). Investment directors had the authority to direct the trustee, and the trustee followed their directions. There was no trustee liability for doing so. (New Hampshire has a directed trustee statute. RSA 564-B:7-711.) *Shelton v. Tamposi*, No. 2010-634 (N.H. 2013).

McLean v. Davis (Mo.). The attorney for a successful plaintiff in a personal injury lawsuit was named as trust protector of a trust that received the settlement proceeds. He had the power to remove the trustees and appoint successor trustees or trust protectors. When the original trustees resigned, the trust protector designated as successor trustees the attorneys who had referred the personal injury case (as well as other cases) to him. The family alleged that the trustees were wasting trust funds, and sued the trust protector for failing to monitor the actions of the trustee, failing to act when the trustees acted against the interests of the beneficiary, and giving his loyalty to the trustees rather than to the beneficiary. The trust protector sought summary judgment in part because he had no duty to supervise or direct the actions of the trustee. The court of appeals denied summary judgment, reasoning that since the trust agreement granted authority to the trust protector in a fiduciary capacity, the protector owed at least the basic fiduciary duties of undivided loyalty and confidentiality. Also, the limitation of liability in the trust agreement implies the existence of a duty of care and liability for actions taken in bad faith. Following a jury trial, the court granted a directed verdict in favor of the trust protector and the court of appeals affirmed, finding no basis for a breach of duty by the trust protector for various factual reasons.

The court specifically addressed the issue of to whom the trust protector owed duties:

> An important question of material fact also exists in the instant case as to who this fiduciary duty of good faith is owed to. Appellant assumes it is owed to the Beneficiary, but the trust provision that created the position of Trust Protector does not explicitly indicate who or what is to be protected.… {I]t is possible that the Trust Protector's fiduciary duties are owed to the trust itself.

McLean v. Davis, 283 S.W.3d 786 (Mo. Ct. App. 2009), *aff'd following remand*, *Robert T. McLean Irrevocable Trust u/a/d March 31, 1999 ex rel. McLean v. Ponder*, 418 S.W.3d 482 (Mo. Ct. App. 2013).

Schwartz v. Wellin. A trust protector sued the trustees (who were also beneficiaries of the trust) to allege that their liquidation of about $95 million of assets and distribution to them as beneficiaries was improper and frustrated the trust purposes. The children removed the case to federal court. The federal court in one 2014 decision refused to grant an injunction extending a TRO from the probate court to protect trust assets pending the outcome. The federal court earlier in 2014 also determined that the trust protector lacked standing and allowed 15 days from the April 17, 2014 Order to substitute a party in interest or else the case would be dismissed with prejudice. The children purported to exercise their power to remove the trust protector on April 29, 2014 but did not appoint a successor. On May 2, 2014 the trust protector purported to appoint a new trustee and to substitute the new trustee as a party in the proceeding. The court on October 9, 2014 approved the substitution of the new trustee, reasoning that the children violated the trust terms by removing the trust protector and not appointing a replacement for 3 months, and that the protector therefore had the power to appoint a new trustee. *Schwartz v. Wellin*, 2014 U.S. Dist LEXIS 143644 (D. S.C. Oct. 9, 2014).

e. **Best Practices**.

(1) Use a trust protector only if necessary or desirable for particular purposes.

(2) Never rely on state law, but spell out in detail what powers are included. Do not just adopt a list of power that may be included in a state statute because some of those powers are likely not appropriate for a particular situation.

(3) Make clear in the trust instrument that the trust protector acts in a non-fiduciary capacity. If the protector acts in a fiduciary capacity, state very clearly what that means specifically in the context of the powers that the protector has.

(4) Clearly and specifically describe the powers, duties and compensation of the protector.

- State whether the protector has a duty to monitor the trust situation continually or whether the protector is just in a stand-by mode until requested to act or until some event described in the instrument occurs.
- If the protector has a duty to monitor, provide that the protector has the right to receive information from the trustee that is appropriate to the monitoring function.
- Provide for compensation appropriate to the protector's functions.

- Provide for appropriate exoneration of the trustee, the protector, or both with respect to actions taken or not taken by the protector.
- Describe the manner in which the protector's powers are exercised. For example, if a protector has the power to remove and replace trustees, clarify whether the protector must monitor the trustee's performance or just exercise its discretion when requested by a beneficiary.
- Provide that the protector has standing to enforce its powers in a court action.

(5) Use the appropriate name (protector rather than advisor—assuming that is the intent).

(6) Do not mandate that the protector exercise its power (unless that is the settlor's intent) but provide that the protector may exercise its powers in its sole and absolute discretion and that its decisions will be binding on all persons.

(7) Specify the duty and liability of the protectors—for example that there is no liability absent bad faith or willful misconduct. In providing for the protection of the protector, specify who will pay the protector's attorney fees if the protector is sued.

(8) Clarify whether the protector has the right to receive information from the trustee and what information is intended.

(9) Make clear that the term "protector" is just the name given to the person and that the protector does not have the function of "protecting" the trust generally.

(10) The protector should discuss with the settlor what the settlor intends the protector to do and how to carry out its functions. The trustee should clarify what its role is with the protector in the wings and what information it should provide to the protector and at what times.

22. Digital Assets; Revised Uniform Fiduciary Access to Digital Assets Act

a. **Significance.** Americans routinely use the Internet and have many forms of digital assets. Google is the only major digital company that allows the designation of someone to have post-mortem access to digital data, through its "Inactive Account Manager." Facebook historically has refused access to digital content by fiduciaries but allows users to add "legacy contacts" to posthumously manage accounts, and Facebook's website provides that "Facebook may provide access to this type of information in response to a valid will or other legal consent document expressing clear consent.". Few states have enacted laws specifically granting some type of fiduciary access to digital assets. Federal privacy and computer fraud and abuse laws create confusion regarding fiduciary access, but do not specifically address fiduciaries.

Being able to access digital information after an individual's death or disability is very important, not only to obtain the information in that account, but because the information may lead to valuable information about other accounts or assets.

b. **Uniform Act Promulgation**. The Uniform Fiduciary Access to Digital Assets Act (UFADAA) drafting committee was approved in 2012 and the UFADAA was approved in the summer of 2014.

c. **Challenges Without State Law**. Federal privacy laws (Stored Communications Act), federal criminal laws (Computer Fraud and Abuse Act), state criminal laws, and "term of service" agreements all create possible roadblocks to fiduciaries being able to access digital assets.

Federal Privacy Laws—Stored Communications Act. The Fourth Amendment offers citizens an expectation of privacy in their homes, but a computer network is not physically located in homes so is not protected by the Fourth Amendment. To fill the gap, Congress enacted the Stored Communications Act (SCA) in 1986 as part of the Electronic Communications Privacy Act. It limits certain providers of public communications services from disclosing the *contents* of users' communications to a government or nongovernmental entity (there are different rules that apply to each) without what amounts to a warrant. If the provider only supplies services to a limited group of people and not the general public, the SCA does not apply (so should not be an excuse to refuse disclosure to fiduciaries). Under §2702(b)(3) of the SCA, the originator or an addressee or intended recipient may provide lawful consent for disclosures, but it does not mention fiduciaries or agents (despite some Congressional history suggesting an intent that agents could authorize disclosure). To provide assurance that a fiduciary can give "lawful consent," underlying state law or a court order should expressly provide that the fiduciary requesting the contents of SCA protected material has the user's lawful consent. Providers are allowed to divulge *non*-content information such as the name, address, account information, etc. Some providers try to argue that is all a fiduciary needs, but that information by itself is not overly helpful.

Federal Criminal Laws—Computer Fraud and Abuse Acts. Each state and Congress has enacted a Computer Fraud and Abuse Act ("CFAA") that criminalizes (or at least creates civil liability) for the "unauthorized access" of computer hardware and data stored therein including computer systems. If the account holder expressly authorized a fiduciary to access her computers, such access would seemingly not violate CFAA (because that access would be authorized by the user). However, even with user authorization, a fiduciary may still be breaking the law because the fiduciary would have to access the provider's computers, which requires the *service provider's* further authorization.

Terms of Service Agreements. If the provider's term of service agreement ("TOS") prohibits third parties from accessing the account, when the fiduciary does so (even with user consent) he violates the TOS, which in turn results in a violation of the CFAA. Federal prosecutors have prosecuted defendants under CFAA based solely on violations of a website's TOS. There have been several well publicized cases over the last several years involving fiduciaries trying to access online accounts, despite contrary provisions in TOS agreements.

d. **UFADAA Approach and Major Provisions**. After contentious negotiations with service providers over provisions of the Act, the general approach is to (i) define digital assets, (ii) provide default rules for fiduciary access with specific provisions for personal representatives, conservators/guardians, agents and trustees, (iii) defer to the account holder's intent and privacy desires, (iv) encourage custodian compliance, and (v) protect fiduciaries, custodians and content providers.

"Digital asset" is defined very broadly as a record that is electronic, including both the catalog of the communication and its actual contents, but not including any underlying asset that is not an electronic record.

Personal Representatives. Section 4 provides that personal representatives will have authority to access the decedent's digital assets (including content) unless prohibited by the decedent's will, a court, or a TOSA provision recognized under the Act (see below regarding the effect of TOSA provisions on fiduciary authority). Access is granted to electronic communications content if permitted under federal law (and it probably is so permitted under federal law).

Conservator/Guardian. Section 5 provides that courts are permitted to authorize the conservator/guardian access to digital assets. (The term "access" is used rather than "management" because social media companies object to ongoing management of someone else's account; they call it "impersonation.")

Agents Under Power of Attorney. Section 6 provides that the principal must expressly permit the agent to access the content of digital assets. That creates a problem for existing powers of attorney that do not address digital assets. This provision is controversial and may be revised by some states in adopting the Act.

Trustee. Section 7 confirms a trustee's authority over digital assets held in a trust, and authority is presumed when the trustee is the initial account holder. If digital assets are subsequently added to the trust, the Act draws distinctions between access to the catalog vs. contents. The Act does not have specific provisions about how digital assets are transferred to a trust. Trust instruments should address which trustees will have access to digital assets, particularly for digital assets that will be added to the trust at a later time.

Fiduciary Authority. Section 8 addresses the nature, extent and limitation of a fiduciary's authority over digital assets. **This is a key provision of the Act.** Subsection (a) establishes that the fiduciary is authorized to exercise control over digital assets (subject to the account holder's ability to opt out as provided in subsection (b)) subject to the TOSA and other applicable laws (such as copyright [service providers are very concerned about protection of their copyrights]). It provides that the fiduciary has the account holder's lawful consent under applicable electronic privacy laws and is an authorized user under any applicable CFAA.

Subsection (b) permits the account holder to opt out of fiduciary access. It renders a boilerplate provision in a TOSA that limits fiduciary access as void against public policy. The TOSA can allow an account holder to prevent access (or to opt for a "digital death"), but it must be in a separate affirmative election. It also provides that the fiduciary's access, by itself, will not violate a TOSA provision prohibiting third party access and will not be deemed to be a transfer.

Subsection (c) provides that any choice of law governing a TOSA that prevents fiduciary access is unenforceable.

Subsection (d) clarifies that the fiduciary is authorized to access digital assets stored on devices, such as computers or smartphones, avoiding violations of state or federal laws on unauthorized computer access This will prevent future prosecutions based solely on the fiduciary's access, which is otherwise authorized but technically violates the TOSA and thus, the CFAA.

Compliance and Immunity. Section 9 provides that a custodian *must* comply with a fiduciary's request for access, control or a copy of the digital asset (if the fiduciary has access under the provisions described above). Thus, the Act *mandates* access that the SCA only permits. Section 10 immunizes a custodian who complies with the request. (This was a central provision to getting service providers to support the Act.)

Applicability. Section 3 provides that the Act will govern the actions of a fiduciary or agent acting under a will, trust, or power of attorney executed before, on, or after the Act's effective date. The Act applies to all active conservatorship/guardianship proceedings. It does not apply to digital assets of employers used by employees in the ordinary course of the employer's business.

Only Applies to Fiduciaries. It is very important to understand that the Act only applies to fiduciaries, as described in the Act. It does not apply to a family member who is not a fiduciary that wants to access a decedent's digital account.

e. **The War**. The UFADAA was introduced in 26 states. That is a blockbuster for a Uniform Act (there are usually 5-6 introductions in the first year). None of those 26 bills were enacted. (Delaware enacted a version in 2014 before the UFADAA was final and before the opposition was readied for battle.)

Lobbyists for many larger providers of electronic communications to the public (Yahoo!, Facebook, AOL, and Google were the most commonly seen, often with a representative of their trade association, NetChoice) vehemently opposed UFADAA in nearly every state in which it was introduced. These efforts were well funded; there are some estimates that the groups were spending about $250,000 in every state in which the legislation was introduced.

f. **PEAC Act.** The service providers' major complaints are that UFADAA is too broad, it raises serious privacy concerns, it potentially conflicts with federal and state law, and it implicitly overrides TOS Agreements. To address these concerns, Netchoice drafted a model act offered as an alternative to UFADAA—the Privacy Expectation Afterlife Choices Act (PEAC Act), pronounced as the "peace act." It was proposed as a legislative alternative in roughly half the states where UFADAA was introduced. The NetChoice website summarizes how the PEAC Act would work:

> "ACCESSING RECORDS OF ELECTRONIC COMMUNICATIONS. The probate court can order copies of the records of the communications for the fiduciary. These records (like the To and From lines of an email) help fiduciaries identify important interactions, like those with a bank or online broker, and then contact those institutions as part of closing the account.
>
> ACCESSING THE CONTENTS OF ELECTRONIC COMMUNICATIONS. Fiduciaries can see the contents of communications only when the deceased expressly allowed it in their will or through a

setting within the product or service. If the deceased bequeathed these communications, service providers will comply subject to verification and indemnification processes.

RESPECTING USER CHOICES. The deceased user chooses if and how their contents are accessed via user level controls and the terms of service they agreed to in life."

This summary, other information about the PEAC Act, and the statutory language of the PEAC Act are available at **http://netchoice.org/library/decedent-information/#peac**.

. The major positions of the PEAC Act are as follows.

- It addresses executor and administrators only—not trustees, conservators or agents acting under a power of attorney.
- It takes a default privacy approach instead of the default access approach taken by UFADAA.
- It distinguishes between "catalogues" of electronic information (such as the "to" and "from" lines in an email) and the content of electronic records.
- A court order is required to access electronic records (both the catalogue and the contents) stipulating various things, and the required elements of the court order differ for accessing the contents vs. the catalogue of the account. The *content* of electronic communications can be accessed by the personal representative only with (i) a court order), *and* (ii) express consent by the account holder (i.e., "opting in").
- Even if a court order is obtained, the service provider may still refuse to disclose or may quash the order under certain circumstances, including that the disclosure would cause an undue burden or violate other applicable law.
- A broad indemnification and release is provided for the ISP. A provider will not be held liable in any civil or criminal action for good faith compliance with a court order issued under the PEAC Act and will be indemnified by the requestor for any damages the provider suffers in connection with disclosure.

See generally Prangley, *War and PEACE in Digital Assets: The Providers' PEAC Act Wages War with UFADAA*, 29 PROB. & PROP. 4 (July/August 2015). A version of the PEAC Act was enacted in Virginia.

g. **Stalemate.** The ISPs were not successful in getting legislatures to pass the PEAC Act, and they eventually realized there was a stalemate, as summarized by Turney Berry (ULC Commissioner):

"[w]e were facing people who don't normally lose: privacy advocates; the ACLU; the Center for Democracy; and Technology. We were also facing a consortium of internet providers who [have] very effective lobbyists and are accustomed to getting their way. We fought them to a draw, which was, I think, shocking to them." Transcript to Third Sessions, Revised Uniform Fiduciary Access to Digital Assets Act, Friday Morning, July 11, 2015, ULC's 124th Annual Conference, Williamsburg, Virginia.

