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# Estate Planning Current Developments and Hot Topics

**December 2018**

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January 10, 2019

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## Introduction

The 52nd Annual Philip E. Heckerling Institute on Estate Planning was held in Orlando during the week of January 22, 2018. This summary includes observations from that seminar, as well as other observations about various current developments and interesting estate planning issues. My goal is not to provide a general summary of the presentations. Rather, this is a summary of observations of selected items during the week as well as a discussion of other items. I sometimes identify speakers, but often do not (some topics are discussed by various speakers). I take no credit for any of the outstanding ideas discussed at the Institute — I am instead relaying the ideas of others that were discussed during the week.

### 1. Summary of Top Developments in 2018

Ron Aucutt (Washington, D.C.) lists the following as his “top ten” list of the major developments in the estate planning world in 2018 (his report is available [here](#) (from the ACTEC “Capital Letters” webpage)):

- (1) Developments regarding limits on the state income taxation of trusts (*Kaestner, Fielding*, and maybe *Wayfair*) (see Item 23 below);
- (2) Proposed regulations regarding the Section 199A qualified business income deduction and the Section 643(f) multiple trust rules (see Item 2.f below);
- (3) Another speedbump for domestic asset protection trusts (*Toni 1 Trust*);
- (4) The proposed “anti-clawback” regulations (see Item 2.d. (2)-(4) below);
- (5) Crunch time for intergenerational split-dollar arrangements (*Cahill, Morrissette*) (see Item 7 below);
- (6) State taxation of QTIP trusts at the surviving spouse’s death (*Taylor, Seiden*);
- (7) Travails of family limited partnerships (*Straightoff, Turner III*) (see Item 6.f-g below);
- (8) Inclusion of the value of GRAT assets in the gross estate (*Badgley*);
- (9) Trust flexibility versus “dead hand” control (*Horgan, Shire*); and
- (10) Spotlight on trust beneficiaries’ rights to be informed (*Forgey*).

Ron Aucutt’s “top ten” list of 2017 major developments was as follows:

- (1) The 2017 Tax Act (see Item 2 below);
- (2) Regulatory environment in the Trump administration (see Item 4.a below);
- (3) An extreme family limited partnership case (the *Powell* case, see Item 6.e below);
- (4) Withdrawal of the proposed regulations under §2704 (see Item 4.a below);
- (5) Continued tension between Congress and the IRS;
- (6) Developments with portability on several fronts (including Rev. Proc. 2017-34, and the *Sower* and *Vose* cases; see Item 15 below);
- (7) Growing legislative acceptance of asset protection trusts;

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- (8) Measured retroactive relief for same-sex married couples (Notice 2017-15; see Item 4.g below);
  - (9) Decline of state estate taxation; and
  - (10) Challenges to the substantiation of charitable contributions, including conservation easements (see Item 10.e below).

Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2017*, McGuireWoods Website (posted January 11, 2018).

## **2. 2017 Tax Act and Tax Reform**

- a. **Estate Tax Repeal History-1986 Tax Reform Act; Proposals for 2017.** Estate tax repeal has been considered by various administrations. One staffer from 1986 has stated that negotiation of the momentous 1986 Tax Reform Act came down to one last item. The legislative staffers told President Reagan that he could get rid of the estate tax, but he would have to give up the B-2 bomber. President Reagan replied that he would rather keep the B-2 bomber.

The House Republican Blueprint for Tax Reform published June 24, 2016 included a proposal to repeal the estate and GST tax (but presumably to retain the gift tax). President Trump's campaign proposal was to "repeal the death tax, but capital gains held until death and valued over \$10 million [presumably that is per couple] will be subject to tax to exempt small businesses and family farms." The 2017 Tax Act, as described below, does not repeal the estate and GST tax but roughly doubles the estate and gift tax exclusion amount for 2018-2025.

- b. **Legislative Process for Tax Reform Using Reconciliation.** The process for getting tax reform legislation in 2017 was using the budget reconciliation act. The Congressional Budget Act of 1974 (Titles I – IX of the Congressional Budget and Impoundment Control Act of 1974) modified and clarified the role of Congress in the federal budgetary process. It governs the process of annual budget resolutions and budget reconciliations. Title II created the Congressional Budget Office (CBO) to give Congress independent economic analysis; previously the Executive Branch controlled budgetary information. Standing budget committees in the House and Senate were created and additional staffing was authorized for committees involved with budget decisions.

(1) **Budget Resolution.** Title III specifies procedures for the adoption of an annual budget resolution, which is a concurrent resolution that is not signed by the President, that sets out fiscal policy guidelines for Congress (but Congress does not adopt a budget resolution in all years, for example it did not do so last year). (The budget resolution cannot be filibustered in the Senate.) The budget resolution does not enact spending or tax law, but sets targets of overall receipts and expenditures, based on CBO estimates, for other committees that can propose legislation changing spending or taxes. The limits on revenue and spending that it establishes may be enforced in Congress under "points of order" procedural objections (which requires 60 votes in the Senate to waive). Budget resolutions set spending and revenue levels for a budget window (at least five years but typically 10 years). The budget resolution typically is rather straightforward, primarily stating how much should be spent in each

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of 19 broad spending categories, and specifying how much total revenue the government will collect for each year in the budget window.

The House passed its budget resolution on October 5, 2017 on a mostly party-line vote. The House budget included \$203 billion in mandatory spending cuts and tax changes that do not add to the national debt, but the Senate budget included much fewer mandatory spending cuts and authorized a \$1.5 trillion reduction of federal revenues over the ten-year budget window. Senator Corker emphasized that the \$1.5 trillion deficit agreement was merely to get a budget resolution passed, and that he would still want revenue neutrality over the budget window after applying a reasonable “dynamic scoring” approach before he would vote in favor of the tax legislation in a reconciliation act. See Erik Wasson, *GOP Budget Kicks Off Effort on Tax Cuts. Now Comes the Hard Part*, DAILY TAX REPORT (October 5, 2017). However, he subsequently agreed with the tax reform package, discussed below, despite the revenue impacts.

(2) **Reconciliation Act.** The budget resolution can specify that a budget reconciliation bill will be considered to “reconcile” the work by various committees working on budget issues and to enforce budget resolution targets. Like the budget resolution, it cannot be filibustered in the Senate and only requires a majority vote. The reconciliation directive directs committees to produce legislation by a certain date that meets specified spending or tax targets. The various bills are packaged into a single bill (only one reconciliation act is allowed in each Congressional session) with very limited opportunity for amendment. The reconciliation bill, when ultimately approved by the House and Senate, goes to the President for approval or veto.

The reconciliation process has proved instrumental in being able to pass measures connected with the budget process without the necessity of garnering 60 votes in the Senate. For example, reconciliation was instrumental in the passage of the 2001 and 2003 tax cuts, healthcare reform in 2010, and welfare reform in 1996. Tax reform will not necessarily have to be subject to a 10-year sunset provision (what some planners refer to as a “sunrise” provision) if 60 votes cannot be secured in the Senate if the overall package does not add to the deficit outside the budget window of the act. Some significant tax acts have been passed under the reconciliation process without the sunset provision by finding other “pay-fors” so that net tax revenue decreases do not exceed net outlay decreases outside the budget window. (That was accomplished with the 1997 tax act, but that was in a time of budget surpluses.)

(3) **Byrd Rule.** While the reconciliation act is not subject to Senate filibuster, under the “Byrd rule” (added permanently as §313 of the Congressional Budget Act in 1990) any single Senator can call a point of order against any provision or amendment that is “extraneous” to the reconciliation process for various prescribed reasons—one of which is an entitlement increase or tax cut that will cost money beyond the budget window of the reconciliation bill (typically ten years) unless other provisions in the bill fully offset these costs. (The actual language of the Congressional Budget Act is cumbersome, stating that:

a provision shall be considered to be extraneous if it increases, or would increase, net outlays, or if it decreases, or would decrease, revenues during a fiscal year after the fiscal years covered by such reconciliation bill or reconciliation resolution, and such increases or decreases are greater

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than outlay reductions or revenue increases resulting from other provisions in such title in such year. 2 U.S. CODE §644(b)(1)(E).)

