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Upcoming IRS Regulatory Projects (Including Section 2704 Proposed Regulations)

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IRS Regulatory and Guidance Projects Possibly Coming by This Summer (Including §2704 Proposed Regulations and Regulations That May Impact Graegin Loans)

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TABLE OF CONTENTS

Recent Statements by Treasury and IRS Officials 1

Projects Possibly Coming By This Summer 1

Longer Term Projects—Material Participation by Trusts and Three New Projects in 2015-2016 Priority Guidance Plan 3

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Recent Statements by Treasury and IRS Officials

At the ABA Tax Section Meeting on May 6, 2016 Cathy Hughes with the Treasury Department Office of Tax Policy) and Melissa Liquerman (Branch 4 chief, IRS Office of Associate Chief Counsel [Passthroughs and Special Industries]) spoke about upcoming IRS guidance. In addition Ms. Liquerman spoke at the ABA Real Property, Trust & Estate Law Section meeting on May 12, 2016. They addressed various projects on which guidance would likely be issued in the near future. Ms. Liquerman said that "we hope in the next couple months to issue five or six projects." *Several Gift, Estate, and Trust Projects Expected Before July,* TAX NOTES TODAY, 2016 TNT 90-11 (May 10, 2016) (hereinafter "*Projects Expected,* TAX NOTES TODAY").

The first of these projects that will be issued are §2704 proposed regulations (discussed below).

Projects Possibly Coming By This Summer

The projects on which guidance will likely come this spring or summer include the following.

1. **§2704 Proposed Regulations**. At various times the following terms were used by Treasury Officials to describe the timing of when these will be issued: "very, very shortly," "this spring, before summer," "some could come as soon as the next two weeks," "the next four to eight weeks". They spoke of these as proposed regulations as compared to other possible types of guidance. Melissa Liquerman indicated that the first of the estate and gift projects that would be issued by the IRS in the near future would be the §2704 proposed regulations.

   The proposed regulations may place further restrictions on being able to apply valuation discounts in valuing transfers of interests in entities (such as limited partnerships and LLCs). The approach and scope of the proposed regulations are highly uncertain at this point, but the regulations could have a very important impact on valuing transfers of interests in entities.

   Neither of the speakers gave any hint as to whether the proposed regulations would take the rare approach of providing that the regulations, once finalized, would be applied retroactively to the date of the proposed regulations.

2. **§1022 Final Regulations**. The regulations provide guidance to recipients of property acquired from decedents who died in 2010; there will likely be few changes from the proposed regulations that were issued in May 2015).

3. **Revenue Procedure 2001-38**. The IRS will clarify whether portability can be used in connection with QTIP trusts (in light of Revenue Procedure 2001-38). The 2014-2016 IRS Priority Guidance Plans include the following item: "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 was the only new item on last year's list of projects in the Gifts and Estates and Trusts section of the Priority Guidance Plan). 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.

4. **Qualified Contingencies in Charitable Remainder Trusts**. The "exhaustion test" requires that there be no more than a 5% probability that the charity will receive nothing at the termination of the CRT, assuming that any life annuitant will live to age 110, *see* Treas. Reg. §25.7520-3(b)(2); Rev. Rul. 77-374, 1977-2 C.B. 199. Meeting the exhaustion test is significantly more difficult for CRTs with life annuities than meeting the requirement that the remainder has a present value of at least 10% of the initial CRT value. For example, with a 2% §7520 rate, a life annuitant must be at least 72 years old for a CRAT to meet the exhaustion test. The California bar has suggested including as a qualified contingency (*see* §664(f)) in a charitable remainder annuity trust that the trust will terminate immediately before the payment of an annuity that would cause the CRT to fall below 5% of the initial value of the CRT. *See* Parks, Finestone, & Laehy, *Charitable Remainder Trusts and The Probability of Exhaustion Test,* Tax Notes, at 1411 (September 7, 2015).) Cathy Hughes said "That project is very far along and I think you're going to see it soon." *Projects Expected,* Tax Notes Today.