In May 2015, ISP representatives asked to "re-group" with representatives from the Uniform Law Commission. In Mid-May, a small group of representatives from the

Uniform Law Commission and counsel from some of the large providers—lobbyists were deliberately excluded—met and decided to tweak the UFADAA to reach a compromise solution. After about a dozen drafts, a consensus emerged, and was introduced as the Revised Uniform Fiduciary Access to Digital Assets Act (RUFADAA) at the July 2015 meeting of the Uniform Law Commission.

h. **RUFADAA.** The Uniform Law Commission approved RUFADAA on July 15, 2015. One of the major changes is that the *default* rule for personal representatives is for *privacy* of an account rather than for access; access is not permitted unless the decedent consented to disclosure (but restrictions on access in an online tool setting of an account will override a consent to disclosure in an estate planning document). The revised UFADAA continues to apply beyond just executors and administrators, and addresses access to electronic information by trustees, conservators, and agents acting under a power of attorney. For a detailed summary of other provisions in the revised UFADAA, see Sharon Klein, *Fiduciary Access to Digital Assets: Breaking Developments After Provider Giants Flex Their Muscles*, LEIMBERG EST. PL. NEWSLETTER #2332 (August 12, 2015).

RUFADAA is organized differently from and is a complete rewrite of UFADAA. Major provisions of RUFADAA include the following:

- RUFADAA includes an entirely new section of fiduciary duties, §15. It restates basic fiduciary duties to clarify to ISPs that stringent legal duties apply to fiduciaries and that fiduciaries cannot behave recklessly when managing the digital assets of a deceased or disabled person.
- RUFADAA grants a fiduciary full access to digital assets ***other than content*** of electronic communications unless the user opts out or the court directs otherwise. More specifically, the fiduciary has access, except that (i) the custodian of the digital asset may require specific identification of the account and evidence linking the account to the principal (via documentation or court order); and (ii) any TOS restricting fiduciary access will be upheld, absent a conflicting provision in the user's estate planning documents or an online tool/setting, §§4(c) & 5(c). *E.g.*, §8 (personal representative's access to content for a deceased user).
- For a fiduciary to access the ***content*** of electronic communications, the governing document must expressly authorize fiduciary access, or the account holder must otherwise consent to fiduciary access via an online tool. *E.g,*, §7 (personal representative's access to content for a deceased user).
- If there is a conflict between the online tool/account setting and the estate planning documents, the online tool/account setting prevails. §4(a). [This was a very important and significant concession by the ULC representatives; see Item 8 below.]
- Comments to §4 explain the relationship and priority of (i) online tools, (ii) estate planning documents, and (iii) TOS agreements:

> This section addresses the relationship of online tools, other records documenting the user's intent, and terms-of-service agreements. In some instances, there may be a conflict between the directions provided by a user in an online tool that limits access by other parties

> to the user's digital assets, and the user's estate planning or other personal documents that purport to authorize access for specified persons in identified situations. The act attempts to balance these interests by establishing a three-tier priority system for determining the user's intent with respect to any digital asset.
>
> Subsection (a) gives top priority to a user's wishes as expressed using an online tool. If a custodian of digital assets allows the user to provide directions for handling those digital assets in case of the user's death or incapacity, and the user does so, that provides the clearest possible indication of the user's intent and is specifically limited to those particular digital assets.
>
> If the user does not give direction using an online tool, but makes provisions in an estate plan for the disposition of digital assets, subsection (b) gives legal effect to the user's directions. The fiduciary charged with managing the user's digital assets must provide a copy of the relevant document to the custodian when requesting access. See Sections 7 through 14.
>
> If the user provides no other direction, the terms-of-service governing the account will apply. If the terms-of-service do not address fiduciary access to digital assets, the default rules provided in this act will apply. RUFADAA §4 cmt.

i. **Importance of Online Tools Under UFADAA**.

Description. RUFADAA defines an "online tool" as an electronic service provided by a custodian of a digital asset, distinct and separate from the TOS required to open the account (*i.e.*, not a "click through"). Google's Inactive Account Manager and Facebook's Legacy Contact features are two examples of such online tools. Google's Inactive Account Manager allows a user to designate up to 10 individuals to receive the contents of the user's account if it is inactive for a period of time designated by the user, or the user could choose to have the account terminated after the designated period of inactivity.

*Compromise***.** Giving priority to online tools over provisions in estate planning documents was necessary or else ISPs would have no incentive to provide those tools. The online tools may provide a way for ISPs to handle access issues automatically rather than hiring attorneys to interpret wills or other estate planning documents. The concession to the priority of online tools over estate planning documents was granted in order to obtain the concession by ISPs that the estate planning documents (and online tools) would have priority over the "click through" TOS. That was a strongly negotiated issue that the ISPs conceded very reluctantly.

Significance Going Forward. Whether more providers will develop online tools regarding account access is unknown. If these tools become more prevalent, estate planning attorneys will have to caution clients that decisions that they made, perhaps unwittingly, years ago about their account settings will override provisions in their estate planning documents granting fiduciary access to digital assets (analogous to life insurance or retirement plan beneficiary designations overriding provisions in wills and trust documents).

j. **Legislative Prospects Looking Forward.** There are now 29 (perhaps soon 30) states considering RUFADAA. Facebook and Google have endorsed the Act; the expectation is that ISPs will not oppose RUFADAA like they did UFADAA. Proponents

are aware, however, that the agreement of Facebook and Google may mean little to lobbyists who have been pushing the PEAC Act. (The RUFUDAA proponents are still working with the ACLU to satisfy them.)

California is a very important legislative battleground, because most ISPs use California as their choice of law for dispute resolution. There is a pending bill in California, generally based on the PEAC Act, that deals just with decedents (not living account owners). Negotiations are under way to modify the bill to more closely match the RUFADAA provisions. If RUFADAA passes in some other states, that may help in slanting the California bill toward the RUFADAA approach.

k. **Planning Issues and Sample Document Providing Fiduciaries With Access to Digital Assets.** Before the Act is passed by states, account holder should provide as specific authorization as possible to agents and fiduciaries to access digital assets (if that is desired). Even with consent, service providers may balk at providing access to agents and fiduciaries. Passage of the Act will help with authorizing fiduciary access; even then, having specific provisions in trust agreement acknowledging a fiduciary's rights to access digital assets (with any desired limitations) will be helpful in convincing service providers.

For general planning suggestions, see Sasha Klein and Mark Parthemer, *Where Are Our Family Photos—Planning for a Digital Legacy*, 29 PROBATE & PROPERTY 45 (January/February 2015). Planning considerations include (i) identify and create an inventory of digital assets and passwords, (ii) authorize agents under a power of attorney to access digital assets (which could be specific to certain types of digital assets or broadly apply to all digital assets), and (iii) add provisions to wills and trusts authorizing fiduciary access to digital assets.

The following is a form clause provided by Jim Lamm (ACTEC Fellow practicing with the Gray Plant Mooty law firm in Minneapolis, Minnesota) that is designed as a stand-alone document that a person could sign to authorize disclosure of the content of electronic communications (and other digital assets) to all of the person's fiduciaries. Jim has graciously given me permission to include the document in this summary.

Authorization and Consent for Release of Electronically Stored Information

I hereby authorize any individual or entity that possesses, custodies, or controls any electronically stored information of mine or that provides to me an electronic communication service or remote computing service, whether public or private, to divulge to my then-acting fiduciaries at any time: (1) any electronically stored information of mine; (2) the contents of any communication that is in electronic storage by that service or that is carried or maintained on that service; and (3) any record or other information pertaining to me with respect to that service. The terms used in this authorization are to be construed as broadly as possible, and the term "fiduciaries" includes an attorney-in-fact acting under a power of attorney document signed by me, a guardian or conservator appointed for me, a trustee of my revocable trust, and a personal representative (executor) of my estate.

This authorization is to be construed to be my lawful consent under the Electronic Communications Privacy Act of 1986, as amended; the Computer Fraud and Abuse Act of 1986, as amended; and any other applicable federal or state data privacy law or criminal law. This authorization is effective immediately. Unless this authorization is revoked by me in writing while I

am competent, this authorization continues to be effective during any period that I am incapacitated and continues to be effective after my death.

Unless an individual or entity has received actual notice that this authorization has been validly revoked by me, that individual or entity receiving this authorization may act on the presumption that it is valid and unrevoked. An individual or entity may accept a copy or facsimile of this original authorization as though it were an original document.

Date: ________________________ ____

Signature

____

Printed Name

STATE OF __________________

COUNTY OF ________________ }

This instrument was acknowledged before me on __________________ (date) by __________________ (name of person).

____

Notary Public

23. Business Succession—Dealing with Sibling and Cousin Rivalries

Lou Mezzullo addressed strategies for dealing with intra-family disputes in business succession planning.

a. **Impact of Intra-Family Relationships At Various Stages of a Business's Development.**

Founding Stage. In the initial founding stage of a business "mom can tell the children to stop fighting or they will not get any stock in the company." The concern is that if children cannot work out their differences when the parents are alive, how will they work out differences when the parents are dead?

Next Generation. Some businesses can be split into separate business to be owned separately by different children. If that is not workable, the family must find a workable paradigm for management and control. If control is left to one child, the structure may remain the same as when the parent was in control. If more than one child is active, the potential for discord is elevated. Possible paradigms are for one child as CEO or for co-CEOs. There seems to be a growing trend to having multiple persons with dual status in running companies. The best chance for that to work is if the children had good examples when growing up in dealing with conflicts.

Third Generation and Beyond. The business will be owned by cousins. This almost certainly requires a more structured management system with a strong and involved board of directors.

Termination of Family Ownership/Control. A sale to a third party may be a favorable outcome for the family—or it may be the result of the failure of planning.

b. **Steps to Prevent Disputes**.

(1) *Mission Statements*. A *family mission statement* should set out the core values of the family and the role the family wishes to play in the community, including charitable desires. The process of developing a mission statement for the family involving all adult members will expose any significant differences of opinion regarding core values.

A *separate company mission statement* will highlight the different considerations that go into business relationships as opposed to family relationships. Also a strategic plan for the company for the next five or ten years will help in developing a business succession plan.

(2) *Specific Policies*. Specific policies should be adopted dealing with compensation, standards for family employment, distributions of profits to the equity owners, retirement of family members, redemption of equity interests, transferability of equity interests, and other matters that have the potential for conflict.

Compensation. The best practice is to pay family members what they would earn in a non-family controlled business. However, if two siblings have different positions, but similar responsibilities, it may be better not to differentiate.

Standards for family employment. The best practice is to apply the same standards for employment and promotion to family members that apply to non-family members.

Some companies require that family members work some specified number of years (say 3-5 years) for another company before being considered for employment in the family business. Family members should not be hired if there is no position that he or she is qualified to fill. This may mean that not all family members will be assured of working in the business.

Distributions of profits to equity owners. The best practice is to make distribution decisions based on profits and business needs rather than on what family members need. Consider some minimum level of distributions, (for a pass through entity, above what is needed to pay income taxes on the flow-through income).

Retirement of family members. The best practice is to require family members to retire at a certain age, but the founding entrepreneur will object because he or she will not want to retire. Having a retirement policy allows room for young family and non-family employees to move up in the company.

Redemption of equity interests. A policy that allows disgruntled family members to "cash out" may nip disputes before they become unmanageable. Specific provisions regarding valuation and payment terms would be needed.

Transfers of equity interests. Permitted transferees should be identified. In particular, policies should specify if and when transfers can be made to a spouse, including a surviving spouse, and whether such transfer must be in trust with specified general terms.

Investment opportunities. Should there be restrictions on a particular family member being able to take advantage of investment opportunities that arise?

Individual estate plans. Should family members at the same level share their estate plans with each other?

(3) *Specific Goals/Timetable.* Develop specific goals and a timetable regarding the development of policies and elements of the business succession plan. There should be a periodic review of specific goals of the business.

(4) *Communication Guidelines*. There should be regularly scheduled family meetings and rules of order for conducting the meetings. In addition, regular meetings to review the conduct of the business should be established. There may be frequent meetings of key family and non-family employees and less frequent meetings of all family equity owners. The goal is transparency of communication in an atmosphere of mutual trust and respect.

(5) *Appoint an Advisory Board.* The number and make-up of the advisory board would depend on the perceived need for outside input and expertise. Establish terms so that unproductive members can have their terms lapse without being prematurely terminated.

(6) *Consider Adding Nonfamily Members to Board of Directors*. Recognizing the need for objective outside input is a sign of maturity for the leadership and the business.

(7) *Get Commitment From Family Members*. All family members should commit to the process by having a sincere recognition of the benefits to be derived from the process. Stress the importance of each family member participating and refraining from Monday-morning quarterbacking as the process proceeds.

c. **Special Considerations for Family Businesses**.

Control Voting Stock. Do not give voting stock to younger family members or to non-active family members. Consider using preferred or fixed value interests for non-active family members.

Downside Protection. Provide downside protection to non-active family members by giving them a put right and by placing restrictions on the active younger family members' ability to receive excessive compensation and other financial benefits.

Call Right. Similarly, consider giving active family members a "call right" to buy out inactive family members if irreconcilable differences arise over running the business.

Planning for Possible Divorce. Disposition of a family business interest may be addressed in premarital agreements for family members. Buy-sell agreements should

specify that the family member has the first right to acquire any stock awarded to the divorced spouse by the divorce court. One solution is to provide that any stock held for spouses will be in trust with specified terms of the trusts.

24. Valuation Cases

Interestingly, there have been far fewer than normal valuation cases over the past year.

a. **Richmond v. Commissioner**. The decedent's 23.44% interest in a closely-held investment holding company (a C corporation) that owned $52 million of publicly traded securities was determined. *Estate of Helen P. Richmond v. Commissioner,* T.C. Memo 2014-26 (February 11, 2014) (Judge Gustafson). The court rejected the estate's approach of valuing the company based on a capitalization of the dividends, reasoning that the net asset value approach was more appropriate for a non-operating company that held publicly traded stock.

   The court determined the present value of the built-in gains ("BIG") tax at the entity level, rather than just including a BIG tax discount as part of the marketability discount. A dollar-for-dollar liability offset was not allowed (the case is not appealable to either the 5th or 11th Circuits, which allow dollar-for-dollar discounts). The court examined the present value of the BIG tax by assuming the stock portfolio would be sold over 20 and 30-year periods and by using various discount rate assumptions. (The court did not consider the built-in gains tax on future appreciation in its analysis, which had been considered in *Litchfield v. Commissioner*.) The BIG liability allowed by the court was 43.16% of the total BIG tax liability if all of the assets had been sold immediately at the date of the decedent's death.

   The lack of control discount (7.75%) was determined by reference to reference to closed-end fund studies (both parties agreed to that approach).

   The lack of marketability discount (32.1%) was determined based on data from restricted stock/pre-IPO stock studies (which produced discounts ranging from 26.4% to 35.6%, with an average of 32.1%). Both sides' experts used those same studies.

   The estate did not meet its burden of proving reasonable cause to avoid a 20% undervaluation penalty. The Form 706 used as the value for the stock the value conclusion on an unsigned draft report by an accountant who had some experience preparing appraisals (having written 10-20 valuation reports) but who did not have any appraiser certifications.

b. **Giustina v. Commissioner.** The court determined the value of the decedent's 41.1% interest in an FLP with timberland forestry operations. *Estate of Giustina v. Commissioner,* T.C. Memo 2011-141(Judge Morrison), *rev'd and remanded for recalculation of valuation,* 114 AFTR 2d 2014-6848 (9th Cir. December 5, 2014). The Tax Court based its valuation 75% on the cash flow method using pretax (not tax-affected) cash flows [for which a 25% marketability discount applied] and 25% on an asset method [for which no marketability discount applied because a 40% absorption discount had been allowed in valuing the large tract of timberland and the court viewed an additional marketability discount in valuing the limited partnership interest

as a "double discount." The liquidation value of the timberland far exceeded the value based on cash flows.

The Ninth Circuit ruled that (1) basing 25% of the valuation on liquidation, and (2) cutting in half the Estate's expert's discount for a "company-specific risk" was improper.