The offending provision is automatically stripped from the bill unless at least 60 Senators waive the rule. (In congressional vernacular, reviewing a reconciliation act to determine if any extraneous provisions exist is referred to as giving the proposed legislation a “Byrd bath,” and any items that are dropped to avoid having extraneous provisions are called “Byrd droppings.”) The Senate parliamentarian makes the decision as to what provisions violate the Byrd rule. The Vice President, as the presiding officer of the Senate, can override the parliamentarian’s decision, but “the long-standing Senate precedent is to defer to the parliamentarian’s rulings.” Steven Dennis & Laura Litvan, *Senate GOP to Snub House Obamacare Repeal Bill, Write Its Own*, BLOOMBERG DAILY TAX REPORT (May 5, 2017). (For example, Democrats believed the provision in the House bill to repeal and replace the Affordable Care Act that let states apply for waivers to allow insurers to charge higher premiums to people with pre-existing conditions if they haven’t maintained continuous coverage, provided the state also has a high-risk pool, violated the Byrd rule and could not have been included in the Senate version of the health care reconciliation act without 60 votes. *Id.*)

If the legislation does not result in revenue neutrality after the budget window, the classic approach is to sunset the offending measures at the end of the budget window (which is why the “Bush tax cuts” in 2001 only lasted for ten years), thus resulting in a tax reform measure or tax cuts that would not violate the Byrd rule and that could be passed with a mere majority in the Senate.

The 2017 Tax Act (discussed below) generally sunsets most of the individual and transfer tax provisions (not including, among other things, the chained CPI approach for indexing) after 2025 to avoid having a 60-vote requirement in the Senate under the Byrd Rule.

c. **Overview of 2017 Tax Act.**

(1) **Passage of “Tax Cuts and Jobs Act” (or Reconciliation Act of 2017 or 2017 Tax Act).** The Tax Cuts and Jobs Act passed the House on December 19, 2017 by a vote of 227-203 (with no Democratic votes and with 13 Republican members from California, North Carolina, New Jersey, and New York voting no). The Senate parliamentarian ruled that three provisions in the version passed by the House were “extraneous” to reconciliation (one of which was removing the short title, discussed in the following paragraph) and were removed in the bill that passed the Senate very early in the morning of December 20 by a straight party-line vote of 51-48 (Senator McCain was absent), forcing a House revote of the version passed by the Senate later that same morning. The President signed Public Law No. 115-97 (the “Act”) on December 22, 2017.

The short title “Tax Cuts and Jobs Act” was removed, but the Act may continue informally to be referred to by that former and commonly used name. The Treasury and IRS continue to refer to the Act by that name. For example, an IRS website (“Resources for Tax Law Changes” at <https://www.irs.gov/newsroom/resources-for-tax-law-changes>) that contains links to its announcements about the Act refers to “tax changes approved by Congress in the Tax Cuts and Jobs Act (TCJA).” The staff of the Joint Committee on Taxation also refer to the Act by that same name.

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See Staff of Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2018* (February 7, 2018). The official title is “To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.” Perhaps the Act will be known as the Reconciliation Act of 2017 or simply as the 2017 Tax Act. Apparently, the Treasury and IRS will refer to it as TCJA.

(2) **Effective Date.** Most of the provisions are effective for taxable years beginning after 2017. Most of the provisions regarding individual tax reform (including the transfer tax provisions) are effective for taxable years from 2018-2025 (i.e., for 8 years). They sunset after that date in order to satisfy the “Byrd rule” so that the Act could be passed with just a majority vote in the Senate under the reconciliation process. The change to the “Chained CPI” indexing approach remains permanent, and generally the business tax reform measures are permanent.

(3) **Simplification.** One of the stated purposes of tax reform was simplification, but many of the provisions add significant complexity. In particular, the various limitations and restrictions on the 20% deduction for pass-through entity qualified business income are very complicated.

(4) **Revenue Impact.** The budget resolution that initiated the reconciliation process for approving the Act (with only a majority vote requirement in the Senate) authorized tax reform that would produce no more than \$1.5 trillion of deficits over the 10-year budget window authorized in the budget resolution. The Joint Committee on Taxation scored the bill as producing \$1.456 trillion of deficits over the 10-year period. It did not provide a “dynamic scoring” estimate taking into consideration economic gains that would result from the Act. The Tax Foundation (a “right-leaning” organization) estimates that the Act would add \$1.47 trillion to the deficit over 10 years, but \$448 billion after considering economic growth. The individual tax provisions of the Act generally sunset after 8 years; the Tax Foundation estimates that making all of the bill’s tax cuts permanent would have resulted in a deficit of \$2.7 trillion over 10 years, or \$1.4 trillion considering economic growth. Accordingly, the sunset provision saves \$1.23 trillion (\$2.7 - \$1.47 trillion) with a static projection, or \$950 billion (\$1.4 - \$0.448 trillion) considering economic gains, and the trend of increasing deficits would have continued to expand in the following decade. Tax Foundation, *Preliminary Details and Analysis of the Tax Cuts and Jobs Act* (Dec. 2017). The Congressional Budget Office posted its Budget and Economic Outlook: 2018 to 2028 on April 9, 2018, estimating that the economy would grow relatively quickly in 2018 and then more slowly in the following several years, with the cumulative debt held by the public rising substantially from 78% of GDP at the end of 2018 to 96% of GDP by 2028. The CBO estimates a deficit of \$804 billion in 2018, an increase over the \$665 billion deficit in 2017. The annual deficits will increase each year, resulting in an estimated \$12.4 trillion additional deficit over the ten-year period from 2018-2028. An August report from the Congressional Budget Office indicates that the federal debt held by the public will rise from 78% of GDP in 2018 to 118% of GDP in 2038, and if the individual income tax provisions in the 2017 Act do not expire in 2026, the federal debt would equal 148% of GDP in 2038 and continue to rise in later years.

Congressional Budget Office, *The Long-Term Budget Outlook Under Alternative Scenarios for Fiscal Policy* (August 2018).

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The deficit is increasing even faster than anticipated. The deficit for the fiscal year ending Sept. 30, 2018, totaled \$779 billion (3.9% of GDP), up from \$666 billion (3.5% of GDP) in fiscal year 2017, and is “headed toward” \$1 trillion in the fiscal year ending Sept. 30, 2019 according to the Congressional Budget Office and White House. Kate Davidson, *Deficit Swells as Tax Cuts Take Bite*, WALL ST.J. (Oct. 16, 2018). The deficit for November 2018 was \$205 billion, up from the \$188 billion predicted by analysts. The deficit for October and November (the first two months of the 2019 fiscal year) has widened 51% from the prior fiscal year, \$305 billion compared to \$202 billion in October-November 2017. See Howard Schneider & Paul Simao, *U.S. Government Posts \$205 Billion Deficit in November*, RIA CHECKPOINT NEWSSTAND (Dec. 14, 2018).

In light of the considerable fiscal impact of the legislation and subsequent spending measures, planning will need to take into consideration the significant possibility that the sunsetting of the individual provisions (including the transfer tax provisions) will occur. See Items 2.e.(21) and 2.h below for estimates of the impact of removing the sunsetting of individual tax cuts on the federal debt.

d. **Transfer Tax Issues.**

(1) **Basic Exclusion Amount Doubled; Other Indexed Amounts.** The Act increases the basic exclusion amount provided in §2010(c)(3) from \$5 million to \$10 million (indexed for inflation occurring after 2011) for “estates of decedents dying, generation-skipping transfers, and gifts made” after 2017 and before 2026. The indexed amount for 2018 using the new “chained CPI” approach is \$11.18 million, Rev. Proc. 2018-18, §3.35, and will be \$11.4 million in 2019 (an increase of \$220,000 from 2018), Rev. Proc. 2018-57 §3.41. The other previously announced indexed amounts for 2018 will remain the same under the chained CPI approach and will increase as follows in 2019: annual gift tax exclusion – \$15,000 (also in 2019); annual gift tax exclusion for non-citizen spouses – \$152,000 (\$155,000 in 2019); limitation on special use valuations – \$1,14 million (\$1.16 million in 2019); “2% portion” under §6166 – \$1.52 million (\$1.55 million in 2019).

The legislative history for the Act (the Joint Explanatory Statement of the Committee of Conference, referred to in this summary as the “Joint Explanatory Statement”) refers to this change as doubling the “estate and gift tax exemption,” but it also doubles the GST exemption because §2631(c) states that the GST exemption is “equal to the basic exclusion amount under section 2010(c).”

The sunsetting of the doubled basic exclusion amount raises the prospect of exclusions decreasing, and taxpayers being motivated to make transfers to take advantage of the larger exclusion amount, as in late 2012, but only significantly wealthy individuals are likely to be concerned with the gift tax exclusion amount decreasing to \$5 million (indexed).