5. **§2053 Proposed Regulations**. This project will address issues left unresolved in the regulations that were issued in 2009 regarding the valuation of disputed claims against an estate. The preamble to those regulations includes the following statement: "The Treasury Department and the IRS believe that the issue of the appropriate use of present value in determining the amount of the deduction allowable under section 2053 merits further consideration. The final regulations reserve §20.2053-1(d)(6) to provide future guidance on this issue." T.D. 9468, §13, I.R.B. 2009-44. The Treasury Priority Guidance Plans for 2009-2016 include a project to address when present value concepts should be applied in determining the deductible amount of claims against an estate and administration expenses (including, for example, attorneys' fees, Tax Court litigation expenses, etc.) as well as the treatment of personal guarantees. (Officials have previously indicated informally that "*Graegin* loans"–on which interest that will be payable for the full term of the loan is deduced from the outset as an administration expense– are within the scope of this project).

6. **§2032(a) Final Regulations**. These regulations will address whether certain transactions will be treated as distributions or dispositions during the six-month alternate valuation period. As a general rule, a sale or distribution of an asset within the six-month alternate valuation period fixes the alternate valuation of that particular asset as of the date of the sale or distribution. Proposed regulations were issued in 2008 in response to *Estate of*

Kohler v. Commissioner, T.C. Memo. 2006-152, *nonacq*. AOD 2008-001 (tax-free reorganization is not a disposition that accelerates alternate valuation date). Those proposed regulations were controversial in various respects, and the proposed regulations were revised and re-issued on November 18, 2011. For example, the proposed regulations, among other things, provide that making multiple distributions of minority interests within the first six months cannot convert a majority interest into a series of minority interests for valuation purposes and that contributing assets to a limited partnership in the first six months cannot result in discounting the assets under the alternate valuation rules. *See* Prop. Reg. § 20.2032-1(c)(1).

Longer Term Projects—Material Participation by Trusts and Three New Projects in 2015-2016 Priority Guidance Plan

Cathy Hughes also referenced other projects that are longer term projects and that will not be issued anytime in the near future. In addition, Melissa Liquerman indicated that the new "trust and estate" projects in the 2015-2016 Priority Guidance Plan (other than qualified contingencies for CRTs) are not as far along in development and will not be issued anytime soon. These include guidance on the basis of assets in a grantor trust after the grantor's death, the valuation of promissory notes, and the gift tax effect of defined value clauses. In addition, two generation-skipping transfer tax projects addressing allocation issued under §2642 are also longer term projects (as well as other projects listed in the "Gifts and Estates and Trusts" section of the 2015-2016 Priority Guidance Plan).

1. **§469 Proposed Regulations Regarding Material Participation by Trusts.** How trusts materially participate in a business under §469 has taken on additional significance in light of the "non-passive trade or business exception" from the net investment income tax under §1411, and in light of the Tax Court's position in *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014). Cathy Hughes indicates that this is a longer term project: "We have taken an approach to this project by deciding we weren't going to be bound by any other approach in the code that exists to the question of material participation; we're starting from scratch and evaluating from the ground up… This is a heavy lift; it will not be out soon." *Projects Expected,* Tax Notes Today.

2. **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 a basis step up should be available 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, various other situations arise 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; or 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.

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 are not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.

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 private rulings are conflicting; 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," no basis step-up arises under §1014).