Assuming 25% Probability of Liquidation. The Ninth Circuit observed that the Tax Court concluded there was a 25% likelihood of liquidation of the partnership even though the decedent could not unilaterally force liquidation, reasoning that the owner of that 41% interest could form a two-thirds voting-bloc with other limited partners to do so. The Ninth Circuit said that conclusion was contrary to the evidence. For a liquidation to occur, (1) a hypothetical buyer would somehow have to obtain admission as a limited partners from the general partners, who have repeatedly emphasized the importance upon continued operation of the partnership, (2) the buyer would seek dissolution of the partnership or the removal of the general partners who just approved his admission; and (3) the buyer would manage to convince at least two (or possibly more) other limited partners to go along, despite the fact that "no limited partner ever asked or ever discussed the sale of an interest." The Ninth Circuit pointed to an earlier case in the same circuit [*Estate of Simplot v. Commissioner,* 249 F.3d 1191 (9th Cir. 2001)], which similarly reasoned that the Tax Court engaged in "imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect" with the existing partners.

Discount for Company-Specific Risk. In determining an appropriate rate for discounting future cash flows to present value under the cash flow method, the Estate's appraiser used an 18% discount rate. Of that 18%, 3.5% was attributable to a partnership-specific risk because the partnership's operations were not diversified and because the timberlands were not geographically dispersed. The Tax Court cut that 3.5% in half because "investors can eliminate [unique risks of the partnership] by holding a diversified portfolio of assets." The Ninth Circuit concluded that the Tax Court did not consider the wealth that a potential buyer would need in order to adequately mitigate risk through diversification.

c. **Elkins v. Commissioner**. The Tax Court allowed a small (10%) discount for undivided interests in art, ignoring under §2703 a co-tenants agreement requiring unanimous consent to sell the art, and reasoning that a hypothetical buyer would know that family members had a strong attachment to the art and would be willing to buy out the third party at little or no discount. Estate of Elkins v. Commissioner, 140 T.C. 86 (2013) (Judge Halpern). (Several prior cases had allowed only a 5% undivided interest discount for art. Estate of Scull v. Commissioner, (T.C. Memo 1994-211) and Stone v. U.S.(103 AFTR 2d 2009-1379 (9th Cir. 2009).)

Synopsis of Fifth Circuit Opinion. The Fifth Circuit reversed and rendered, reasoning that the IRS offered *no* evidence of appropriate discounts and accepting the undisputed testimony of the estate's experts at trial. The Fifth Circuit noted that the Elkins family members should not be viewed as hypothetical willing buyers under the willing buyer/willing standard. A hypothetical willing buyer would know that the family

members owned the other undivided interests and that they might be interested in purchasing interests owned by others, but the court pointed to testimony by a family member that the family would only be willing to buy a third party's undivided interest at a "fair price." The average discount allowed was 67%. 767 F.3d 443 (5th Cir. September 15, 2014).

Fifth Circuit's Analysis. The court agreed with the Tax Court's rejection of the IRS's "no discount" position. The court emphasized that the IRS offered NO evidence of the proper amount of discount if any discount is allowed. The estate attached an appraisal to the Form 706 and offered even more evidence of discounts (larger than on the Form 706) at trial.

The court noted that the taxpayer had the burden of proof, but the burden shifted to the IRS when the estate offered credible evidence. Because the IRS offered no evidence of the appropriate discount amount, the court observed that the estate should have prevailed under the burden of proof, but the court did not rely on that issue.

The court stated that there was no factual support for the Tax Court's own nominal 10% discount. The court believed that the estate's experts considered all the characteristics of the Elkins heirs, who testified that they would purchase a third party's undivided interest, but only at a "fair price."

The Fifth Circuit rejected the Tax Court's assumption that a hypothetical buyer would know the family would buy any undivided interest with no (or little discount).

> It is principally within the last few pages of its opinion that the Tax Court's reversible error lies. While continuing to advocate the willing buyer/willing seller test that controls this case, the Tax Court inexplicably veers off course, focusing almost exclusively on its perception of the role of 'the Elkins children' as owners of the remaining fractional interests in the works of art and giving short shrift to the time and expense that a successful willing buyer would face in litigating the restraints on alienation and possession and otherwise outwaiting those particular co-owners. Moreover the Elkins heirs are neither *hypothetical* willing buyers nor *hypothetical* willing sellers, any more than the Estate is deemed to be the hypothetical willing seller.
>
> We acknowledge, of course—as did the Estate's experts—that a hypothetical willing buyer would be aware of and take into account *all* aspects of the remaining fractional interests in the art that the Elkins heirs owned, not just the likelihood of their hypothetical desire to acquire the Decedent's fractional interests in the art from any successful hypothetical buyer thereof. [The court reviewed various characteristics about the heirs, including their testimony that they would be willing to purchase interests only "after first determining from experts that any price was fair and reasonable."]"

The court allowed discounts based on the only evidence at trial about the amount of discounts (i.e., the estate's experts). The court did not raise whether the estate's position on the Form 706 (44.75% discount) was an admission against interest that was binding absent "cogent proof" of why the valuation should be different.

Estate's expert at trial opined that the discounts varied among the 64 works of art. The aggregate fractional interest discount was 67%.

The Fifth Circuit did not mention §2703 at all. It is not clear whether the discount allowed by the court was based in part on the co-tenants agreement that the art could be sold only with unanimous consent of the undivided interest owners.

d. **Strategic Buyer Issue.** Both Giustina and Elkins rejected a strategic buyer approach of assuming that a purchaser will have a particular attitude towards sales or that an entity will redeem the interests of a prospective seller.

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. Commissioner, 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. Commissioner, 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. Commissioner, 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. Commissioner, 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. Commissioner, 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 Tax Court opinion was 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.

25. Unbundling Requirements for Expenses of Trusts and Estates, Final Regulations to §67(e)

a. **Statutory Provision**. Under §67(a) miscellaneous itemized deductions may be deducted only to the extent that they exceed 2% of adjusted gross income. Under §67(e) the same rules apply to estates and trusts, except that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such

trust or estate" are allowed in full. This exception has been analyzed under a two prong test: (1) costs paid or incurred in connection with the administration of the estate or trust, and (2) which would not have been incurred if the property were not held in such trust or estate.

b. **Case Law; Knight v. Commissioner.** Following a tortured history of inconsistent treatment by circuit courts of whether trust investment advisory fees are subject to the 2% floor, the Supreme Court spoke to the issue in *Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner*, 552 U.S. 181 (2008). The Supreme Court held in favor of the government, but it did not agree with the Second Circuit's test. The Court adopts the "unusual or uncommon" test used by the Fourth and Federal Circuits and concludes generally that "§67(e)(1) excepts from the 2% floor only those costs that it would be *uncommon (or unusual, or unlikely*) for such a hypothetical individual to incur." (emphasis added)

c. **Proposed and Final Regulations**. Regulations regarding the application of §67(e) to trusts, following the Supreme Court's decision in Knight v. Commissioner, were finalized in 2014. The IRS had issued proposed regulations prior to the Knight decision and in 2011 issued a new set of proposed regulations after the Knight case that imposed an unbundling requirement on trusts to identify the portion of trustee fees and professional fees that are subject to the 2% haircut rule for the deduction of miscellaneous itemized deductions by trusts under §67(e). The IRS continued its approach of imposing the unbundling requirement despite substantial criticism of those provisions in the initial proposed regulations. The IRS in Notice 2011-37 committed that it would not impose the unbundling requirement until trust and estate tax years beginning after the issuance of final regulations. The IRS finalized the regulations on May 9, 2014, with very few changes from the proposed regulations. The final regulations apply to any taxable year of any trust or estate that begins on or after January 1, 2015.

   Highlights of the regulations include the following.

   - The allocation of costs of a trust or estate that are subject to the two-percent floor is based not on whether the costs are "unique" to trusts or estates (as in the prior proposed regulations), but whether the costs "commonly or customarily would be incurred by a hypothetical individual holding the same property."
   - In making the "commonly or customarily incurred" determination, the type of product or service actually rendered controls rather than the description of the cost.
   - "Commonly or customarily" incurred expenses that are subject to the two-percent floor include costs in defense of a claim against the estate that are unrelated to the existence, validity, or administration of the estate or trust.
   - "Ownership costs" that apply to any owner of a property (such as condominium fees, insurance premiums, maintenance and lawn services, etc. [other examples are listed]) are subject to the two-percent floor. Expenses that are deductible under §§62(a)(4), 162, or 164(a) may be fully deductible

because they would not be miscellaneous itemized deductions subject to §67(e).

- A safe harbor is provided for tax return preparation costs. Costs of preparing estate and GST tax returns, fiduciary income tax returns, and the decedent's final income tax return are not subject to the two-percent floor. Costs of preparing all other returns are subject to the two-percent floor. (Interestingly, gift tax returns are not included. What if the estate has protracted litigation over gift tax issues—are all of those expenses subject to the 2% rule?)
- Investment advisory fees for trusts or estates are generally subject to the 2% floor except for certain incremental fees (above what is normally charged to individuals). Those incremental fees that are not subject to the 2% rule are (i) an "additional charge that is added solely because the investment advice is rendered to a trust or estate rather than to an individual," or (ii) an additional charge "attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen)." If an investment advisor charges an extra fee to a trust or estate because of the "usual" need to balance the varying interests of current beneficiaries and remaindermen, those extra charges *are* subject to the two-percent floor. The incremental portion of investment advisory fees not subject to the 2% floor "is limited to the amount of … fees, if any, that exceeds the fees normally charged to an individual investor." (Excepting only "specialized balancing" expenses but not "usual balancing" expenses from §67 seems unfair. Individuals have no need for balancing the interests of various parties, so it would seem that all additional expenses for balancing the interests of beneficiaries would be different than expenses "commonly" incurred by individuals.) Determining what types of expenses for balancing the interests of various trust beneficiaries is sufficiently "specialized" or "unusual" will require careful consideration by fiduciaries. *See* McGuire Woods, *IRS Publishes Final Regulations Under Section 67 on Deductibility of Fiduciary Expenses; Postpones Effective Date* (August 6, 2014).
- Bundled fees (such as a trustee or executor commissions, attorneys' fees, or accountants' fees) must be allocated between costs that are subject to the 2% floor and those that are not. The unbundling requirements are discussed immediately below.

d. **Unbundling Requirement**.

- A safe harbor is provided in making the allocation of bundled fees. If a bundled fee is not computed on an hourly basis, only the portion of the fee that is attributable to investment advice is subject to the 2% floor. The balance of the bundled fee is *not* subject to the 2%. Reg. §1.67-4(c)(2). (This exception may seem overly broad as applied to attorneys' and accountants' fees, but the exception is explicit. If attorneys or accountants charge on a project basis rather than on an hourly basis, there is no need for unbundling any of the fees if none of them relate to investment advisory expenses.)

- If the recipient of the bundled fee pays a third party or assesses separate fees for purposes that would be subject to the 2% floor, that portion of the bundled fee will be subject to the 2% floor.
- Any reasonable method may be used to allocate the bundled fees. The Preamble to the proposed regulations provides that detailed time records are not necessarily required, and the IRS requested comments for the types of methods for making a reasonable allocation, including possible factors and related substantiation that will be needed. The IRS was particularly interested in comments regarding reasonable allocation methods for determining the portion of a bundled fee that is attributable to investment advice — other than numerical (such as trusts below a certain dollar value) or percentage (such as 50% of the trustee's fee) safe harbors, which the IRS suggested it would not use. The Service received only one comment about allocating bundled expenses-stating that no single standard could be applied to multiple trusts or even to the same trust in different years. The final regulations provide three facts that may be considered (among others) in making a "reasonable" allocation:

  > Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to, the percentage of the value of the corpus subject to investment advice, whether a third party advisor would have charged a comparable fee for similar advisory services, and the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions. Reg. §1.67-4(c)(4).

e. **Mutual Fund Investments for Trusts**. In the future, trustees may tend to make investments through mutual funds rather than through common trust funds or by direct investments, because the investment expense of administering a mutual fund is netted out before the taxable income from the fund is determined. Thus, there is not an issue of having a separate expense that is not fully deductible (or that is subject to the alternative minimum tax).

   The final regulations were originally effective for taxable years beginning on or after the date the regulations were published (May 9, 2014). That would cause the regulations to apply to new trusts or estates that begin in 2014 after May 9 (or estates with fiscal years beginning after May), and apparently that was not intended. The IRS on July 16, 2014 amended the effective date so that the regulations apply to taxable years of trusts or estates beginning on or after January 1, 2015.

f. **Impact of §67(e) 2% Floor for Trusts and Estates.** For many trusts, the most substantial impact of having expenses subject to the 2% floor is that all of the expenses subject to the 2% floor (not just the amount within 2% of adjusted gross income that cannot be deducted) is a tax preference item for alternative minimum tax purposes.

   If the 2% limitation applies, the effect will be to increase DNI — so there will be a larger hit to beneficiaries of the DNI carryout.

   Trust distributions reduce trust AGI and minimize the impact of §67. The distribution deduction is subtracted in arriving at the adjusted gross income of the trust (and the 2% limit under §67 is based on the adjusted gross income).

Unlike individuals, estates and trusts are not also subject to an overall limitation on itemized deductions under §68 (generally reducing overall allowable itemized deductions by 3% of adjusted gross income over an "applicable amount," but not to exceed 80% of the itemized deductions).

Calculating the 2% floor is a complicated interrelated calculation if the trust pays the beneficiary more than its DNI. The AGI depends on the distribution deduction, which is limited by DNI, which depends on the trust's allowable miscellaneous itemized deductions (AMID), which depend on its AGI.

26. Business Opportunities—Bross Trucking, Adell, Cavallaro Cases

a. **Background.** A fascinating way to build value in younger generations is to allow the younger generations (or trusts for them) to take advantage of business opportunities, using the parent's business knowledge and acumen. For example, a business owner-parent might have an idea for opening a new location or opening a new line of services or products. The parent might create a trust for the children and allow the trust to open the new business or to acquire a large non-voting interesting in the new business. Or the parent might assist the trust in acquiring financing to build a building or purchase equipment and lease the building or equipment to the business. The children would be able to benefit from the parent's knowledge without any transfer of property ever taking place.

The IRS might argue that a business opportunity is an opportunity that belongs to the owner's business, and that a transfer of that opportunity is treated as a distribution to the owner and as a gift from the owner to the children. The U.S. Supreme Court in *Dickman v. Commissioner*, 465 U.S. 330 (1984) held that allowing the gratuitous use of property constituted a gift, and that gifts could result from interest-free loans. The Supreme Court stated that there was a broad reach in determining what constitutes taxable gifts and that "the gift tax was designed to encompass all transfers of property and property rights having significant value." The IRS has taken the position in various private letter rulings and technical advice memoranda that the failure to exercise legal rights can constitute a gift. *E.g.,* Tech. Adv. Memo. 8726005 (failure to convert preferred stock to common stock was a gift if corporation's financing document precluded making dividends for a substantial period), 8723007 & 8403010; Letter Ruling 9117035 (foregoing right of first refusal to acquire father's shares at a below market price was a gift equal to difference between the market price and the option price where the son was financially able to exercise the right of first refusal option). There is relatively little case law regarding the gift consequences of allowing one's children to take advantage of new opportunities. *E.g.*, *Crowley v. Commissioner*, 34 T.C. 333 (1960) (parent created partnership owned by his children that generated income from appraisal fees, insurance fees and title commissions with respect to savings and loan owned by parent; court concluded no gift); *see* Gingiss, *The Gift of Opportunity*, 41 DEPAUL L. REV. 395, 410 (1991-1992).

What is the dividing line between transferring a current right owned by the parent and allowing children to take advantage of new opportunities? Three recent cases impact this issue.

b. **Bross Trucking Inc. v. Commissioner**. In *Bross Trucking Inc. v. Commissioner*, T.C. Memo 2014-17 (June 5, 2014) (Judge Paris), the taxpayer's existing company (Bross Trucking) had lost most of its corporate goodwill because of negative publicity from regulatory infractions and a possible shutdown of the company. Mr. Bross (the owner) never had an employment agreement or noncompete agreement. However, he had personal relationships and had a long tenure in road construction industry. His sons created a new trucking company that provided more service than Bross Trucking had offered (including GPS products and mechanic services). The new company acquired its own insurance and license and leased equipment that a separate company had previously leased to Bross Trucking after the lease to Bross Trucking expired. Bross Trucking remained in existence, but its business dwindled while the business of the sons' new business flourished.

The IRS position was that Bross Trucking distributed its goodwill to Mr. Bross (as ordinary income) and Mr. Bross made a gift of that goodwill to the sons. The court concluded that there was little corporate goodwill to be distributed to Mr. Bross and that he made no gift with respect to the sons' new company.