(2) **“Anti-Clawback Regulation.”** The Act amends §2001(g) to add a new §2001(g)(2) directing the Treasury to prescribe regulations as may be necessary or appropriate to address any difference in the basic exclusion amount at the time of a gift and at the time of death. Section 2001(g)(2) provides as follows:

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(2) MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—

- (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and
- (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

Although the Joint Explanatory Statement provides no further guidance as to the intent of §2001(g)(2), this provision appears to deal with the possibility of a “clawback” – i.e., a prior gift that was covered by the gift tax exclusion at the time of the gift might result in estate tax if the estate tax basic exclusion amount has decreased by the time of donor’s death, thus resulting in a “clawback” of the gift for estate tax purposes. This is the same issue that was a concern in the 2001 Tax Act, which provided that the exemption amount would be reduced in 2011. Most commentators thought there was unlikely to be a “clawback” in that situation; indeed, Congressional staffers had indicated that clawback was not intended.

Unfortunately the calculation procedure described in the Instructions to the Form 706 would have resulted in a “clawback.” (Section 2001(g) was added in 2010 to clarify that in making the second calculation under §2001(b)(2)), the tax **RATES** in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year, but §2001(g) does not specify whether to use the exclusion amount at the date of the gift or at the date of death for multiplying by the date of death rate to determine the gift credit amount in making the second calculation.)

The estate tax calculation method under § 2001(b) is as follows:

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits). I.R.C. §2001(b)(1).
- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent’s death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). The statute does not say whether to use the gift credit amount that applied at the time of the gift or at the time of death — and this is what leads to the uncertainty. Form 706 instructions for the “Line 7 Worksheet” specifically state that the basic exclusion amount *available in each year using a Table of Basic Exclusion Amounts provided for each year from 1977 to 2017* (plus any applicable DSUE amount) that gifts were made is used in calculating the gift tax that would have been payable in that year. (That conclusion is confirmed by the preamble to the anti-clawback proposed regulation discussed below. In that preamble the IRS describes the calculation procedure as determining the hypothetical gift tax after subtracting the credit computed by “using the [basic exclusion ] amounts allowable *on the dates of the gifts* but determined using the date of death tax rates.” [emphasis added]) The effect of this calculation is that the tentative tax on the current estate plus adjusted taxable

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gifts would not be reduced by any gift tax payable on those gifts if the gifts were covered by the applicable exclusion amount during the years that gifts were made. In effect, the tentative estate tax would include a tax on the prior gifts.

- Step 3: Subtract the estate tax applicable credit amount.

The apparent intent of the Act is that regulations would clarify that clawback would *not apply* if the estate exclusion amount is smaller than an exclusion amount that applied to prior gifts.

The IRS released the anti-clawback proposed regulation on November 20, 2018. The preamble has an excellent description of the gift and estate tax calculation processes in detail, and addresses various possible effects of changes in the basic exclusion amount. The applicable exclusion amount (AEA) is the basic exclusion amount (BEA) plus the DSUE amount plus any restored exclusion amount allowed under Notice 2017-15 for certain prior gifts between same-sex spouses. The proposed regulation makes very clear that the adjustments to the credit amount (to fix the clawback problem) applies only the portion of the credit attributable to the BEA, and the credit attributable to the DSUE amount is not affected. For simplicity, the balance of this discussion will assume that no adjustments are made to the AEA with respect to DSUE or adjustments under Notice 2017-15, and that the AEA is the same as the BEA.

A refresher of the basic process for calculating the gift and estate tax is helpful in understanding the analysis in the preamble.

**Gift Tax Computation Overview.** The preamble describes a 7-step process for calculating the gift tax. To calculate the gift tax on gifts made in each year, use the rate schedule in effect for that respective year.

- (1) Calculate the tentative tax (unreduced by any credits) on the sum of all taxable gifts (current year plus prior periods)
- (2) Calculate the tentative tax on the sum of gifts made in prior periods.
- (3) Determine the net tentative gift tax on gifts for the current year by subtracting Step (2) from Step (1).
- (4) Determine the “applicable credit amount,” which is the tentative tax on the AEA determined as if the donor had died on the last day of the current year.
- (5) Determine the sum of the amounts allowable as a credit to offset gifts in each prior period, by applying the tax rates in effect for the *current* period to the AEA for such prior period, but not exceeding the tentative tax on gifts actually made in such prior period.
- (6) Determine the credit available for the current period by subtracting Step (5) from Step (4).
- (7) Calculate the gift tax for the current period by subtracting the credit amount in Step (6) from the net tentative tax in Step (3).

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**Estate Tax Computation Overview.** The preamble describes a 5-step process for calculating the estate tax.

- (1) Calculate a tentative tax (unreduced by any credits) on the sum of the taxable estate and adjusted taxable gifts (i.e., taxable gifts after 1976 other than those included in the gross estate).
- (2) Determine the hypothetical gift tax on all post-1976 gifts, whether or not included in the gross estate, using rates in effect at the date of death, and after subtracting credits allowable in the year of the gifts. The credit amounts allowable for each year are computed by applying the tax rates in effect at the date of death to the AEA for that year (i.e., the BEA for that year plus the unused DSUE amount), less credit amounts used in the hypothetical gift tax calculation for prior year gifts. (This is the number that goes on Line 7 of the Form 706, and the Instructions to Form 706 have a very detailed Worksheet for making this calculation. The Instructions and the preamble both make clear to use the BEA for the date of the gift.)
- (3) Determine the net tentative tax by subtracting Step (2) (the hypothetical gift tax on gifts after 1976) from Step 1 (the tentative tax on the gross estate plus adjusted taxable gifts).
- (4) Determine the allowable estate tax credit, equal to the tentative tax on the AEA in effect at the date of death.
- (5) The estate tax is Step (3) (the net tentative tax) minus Step (4) (the allowable estate tax credit).

**Situations Not Affected by BEA Changes.** The IRS analyzed the tax calculations for three situations to conclude that they are not affected by changes in the BEA:

- (1) *Effect of increased BEA on gift tax if prior gift on which gift tax was paid* - "the increased BEA is not reduced by a prior gift on which gift tax in fact was paid";
- (2) *Effect of increased BEA on estate tax if prior gift on which gift tax was paid* -- "the increased BEA is not reduced by the portion of any prior gift on which gift tax was paid, and the full amount of the increased BEA is available to compute the credit against the estate tax"; and
- (3) *Effect of decrease in BEA on gift tax if gift made that was covered by increased BEA* - if a donor made gifts during the increased BEA period that were sheltered from the gift tax by the increased BEA during those years, and also made a post-2025 gift after the BEA had decreased, the gift tax will not be increased on subsequent gifts as a result of having a BEA lower than the BEA that sheltered prior gifts. Stated differently, "the gift tax on a gift after 2025 will [not] be inflated by a theoretical gift tax on gifts made during the 2018-2025 period that were sheltered from gift tax when made." Ron Aucutt, *Proposed "Anti-Clawback" Regulations*, ACTEC CAPITAL LETTER NO.46 (Nov. 29, 2018).

**Clawback Situation.** A fourth situation addressed in the preamble is the classic clawback situation, and the IRS agreed that regulatory relief was needed to reach the desired result. Otherwise, a gift made during the increased BEA period that was sheltered from gift tax by the increased BEA would inflate a post 2025-estate tax

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liability—the classic clawback problem. The preamble acknowledges that under Step (2) of the estate tax calculation (as described above and in the preamble), the amount of hypothetical gift taxes on post-1976 gifts, whether or not included in the gross estate, is determined using BEA amounts allowable on the dates of the gifts. Rather surprisingly, the response of the IRS is to revise the determination of the unified credit against estate tax under §2010 rather than revising the determination under §2001 of the hypothetical gift tax that is subtracted in the estate tax calculation process. The Treasury and IRS concluded that the “most administrable solution would be to adjust the amount of the credit” that is applied against the net tentative estate tax. The credit is equal to the tentative tax on the AEA as in effect at the date of the decedent’s death, but “the BEA included in that AEA is the larger of (i) the BEA as in effect on the date of the decedent’s death under section 2010(c)(3), or (ii) the total amount of the BEA allowable in determining Step 2 of the estate tax computation (that is, the gift tax payable).” The operative sentence of the proposed regulation is a long (145-word) confusing sentence, reduced to its essential elements as follows (many of the omissions are phrases emphasizing that only the BEA element of the AEA is adjusted):

If the total of the amounts allowable as a credit in computing the gift tax payable on the decedent’s post-1976 gifts, within the meaning of section 2001(b)(2) [i.e., in determining of the hypothetical gift tax on post-1976 gifts that is subtracted in calculating the estate tax] , ... exceeds the credit allowable within the meaning of section 2010(a) [i.e., the AEA at the date of death] ..., then the ... credit ... is the sum of the amounts ... allowable as a credit in computing the gift tax payable on the decedent’s post-1976 gifts. Prop. Reg. §20.2010-1(c)(1).