Ron Aucutt provides insight regarding these rulings:

> The holdings in Letter Ruling 201245006 and CCA 200937028 would be entirely reconcilable under the standards of section 1014(b) if the trusts involved were both U.S. trusts and the grantors were U.S. persons. In Letter Ruling 201245006 the grantor retained the right to income for life, which of course would be a retained section 2036 interest (although that doesn't explain the ruling's invocation of section 1014(b)(1)). In CCA 200937028 the reservation was only of a power to substitute assets, which under Rev. Rul. 2008-22, 2008-1 C.B. 796, the IRS does not regard as a section 2036 power. In that light, the opposite results in those two rulings may have limited significance in the context of U.S. grantor trusts that buy assets from U.S. grantors.
>
> For other possible clues about the origin and purpose of the guidance project, or at least the Service's no-rule position, see Letter Ruling 201544002…. In that ruling the IRS ruled that the assets in a revocable trust created by foreign grantors for their U.S. citizen children would receive a basis equal to date-of-death value under section 1014(b)(2) at the grantors' deaths. The ruling acknowledged the no-rule policy of Rev. Proc. 2015-37 (which had been published in the Internal Revenue Bulletin the day before the ruling was issued), but avoided it on the ground that the ruling request had been submitted before the no-rule policy was announced. (And for a particularly ambitious, but unsuccessful, attempt to obtain a stepped-up basis in a cross-border context, see *Hughes v. Commissioner*, T.C. Memo 2015-89.)

Aucutt, ed., *Recent Developments 2015*, 50th ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2016).

3. **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 such that collectability problems exist. While §7872 clearly applies in valuing a cash loan for gift tax purposes, its concepts do not clearly apply for sale transactions. Section 7872(f)(8) specifically says that §7872 does not apply to any loan to which section 483 or 1274 applies (which generally apply to sales or exchanges of property). The taxpayer response is that §7872, *Frazee v. Commissioner*, 98 T.C. 554, 588 (1992), and *True v. Commissioner*, T.C. Memo. 2001-167, *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004) support using the AFR with notes given in sales transactions. The Tax Court in *Frazee* specifically pointed to the language in §7872(f)(8) in support of this position:

"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." 98 T.C. 554, at 588 (1992).

Private Letter Rulings 9535026 and 9408018 similarly take the position that §7872 will apply to the gift tax valuation of notes issued in intra-family sales transactions. (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*.)

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 a reasonable expectation of repayment exists.

(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, no such similar certainty exists for estate tax purposes. Does that mean that the note can be discounted for estate tax purposes because no regulations are on point for estate tax purposes? Because no coordinating regulation exists 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.

Section 7872 specifically authorizes the issuance of regulations addressing the valuation of notes in light of §7872. The IRS indeed has issued a proposed regulation that 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." Prop. Reg. § 20.7872-1. This regulation has never been finalized.

For a more detailed discussion of the note valuation issues, see Item 2.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

(3) ***Income Tax Effects of Discounting Notes.***

If a note is discounted for estate tax purposes, but the full amount of the note is later paid, the excess payments over the basis of a note (i.e., the estate tax value) will be ordinary income to the recipient. If an individual inherits a note (other than an installment sale note) that is valued below face, and if the individual receives payments on the note exceeding the discounted value of the note, the excess is treated as ordinary income. For example, §§ 1271-1275 deal with OID by requiring the debt holder to take any discount into income as ordinary income, not as capital gain. *E.g.,* Treas. Reg. §1.1275-1(b)(3) (treatment of market discount for calculating OID accruals).

The income tax effect should be different if an individual receives the note by gift. Under the dual basis rules of § 1015, the donee's basis in the note would be the donor's basis for purposes of determining the amount of any gain. Therefore, the reduction in value of the note up to the time of the gift would not result in a decreased basis for purposes of determining later gain on the note.

If the note is an installment sales note, special rules apply if the note is satisfied at less than face value, if a disposition or cancellation of the note occurs, or if related parties dispose of property purchased with the installment note within two years of the sale. I.R.C. §§ 453B(a), 453(e)(1).

In summary, discounting a note may provide immediate estate tax benefits, but it may come at a cost for income tax purposes. (The income tax cost may be greater than the estate tax savings; the federal top rate is 39.6% +3.8% net investment income tax, or 43.4%. In addition, some states have income tax rates of up to 10%.)

4. **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, which was settled with the IRS apparently respecting the *Wandry* provision. *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.