The court pointed to prior cases that have addressed whether sales of certain interests from a corporation included personal goodwill of some of the shareholders that should be excluded in determining the value that should be realized by the corporation. *See Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998) (certain distribution rights spun off to subsidiary owned by one shareholder were subsequently sold by that subsidiary; customer relationships and distribution rights were the shareholder's personal assets and not company assets-because he never transferred the goodwill to the parent company through an employment or noncompete agreement-so the parent company was not taxed on the sale proceeds); *Solomon v. Commissioner*, T.C. Memo. 2008-102 (one branch of a company was sold to a competitor; sale proceeds taxed at corporate level not reduced by any value attributable to personal goodwill of shareholder; court reasoned that the customers conducted business with the company because of its products, not because of the relationships formed with the shareholder).

Key Factors. Key factors that were noted in *Bross Trucking*, in finding that there was little corporate goodwill, include the following:

- Mr. Bross did not have an employment agreement or noncompete agreement with Bross Trucking.
- Customers of Bross Trucking "patronized the company solely because of the relationships that Mr. Bross personally forged."
- The court referred to goodwill as "the expectation of continued patronage." Under this definition, Bross Trucking had lost any goodwill that it might have had because of the regulatory problems.
- Bross Trucking did not distribute any cash assets and retained all the necessary licenses and insurance to continue in business.
- The only attribute of goodwill left was the workforce of Bross Trucking. While 50% of the employees of the new company worked for Bross Trucking, the

court did not view this as a transfer of an established workforce, in part because of the new lines of services offered by the new company. (Furthermore, the court noted that they may have been independent contractors.)

- Mr. Bross was not involved in managing the new company.
- There is no indication the new company used Mr. Bross's relationships; the sons were in a similarly close relationship with Bross Trucking's customers. (The principal customers were Bross family members.)
- "Cultivating and profiting from independently created relationships are not, however, the same as receiving transferred goodwill."

c. **Estate of Adell v. Commissioner.** The Adell estate has been through various court cases previously involving §6166 and tax payment issues. T.C. Memo. 2013-228; T.C. Memo. 2014-89. In the most recent reported decision, the court addresses the value of a business (STN.Com, Inc.) owned by a trust that was includable in the gross estate (presumably, it was a revocable trust). *Estate of Adell v. Commissioner,* T.C. Memo. 2014-155 (Aug. 4, 2014) (Judge Paris).

Facts. The facts surrounding STN are very messy. A non-profit entity ("The Word") was formed by relationships that the decedent's son had with religious leaders. The Word entered into a broadcast contract with STN (a company owned by the decedent's revocable trust) for its uplinking services. The son was the President of STN but he never had an employment agreement or noncompete agreement with STN and did not own any of its stock. STN received millions from The Word under this arrangement. The appraisal of STN attached to the estate tax return subtracted from the company value an "economic charge of $8 million to $12 million for Kevin's personal goodwill" that he contributed but that was not a corporate asset. An amended Form 706 claimed a lower value (based on an adjusted book value method, primarily because the appraiser discovered that The Word had overpaid STN.Com under the strict contract terms) (The facts were really messy [and "juicy"] in this case. For a more detailed discussion of the facts and reasoning in this case, see Item 28.c of the Hot Topics and Current Developments Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.)

Holding. The court agreed with the estate's appraiser's value reduction to account for the significant value of Kevin's personal goodwill that accounted for much of the success of STN. The court did not use the lower value described in the amended return. Key points in the court reasoning are (i) the burden of proof did not shift from the taxpayer to the IRS; the estate did not present "credible evidence" regarding the valuation issue—because of the inconsistent positions in the various estate valuation reports; (ii) the value listed in the original Form 706 was an admission against interest; there was no cogent proof of the changed valuation so the estate's expert's testimony regarding the amended return value was given no weight; and (iii) the value was reduced by personal goodwill attributable to the decedent's son.

Analysis Regarding Personal Goodwill Value Reduction. Key factors in the court's determination that STN depended on Kevin's relationships with The Word and its

customers, and in its determination that Kevin's goodwill was primarily his personal goodwill that had not been transferred to STN:

- The son had the key contacts;
- Ministers who provided programming for the exempt entity (the customer of STN) did not realize that the son worked for STN; therefore, the relationships were not the goodwill of STN;
- Kevin did not transfer goodwill to STN through a covenant not to compete or an employment agreement; and
- Kevin was free to leave any time and use his relationships to compete directly with STN.

d. **Cavallaro v. Commissioner**. In *Cavallaro v. Commissioner*, T.C. Memo 2014-189 (Judge Gustafson), the parent's company manufactured tools. The company developed a special prototype tool, with which it had limited success. At some point the parent's adult sons developed an interest in the special tool, and worked to improve and market it. The sons formed their own company to sell this product. Some years later, the two companies were merged, and the issue was whether the sons received too large an interest in the merged company. The court held a large gift did result, reasoning that there was no evidence of arm's length negotiations between the two companies. A key fact was that the parent's company owned the technology for the special tool and there was no documentation that the technology had ever been transferred to the son's company. The estate was not able to meet its burden of proof to establish a lower gift amount. The court rejected accuracy-related penalties, finding that the taxpayers had reasonably relied on the advice of their professional advisors. Interestingly, *Cavallaro* arose from an income tax audit. The income tax examiner referred the case to gift tax examiners.

The taxpayer has appealed the *Cavallaro* case to the First Circuit. The taxpayer's brief to the First Circuit was filed on July 6, 2015.

e. **Planning Observations.**

Bross Trucking and *Estate of Adell* both involved situations in which:

other family members had key relationships with customers of the business; and there was no employment agreement or covenant not to compete signed by the person with key contacts (the owner/potential donor in Bross Trucking and the decedent's son in Estate of Adell).

In addition, in *Bross Trucking* the current business was going to be discontinued for business reasons.

These are unusual facts that will not apply in many client situations involving new business opportunities. Nevertheless, these cases highlight that the key issue is whether the client (or the existing business) owns existing rights that are transferred to someone else. These two cases refer to this general issue in terms of whether the new opportunity is a result of a personal goodwill or business goodwill that is owned by the existing business. One factor is whether the client (or the person with the relationships) has an employment agreement or noncompete agreement, but that is merely one factor that might or might not be relevant in other particular situations.

The key issue is whether the client (or the existing business) is relinquishing legal rights when other family members pursue new business opportunities.

Cavallaro involves a situation in which an existing company owns the rights to a particular product, and does not legally transfer those rights to a new company formed by the children to develop the product before the development occurs. The lesson to be learned is that if an existing company does own the rights to certain interests that are going to be developed by a new entity owned by younger generation owners, be careful to document a legal transfer of the rights before the development occurs to increase the value of those rights in the new entity.

27. Family Limited Partnership Attack for Estate Inclusion Without Any Discounts, *Estate of Williams* Recently Stipulated Case

The IRS assessed about $1.5 million in estate taxes and $300,000 in penalties regarding a property that was transferred to a family limited partnership by the decedent four years before his death. *Estate of Jack Williams,* T.C. No. 029736-13 (petition filed December 19, 2013). The partnership owned real properties, business and investment assets. The IRS appears to have "thrown the kitchen sink" at the estate with a wide variety of arguments including disregarding the existence of the partnership and treating transfers to the partnership as a testamentary transaction occurring at the decedent's death, undervaluation of the underlying partnership assets, the partnership lacked a valid business purpose or economic substance, the decedent retained enjoyment of the partnership assets triggering estate inclusion of the assets under §2036, ignoring restrictions on the right to use or sell the partnership interest under §2703(a), ignoring liquidation restrictions under §§2703, 2704(a) and 2704(b), any lapse of voting or liquidation rights in the partnership is a transfer under §2704(a), and that gifts of partnership interests should be brought back into the estate under §2036 and should be removed from the decedent's adjusted taxable gifts.

The estate maintains that the partnership had various non-tax purposes including limiting future potential personal liability of the decedent, limiting litigation risks associated with future improvements and maintenance on various real properties, pooling of income in one entity to provide centralized and continuous management of properties and to diversify and reducing investment risk, facilitating transfers without having to fractionalize real property interest, provide a structure of ownership and operation of real properties to provide continuity and minimal interruption upon the death of a partner, minimizing litigation among family members or spouses and preservation of family harmony, increased marketability of the partnership and an affiliate company that was the lessee of commercial property owned by the partnership. The estate maintains that the transfers to the partnership were bona fide and for full consideration decedent retained assets outside the partnership that were more than adequate to maintain his then current lifestyle, and that §2036 should not apply. The estate also argues that it adequately disclosed gifts of the partnership interests on gift tax returns. In summary, the IRS is attempting to increase the value attributable to the decedent's limited partnership interest from $4.5 million to $7.7 million.

Another issue is the value of notes in the estate.

The case was set for trial April 20, 2015, but a stipulated decision was entered on March 19, 2015, providing that there is an estate tax deficiency of $487,985, and no penalty is due

under §6662. The increase in estate value under the stipulated decision is obviously much less than the IRS position of increasing the value by $3.2 million. Attorneys for the estate were John Thornton and Kevin Belew, Boise, Idaho.

28. QSST—Paying Trustee Fees

If an S corporation declares dividends that are payable to a QSST, cash dividends are received as fiduciary accounting income of the trust, and the QSST must distribute all income annually to the beneficiary. Under most state laws, trustee fees are allocated one-half to income and one-half to principal. The trust does not receive any principal cash, so how does it pay the one-half of the trustee fee that is to be paid from principal?

- If the issue is ignored, the beneficiary may be treated as making a contribution to the trust, which could have adverse gift tax consequences.
- One approach is to pay the entire fee from income and establish a liability from the principal account to the income account. Query, does it have to bear interest? When the S corporation stock is sold or when a large distribution is made that is characterized as principal, the principal account would be able to repay the income account.
- Another approach is to exercise a "power to adjust," to declare that a portion of the cash receipt is principal.
- Another is to convert the trust to a unitrust (assuming the distributions exceed 3% of the trust value on an annual basis). For example, with a 3% unitrust, the distribution would be income up to 3% of the trust value and the excess would be principal, which the trust could use to pay expenses that are charged to principal.
- Another creative approach is to have the S corporation make distributions in marketable securities. The general income –principal allocation rule is that *cash* dividends from an entity are treated as income but not in-kind distributions.
- If all else fails the S corporation could redeem a portion of the QSST's stock; the redemption proceeds would be principal.

29. Possible Unconstitutionality of Perpetuities Repeal in States With Constitutional Prohibitions

A recent law review article by Professor Robert Sitkoff and Stephen Horowitz questions the constitutionality of provisions that repeal or greatly extend the rule against perpetuities in five states that have state constitutional prohibitions on "perpetuities" but that by statute have repealed or greatly expanded the time limit on perpetuities (ranging from 360 years to 1,000 years and full repeal). Stephen Horowitz & Robert Sitkoff, *Unconstitutional Perpetual Trusts*, 67 VANDERBILT L. REV. 1769 (2014). Those states are Arizona, Nevada, North Carolina, Tennessee and Wyoming. That article was publicized in a detailed column in the December 5, 2014 issue of The New York Times.

A very brief summary of the reasoning of the article is as follows.

- The constitutional prohibitions vary, but they generally state that "perpetuities" are not allowed.

- The term "perpetuities" is referring to "entails," which was a method of providing that an estate would pass forever in accordance with a prescribed succession that could never be changed. The first cases to use the term "perpetuity" were referring to an "unbarrable entail, meaning a perpetual string of inalienable life estates 'in whatever guise it appeared.'" *Id.* at 1821.
- A perpetual trust is an entail in form and function, so it violates the prohibition on "perpetuities."
- The common law rule against perpetuities satisfies the constitutional bans because it prohibits entails in form or function.
- There are four additional states with constitutional prohibitions on perpetuities that have not tried to change that by statute. (Those states are Montana, Arkansas, Oklahoma, and Texas.)
- Summary: "[W]e conclude that legislation authorizing perpetual or long-enduring dynasty trusts is constitutionally suspect in a state with a constitutional prohibition of perpetuities, but more modest reforms that approximate the common law Rule are permissible." *Id.* at 1803.

A very strongly worded rebuttal was written by Steven Oshins, particularly addressing the Nevada situation. Among other things, Mr. Oshins makes the following observations.

The various constitutional bans appear to follow the lead of the initial ban in North Carolina and that the North Carolina court of appeals has upheld the validity of the North Carolina statute repealing the rule against perpetuities as long as a trustee has a power of sale. *Brown Brothers Harriman Trust Co. v. Benson*, 202 N.C. App. 283, 688 S.E.2d 752 (2010).

The Horowotz & Sitkoff article considers that the Uniform Statutory Rule Against Perpetuities (USRAP) wait-and-see period of 90 years is an acceptable legislative modification, "notwithstanding it admitted deviation from the common law rule against perpetuities, which they argue is the constitutional meaning of 'perpetuities.' In contrast they contend than an extension for several hundred years is too much." Mr. Oshins observes that the article recognizes "the right of legislatures to define the perpetuities period and to change it over time." He asks why "a modern day legislature in its capacity as the principle formulator of public policy and representative of the people" could not enact a perpetuities period much longer than the old common law rule against perpetuities (the Nevada limit is 365 years) but still be consistent with a constitutional prohibition on "perpetuities."

Conflict of laws principles do not permit the forum states to ignore the choice of law because it violates the strong public policy of the forum state, but rather look to the policy of the state with the "most significant relationship" to the trust.

The point of this debate is that, at a minimum, there is some degree of uncertainty. For a further discussion of the Horowitz & Sitkoff article, see Jonathan Blattmachr, Mitchell Gans & William Lipkind, *What If Perpetual Trusts Are Unconstitutional?*, LISI ESTATE PLANNING NEWSLETTER #2263 (December 18, 2014) ("Without question, lawyers, bankers and other advisors in Arizona, Nevada, North Carolina, Tennessee and Wyoming will contend the Sitkoff/Horowitz conclusion is wrong or overstated. However, it seems it would not be prudent to ignore the issue either…..In fact, it would seem prudent to consider creating the trust under the laws of states whose constitutions do not contain the perpetuities prohibition in Arizona, Nevada, North Carolina, Tennessee and Wyoming.")

30. Uniform Voidable Transactions Act

The Uniform Fraudulent Transfers Act was amended in various relatively minor respects (except for a new Section 11 dealing with Series LLCs). A significant change is that the title was changed to the Uniform Voidable Transactions Act (referred to in this Item as the Act). The Act was approved by the Uniform Law Commission on July 16, 2014.

Comments to Section 14 explain that the term "Fraudulent" in the prior name was misleading and caused confusion among parties and the courts. Fraud has never been a necessary element of a claim under the Act. Furthermore, the use of term has led to misleading shorthand references to the theories of recovery under the Act. Recovery under §4(a)(2), 5(a) for theories that have been termed "constructive fraud" has "nothing whatsoever to do with fraud (or with intent of any sort)." Recovery under §4(a)(1) for theories that have been given the shorthand term "actual fraud" "does not in fact require proof of fraudulent intent."

The word "Transfers" was changed to "Transactions." The word "Transfers" "was underinclusive, because the Act applies to the incurrence of obligations as well as to transfers of property."

Judge Margaret Mahoney, Judge of the Bankruptcy Court, was delighted with this change. She explained that debtors always react very defensively to having been charged with having made a "*fraudulent* transfer" with the connotation that they have committed fraud. Calling these "voidable transactions" will avoid that stigma and facilitate reaching settlement between creditors and debtors.

31. Fees Increasing for Private Ruling Requests

The user fees for requests for letter rulings and determination letters increased (rather dramatically), effective for requests received after February 4, 2015. The user fee amounts are listed in Appendix A to Rev. Proc. 2015-1.

- The "regular" user fee for most letter ruling requests increased from $19,000 to $28,300.
- There are reduced fees for taxpayers with gross income below certain levels. The fees did not increase as dramatically for those taxpayers. For taxpayers with gross incomes less than $250,000, the fee increased from $2,000 to $2,200. For taxpayers with gross incomes between $250,000 and $1 million, the fee increased from $5,000 to $6,500.