**Simple Explanation.** A new release issued contemporaneously with the release of the proposed regulations explained that “the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA [basic exclusion amount] applicable to gifts made during life or the BEA applicable on the date of death.”

In determining the unified credit for estate tax purposes, the credit attributable to the BEA portion of the AEA is (i) the credit attributable to the BEA at the date of death, or if larger, (ii) the sum of the amounts attributable to the BEA allowable in computing the gift tax payable on the decedent’s post-1976 gifts (but for any particular year, not exceeding the tentative tax on gifts during that year).

**Example.** A simple example in the proposed regulation addresses an individual (A) who made cumulative post-1976 taxable gifts of \$9 million that were sheltered from gift tax by the cumulative total of \$10 million in BEA allowable on the dates of the gifts. A dies after 2025 when the BEA is \$5 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on A’s post-1976 gifts (i.e., the tentative tax on \$9 million) exceeds the credit based on the \$5 million BEA applicable at the date of death, the credit applied in computing the estate tax is based on a BEA of \$9 million, “the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A.” Prop. Reg. §20.2010(c)(2).

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**Surprising Approach.** The approach of adjusting the determination of the unified credit amount, rather than adjusting the AEA applied in any year in determining the hypothetical gift tax payable on post-1976 gifts in the estate tax calculation, is a surprise. Various prior legislative proposals would have adjusted the hypothetical gift tax calculation procedure. For example, a legislative “fix” that was proposed in the Sensible Estate Tax Act of 2011 (H.R. 3467, §2(c)), would have calculated the hypothetical gift tax payable on post-1976 gifts (which is subtracted in determining the estate tax) using the gift credit amount that applied in the year of the gift, *but not exceeding* the estate tax applicable credit amount in the year of death. Therefore, the higher exemption amount that applied in the year of the gift would not be used in calculating the hypothetical gift tax payable. A similar approach of adjusting the hypothetical gift tax calculation approach under §2001 (b)(2) was proposed in the 2012 Middle Class Tax Cut Act (S. 3393, §201(b)(2)). The preamble to the proposed regulation does not suggest why the approach of adjusting the unified credit amount was a more “administrable solution” than adjusting the hypothetical gift tax calculation procedure.

**Avoids “Reverse Clawback.”** The approach adopted in the proposed regulation avoids a potential “reverse clawback problem” that would apply if the hypothetical gift tax on post-1976 gifts was determined in all situations based solely on the BEA at the date of death (rather than the lower of the BEA at the date of death or the BEA in the year of each gift). If the BEA at the date of death were used, when exclusion amounts are increasing, no hypothetical gift tax payable would be subtracted in calculating the estate tax if the gifts were always covered by the increasing exclusion amount, even though some gift tax may actually have been paid in years before the exclusion amount had increased enough to cover the gifts made in those years. *See generally* Austin Bramwell, *Treasury Squashes the Reverse Clawback Bug*, LEIMBERG ESTATE PLANNING NEWSLETTER #2689 (December 17, 2018).

**Loss of Inflation Adjustments.** Daniel B. Evans (Glenside, Pennsylvania) observes that the proposed regulations “eliminate any benefit for inflation adjustments to the BEA after gifts are made that exceed the \$5 million BEA, at least until the inflation adjustments to the BEA exceed the total of the gifts made that were sheltered from gift tax by the \$10 million BEA.” Daniel Evans, *Proposed Regulations on Exclusion Amount Changes* (Nov. 26, 2018) (available at <http://resources.evans-legal.com/?p=6344>). Mr. Evans provides the following example.

To illustrate, assume that an individual, “A,” who is not married and has never been married (so there is no DSUE), makes \$12 million in taxable gifts in 2018, when the BEA (adjusted for inflation) is \$11,180,000. A would then pay gift tax of \$328,000 on the \$820,000 of gifts in excess of the BEA. In 2027, after the BEA has returned to \$5 million, the BEA could be \$6,580,000 after adjusting for inflation of about 1.8% per year. If A dies in 2027 with a taxable estate of \$1,000,000, the BEA for A’s estate would be \$11,180,000 under the proposed regulation, which would eliminate any estate tax on the lifetime gifts. But the entire \$1,000,000 taxable estate would be subject to estate tax, resulting in a tax of \$400,000, even though there were inflation adjustments to the BEA after the gifts were made in 2018 and after the \$10 million BEA ended after 2025. ...

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Not having the benefit of inflation adjustments to the \$10 million BEA would be consistent with the “use it or lose it” principle …, but not having the benefit of inflation adjustments after the BEA reverts to \$5 million seems strange, because normally a donor is entitled to increases in the BEA even after gifts have been made that have used up the BEA. *Id.*

(3) **Related Clawback Issue – “Off the Top” Gifts.** Another issue that some planners thought might conceivably be covered by the regulation issued pursuant to §2001(g)(2) was whether gifts during the period that the exclusion amount is \$10 million (indexed) “come off the top” of the \$10 million (indexed) exclusion amount that applies before 2026. For example, under current law if a donor who has not previously made a taxable gift makes a gift of \$5 million, and if the donor dies after the exclusion amount has been reduced to \$5 million (indexed), the donor effectively will be treated as having used the \$5 million of the exclusion amount, and the donor will not have made any use of the extra \$5 million (indexed) of exclusion amount available in 2018-2025. The Treasury conceivably could issue regulations providing that gifts come “off the top” of the \$10 million (indexed) exclusion amount, so that a donor who makes a \$5 million gift when the exclusion amount is \$10 million (indexed) would still have all of his or her \$5 million exclusion amount after the exclusion amount is reduced to \$5 million (indexed) after 2025. By analogy, the portability regulations provide that a surviving spouse “shall be considered to apply [the] DSUE amount to the taxable gift before the surviving spouse’s own basic exclusion amount.” Reg. §25.2505-2(b). A surviving spouse’s DSUE amount from a predeceased spouse could be eliminated if the surviving spouse remarried, and the IRS chose to apply an ordering rule so that gifts would first be deemed to use the portion of the applicable exclusion amount that might disappear (i.e., the DSUE). That could be analogous to current law which treats a portion of the basic exclusion amount as disappearing after 2025.

Whether §2001(g)(2) contemplated that the regulation would address that issue is unclear. In any event, the anti-clawback proposed regulation does not address the issue, and at this point, no further IRS action on the issue is anticipated.

Consider not making the split gift election, so that all gifts come from one spouse, utilizing that spouse’s excess exclusion amount that is available until 2026.

(4) **Related Clawback Issue – Portability Impact.** The clawback proposed regulation does not address the portability effect of the changing BEA. If the first spouse dies when the estate exclusion amount is about \$11 million, and calculates the DSUE based on that larger exclusion amount, and if the surviving spouse dies after the exclusion amount has reverted back to \$5 million (indexed), will the DSUE from the first spouse remain at the higher level, or is it limited to the exclusion amount in existence at the second spouse’s death? The existing portability regulations provide that the DSUE based on the exclusion amount in effect at the first spouse’s death continues to apply. Regulation Section 20.2010-2(c)(1) defines the DSUE amount as consisting of the lesser of two elements, and one of those elements is “the basic exclusion amount in effect in the year of death of the decedent.” The regulations in this context are discussing the decedent and the surviving spouse, so the regulation is referring to the basic exclusion amount of the first spouse to die. Furthermore, the preamble to the June 2012 temporary

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regulations states that “[t]he temporary regulations in § 20.2010-2T(c)(1)(i) confirm that the term ‘basic exclusion amount’ referred to in section 2010(c)(4)(A) means the basic exclusion amount in effect in the year of the death of the decedent whose DSUE amount is being computed.” Nothing in the anti-clawback proposed regulation addresses or changes that result.

Admittedly, the statutory provisions suggest a different result. Section 2010(c)(4) defines the DSUE amount as the lesser of two amounts, one of which is “the basic exclusion amount.” The statute is not totally clear as to whether that is referring to the BEA of the prior deceased spouse or of the surviving spouse, but it appears to refer to the BEA of the surviving spouse (because the next phrase refers to “the applicable exclusion amount of the *last such deceased spouse of such surviving spouse*”). Even so, the regulations seem very clear that it is the BEA of the deceased spouse and not the surviving spouse that limits the amount of the DSUE. Keep in mind that many provisions of the portability regulations seem to be a very expansive interpretation (to say the least) of the words of the statute, but the interpretations are almost universally taxpayer-friendly and are designed to make the portability concept as administrable as possible and to cure various potential problems that arose from the statutory language itself.