  The fee for substantially identical ruling requests increases from $1,800 to $2,700 after the $28,300 fee (or the reduced fee for lower income taxpayers) has been paid for the first ruling request.
- The fee for requests under Reg. §301.9100-3 for extensions of time for regulatory elections (not including elections qualifying for automatic extensions under Reg. §301.9100-2, for which no ruling request is required) increased from $6,900 to $9,800.

In general, user fees will not be refunded unless the Service declines to rule on all issues for which a ruling is requested. However, the user fee is not refunded if the request is withdrawn at any time, unless the only reason for the withdrawal is that the Serviced has

advised that a higher user fee is required than what was sent with the request. (There are various other listed situations in which the user fee will not be refunded.) Rev. Proc. 2015-1, §10.

32. Overview of Significant Fiduciary Law Cases in 2014

Every day, Dana Fitzsimons (Bessemer Trust in Atlanta, Georgia) reviews cases from across the country to identify developments or trends in the law, or to learn valuable lessons about fiduciary practice and administration. This is a brief overview of fiduciary cases from 2014 (prepared by Dana Fitzsimons).

a. **Trust Investments.** As trust and estate attorneys consider expanding their practices into the area of fiduciary litigation (which seems likely in view of the sharply increased exemption levels), it is important either to develop the skill on pleading and proving the elements of a claim or affiliate with an experienced fiduciary litigation. *Kastner*, 2014 U.S. App. LEXIS 11864 (10th Cir. Court of Appeals, 2014) illustrates how breach of trust claims can and will be dismissed for failures of proof and pleadings, including the failure to provide expert testimony on the standard of care (with a bare law degree not being sufficient to qualify the plaintiff as his own expert) and for lack of factual support where the trust assets outperformed the S&P 500 while also disbursing $500,000 to the beneficiaries during the period in question.

   The importance of the equities of the case, and fiduciary process, as potential predictors of judicial inclinations was explored through three New York cases. In *Greenberg*, 2014 N.Y. Misc. LEXIS 2011 (2014) and *Matter of Littleton*, 2014 N.Y. Misc. LEXIS 2586 (2014), there were allegations of either bad faith or deficient process and the courts refused to dismiss claims for investment losses as a matter of law. In contrast, in *Matter of Gill*, 2014 NY App Div LEXIS 7828 (2014), in the absence of claims of bad faith or deficient process, the court dismissed claims that the trustee had breached its duties by investing in proprietary products that did not perform as well as other available investments.

b. **Damages and Attorneys' Fees**. In *Miller,* 2014 NMCA 053 (New Mexico Court of Appeals 2014), a trustee appealed a judgment for breach of duty for investing in nonproductive commercial real estate contrary to the trust terms. The trustee had also borrowed funds that were distributed to the income beneficiaries (the trust terms prohibited principal distributions) as what the court called "phantom income", which the trial court took into account in determining the amount of damages. On appeal the court increased the damages for the distributed phantom income because the funds were actually principal that the trust did not permit to be distributed (a "two wrongs don't make a right" approach), and also imposed both inflation adjustments and prejudgment interest to increase the damage award.

   If a trustee successfully defends against a surcharge claim, *Lowrey,* 2014 Ala. LEXIS 53 (Alabama Supreme Court 2014) illustrates that a trial court cannot deny the trustee payment of its attorneys' fees out of the trust, and cannot categorically deny or reduce the fees. The size of the claim, in this case $13 million, is a factor to consider in the extent to which the fees are reasonable. Informing the plaintiff about this long-standing feature of trust law could lead to more reasonable discussions about how to resolve disagreements.

c. **Abusive Litigation**. If a beneficiary brings repetitive claims that are frivolous or harass a fiduciary, the courts can impose a "gate keeping order" as a remedy. However, for reasons of constitutional due process, there must be substantive findings of frivolousness or harassment (which may require more than just two lawsuits), and the restrictive order must be tailored to remedy the improper action of the "vexatious litigant". Without those things, the restrictive order may be vulnerable on appeal. *Ringgold-Lockhart, et. al. v. County of Los Angeles, et. al.*, 2014 U.S. App. LEXIS 14979 (9th Cir., August 4, 2014).

d. **Arbitration**. If co-trustees agree to arbitrate their disputes, the scope of the arbitrator's authority may allow him to compel distributions from trust owned entities for the payment of estate taxes. However,if a trustee does not have the power to remove a co-trustee under the document, the arbitrator cannot usurp the power of the court and remove a trustee. *Brown v. Brown-Thill,* 2014 U.S. App. LEXIS 15349 (8th Cir. 2014).

   Courts continue to grapple (sometimes clumsily) with the friction between the policy favoring arbitration as a general matter and the nature of trusts and the rights of beneficiaries. In *Archer v. Archer,* 2014 Tex. App. LEXIS 6551 (2014), the Texas court distinguished last year's decision in *Rachal v. Reitz* and held that a trust term "requesting" arbitration of disputes is precatory and cannot establish an enforceable agreement to arbitrate under the trust agreement. In *Gupta v. Merrill Lynch,* 2014 U.S. Dist. LEXIS 113670 (E.D. Louisiana August 15, 2014), the court enforced a broad arbitration provision in a separate unrelated custody agreement as barring claims against a trustee for breach of trust, but refused to apply direct benefits estoppel to bind trust beneficiaries who had no contractual connection to arbitration provisions in the trust agreement. In *Warren v. Geller,* 2014 U.S. Dist. LEXIS 117332 (E.D. Louisiana August 22, 2014), in a case concerning deceased New Orleans Saints football player Frank Warren, the beneficiaries were bound by arbitration provisions in a "client agreement" creating a trust by the court's finding that they were third party beneficiaries of the contract and through equitable estoppel by accepting modest distributions.

e. **Directors**. The nature of the office and duties of a trust protector is not well defined under existing domestic common law. A few new points of reference were received in 2014 and examined. In *SEC v. Wyly*, Case 1:10-cv-05760-SAS (S.D.N.Y. September 25, 2014), a securities law case, the court rejected the "independent trustee" exception in §674(c) and found trusts were grantor trusts despite professional offshore trustees, where the trust protectors consistently relayed the family's directions to the trustee (where the trust protector had the power to remove and replace the trustee). In *Schwartz v. Wellin,* 2014 U.S. Dist. LEXIS 143644 (October 9, 2014); *Schwartz v. Wellin,* 2014 U.S. Dist. LEXIS 1528 (Charleston South Carolina Division, January 7, 2014), the court found that a trust protector did not having judicial standing to bring claims against the trustee, despite trust terms granting that standing. However, a trustee appointed by the trust protector would be substituted as a plaintiff because the beneficiaries' removal of the trust protector without appointing a successor protector for three months violated the trust terms and did not bar the protector from appointing a trustee. In *Minassian v. Rachins* (Fla. 4th Dist. Court of App., No. 4D13-2241 (2014)), a drafting lawyer named as trust protector

validly amended the trust terms to impact a dispute between a widow and children concerning the widow's distributions to herself out of the trust.

f. **Creditor Claims**. In view of its long-running popularity as a trust jurisdiction, it was not a surprise that some interesting cases on spendthrift provisions came out of the Delaware courts. In *Mennen,* 2013 Del Ch. LEXIS 204 (2013); C.A. No. 8432-ML (January 17, 2014), a special master rejected a call for a public policy exception to a spendthrift clause based on family relations beyond spousal support claims. The master has since recommended a significant surcharge against the individual co-trustee based on imprudent investment of the trust assets. In two similar cases, the Delaware chancellor was reluctant to render rulings about Delaware trusts in the middle of out-of-state divorce proceedings, in advance of those other courts entering actual orders that would interfere with the trusts or raise matters of Delaware law that are the chancellor's concern. *Scott v. Dondero,* 2014 Del. Ch. LEXIS 166 (2014); *IMO Daniel Kloiber Dynasty Trust,* C.A. No. 9685-VCL (Del. Chancery Court, August 6, 2014).

g. **Fiduciary Succession**. On the heels of last year's *McKenney* decision giving beneficiaries a favorable interpretation of the "no fault" removal of trustee provision in the Pennsylvania Uniform Trust Code, there were two unsuccessful attempts to give the beneficiaries the power to remove trustees without fault where the document did not give them that power. In *Testamentary Trust of Conti,* 2014 Phila. Ct. Comm. Pl. LEXIS 289 (September 17, 2014), the court refused to approve a UTC nonjudicial settlement agreement that provided terms for the change of corporate trustees in conflict with the UTC judicial change of trustee provisions. In *Taylor Intervivos Trust,* 2014 Phila. Ct. Comm. Pl. LEXIS 239 (August 18, 2014), the court held that the beneficiaries cannot use the UTC modification by consent statute to grant themselves the power to remove and replace the trustee without cause and contrary to the UTC judicial removal of trustee provision. In the absence of a trust term to the contrary, the courts here felt they had a vital role to play in the succession of trustees.

   In *Vincent J. Fumo Irrevocable Children's Trust FBO Allison Fumo,* 2014 PA Super 235 (2014), the court applied the doctrine of unclean hands to void the settlor's appointment of a trustee under a power reserved in the trust where the trustee was found to be the "alter ego" of the settlor to facilitate the settlor's plan to reclaim the benefit of the assets in the trust following his federal incarceration for mail fraud and tax evasion.

h. **Business Interests**. The consequences of friction between the transfer restrictions in corporate documents and the estate plan were explored in *Jimenez v. Corr,* 2014 Va. LEXIS 153 (2014) and *Blechman v. Blechman*, 2015 Fla. App. LEXIS 193 (2015). In these cases, deviations from the strict terms of the corporate documents resulted in long running disputes and appellate litigation.

i. **Trustee Disclosure and Privileges**. An important issue in trust administration remains the extent to which information provided to beneficiaries meets the trustee's duty to disclose and starts statutes of limitations running on claims. In *Smith,* A13A2256 (Georgia Court of Appeals, January 15, 2014), a Line item on an account statement reporting a sale to a "straw man" did not start the statute of

limitations running on a sale by the trustee, but the trustee's detailed letter received by the beneficiaries started the limitations period on income distributions. In *Abbott v. Brennemann,* 288 Neb. 389 (2014), the court held that Form K-1s were not adequate disclosure under pre-UTC law or the UTC, but the breach was harmless where the trust was otherwise properly administered.

The split among the states (with most states not yet addressing the issue) on the validity of the "fiduciary exception" to the attorney-client privilege continued in 2014. Connecticut refused to recognize the fiduciary exception to the attorney-client privilege. *Heisenger v. Cleary,* 2014 Conn. Super. LEXIS 1835 (2014). In contrast and in a case of first impression, the Arizona Court of Appeals held that the UTC and state law support adoption of the fiduciary exception to the attorney-client privilege, but reversed trial court for ordering disclosure of all communications to both the beneficiary and successor trustee without determining whether the advice was for trust administration and should be disclosed, or for self-defense that is not required to be disclosed, and for requiring disclosure merely because advice was paid for with trust funds and obtained from trust counsel. *Hammerman v. Northern Trust Company,* No. 1 CA-CV 13-0260 (Arizona Court of Appeals, 2014).

j. **Charities**. A Missouri court reminds us that consent trust termination does not apply to charitable trusts. In *Hudson v. UMB Bank, N.A.,* 2014 Mo. App. LEXIS 936 (August 26, 2014), the court held that charitable remainder trusts are not "noncharitable trusts" subject to modification under the UTC codification of the *Clafflin* doctrine. In a case involving charitable land gifts to New Britain, Connecticut by Alix Stanley (the founder of Stanley Works), the court held that the terms of a deed granting standing to local citizens to enforce the charitable gift is not effective to grant citizens, rather than the attorney general, standing to enforce terms of a charitable gift. *Lechowicz v. Costco Wholesale Corporation,* 2014 Conn. Super. LEXIS 2277 (2014).

k. **Modification and Construction**. Two Massachusetts Supreme Court decisions illustrated the need to demonstrate an actual drafting error or ambituity when seeking the assistance of the state supreme court in binding the IRS. In *O'Connell v. Houser,* 2014 Mass. LEXIS 841 (October 28, 2014), reformation of a trust was affirmed under *Commissioner v. Bosch* principles on adequate proof that the reformation was proper to avoid loss of grandfathered GST-exempt status. However, in *Babcock,* 2014 Mass LEXIS 840 (October 28, 2014), the court rejected a suit to construe trust terms to protect the marital deduction where there was no alleged drafting error or misconstruction of trust terms.

In *Purcella v. Olive Kathryn Purcella Trust*, 325 P.3d 987 (Supreme Court of Alaska, April 18, 2014), the court refused to terminate a trust that was established to protect an elderly woman from financial abuse, finding that the grantor of the self-settled irrevocable trust did not produce evidence sufficient to establish that trust was the product of undue influence or due to an actionable mistake.

Crowe v. Tweten, 2014 Cal. App. Unpub. LEXIS 9292 (2014) involved reformation of a formula division clause where the testator died during the 2010 temporary estate tax "repeal".

A court derogated what appeared to be customary will and trust drafting conventions as archane, and in *Estate of George McFadden,* 2014 PA Super 203 (2014) construed

the "ambiguous" perpetuities termination provision to allow a trust to exist for the longest possible period allowed under the rule against perpetuities.

In a case of first impression, the Wyoming Supreme Court rejected the doctrine of equitable adoption for purposes of intestate succession. *Knudson v. Scherer,* 2014 WY 129 (2014).

l. **Potpourri**. *Walton v. Estate of Swisher,* 2014 Ind. App. Unpub. LEXIS 114 (2014) involved what may be the first reported case of regret for not charging a widower enough money for making the DSUE portability election.

Estate of Truong Tran, 2014 N.Y. Misc. LEXIS 3501 (NY Surr. Ct., August 5, 2014) appears to stand for the proposition that a plucked hair from a fresh corpse is an estate asset (it was desirable as a DNA sample in the case).

In a dispute over an "E-Z Legal Form" that failed to include a residuary clause, the court in *James Michael Aldrich v. Laurie Basile*, 136 So.3d 530 (Fla., March 27, 2014) observed that that cost cutting measures and do-it-yourself legal forms are not always the cheapest method when the results lead to very costly and time consuming litigation.

33. Impact of Arbitration or "In Terrorem" Provisions in Crummey Trusts—*Mikel v. Commissioner*

a. **Brief Synopsis**. The IRS created somewhat of a stir in 2012 among estate planners when it issued CCA 201208026, suggesting that the gift tax annual exclusion would not be available for gifts to Crummey trusts that have arbitration or "in terrorem" (*i.e.*, "no contest") provisions. That CCA apparently was issued in relation to *Mikel v. Commisioner*, decided April 6, 2015, which rejects the IRS's position in that CCA regarding arbitration and in terrorem provisions in Crummey trusts.

Spouses in 2007 each gave $1,631,000 to a Crummey trust with 60 beneficiaries having withdrawal rights. If those transfers qualified for the $12,000 gift tax annual exclusion for 60 beneficiaries, the resulting $720,000 of annual exclusion reduced the taxable gift by each spouse to $911,000, which would have been sheltered by each spouse's $1 million gift exemption amount.

The trust agreement provided that if any dispute arises regarding the proper interpretation of the agreement, the dispute "shall be submitted to arbitration before a panel consisting of three persons of the Orthodox Jewish faith." The panel is directed to "give any party the rights he is entitled to under New York law." The trust agreement also had an in terrorem provision stating that a beneficiary would cease to be a beneficiary if the beneficiary institutes or participates in any proceeding to oppose or challenge a trust distribution or "files any action in a court of law."

In a summary judgment proceeding before the Tax Court, the IRS took the position that the beneficiaries did not receive a present interest in property because the rights were not legally enforceable, which the IRS maintains requires that a beneficiary can "go before a state court to enforce that right" and that the arbitration provision would not meet that requirement. Furthermore, even though a beneficiary is not bound by the arbitration decision and can bring a state court action to contest the arbitration

decision under local (New York) law, the judicial enforcement remedy is "illusory" because of the in terrorem provision.

The court rejected the IRS position and granted summary judgment for the donors that the transfers constituted present interests that qualified for the annual exclusion. The court reasoned that "it is not obvious why the beneficiary must be able to 'go before a state court to enforce that right.' … A beneficiary would suffer no adverse consequences from submitting his claim to [the arbitration panel], and respondent has not explained why this is not enforcement enough." The in terrorem provision in this case does not apply to a contest regarding a beneficiary's withdrawal right because it only applies to an action to oppose or challenge a trust distribution. *Mikel v. Commissioner*, T.C. Memo. 2015-64 (April 6, 2015, Judge Lauber).

b. **Basic Facts**.

1. *Transfer to Trust.* Spouses jointly transferred real properties and a condominium with an asserted value of $3,262,000, or $1,631,000 by each, to a Crummey trust with withdrawal powers allegedly for 60 beneficiaries. If those transfers qualified for the $12,000 gift tax annual exclusion for 60 beneficiaries, the resulting $720,000 of annual exclusion reduced the taxable gift by each spouse to $911,000, which would have been sheltered by each spouse's $1 million gift exemption amount.
2. *Crummey Provision and Withdrawal Notices*. The beneficiaries had withdrawal powers limited to the gift tax exclusion amount under §2503(b). The trustees were required to notify all beneficiaries (and the guardians for minor beneficiaries) of trust contributions within a reasonable time after the contribution of property to the trust. A beneficiary's withdrawal power lapsed if not exercised within 30 days of receiving the notice. A savings clause stated that the withdrawal provision will be construed to effect the grantor's intention that the transfers to the trust qualify for the gift tax annual exclusion. The gift to the trust was made on June 15, 2007, and the trustees gave notice to the beneficiaries of the contribution on October 9, 2007.
3. *Distribution Provisions*. The trust authorizes the trustees in their discretion to make distributions under a specific standard to any of the trust beneficiaries.
4. *Arbitration Provision*. If a dispute arises concerning the proper interpretation of the trust, the trust agreement requires that the dispute "shall be submitted to arbitration before a panel consisting of three persons of the Orthodox Jewish faith." Such a panel in Hebrew is called a "*beth din*." The panel is directed to "enforce the provisions of this Declaration … and give any party the rights he is entitled to under New York law." The trust said that the intention was "to effectuate the intent of the parties … that they have performed all the necessary requirements for this Declaration to be valid under Jewish law." The opinion states in Footnote 4 that any decision by the arbitration panel will not be binding on a beneficiary:

> According to respondent, beneficiaries of a trust will not be deemed by a New York court to have consented to an arbitration provision, and a New York court will not enforce an arbitral award against a nonconsenting party. Given respondent's concession on this point, we need not address the correctness of these State law propositions.

5. *In Terrorem Provision.* The trust contains an in terrorem provision designed to discourage beneficiaries from challenging discretionary decisions of the trustees to make distributions. A beneficiary's interest in the trust ends "[i]n the event a beneficiary of the Trust shall directly or indirectly institute, conduct or in any manner whatever take part in or aid in any proceeding to oppose the distribution of the Trust Estate, or files any action in a court of law, or challenges any distribution set forth in this Trust in any court, arbitration panel or any other manner…."

6. *Gift Tax Returns*. The donors did not file timely gift tax returns reporting the 2007 gifts. For some reason [not discussed in the opinion], the IRS became aware of the large 2007 gifts and contacted the donors about the transfers. Subsequently, the donors in late 2011 filed gift tax returns, each reporting gifts of several residences and a condominium to the trust of $1,631,000, but reporting that no gift tax was due (presumably claiming $720,000 of annual exclusion on each return and reducing the taxable gift below the donor's remaining gift exemption).

c. **Holding**. The court grants the donors' motions for summary judgment to treat transfers to the trust as gifts of present interests in property that qualify for the gift tax annual exclusion. (Open questions still remain in the case, including issues regarding the underlying value of the gift properties and the proper number of trust beneficiaries (see footnote 2 of the opinion) and therefore the number of annual exclusions.)

d. **Analysis**.

1. *Background*. The gift tax annual exclusion is available for gifts of present interests in property, §2503(b)(1), and a beneficiary that has a right to demand immediate distributions of a contribution to the trust is deemed to receive a present interest. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). This case is appealable to the Second Circuit Court of Appeals, and a 63-year old Second Circuit case held that whether a beneficiary receives a present interest is based on whether a beneficiary is "likely" to receive present enjoyment of trust property. *Stifle v. Commissioner*, 197 F.2d 107 (2d Cir. 1952). The Tax Court rejected that approach in *Estate of Cristofani v*. Commissioner, 97 T.C. 74 (1991) (focus is not "the likelihood that the minor beneficiaries would actually receive present enjoyment of the property," but "the legal right of the minor beneficiaries to demand payment from the trustee"). The "likely to receive present enjoyment" principle is not applied by the court even though this case is appealable to the Second Circuit, however, because the IRS has issued several rulings accepting the *Crummey* approach (Rev. Ruls. 85-24, 81-7, 73-405), and because the IRS did not rely on *Stifle* in this case.

   Other requirements discussed in prior cases are that the trustee cannot "legally resist a beneficiary's demand for payment," *Estate of Cristofani*, 97 T.C. 74, at 83 (1991), and that there is no "prearranged understanding" that the withdrawal right would not be exercised, *Estate of Kohlsaat v. Commissioner*, T.C. Memo. 1997-212. In its acquiescence in *Estate of Cristofani*, the IRS also indicated that it would challenge annual exclusions if exercising a withdrawal right "would result in adverse consequences to its holder (*e.g.,* losing other rights or gifts under the instant trust instrument or other beneficial arrangement)." AOD 1992-9.

2. *IRS General Position.* The IRS did not contest that the trust beneficiaries (including the minor beneficiaries) received timely notice of their withdrawal rights, that the trustees had no power to legally resist a withdrawal demand, or the absence of a prearranged understanding that withdrawal rights would not be exercised. Instead, the IRS argued that the withdrawal right was "'illusory' and that any attempt to seek legal enforcement of that right 'would result in adverse consequences to its holder.'"

3. *Arbitration Provision; Legally Enforceable Before State Court*. The IRS position is that the withdrawal rights were not "legally enforceable" in practical terms unless the "beneficiary can 'go before a state court to enforce that right.'" The IRS hypothesizes that if the trustees refuse a withdrawal demand, the beneficiary would be required to submit the dispute to a *beth din*. The IRS acknowledged that if the *beth din* rules adversely, the beneficiary "could seek redress in a New York court," reasoning that under New York law trust beneficiaries will not be deemed to have consented to an arbitration provision and the New York court will not enforce an arbitration award against the nonconsenting party. (See footnote 4 of the opinion.)

   The Tax Court stated that even if it accepted the IRS's contention that a withdrawal power must be "'legally enforceable" in an extrinsic sense, it did not know why that had to be in a state court and why submission of the claim to a *beth din* is not sufficient:

   > First, if we adopt his premise that a withdrawal right must not only be "legally irresistible" under the trust instrument, but also be "legally enforceable" in an extrinsic sense, it is not obvious why the beneficiary must be able to "go before a state court to enforce that right." Here, if the trustees were to breach their fiduciary duties by refusing a timely withdrawal demand, the beneficiary could seek justice from a beth din, which is directed to "enforce the provisions of this Declaration … and give any party the rights he is entitled to under New York law." A beneficiary would suffer no adverse consequences from submitting his claim to a beth din, and respondent has not explained why this is not enforcement enough.

4. *In Terrorem Provision Does Not Apply to Claims to Enforce Withdrawal Right*. The IRS's second argument is that even if judicial enforcement is available, the remedy is "'illusory' because the in terrorem provision would deter beneficiaries from pursuing it." The court interpreted the in terrorem provision to apply only to claims challenging any distribution from the trust, and that would not impact a beneficiary who is challenging the refusal of a trustee to honor a beneficiary's withdrawal right.

   The exact language of the in terrorem provision was to cause a beneficiary to forfeit his rights under the trust if he "directly or indirectly institute[s] … any proceeding to oppose the distribution of the Trust Estate, or files any action in a court of law, or challenges any distribution set forth in this Trust in any court, arbitration panel or any other manner." The court had little trouble concluding that the restriction on an action to oppose a distribution or challenging any distribution would not be triggered by an action to enforce a beneficiary's withdrawal right. The court interpreted the "files any action in a court of law" clause "in pari materia with the two clauses that surround it," observing that the clause could not apply

literally or it would force a forfeiture if beneficiaries "filed suit to recover for mischievous behavior by their neighbor's dog."

5. *Summary of Analysis*. The court concisely summarized its holding and reasoning as follows:

> In sum, we conclude that the beneficiaries of the trust possessed a "present interest in property" because they had, during 2007, an unconditional right to withdraw property from the trust and their withdrawal demands could not be "legally resisted" by the trustees. Crummey, 397 F.2d at 88; Estate of Cristofani, 97 T.C. at 84. Assuming arguendo that the beneficiaries' withdrawal rights must be enforceable in State court, we conclude that this remedy, which respondent concedes was literally available, was also practically available because the in terrorem provision, properly construed, would not deter beneficiaries from pursuing judicial relief.

e. **Observations**.

1. *CCA 201208026*. CCA 201208026 was released February 24, 2012 from the IRS Chief Counsel office. In CCA 201208026 individuals made a gift to a trust, which included Crummey withdrawal rights for beneficiaries and which provided that the trustee (the grantor's son) could make distributions to a variety of beneficiaries (including a charity) for "health, education, maintenance, support … or for any other purposes." The trust lasts for the grantors' lives (unless the trust is sooner terminated by reason of distributions of all of its assets). The grantors retained testamentary limited powers of appointment.

   The trust provides that the construction, validity and administration of the trust will be determined by state law "but provision is made for Other Forum Rules". In addition, a beneficiary filing or participating in a civil proceeding to enforce the trust will be excluded from any further participation in the trust (sometimes referred to as an "in terrorem" or "no contest" clause). The CCA concludes that the withdrawal rights are "illusory" because of these two provisions and the withdrawal rights do not create present interests that qualify for the annual exclusion.

   CCA 201208026 also addressed whether retained testamentary powers of appointment for the grantors kept the transfer to the trust from being a completed gift. That issue was not addressed in the summary judgment proceeding in the *Mikel* case. (The CCA concluded that the entire transfer was a completed gift despite the grantor's retained testamentary limited power of appointment. It reasoned that the retained testamentary powers of appointment *do* cause the *remainder interest* to be an incomplete gift, but not the term interest prior to the grantor's deaths. The IRS reasoned that the remainder interest had to be valued at zero under §2702, so the completed gift of the term interest was the full value transferred to the trust.)

2. *Holding Does Not Address A Binding Arbitration Provision*. The court believed that submitting disputes to an arbitration panel should create as much "legal enforceability" as submitting the dispute to a state court. This statement is really dictum, however, because the parties acknowledge that the beneficiary can ultimately submit any dispute to a state court under the relevant (New York) state law (if the beneficiary gets an adverse arbitration decision). (Most of the cases that have addressed the enforceability of trust arbitration clauses have similarly held that arbitration clauses are not enforceable against trust beneficiaries.) Even if the

relevant state law recognized that the arbitration decision would be binding, however, the court believed that the availability of an arbitration proceeding should be just as good as a state court proceeding for purposes of being able to enforce a withdrawal right.

3. *In Terrorem Provision*. The in terrorem provision in this trust agreement was unusual, in that it applied only to a beneficiary who contests a trustee's decision to make a distribution from the trust. Traditional in terrorem clauses address a beneficiary who contests the validity of a trust (which also would not seem to apply to a beneficiary attempting to enforce his or her withdrawal power). Unless a particular in terrorem provision would apply to a beneficiary's attempt to enforce a withdrawal power, the court's reasoning would seem to apply: including traditional in terrorem clauses in Crummey trusts should not disqualify gifts to the trust for the gift tax annual exclusion.

34. "Net Net Gifts" Recognized—*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 issues in this case are (1) whether the second element, the assumption of any estate tax liability under § 2035(b) if the donor died within three years, constitutes consideration in money or money's worth that can be subtracted in determining the amount of the gift under § 2512(b), and (2) the determination of the amount of such gift tax offset.

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).

In this case, the Tax Court previously rejected the IRS motion for summary judgment to deny a gift tax offset for the assumption of any estate tax liability under §2035(b) if the donor died within three years. The court held that the donees' assumption of the §2035(b) estate liability (if the donor died within three years of the gift) might be quantifiable and reducible to monetary value and that a willing buyer and a willing seller, in arriving at a sale price, might take the donees' assumption of this liability into account in appropriate circumstances. *Steinberg v. Commissioner*, 141 T.C. 258 (2013) ("Steinberg I").

Following a trial, the Tax Court held that the assumption of liability for estate tax under §2035(b) if the donor dies within three years of the gift does constitute consideration in money or money's worth that can be subtracted in determining the amount of the

"net, net gift," and accepted the taxpayer's expert's calculation of that contingent liability. *Steinberg v. Commissioner,* 145 T.C. No. 7 (Sept. 16, 2015) (Judge Kerrigan) ("Steinberg II"). The court reasoned that the donees' assumption of the §2035(b) estate tax liability was a detriment to the donees and a benefit to the donor, and that a hypothetical willing buyer purchasing the property subject to that assumption of liability would demand that the price be reduced to account for the §2035(b) potential liability. The court rejected the IRS's contention that the assumption of the §2035(b) liability was merely a recognition of the apportionment of estate tax that would apply in any event, because there was no assurance at the time of the gift that the New York apportionment statute would continue to apply or that the donor would not change her will to remove the donees as the residuary beneficiaries, and the contractual obligation provided an additional enforcement mechanism not available under the state apportionment statute. The court also noted nothing in the record indicated that the net gift agreement was not bona fide or not made at arm's length.

Steinberg II accepted the taxpayer's expert's determination of the amount of gift tax offset attributable to the assumption of the §2035(b) potential liability. The expert used the government's actuary tables to estimate the likelihood that the decedent would die in each of the three years after making the gift. The court accepted that approach, reasoning that using the IRS's actuary tables "is the most common way to measure the value of a property interest that is dependent on the life expectancy of an individual," and noting that there were no specific facts or circumstances that would justify special consideration of the decedent's health or general medical prognosis beyond use of the tables. The expert also used the §7520 rate to discount the potential estate tax liability to present value; the government objected to the use of that discount rate, but the court concluded that the government "has not persuaded us that there was a more appropriate method that should have been used."

b. **Basic Facts and Issue**. The donor made gifts of assets having a value of about $109.4 million 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.

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. **Steinberg I**. The majority opinion (written by Judge Kerrigan, joined by seven other judges) denied the IRS's summary judgment motion. The majority reconsidered and reversed the Tax Court's position 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), 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 court noted that the case is not appealable to the Fifth Circuit so was not bound by the *McCord* result, but nevertheless reconsidered and reversed its prior position in *McCord*.) 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) stated 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. 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.

e. **Steinberg II Analysis**.

1. *Burden of Proof*. The case is decided based on the preponderance of the evidence, and the burden of proof is irrelevant to the case.
2. *Willing Buyer/Willing Seller Test for Adequacy of Consideration*. In determining whether the assumption of the §2035(b) potential estate tax liability can be taken into account in determining the value of the net gift, the court began with stating that the "fundamental question posed by this case is the fair market value of the property rights transferred under the net gift agreement." Steinberg II at 15. The willing buyer/willing seller test is applied to determine the value of the donees' assumption of the §2035(b) potential estate tax liability.

> "The 'willing buyer/willing seller' test is the bedrock of transfer tax valuation. It requires us to determine what property rights are being transferred and on what price a hypothetical willing buyer and willing seller would agree for those property rights.
>
> …
>
> In Steinberg I we held that a willing buyer and a willing seller in appropriate circumstances could consider the donee's assumption of the section 2035(b) estate tax liability when determining a sale price. 141 T.C. at 281. We now decide whether the net gift agreement is such an appropriate circumstance. An appropriate circumstance arises when the donee's assumption of the section 2035(b) estate tax liability is a detriment to the donee and is a benefit to the donor." Id. at 15-16.

Thus, the court, without citing any authority, says the test for determining whether the assumption of §2035(b) estate tax potential liability can be considered as a gift offset under the willing buyer/willing seller analysis is whether the assumption of such liability "is a detriment to the donee and is a benefit to the donor."