(4) **No Estate Tax Repeal.** The House version of the Act would have repealed the application of the estate tax to decedents dying after 2024 (but would have left in place references to chapter 11 in §1014(b) for basis adjustment purposes at a decedent’s death). The House version would have left the gift tax in place, but with a reduction in the rate to 35% after 2024.

e. **Individual Income Tax Issues.**

(1) **Rate Brackets.** The Act preserves seven tax brackets, with a top rate of 37% for income starting at \$500,000 (indexed) for single individuals and heads of households and at \$600,000 (indexed) for married individuals filing joint returns. (The applicable income levels for the top rate bracket results a “marriage penalty” of about \$8,000 for taxpayers in the top bracket.) The brackets are revised significantly. As an example, a married couple filing jointly with taxable income of \$700,000 in 2018 would pay \$222,431 under pre-Act law and would pay \$198,379 under the Act (ignoring any applicable credits).

The top rate for trusts and estates applies to taxable income in excess of \$12,500 (indexed). (Under pre-Act law, the top rate bracket for trusts and estates would have applied to taxable income in excess of \$12,700 in 2018.)

The rate brackets for ordinary income and capital gain income have breaks at different amounts under the 2017 Tax Act. For capital gains tax purposes, the 0% rate applies up to \$38,600 for single individuals (\$77,200 for married individuals), the 15% rate applies up to \$425,800/\$479,000 for single/married individuals, and the 20% rate applies over those amounts. For estates and trusts, the 0% rate applies up to \$12,600, the 15% rate applies up to \$12,700, and the 20% rate applies above \$12,700 (not the \$12,500 level that applies to the maximum ordinary income tax rate). §1(j)(5).

The indexed rate brackets for 2019 are listed in Rev. Proc. 2018-57, §3.01. In 2019, the top income tax bracket applies for single and head of household taxpayers at \$510,300 for married filing jointly taxpayers at \$612,350, and the estates and trusts at \$12,750. For capital gains in 2019, the 0% rate applies up to \$39,375 for single

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individuals (\$52,750 for head of household taxpayers, and \$78,750 for married individuals), the 15% rate applies up to \$434,550/\$461,700/\$488,850 for single/head of household/married individuals, and the 20% rate applies over those amounts. For estates and trusts, the 0% rate applies up to \$2,650, the 15% rate applies up to \$12,700, and the 20% rate applies above \$12,950.

(2) **Indexing Using “Chained CPI.”** A different measure of inflation will be used for indexing. The “chained CPI” approach would put more taxpayers in higher brackets over time than under the current indexing approach (and it continues to apply even after the tax changes for individuals sunset after 2025). The chained CPI approach uses the Department of Labor Chained Consumer Price Index for All Urban Consumers (“C-CPI-U”) rather than the “CPI-U” index that is used under pre-Act law. Values that are reset for 2018 are indexed with the chained CPI index in taxable years beginning after 2018. Unlike most of the other provisions applicable to individual taxpayers, changing to the chained CPI indexing approach does not sunset after 2025.

Inflation adjustments for 2018 using the chained CPI index were published in Rev. Proc. 2018-18.

(3) **Standard Deduction and Personal Exemption.** The standard deduction is increased to a deduction of \$24,000 for married individuals filing joint returns (\$24,400 in 2019), and the personal exemption is eliminated. The net result of these two changes will produce a modest tax savings for some (but not all) taxpayers. Under pre-Act law, in 2018 the standard deduction for married couples would have been \$13,000 and the personal exemption would have been \$4,150 so the combined standard deduction and personal exemptions for a married couple would have been \$13,000 + 4,150 + 4,150, or \$21,300 for a couple without children, or \$25,450 for a couple with one child.

Because of the increased standard deduction and the fact that many deductions for individuals are eliminated or limited (as discussed below), the percentage of taxpayers that will itemize is expected to decline from about 30% to about 5%. As a result, many taxpayers will not realize any income tax benefits from charitable contributions, home mortgage interest payments, state and local tax payments, or other payments still qualifying as deductions to those who itemize deductions. Very importantly for business owners, as discussed above, the 20% deduction for qualified business income is allowed in addition to the standard deduction.

Taxpayers may consider “bunching” deductions into a particular year. For example, a taxpayer might make large charitable contributions in a single year to a donor advised fund, which can be implemented with very little expense or administrative inconvenience by creating an account with an established donor advised fund at a financial institution, community foundation, or other institutional sponsor. The account could be used to fund annual charitable contributions that the taxpayer would otherwise make in later years. The taxpayer could itemize deductions in the year in which the large payments are made, and use the increased standard deduction in other years.

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The aged (age 65 and older) or blind deduction under §63(f) is not eliminated. The Joint Explanatory Statement describes the Senate version: “The additional standard deduction for the elderly and the blind is not changed by the provision,” and the Conference Agreement followed the Senate amendment. The aged or blind indexed deduction has previously been announced as being \$1,300 (\$1,600 for an unmarried person who is not a surviving spouse) for 2018.

(4) **Kiddie Tax.** Under pre-Act law, the earned income of a child is taxed under the child’s single individual rates, but unearned income of a child who is subject to the Kiddie Tax (generally children with unearned income exceeding \$2,100 who are under age 18 and some children up to age 23 meeting certain requirements) is taxed at the parents’ rates if those rates are higher than the child’s rate. The Act continues but simplifies the Kiddie Tax by applying ordinary and capital gains rates applicable to trusts and estates, which often are higher than the parents’ rates, to the unearned income of the child. The changes increase the importance of delaying significant investment income events, if possible, until the child is no longer subject to the Kiddie tax. This change does not affect the ability of the child to take advantage of the \$200,000 threshold for protection from the 3.8% net investment income tax.

(5) **Child Tax Credit.** The Act increases the child tax credit from \$1,000 for each qualifying child under age 17 to \$2,000 (not indexed) and the phase-out would not begin until income exceeds \$400,000 (not indexed) for married taxpayers filing jointly or \$200,000 (not indexed) for other taxpayers. The Act also increases the refundable portion of the credit.

The Act also allows a \$500 (not indexed) nonrefundable credit for qualifying dependents other than qualifying children.

No credit is allowed with respect to qualifying children unless the taxpayer provides the child’s Social Security number.

Because of the substantial increase in the child tax credit, families with multiple children may be among the most likely to realize significant income tax decreases under the Act. The expanded child tax credit provision has a very large revenue impact—projected at \$573.4 billion over ten years.

(6) **Charitable Deduction.** The Act continues to provide that charitable contributions are deductible, with an increased percentage limitation on cash contributions to public charities – i.e., 60% of the “contribution base” (generally AGI with a few modifications), up from 50%. Some planners read the technical language of the Act to mean that the new 60% limit is applicable if only cash gifts are made to public charities; for example, if “one dollar of non-cash assets is donated (such as securities),” the traditional 50% limitation would apply. Letter from AICPA to Congressional Leaders Recommending Technical Corrections to Pub. L. No. 115-97 (February 22, 2018). However, other planners point out that the 60% cash limit under new §170(b)(1)(G) applies before applying the limitations under §170(b)(1)(A)-(D), which means that cash gifts can be deducted up to the 60% limit even if noncash gifts are also made. (Excess contributions above the deductible amount allowed under the percentage limitations may be carried over.) What the new Act does not

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allow is “stacking” cash and noncash contributions. For example if an individual makes 30% noncash contributions and 30% cash contributions, the cash contribution will be subject to an overall 50% limit, with all cash allowed under new subparagraph (G) and the noncash contributions allowed to fill the other 20% (per subparagraph (A), as modified by subparagraph (C) if long-term capital gain property is given and by the coordination provisions of §170(b)(1)(G)(iii), which operate to reduce what subparagraphs (A) and (B) would otherwise allow), and the rest of the noncash contributions would carryover to 2019. Section 123 of H.R. 6760 (the Protection Family and Small Business Tax Cuts Act of 2018, filed as part of the House Republican “Tax Cut 2.0 package” on September 10, 2018) would revise §170(b)(1)(G) to make that result clear. See Item 2.h below for a discussion of that package of bills.

The 80% deduction for contributions made for university athletic seating rights is eliminated. In addition, the exception from the substantiation requirement if the donee organization files a return that contains the same required information is repealed, effective for contributions made in taxable years beginning after 2016.

(7) **Home Mortgage Interest Deduction.** Home mortgage interest for acquisition indebtedness of a residence that is incurred after December 15, 2017 is limited to the interest on \$750,000 (down from \$1 million) of debt. The \$750,000 limitation is not indexed. Pre-Act rules apply to acquisition indebtedness incurred prior to that date, and to refinancings of those loans not exceeding the refinanced indebtedness. No deduction is allowed for interest on home equity indebtedness (regardless when incurred) for 2018-2025 (after which time the individual provisions sunset, as discussed in Item 2.e.21 below).

(8) **State and Local Taxes Deduction.** After considerable negotiation, the deduction for state and local income, sales, and property taxes (colloquially referred to as “SALT”) not related to a trade or business or a §212 activity is retained but limited to \$10,000 (not indexed) for joint filers and unmarried individuals and \$5,000 (not indexed) for a married individual filing a separate return (now representing another “marriage penalty” provision in the Code). This limitation may be significant for taxpayers living in high income tax states, and can be a factor in deciding where to establish (or whether to change) one’s domicile.

The \$10,000 limit on SALT deductions has led some states to consider implementing laws providing relief from state income tax to the extent of contributions to a specified charitable fund, in hopes that the taxpayer could deduct the full charitable contribution without any \$10,000 limitation. New York legislation allows local governments to create charitable organizations, contributions to which would qualify the donor for an 85% credit against the respective local taxes. New Jersey legislation has a similar program providing a 90% credit for donations made to local municipalities, counties, and school districts. Despite some prior indications that such programs might be respected (see Chief Counsel Advice 201105010), on August 23, 2018, the IRS issued proposed regulations blocking these types of arrangements by disallowing a federal charitable deduction when the donor expects to receive an offsetting credit against state and local taxes. The proposed regulations are based on the generally recognized “quid pro quo” rationale of not allowing a

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charitable deduction to the extent that the donor receives a benefit from the donation. Under the proposed regulations–

- **Offsetting credit**—The amount of a taxpayer’s charitable contribution deduction under §170(a) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer’s payment or transfer. Only the excess over the anticipated credit qualifies for the charitable deduction. Prop. Reg. §1.170A-1(h)(3)(i).
- **Not apply to offsetting deductions**—The reduction or elimination of a charitable contribution deduction under §170 does not apply if a taxpayer anticipates receiving a *deduction* (rather than a credit) against state or local taxes not exceeding the amount of the contribution. The preamble to the proposed regulation reasons that because local rates are typically fairly low, the risk of deductions being used to circumvent the limit on the deduction for state and local taxes is comparatively low, and applying the reduction to deductions against state and local taxes would be administratively complex because the of the amount of the offsetting benefit, and therefore the amount of the reduction in the federal charitable deduction, would vary depending on the local tax rate. Prop. Reg. §1.170A-1h(3)(ii).
- **Amount based on maximum state or local tax credit**—The reduction of the charitable deduction is based on the maximum credit allowable that corresponds to the amount of the taxpayer contribution. Prop. Reg. §1.170A-1h(3)(iv).
- **De minimis exception**—The reduction in the amount of the federal charitable deduction does not apply if amount of the anticipated credit for state or local tax does not exceed 15% of the amount of the donation. Prop. Reg. §1.170A-1h(3)(vi).
- **Trust charitable deduction**—A similar change is made to §642(c) to limit the charitable income tax deduction for trusts in a similar manner. Prop. Reg. §1.642(c)-3(g)(1).
- **Effective date**—the new rules apply to contributions made after August 27, 2018. The preamble to the proposed regulations makes clear that the rules apply to preexisting as well as new state credit programs. *See generally* Richard Fox & Jonathan Blattmachr, IRS Proposed Regulations Nullify \$10,000 Annual SALT Limitation Workaround Attempts by States and Political Subdivisions, LEIMBERG INC. TAX PL. NEWSLETTER #155 (Sept. 27, 2018).

Connecticut, Maryland, New York, and New Jersey sued the administration in mid-July 2018 to invalidate the new limit on the deduction for state and local taxes and will likely allege that the proposed regulations should be invalidated (but the chances for success of that litigation are dim, and a divided Congress is unlikely to revisit the cap).

This limitation might lead to some taxpayers having residences owned by various trusts for various beneficiaries, each of which would have its own \$10,000 limitation for the property tax deduction. See Item 2.e.(8) and Item 2.e.(20)(c) below.

The SALT \$10,000 limitation does not apply to taxes paid “in carrying on a trade or business or an activity described in section 212” (i.e., investment activities), so

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should not apply to state and local taxes reported on Schedule C (for a trade or business) or Schedule E (net income from rents and royalties).

(9) **Miscellaneous Itemized Deductions Not Deductible.** The Act adds new §67(g) as follows:

(g) SUSPENSION FOR TAXABLE YEARS 2018 THROUGH 2025.—Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.

Section 67(a) provides that “miscellaneous itemized deductions” (described in §67(b)) may be deducted only to the extent they exceed 2% of adjusted gross income (AGI). Miscellaneous itemized deductions are all itemized deductions *other than* those specifically listed in §67(b). “Itemized deductions” are deductions under chapter 1 (the income tax) other than deductions allowable in determining adjusted gross income, the deduction for personal exemptions under §151, and any deduction under §199A. §63(d). The deductions specifically mentioned in §67(b) that are not “miscellaneous itemized deductions,” and that are still deductible even under §67(g), include deductions for payment of interest, taxes, charitable contributions by individuals or trusts and estates, medical expenses, and estate tax attributable to income in respect of a decedent (under §691(c)).

The effect is that the Act, in very few words, eliminates many itemized deductions for taxable years beginning in 2018-2025. The Joint Explanatory Statement summarizes the present law by listing a large number of deductions treated as miscellaneous itemized deductions, and concluding that “taxpayers may not claim the above-listed items” as deductions during the suspension years. (The listed expenses include tax preparation expenses.)

“Above the line” deductions from gross income to arrive at the adjusted gross income are not “itemized deductions” under §63(d), and therefore are not affected by the disallowance of miscellaneous itemized deductions under §67(g). These include §162 trade or business expenses, capital losses, §1231 losses, and certain deductions attributable to rental property and royalties.

The new deduction under §199A for qualified business income is specifically excepted from the definition of “itemized deductions,” §63(d), and therefore is not affected by the §67(g) suspension of miscellaneous itemized deductions.

The disallowance of many deductions for individuals may have an impact on state income taxes as well, because many states base their income tax calculation on the federal taxable income.

For an excellent overview of the impact of §67(g), see Lad Boyle & Jonathan Blattmachr, *The Impact of the 2017 Tax Act on the Itemized Deductions of Estates and Trusts and the Pass-Through of Excess Deductions to Beneficiaries*, LEIMBERG INC. TAX PL. NEWSLETTER #138 (April 12, 2018).

See Item 2.e.(20)(d) below regarding the impact of this provision on the deductibility of the executor and trustee fees and other expenses of trusts and estates.

(10) **Pease Limitation Eliminated.** The Pease limitation (reducing most itemized deductions by 3% of the amount by which AGI exceeds a threshold amount

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[\$313,800 in 2017 for married couples] but with a maximum reduction of 80%) is eliminated for 2018-2025. Eliminating the Pease limitation may have little impact for many taxpayers, however, in light of the elimination of most itemized deductions. Eliminating the Pease limitation can still be important for individual taxpayer itemizers who have substantial charitable or home mortgage interest deductions (as well as the SALT deduction, up to \$10,000).

(11) **Qualified Business Income Deduction.** In connection with the decrease of the top corporate tax rate to 21%, a deduction is allowed for individual business owners of businesses operated in pass-through entities (sole proprietorships, partnerships, limited liability companies, or S corporations). The deduction under new §199A is included in the portions of the Act dealing with individuals, but the deduction is discussed in the Business Tax Matters section of this summary, below. The deduction will be a very significant deduction for some business owners.

(12) **Medical Expenses.** The Act retains the medical expense deduction and even expands the deduction for two years by reducing the threshold to 7.5% (rather than 10%) of AGI for 2017-2018.

(13) **Alimony; Repeal of §682.** Alimony payments will not be deductible and will not be income to the recipient. In addition, §682 is repealed; that section provided that if one spouse created a grantor trust for the benefit of the other spouse, following the divorce the trust income would not be taxed to the grantor-spouse under the grantor trust rules to the extent of any fiduciary accounting income that the donee-spouse is "entitled to receive." The repeal of §682 is particularly troublesome, in part because §672(e) treats a grantor as holding any power or interest held by an individual who was the spouse of the grantor at the time of the creation of such power or interest, so the ex-spouse's interest as a beneficiary arguably might be sufficient to trigger grantor trust status under §677 even following the divorce (but see the discussion below about the ACTEC comments filed with the IRS on July 2, 2018 suggesting the possibility of a contrary result).