(a) *Detriment to Donee*. The assumption of the §2035(b) estate tax liability was a detriment to the donees because they did not have liability for that estate tax before assuming that liability under the net gift agreement. The net gift agreement was the product of lengthy negotiations, and the donor would not have made the gift without the donees' agreement to assume the §2035(b) estate tax liability. The court analogized to the built-in gain cases that have applied the willing buyer/willing seller test to reduce the value of transferred stock to account for the built-in gains tax liability. The court cites other cases in which transfer restrictions or business liabilities have reduced the value of transferred interests. E.g., Estate of Hull v. Commissioner, 92 T.C. 312, 338-

339 (1989) (transfer restrictions); Sackett v. Commissioner, T.C. Memo. 1981-661 (business liabilities). The assumption of the §2035(b) potential estate tax liability is a detriment to the donees "because it might result in reductions in the values of the gifts they received."

(b) *Benefit to Donor*. The court applied the estate depletion theory and concluded that it was satisfied.

> "Under the estate depletion theory, a donor receives consideration in money or money's worth to the extent that the donor's estate has been replenished…. Thus, the benefit to the donor in money or money's worth, rather than the detriment to the donee, determines the existence and amount of any consideration offset in the context of an otherwise gratuitous transfer. See Commissioner v. Wemyss, 324 U.S. at 307-308. [OBSERVATION: In light of that last sentence, why is a detriment to the donees required under the court's analysis?]
>
> …
>
> The daughter's assumption of the section 2035(b) estate tax liability might relieve petitioner's estate of a portion of its estate tax liability. If petitioner died within three years of the gift, her estate would have recourse against the daughters. Accordingly, the willing buyer would demand that price of the properties be reduced to account for the section 2035(b) estate tax liability." Steinberg II at 19-21.

3. *Apportionment Clause Does Not Negate Gift Offset*. The government argued that the assumption of §2035(b) potential estate tax liability "did not create any new burden on the daughters or benefit for petitioner because the daughters would have had to bear the burden of the section 2035(b) estate tax liability either under New York law or as beneficiaries of petitioner's residuary estate." Id. at 21. [OBSERVATION: 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 court pointed to various reasons for refusing to treat the contractual obligation to pay the §2035(b) estate tax as merely a reflection of estate taxes the donees would bear in any event: (1) the decedent could have moved to another state, in which event the special New York apportionment law would not have applied; (2) the decedent could have changed her will so that the donees were no longer the residuary beneficiaries responsible for estate taxes (the decedent at one time had removed one daughter as an estate beneficiary under her will); (3) the apportionment statute is merely a default provision that can be changed in a decedent's will; and (4) the net gift agreement included specific enforcement mechanism that were not explicitly available under the apportionment statute.

   The court concluded that the estate depletion theory was satisfied:

   > "For all these reasons, respondent's 'estate depletion' argument does not persuade us that the obligation assumed by petitioner's daughters to pay the section 2035(b) estate tax adds zero to petitioner's estate because that obligation is an obligation the daughters would have borne anyway under the New York apportionment statute. Because of factual uncertainties as to whether and how the New York apportionment statute would apply at petitioner's death, the daughters' contractual assumption of this tax liability gave rise to a new asset that could be deployed effectively by the executor. This new asset 'augmented' or 'replenished' petitioner's estate. [Citations omitted]. Id. at 23-24.

4. *Arm's Length and Ordinary Course of Business*. While intra-family transactions are subject to special scrutiny, intra-family transactions are not necessarily gifts merely because they are not in the ordinary course of business. There was no evidence

that the net gift agreement was not bona fide or was not made at arm's length. Indeed, it was the culmination of months of negotiation.

5. *Fair Market Value of Assumption of Liability for §2035(b) Estate Tax Liability*. Having resolved the first issue, that the donees' assumption of estate tax liability under §2035(b) could offset the amount of the net gift, the court addressed the second issue—the fair market value of such assumption of liability. The donor's expert (William Frazier with Stout Risius Ross, Inc.) used the same approach that he used (and that the Fifth Circuit approved) in Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), rev'g 120 T.C. 358 (2003). His general approach was a three-step process: (i) use the mortality factors in Table 90CM (which Table was applicable for transfers in 2007, see Treas. Reg. §20.2031-7(d)(7)) to determine the probability that the donor would die in each of the three years following the date of the gift, (ii) multiply that probability times the estate tax taxes that would have resulted under §2035(b) in each of those three years, and (iii) discounted such estate tax liabilities for each of those years to present value using the §7520 rate as the discount factor.

   (a) *Use of Government Mortality Table*. The government complained that the appraiser merely used the government mortality table without considering the donor's "health and general medical prognosis." The court disagreed, reasoning that using the government's actuarial table is a "common way to measure the value of a property interest that is dependent on the life expectancy of an individual," and there was no evidence of special medical issues involving the donor that would make reliance on the government's table unreasonable. Steinberg II at 29-30.

   (b) *Discount Rate*. The government also questioned the use of the §7520 rate as a discount rate to determine the present value of the potential future estate tax liabilities if the donor had died in any of the following three years after making the gift, under the theory that the §7520 rates "apply only to annuities, life interests, terms of years, and reversionary interests." [OBSERVATION: This is similar to the argument that the government made in Estate of Davidson v. Commissioner (now settled without a trial) claiming that §7520 does not apply to self-canceling installment notes.] The court noted that the fact that the potential estate tax liabilities are contingent does not preclude use of the § 7520 rates, and made short shrift of the argument: "Respondent has not persuaded us that there was a more appropriate method that should have been used. We conclude that the valuation was proper."

f. **Planning 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 $109.4 million gross 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. Indeed, the court referred to the donees' obligation to pay that portion of the estate tax as a "new asset" of the estate. Steinberg II at 24 ("new asset that could be deployed effectively by the executor"). 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.

In any event, for younger donors (say in their 50s or 60s), the actuarial likelihood of dying within the three years following the date of the gift is very low and the gift offset by having the donees assume the potential § 2035(b) estate tax liability would be low. Reducing the current gift by this small amount may not be worth of risk of the additional estate tax that would be incurred if the donee's contractual obligation to pay such part of the estate tax is treated as an additional asset of the decedent's gross estate that is itself subject to estate tax.

2. *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 general approach for calculating the present value of the potential § 2035(b) estate tax liability was summarized by the court as follows:

> "Mr. Frazier testified that he used the actuarial tables promulgated by the Commissioner to calculate the probability that petitioner would die within each of the three years after the date of the net gift agreement. The report calculated petitioner's annual mortality rate for year 1, year 2, and year 3 to be 13.84%$, 13.04%, and 12.13%, respectively. The report used the section 7520 interest rate applicable on the date of the transfer to determine the present value factors for each of the three years. Then the report took the effective State and Federal estate tax rates for each of the three years and multiplied them by the gift tax included in the estate under section 2035(b). Using this methodology, the report calculated that the daughters' assumption of the section 2035(b) estate tax liability reduced the value of the combined gift by $5,838,540." Steinberg II, at 28-29.

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.) 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.

(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.

35. Settlement Agreement Did Not Result in Taxable Gift, *Estate of Edward Redstone v. Commissioner*; Voluntary Transfer by Brother on Same Terms But Not Under Settlement Agreement Did Result in Gift, *Sumner Redstone v. Commissioner*

a. **Synopsis**. A settlement of litigation resulted in a resolution of a dispute regarding the ownership of 100 shares of closely-held stock registered in the name of Edward Redstone . The settlement resulted in the company agreeing to pay $5 million for 66 2/3 shares to Edward, with the remaining 33 1/3 shares being held in a trust for his children. The dispute centered around disagreements between Edward and his father, who was the president of the company, and who insisted that a portion of the shares were held in an "oral trust" for the benefit of the shareholder's children. The court concluded that the settlement constituted a bona fide, arm's-length transaction that was free from donative intent and that was "made in the ordinary course of business." The transfer was made "for a full and adequate consideration in money or money's worth," which was the recognition that Edward was the outright owner of 66 2/3 of the shares in the agreement and that the company would pay $5 million in exchange for the shares. (The fact that Edward's children were not parties to the settlement agreement - and therefore provided no consideration for the transfer of the shares - did not matter for purposes of determining whether Edward received full consideration in the settlement.) *Estate of Edward Redstone v. Commissioner*, 145 T.C. No. 11 (October 26, 2015) (Judge Lauber).

Edward's brother, Sumner Redstone, similarly had 100 shares of the company registered in his name. Three weeks after the settlement between Edward and the company was signed (and two days after the parties filed a stipulation with the court and the court issued a final decree incorporating the terms of the settlement agreement), Sumner engaged in similar transactions—agreeing to be paid $5 million for 66 2/3 shares and transferring his remaining 33 1/3 shares to irrevocable trusts for his children. Sumner said that he did this as a "gesture of goodwill to his father, who desired to ensure the financial security of his four grandchildren on equal terms," but Sumner was not required to take these actions under the settlement agreement between Edward and the company. The Tax Court (again Jude Lauber) concluded

Sumner's transfer of shares to the trusts for his children constituted taxable gifts, reasoning that pleasing parents is presumptively a family motivation. The court concluded: "There was no claim against Sumner; there were no arm's length negotiations; and he received no consideration from anyone in exchange for his transfer." *Sumner Redstone v. Commissioner,* T.C. Memo. 2015-237 (December 9, 2015) (Judge Lauber).

b. **Basic Facts.** Edward sued a family closely-held company to recover 100 shares of stock that were registered in his name. He felt that his father was intruding into his personal life in reaction to decisions Edward had made about his son (institutionalizing him for a period for psychiatric problems) and because Edward felt disrespected and was dissatisfied with his role at the company. His father (Mickey), who was President of the company, refused to transfer the 100 shares to Edward, arguing that the company had a right of first refusal on the shares and contending at that least half the shares were held from the outset in an "oral trust" for Edward's children. After six months of negotiations, Edward sued. The parties tried to reach a settlement, with the company agreeing to buy back Edward's shares from him, but the father insisted that Edward recognize that some of the shares were held in trust for his children. The litigation became quite adversarial, and Edward's attorney eventually concluded that "Mickey would not be placated unless Edward acknowledged the supposed 'oral trust' and placed some of the disputed shares in trust for his children." 145 No. 11, at 11.

Six months after the lawsuit was filed a settlement was ultimately reached, with the parties agreeing that Edward owned 66 2/3 of the shares outright and that 33 1/3 shares were held by Edward for the benefit of his children in trust. The settlement agreement provided that the company would pay Edward $5.0 million for his 66 2/3 shares, and that Edward would execute irrevocable trusts for his children and 16 /2/3 shares would be distributed to each of the two trusts for Edward's two children. In addition, the settlement agreement required that Edward resign from all positions he had held in the family business and resigned as trustee and relinquished the right to serve as successor trustee of all Redstone family trusts.

Edward's brother, Sumner Redstone, similarly had 100 shares of the company registered in his name. Three weeks after the settlement between Edward and the company was signed (and two days after the parties filed a stipulation with the court and the court issued a final decree incorporating the terms of the settlement agreement), Sumner engaged in similar transactions—agreeing to be paid $5 million for 66 2/3 shares and transferring his remaining 33 1/3 shares to irrevocable trusts for his children. Sumner said that he did this as a "gesture of goodwill to his father, who desired to ensure the financial security of his four grandchildren on equal terms," but Sumner was not required to take these actions under the settlement agreement between Edward and the company. Sumner's tax advisor (based on input from J.K. Lasser's national office) advised Sumner that he had not made a taxable gift and that he did not need to file a gift tax return reporting the transfers to the trusts for his children.

Those transactions occurred in 1971-1972. Twelve years later (in 1984), the company redeemed the shares owned by the trusts for Edward's children.

Fast forward 22 years. In 2006, Edward's son filed a separate lawsuit, claiming that the shares had been redeemed from the trusts for less than their fair market value (which claim was rejected on the basis of being time barred), and claiming that all of Edward's 100 shares should have been held in trust for his children. The court in the subsequent lawsuit disagreed that an oral trust was ever created. *O'Connor v. Redstone*, 896 N.E.2d 595 (Mass. 2008). Edward testified in that subsequent litigation with his son that he thought he had never held any shares under an oral trust for his children, but that "he had been forced to acknowledge the existence of an oral trust in order to placate his father and settle the litigation." In that same litigation, Sumner testified that he transferred the shares to trusts for his children voluntarily. He said that his father had never expressed that at least 50% of Sumner's shares were held for Sumner's children, but he voluntarily did the same thing Edward did for his children. Sumner proudly boasted that his actions were totally voluntary, contrary what Edward was forced to do:

> At trial in the O'Connor case Sumner maintained the same position: "Nobody sued me. I gave my kids a third of the stock voluntarily, not as the result of a lawsuit. In [s]o doing, I did what I wanted and appeased my father too." He testified that "[t]here was a big difference between Eddie's position and mine" because Edward "was resisting doing what my father wanted," whereas Sumner was simply trying to maintain good family relations. He later testified to the same effect: "Eddie was sued. I was not. And Eddie had to find a justification for what he was doing in transferring. I wasn't sued. I just made an outright gift."

Apparently as a result of the litigation with Edward's son, the IRS in 2010 became aware of the transfer of stock to the children's trusts back in 1972 and claimed that Edward and Sumner made taxable gifts. Edward died in 2011, and after a gift tax audit the IRS in 2013 assessed $737,625 in gift tax, $368,813 as a fraud penalty, $36,881 as a negligence penalty (an alternative to the fraud penalty), and a $184,406 penalty for failure to file a gift tax return against Edward's estate. The IRS made the same allegations against Sumner with respect to the transfers that he made to his children's trusts.

c. **Analysis in *Estate of Edward Redstone* Case**.

(1) *Burden of Proof.* The taxpayer had the burden of proof and did not contend that the burden shifted to the government.

(2) *"Ordinary Course of Business for Full Consideration" Exception.* A gift results from a transfer of property for less than an adequate and full consideration. §2512(b). The regulations provide an "ordinary course of business" exception:

> However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arms length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." Treas. Reg. §25-2512-8.

A transfer within a family group receives close scrutiny, but a transfer meeting the criteria described in the regulation will treated as "in the ordinary course of business."

(3) *Litigation Settlement Context.* Various cases have recognized that a transfer made in settlement of bona fide unliquidated claims was made for "a full and

adequate consideration because it was a transaction in the "ordinary course of business." Factors that the courts have considered in a litigation settlement context include:

> whether a genuine controversy existed between the parties; whether the parties were represented by and acted upon the advice of counsel; whether the parties engaged in adversarial negotiations; whether the value of the property involved was substantial; whether the settlement was motivated by the parties' desire to avoid the uncertainty and expense of litigation; and whether the settlement was finalized under judicial supervision and incorporated in a judicial decree. 145 T.C. No. 11, at 20.

(4) *Bona Fide*. The settlement was "bona fide" because the parties "were settling a genuine dispute as opposed to engaging in a collusive attempt to make the transaction appeared to be something it was not." *Id.* at 21. Edward was genuinely estranged from his father, and the parties had legitimate business grievances against each other. Although Edward had a reasonable claim to all 100 shares registered in his name, the company had possession of the shares and refused to disgorge them. The father passionately believed the "oral trust" theory and there is some justification for that theory because Edward was registered as the owner of one-third of the company's shares even though he contributed only 25.6% of its assets.

(5) *Arm's Length.* A transfer is at "arm's length" as long as the taxpayer acts "as one would act in the settlement of differences with a stranger." *Id.* at 22. Edward was genuinely estranged from his father. The parties were represented by counsel and engaged in adversarial negotiations for many months. Both parties recognized the compromise as "advantageous economically." The compromise was motivated by their desire to avoid the uncertainty and embarrassment of public litigation, and the settlement was incorporated in a judicial decree that terminated lawsuits.

(6) *Absence of Donative Intent.* Although donative intent is not a prerequisite to a gift, the absence of donative intent is essential for a transfer to satisfy the "ordinary course of business" exception." "Generally, donative intent will be found lacking when a transfer is 'not actuated by love and affection or other motives which normally prompt the making of a gift.'" *Id.* at 24. Although Edward's children were objects of his affection, a transfer to one's children is not necessarily imbued with donative intent. There have been many cases recognizing that transfers to children were nevertheless made "in the ordinary course of business." Edward transferred stock to his children not because he wished to but because his father demanded it. At the time of the settlement, Edward had no desire to transfer stock to his children but was forced to accept this transfer in order to black placate his father, settle the family dispute, and obtain a $5 million payment for his 66 2/3 shares.