The alimony and repeal of §682 provisions are effective for any divorce or separation instrument executed after December 31, 2018 and any divorce or separation instrument executed before that date but modified after that date if the modification expressly states that the amendments made by this section of the Act apply to such modification. In IRS Notice 2018-37, IRB 2018-18, the IRS stated that it intends to issue regulations providing that §682 will continue to apply regarding trust income payable to a former spouse who was divorced or legally separated under a divorce or separation instrument executed on or before December 31, 2018, unless such instrument is modified after that date and the modification provides that the changes made by the 2017 Tax Act apply to the modification. In addition, the Notice requests comments on whether further guidance is needed following a divorce or separation after 2018 regarding the application of §§672(e)(1)(A) (treating grantor a holding any power of interest of the grantor's spouse for purposes of the grantor trust rules), 674(d) (which includes the grantor's spouse as someone who is not an independent party for purposes of the independent party exception to §674)), and 677 (triggering grantor trust treatment if income can be distributed without the consent of an adverse party to the grantor or the grantor's spouse). For example, regulations might

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address whether a trust should continue to be a grantor trust after divorce based on powers or interests held by an ex-spouse in the trust.

The elimination of the alimony deduction and the repeal of §682 are permanent and do not sunset after 2025.

This change will have a significant impact on the negotiation of divorce agreements. Many divorce agreements include agreements to pay alimony in order to take advantage of using the recipient spouse's lower income tax brackets. For wealthy alimony payers, the elimination of the alimony deduction may cost up to about \$36,000 annually. That would apply to a taxpayer with income of at least \$1.0 million who pays \$500,000 to a spouse who has no income. (Repeal of the alimony deduction for payments above \$500,000 would not have an overall cost to the couple because the excess payment will be taxed at the same rate paid by the payor-spouse, i.e. the top 37% rate.) The inability to shift income tax responsibility for alimony payments or for the income of grantor trusts may have an impact on the negotiated amount of alimony. The Act may create an incentive for spouses who are contemplating divorce to complete the divorce before the end of 2018. *See generally* Karbjanian, Franklin, & Law, *Alimony, Prenuptial Agreements, and Trusts Under the 2017 Tax Act*, BNA TAX MNGT. ESTATES, GIFTS & TRUSTS J. (May 10, 2018); Shenkman, Provder, Blattmachr, & Matak, *Divorce Planning After the 2017 Tax Act*, BLOOMBERG Daily Tax Report (Feb. 5, 2018).

Various commentators have criticized the repeal of the alimony deduction, pointing out that the rationale of the alimony deduction is to provide a break to families who are going through the financial stress of divorce. The same gross income that was supporting one household may be supporting two households if one of the spouses has modest income. The alimony deduction effectively allows the portion of the previously combined income that is used to support the low-income earning spouse to be taxed to that spouse's income tax rates. That break is no longer available for divorces after 2018.

Notice 2018-37 solicited comments on whether guidance is needed regarding the application of §672(e)(1)(a), 674(d), and 677 following a divorce or legal separation in light of the repeal of §682. ACTEC submitted comments to the IRS on July 2, 2018, available at <https://www.actec.org/resources/government-relations/>. The comments state that the spousal unity rule appears not to apply following divorce or legal separation for purposes of §§674(c), 674(d), and 675(3) because of changes to the spousal unity rule in 1988 and because of §674(d); the ACTEC recommends that the IRS clarify that position in regulations. Also, ACTEC recommends that the IRS clarify in regulations that Reg. §1.677(a)-1(b)(2), which states that §677 applies "solely during the period of the marriage" should continue to be applicable even after the adoption of the spousal unity rule, and the spousal unity rule does not apply for purposes of §677 following divorce or legal separation of the spouse from the grantor.

The repeal of §682 applies to all divorces or legal separation agreements entered into after 2018, even for irrevocable trusts that were executed before any notice about the possible repeal of §682. This created an extreme unfairness for grantors who created irrevocable grantor trusts with the understanding that the grantor would not

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have to pay income tax on the trust income following a divorce to the extent of any fiduciary accounting income that the donee-spouse is “entitled to receive.” Tax law changes affecting irrevocable trusts are typically prospective only because of the unfairness that can result. *See Estate of Gerson v. Commissioner*, 507 F.3d 435 (6th Cir. 2007). ACTEC also has submitted a letter to Congressional leaders (also available at <https://www.actec.org/resources/government-relations/>) recommending that legislation add, as a transitional rule to the repeal of §682, that the repeal should apply only to trusts that became irrevocable after December 22, 2017 (to the extent that income is not attributable to corpus added after that date).

For an excellent discussion of planning and drafting suggestions for SLATs in light of the repeal of §682, see Laurel Stephenson, *A Second Look at SLATs in Light of the Repeal of I.R.C § 682*, 56 REAL ESTATE, PROBATE, AND TRUST LAW REPORTER (State Bar of Texas Real Estate, Probate and Trust Law Section August 2018). Section 682 might not have even been applicable to SLATs providing for discretionary payments to the grantor’s spouse because §682 applies to the income of a trust that the spouse “is entitled to receive,” and the spouse has no entitlement to the income of a discretionary trust. Planning suggestions include (i) address whether to eliminate or give some third party the ability to eliminate the grantor’s spouse as a beneficiary following a divorce, (ii) negotiate in the divorce for how income taxes will be paid on trust income, (iii) provide for reimbursement of the grantor’s income taxes on trust income by a mandate in the trust agreement or at the discretion of an independent fiduciary or in a marital settlement agreement. The amount to be reimbursed may depend on a variety of factors including the distribution standard and whether the spouse will likely receive a distribution of all trust income following a divorce. For a trust with other discretionary beneficiaries, the trustee might make distributions to beneficiaries other than the ex-spouse; the trust would still be a grantor trust but at least no income distributions would benefit the ex-spouse. Other commentators have discussed planning considerations as well in light of this important change. George Karibjanian, Richard Franklin & Lester Law, *Alimony, Prenuptial Agreements, and Trusts Under the 2017 Tax Act*, BNA ESTATES GIFTS & TRUSTS J. (May 10 2018); Justin Miller, *Tax Reform Could Make Divorce a Lot More Taxing*, ABA FAMILY LAW QUARTERLY (Summer 2018).

Prior to its repeal, §682 does not define “income” and whether it refers only to fiduciary accounting income or also includes capital gains. If capital gains are not distributed to the spouse, §682 probably does not apply to them. If capital gains are allocated to income or are included in DNI and are distributed to the spouse, §682 likely does apply. *See Barry Nelson & Richard Franklin, Inter Vivos QTIP Trusts Could Have Unanticipated Income Tax Results to Donor Post-Divorce*, LISI ESTATE PLANNING NEWSLETTER #2244 (Sept. 15, 2014).

(14) **Moving Expenses.** The deduction for moving expenses incurred in connection with starting a new job at least 50 miles farther from the taxpayer’s former residence than the former workplace and the exclusion from income of moving expense reimbursements are eliminated for 2018-2025, except for members of the Armed Forces in certain circumstances.

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(15) **Alternative Minimum Tax.** The alternative minimum tax (AMT) is not eliminated for individuals, but the AMT exemption for individuals is increased from \$78,750 to \$109,400 (indexed) and the phase-out threshold is increased from \$150,000 to \$1,000,000 (indexed) for married taxpayers filing joint returns.

(16) **Recharacterizing Roth IRAs.** Contributions to Roth IRAs are non-deductible (i.e., are made from after-tax income), but qualified distributions from Roth IRAs are not includable in the recipient's income. Traditional IRAs may be converted to Roth IRAs, and the amount converted is includable in the taxpayer's income as if a withdrawal had been made. Under pre-Act law, a Roth IRA that received a contribution or that resulted from a conversion of a traditional IRA could have been recharacterized as a traditional IRA before the due date for the individual's income tax return for that taxable year. For example, if assets in a Roth IRA decline in value after conversion from a traditional IRA, the Roth IRA could be recharacterized as a traditional IRA to avoid the income recognition from the conversion, and the recharacterized traditional IRA could again be converted to a Roth IRA at the lower values. The Act eliminates the recharacterization option for conversions (but not for contributions), effective for taxable years beginning after 2017 (and this provision does not sunset after 2025).

(17) **Expanded Application of 529 Accounts.** For distributions after 2017, "qualified higher education expenses" will include tuition at public, private, or religious elementary or secondary schools, limited to \$10,000 per student during any taxable year.