(7) *Source of the Consideration*. The IRS made the argument that Edward's two children were not parties to the litigation or settlement, and as a result "they did not provide (and cannot have provided) any consideration to Edward for the transfer of the shares. Because no consideration flowed from the transferees,… Edward's transfer was necessarily a 'gift.'" This argument finds no support from

the regulations, which instead focus on whether the transferor received consideration; "they make no reference to the source of that consideration." No prior cases have directly addressed this "source of consideration" theory. In *Shelton v. Lockhart*, 154 F. Supp. 244 (W.D. Mo. 1957) the taxpayer agreed to place disputed funds into a trust for her children to receive a certificate of competency from the Bureau of Indian Affairs. The IRS contended that the transfer in trust for her children was a taxable gift, but the court disagreed, finding it irrelevant that the taxpayer's children were not parties to the dispute or settlement.

d. **Analysis in *Sumner Redstone* Case**.

(1) *Laches.* The taxpayer argued that the IRS was barred by laches from determining in 2013 a gift tax deficiency for the 1972 transfers. The court responded that the laches doctrine does not apply to tax claims, but even if it did, the taxpayer had not satisfied the requirements of a laches defense (i.e., that the IRS knew of the 1972 gift but "sat on its rights" to the "undue prejudice" of the taxpayer).

(2) *Second Examination Issue*. The IRS had initiated a special "Compliance Project" in 1974 to determine whether certain political contributions constituted taxable gifts. Sumner was audited in the course of that Compliance Project, but the scope of the review was limited to his political contributions. No taxable gifts were uncovered in that audit from a review of Sumner's political contributions. Section 7605(b) provides that taxpayers shall not be subjected to "unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary." Sumner argued that the 2012-2013 gift tax audit was a prohibited second examination. The court reasoned that the 1975 review was not an "inspection of the taxpayer's books of account," in part because compliance checks and compliance initiative projects do not constitute "examinations." Furthermore, the remedy is not to expunge gift tax deficiencies, but for the taxpayer to object to the examination. The taxpayer waived any rights under §7605(b) by failing to object to the "second examination."

(3) *Trust Transfers as Gifts*. Sumner portrayed the transfers to his children's trusts as part of the "overall reconfiguration of stock ownership by which the parties brought Edward's litigation to a close" and that the transfers "facilitated the settlement of his brother's litigation" and "appeased his father." The court disagreed. No dispute existed concerning ownership of Sumner's stock and the father never withheld any of Sumner's shares from him. No demand was placed on his shares, no negotiations ever occurred, Sumner never filed a lawsuit and received no release of claims from his father or anyone else upon transferring his stock. Sumner's transfers did not facilitate the settlement because the settlement agreement never mentioned any transfers by Sumner. "Pleasing parents, like pleasing children, is presumptively a family motivation, and we discern no evidence tending to rebut that presumption here. There was no claim

against Sumner; there were no arm's length negotiations; and he received no consideration from anyone in exchange for his transfer."

(4) *Valuation.* The court agreed with the IRS's appraisal expert that the redemption price that the company paid to Edward to redeem 66 2/3 of his shares was a "reliable index" of the stock's value less than a month later when Sumner transferred shares to his children's trusts.

(5) *Penalties.* The IRS has the burden of proving fraud by clear and convincing evidence. While the oral trust may have been a fiction, the father passionately believed there was an oral trust and it was the central feature of the settlement agreement with Edward. Sumner went along with the oral trust rationale in making the trust transfers to his children and did not merely embrace the oral trust concept to evade gift tax liabilities.

Failure to file and negligence penalties were not imposed because of Sumner's reliance "in good faith on advice from a tax professional that no tax liability existed or that no return was required."

(6) *Irony of the Overall Result.* The dispute between Edward and his father and the company was also the result of festering disputes between Edward and Sumner. Sumner had a more prominent role in the company, and Sumner at one point hired another person to take over Edward's responsibilities. As a result of the hostile atmosphere, Edward eventually left the company and was forced into litigation with the company and his father to receive payment for his shares. As a result of this litigation, the transfer of substantial value to Edward's sons did not cost him any gift tax, whereas Sumner had to pay over $700,000 of gift tax to make the same transfers to his children. One commentator has referred to this saga as "A Tale of Two Brothers: (A Deceased Brother's Revenge)." He concludes "Somewhere, Edward is smiling." Lance S. Hall, FMV Valuation Alert (Dec. 14, 2015).

The differing treatment of the two brothers highlights "the principle that intrafamily transfers that would otherwise be taxable gifts (Sumner's transfers) might not be taxable gifts if they result from arm's length settlement of a bona fide dispute (Edward's transfers)." Ronald Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2015,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2371 (Jan. 4, 2016).

e. **Planning Considerations.**

(1) *Common "Scary Concern."* Almost every settlement of litigation in a family related context at some point raises consternation among the planners as to whether any parties are making taxable gifts as a result of the settlement. Transfers in compromise and settlement of trust or estate genuine disputes typically will be treated as transfers for full and adequate consideration that do not result in gifts. The IRS has issued a number of favorable private letter rulings finding no gift tax exposure in a variety of settlement contexts. E.g., PLR 201342001, 201104001, 200845028, 200825007, 200638020, and 200209008. Some experts have summarized that planners often worry about the gift issue in settlement discussions, but "this is one of the scariest things

that almost never happens." The IRS's approach in Redstone, though highlights why this is such a scary issue—the IRS not only asserted that the settlement resulted in significant gift tax, but also asserted fraud, negligence and failure to file penalties from a settlement of hostile protracted family litigation.

(2) *Factors Considered***.** The Tax Court in *Redstone* summarized factors that the courts often consider in determining whether litigation settlements constitute taxable gifts. Planners will try to satisfy as many of these factors as possible to avoid gift treatment:

- whether a genuine controversy existed between the parties;
- whether the parties were represented by and acted upon the advice of counsel;
- whether the parties engaged in adversarial negotiations;
- whether the settlement was motivated by the parties' desire to avoid the uncertainty and expense of litigation; and
- whether the settlement was finalized under judicial supervision and incorporated in a judicial decree.

36. Charitable Set-Aside Deduction, *Estate of Belmont v. Commissioner* and *Estate of DiMarco v. Commissioner*

a. **Statutory Rule**. Section 642(c)(1) provides that an estate or trust may take a charitable deduction (not subject to percentage limitations that apply to charitable gifts by individuals) "for any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a [charitable] purpose." Furthermore, the executor or trustee may elect to treat a contribution made in one taxable year as having been made in the prior taxable year. §642(c)(2).

An estate or trust may also be entitled to an income tax charitable deduction for amounts of gross income that are permanently set aside for charity even though the income has not actually been distributed charity during the current taxable year... §642(c)(2). The regulations provide that an amount is not "permanently set aside" for a charitable purpose "unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote is to be negligible." Reg. §1.642(c)-2(d).

b. **Estate of Belmont v. Commissioner**. The Tax Court in *Estate of Belmont v. Commissioner*, 144 T.C. 84 (2015), denied a set-aside deduction because of the possibility that some portion of the funds would be used for litigation expenses. The decedent's residuary estate passed to a charitable foundation. The decedent's

condominium had been used by her brother, but her executor ordered him to leave. He refused and filed a claim alleging his sister orally granted him a life estate. The estate claimed a $219,580 charitable deduction for the portion of the estate's net income (primarily from an IRA distribution) that was "set aside" for the charitable beneficiary (although that amount was not segregated from the other estate funds in its checking account). There were subsequent litigation expenses resulting in the estate being unable to pay the entire $291,580 amount to charity. The court denied the charitable set aside deduction in its entirety, because at the time of taking the deduction, the estate knew there was a substantial possibility of a prolonged and expensive legal fight, and the possibility was not "so remote as to be negligible."

c. **Estate of DiMarco v. Commissioner.** The Tax Court again addressed the charitable set-aside deduction later in 2015 in *Estate of DiMarco v. Commissioner,* T.C. Memo. 2015-184. The decedent's will left the residuary estate to the church that he regularly attended. Confusion arose because he attended two churches. Various cousins alleged that the residuary bequest was uenforceable because of its ambiguity and that the estate should pass to them as the decedent's heirs. The parties discussed the settling the case, and the discussion had a reached a point that the estate felt sure that a certain amount of its gross income (apparently from an IRA distribution) would pass to charity. On April 19, 2012 it filed the estate's 2010 income tax return (late) claiming a $319,942 charitable deduction from gross income as an amount permanently set aside for charitable purposes. On April 26, 2012 the court approved a settlement, with one-third passing to each of the two churches and one-third passing to the heirs. After selling the last asset, the parties reached a further settlement regarding the payment of all attorney's fees and executor commissions, which was filed with the court on December 28, 2012 and approved by the court in January 2013.

The estate's position was that the parties' settlement discussions had reached a point that by the time it filed the return on April 19, 2012 "it could determine and account for all of its final administrative expenses" and "the possibility of prolonged legal controversies over estate matters was so remote as to be negligible." The IRS argued that "in view of the uncertainties and legal controversy the possibility that the estate's assets might go to noncharitable beneficiaries was not so remote as to be negligible. Furthermore, it took the position that "the estate cannot permanently set aside funds as a matter of caselaw when there is a pending will contest or active litigation, the result of which might distribute the estate's funds to noncharitable beneficiaries. The Tax Court (Judge Laro) denied the set-aside deduction, pointing out that even the first settlement left the issue of legal fees and executors' commissions unsettled. The estate claimed that it accounted for the commissions and attorney's fees in a proposed distribution schedule, but the court observed that schedule omitted possible future fees for the estate's own attorney and the Attorney General, suggesting that the fee schedule did not account for the final administrative expenses. The court also noted that no funds had physically been segregated to pass to the churches, but reasoned that fact favored the IRS position "to a small degree, taking into consideration the overall circumstances."The court's final conclusion casts doubt over whether a set-aside deduction could be taken when there is an outstanding will contest until the dispute has been *finally* resolved:

At the time the estate filed its income tax return, it was not known how long it would take to validate the will, reach a settlement, or conduct probate. Only after the surrogate's court approved the second settlement on about January 28, 2013, were the estate's funds finally dedicated to the respective parties, thereby eliminating the opportunity to challenge the will. [Citation omitted] By virtue of the fact that the settlements pertaining to designation of the beneficiaries and consequential legal and administrative expenses were not finalized until after the year at issue and the estate filed this income tax return, we find that the possibility that the funds would go exclusively to noncharitable beneficiaries was not so remote as to be negligible."

d. **Planning Considerations.** These cases, and the increased IRS attention to the charitable set-aside deduction for estates and trusts, create significant uncertainties in being able to claim charitable set-aside deductions whenever there is ongoing estate litigation that might impact the amounts passing to charity.

(1) *Segregate Funds.* If the estates had segregated funds for charity in these cases, there would have been a better chance of prevailing (although Judge Laro in *DiMarco* said that helped the government's position only "to a small degree"). How are funds segregated into a separate account if a charity is the only beneficiary of the residuary estate? Some attorneys respond to transfer funds to a separate account anyway to provide a better argument.

(2) *Delay Deduction Until Later Year.* The estate or trust could always claim the deduction in a later year when amounts from gross income are actually distributed to charity, but the estate or trust typically will not want to pay income tax on gross income received in one year when that amount will ultimately be passing to charity (and the estate or trust may not have sufficient income to be offset by the deduction in a later year). The estate or trust can treat the contribution as having been made in the prior year under §642(c)(1). For example, if gross income is received in year one that the estate would like to offset with a charitable deduction, if the amount is actually paid to charity in year two, a deduction could be claimed for year one under §642(c)(1) rather than as a set-aside deduction under §642(c)(2).)

(3) *Manage Receipt of Gross Income*. If the estate owns IRAs, do not withdraw money from the IRAs (other than minimum required distributions) until the dispute is resolved.

37. Trust Income Tax Charitable Deduction for Distribution of Asset With Unrealized Appreciation to Charity, *Green v. United States*

A federal district court addressed, as a matter of first impression, whether a trust could claim an income tax charitable deduction for the full fair market value of appreciated property (rather than just the basis of such property) that it contributes to charity. *Green v. United States*, 116 AFTR 2d 2015-6668 (W.D. Okla. 2015). The trust agreement authorized the distributions to charity of "such amounts from the gross income of the Trust" as the trustee deems appropriate. The trust owned an interest in a partnership,

which in turn owned many Hobby Lobby stores. The trust made charitable donations of appreciated real estate, and filed its income tax return claiming a deduction just for the adjusted basis of those properties. It later filed a claim for refund, claiming a deduction for the full fair market value of the properties, which the IRS denied.

The court granted summary judgment to the trust allowing the refund. The court cited that the purpose of Congress in allowing charitable deduction was to encourage charitable gifts, that statutes regarding charitable deductions are "expression[s] of public policy," and that a liberal construction of charitable deduction statutes in favor of taxpayers is appropriate.   The court observed that §170 imposes limitations on the amount of a charitable deduction for individuals, based on whether the gift is cash or appreciated property, but noted that §642(c) has no such limitation for estates and trusts.

Section 642(c) limits the income tax charitable deduction for an estate or trust to "any amount of gross income … paid," but the court reasoned that section does not require the distribution be made in the same year in which the gross income was realized. The IRS argued that a distribution must be "sourced from and traceable to" gross income to generate a charitable deduction. The court responded that the properties were bought with the proceeds of income distributed from the partnership to the trust in prior years that was gross income of the trust in the year the distributions were received; therefore the real estate properties were purchased by the trust with the trust's gross income.

The IRS argued that the trust agreement only authorized distributions to charity from the trust's gross income, and the properties had become principal by the time they were distributed to charity, so the distributions were not made "pursuant to the terms of the governing instrument" as required by the charitable deduction statute. The court responded that "conflating … fiduciary accounting principles with the federal tax concept of gross income unnecessarily muddies the water – here, there can be no serious question that the donations were made 'pursuant to the terms of the governing instrument.'"

The government argued that gross income does not include unrealized appreciation and that only the adjusted basis of the property could be deducted, not the full fair market value of the appreciated properties.   The court responded that §642(c) does not limit the trust's charitable deduction to the basis of distributed property, and allowed a charitable deduction based on the full fair market value of the distributed property.

The holding of the case is rather surprising, but it is a case of first impression, "[b]ut allowing a deduction of fair market value puts the trust in the same position as if it had sold the property and donated the cash proceeds, while allowing a charitable donee to receive property it can use for its charitable purposes." Ronald Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2015,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2371 (Jan. 4, 2016).   Until there is contrary case law, trusts will likely claim charitable deductions based on the full value of appreciated properties that are distributed to charity if the charitable gifts are authorized by the trust agreement.

Appendix A

FLP/LLC Discount Table of Recent Cases (prepared by John Porter, Houston, Texas)

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Strangi I	securities	Tax	31%
Knight	securities/real estate	Tax	15%
Jones	real estate	Tax	8%; 44%
Dailey	securities	Tax	40%
Adams	securities/real estate/minerals	Fed. Dist.	54%
Church	securities/real estate	Fed. Dist.	63%
McCord	securities/real estate	Tax	32%
Lappo	securities/real estate	Tax	35.4%
Peracchio	securities	Tax	29.5%
Deputy	boat company	Tax	30%
Green	bank stock	Tax	46%
Thompson	publishing company	Tax	40.5%
Kelley	cash	Tax	32%
Temple	marketable securities	Fed. Dist.	21.25%
Temple	ranch	Fed. Dist.	38%
Temple	winery	Fed. Dist.	60%
Astleford	real estate	Tax	30% (GP); 36% (LP)
Holman	dell stock	Tax	22.5%
Keller	securities	Fed. Dist.	47.5%
Murphy	securities/real estate	Fed. Dist.	41%
Pierre II	securities	Tax	35.6%
Levy	Undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Giustina	Timberland; forestry	Tax	25% with respect to cash flow valuation (75% weighting to cash flow factor and 25% weighting to asset method)
Gallagher	publishing company	Tax	47%
Koons	Cash	Tax	7.5%