(18) **Life Settlements of Life Insurance Policies.** For viatification (life settlements) of life insurance policies, the Act provides that the taxpayer's basis in a life insurance policy is not reduced by the "cost of insurance" charges, reversing the IRS position announced in Rev. Rul. 2009-13. Reporting requirements are added for "reportable policy sales," and none of the transfer for value exceptions apply to such sales. These provisions do not sunset after 2025.

(19) **Eliminate Mandate for Health Insurance.** The Act eliminates the mandate for having qualifying health insurance beginning in 2019 (which is anticipated to save \$318-\$338 billion over 10 years because of reduced federal subsidies to low income persons who purchase coverage). The Congressional Budget Office and Joint Committee on Taxation project that this change will result in 13 million fewer people having health insurance by 2027 and will increase insurance premiums for many Americans by about 10%.

(20) **Provisions Impacting Trusts and Estates.**

(a) **Tax Provisions for Individuals Generally Apply to Trusts.** Section 641(b) provides that "[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part."

(b) **Personal Exemption.** In lieu of the deduction for personal exemptions, an estate is allowed a deduction of \$600, a complex trust is allowed a deduction of \$100, and a simple trust (required to distribute all of its income currently) is

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allowed a deduction of \$300. An exception is made for a “qualified disability trust” which gets a deduction equal to the personal exemption of an individual. While the personal exemption for individuals is repealed, the Act adds new §642(b)(2)(C)(iii) to apply a deduction of \$4,150 (indexed) for qualified disability trusts for years in which the personal exemption for individuals is zero (i.e., 2018-2025). The \$600, \$100, and \$300 deduction amounts for estates and trusts other than qualified disability trusts are not changed by the Act.

(c) **State and Local Taxes.** The \$10,000 limit on deducting state and local taxes under the Act applies to trusts (as made clear in footnote 171 of the Joint Explanatory Statement). This may create some incentive for creating multiple trusts, subject to the anti-abuse provisions for multiple trusts under §643(f), so that each separate trust would be entitled to its own \$10,000 limit on the SALT deduction. Having different beneficiaries or other terms of the separate trusts would be important for avoiding §643(f). Section 643(f) applies for trusts having substantially the same grantors and primary beneficiaries if the principal purpose of the trusts is to avoid income tax. Proposed regulations issued on August 8, 2018 address the multiple trust rule. Prop. Reg. §1.643(f)-1. One of the examples in the proposed regulations suggests that trusts that are for the current primary benefit of different beneficiaries may nevertheless be treated as having the same “primary beneficiaries” for purposes of the multiple trust rule of §643(f) (which would result in the separate trusts being “aggregated and treated as a single trust for Federal income tax purposes.”) Prop. Reg. §1.643(f)-1(c)Ex.2). See Item 2.f.(11)(g) below.

(d) **Executor or Trustee Fees and Other Miscellaneous Estate or Trust Expenses.** New §67(g) states that “[n]otwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.” Section 67(a) provides that “miscellaneous itemized deductions” (described in §67(b)) may be deducted but only to the extent they exceed 2% of adjusted gross income. Miscellaneous itemized deductions are all itemized deductions *other than* those specifically listed in §67(b), and executor and trustee fees are not listed in §67(b), so does new §67(g) preclude their deduction?

The answer is not totally clear under the statutory provisions. Executor and trustee fees and other miscellaneous estate/trust expenses are deductible under §67(e) to the extent that they satisfy the requirement of being expenses that “would not have been incurred if the property were not held in such trust or estate.” New §67(g) says that miscellaneous itemized deductions are not allowed “notwithstanding §67(a),” but makes no reference to §67(e), which leaves the possible implication that miscellaneous estate/trust expenses could be allowed under §67(e).

Section 67(e)(1) states (independently of §67(a)) that miscellaneous itemized deductions “shall be treated as allowable” in calculating an estate/trust’s AGI as long as the expenses 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,” and §67(e)(2) makes clear that §67 does not limit the deductions for estates or trusts under §§642(b), 651, or 661.

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Various arguments have been suggested to support the continued deductibility of miscellaneous deductions for estates and trusts notwithstanding §67(g). One argument is that superseding §67(e) would lead to illogical results. To say that new §67(g) supersedes §67(e) would suggest that it overrides not just §67(e)(1) but also §67(e)(2), which addresses §§642(b) (the deduction in lieu of personal exemption), 651, and 661. That would result in the illogical conclusion that §642(b) is overridden although other provisions of the Act provide expanded relief under §642(b), and would also mean that trusts and estates get no distribution deductions (which would completely overturn the basic premise of the income taxation of trusts and estates).

Additionally, the Joint Explanatory Statement describes the addition of §67(g) as suspending “all miscellaneous itemized deductions that are subject to the two-percent floor under present law.” Arguably, therefore, the intent was not to eliminate the deduction of items that were permitted under §67(e) because they are not “subject to the two-percent floor under present law.”

Notice 2018-61, effective July 13, 2018, clarifies that the Treasury and the IRS “intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct expenses described in section 67(e)(1) and amounts allowable as deductions under section 642(b), 651, or 661....” The Notice reasons that under the statutory definitions of “miscellaneous itemized deductions,” “itemized deductions” and “adjusted gross income,” the expenses of estates or trusts to which §67(e) applies are not “miscellaneous itemized deductions” at all, so §67(g) cannot apply to them.

- Section 67(g) suspends deductions for miscellaneous itemized deductions.
- Section 67(b) defines miscellaneous itemized deductions as itemized deductions other than those listed in §67(b).
- Section 63(d) defines itemized deductions by excluding personal exemptions, §199A qualified business income deductions, and *deductions used to arrive at adjusted gross income*.
- Section 67(e) provides that, for purposes of §67, the adjusted gross income of an estate or trust is computed in the same manner as that of an individual, except that (1) deductions for costs that are paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such estate or trust, and (2) deductions under §§642(b), 651, and 661 shall be treated as *allowable in arriving at adjusted gross income*.
- Because the §67(e) expenses are treated as allowable in arriving at adjusted gross income, and because itemized deductions do not include deductions allowable in arriving at adjusted gross income, the §67(e) expenses are not itemized deductions, and therefore cannot be miscellaneous itemized deductions, and therefore are not suspended under §67(g).

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- The portion of the deductible expenses of estates or trusts that are not incurred solely because the property is held in an estate or trust are not §67(e) expenses, and therefore will be suspended from deductibility under §67(g) if they are not within one of the exceptions listed in §67(b).

The Notice is effective July 13, 2018, but estates and non-grantor trusts may rely on the notice for the entire taxable year beginning after December 31, 2017.

(e) **Excess Deductions or Losses at Termination of Estate or Trust.** Section 642(h) provides that on the termination of an estate or trust, a net operating loss carryover or capital loss carryover (§642(h)(1)) or the excess of deductions over from income for the last taxable year (§642(h)(2)) are allowed as deductions to the beneficiaries succeeding to the property of the estate or trust "in accordance with regulations prescribed by the Secretary."

The regulations provide that a net operating loss or capital loss carryover are taken into account in computing the adjusted gross income of the beneficiaries. Reg. §1.642(h)-1(b). Therefore, they are not miscellaneous itemized deductions on the returns of beneficiaries (and therefore are not subject to §67(g)). Capital losses are not itemized deductions, so new §67(g) should not impact them.

Conversely, the regulations provide that the excess deductions in the last year of the estate or trust that are allowed to the beneficiaries are "allowed only in computing taxable income ... [and are] not allowed in computing adjusted gross income." Treas. Reg. §1.642(h)-2(a). Those deductions are not mentioned in §67(b) and are miscellaneous itemized deductions, therefore their deduction is seemingly not allowed for 2018-2025 under new §67(g). Indeed the Joint Explanatory Statement specifically includes "[e]xcess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust" as one of the "above listed items" that cannot be claimed as a deduction under §67(g). The discussion about *estate/trust* deductions in paragraph d above does not apply, because these are deductions to the individual beneficiaries, not to the trust.

Notice 2018-61 observes that the miscellaneous itemized deductions that are not deductible under §67(g) appear to include the §642(h)(2) excess deduction. However, the IRS is studying whether to treat deductions that would have been treated under §67(e) in the hands of the estate or trust (and therefore not a miscellaneous itemized deduction) should be treated similarly to the individual beneficiaries (i.e., allowed in computing adjusted gross income and therefore not subject to §67(g)). The IRS has the authority to adopt such a rule because §642(h) allows beneficiaries to take excess deductions in the last year of the estate or trust "in accordance with regulations prescribed by the Secretary."

If §67(e) applies to certain expenses of an estate or trust, and if the estate or trust terminates and passes to another trust, can those expenses be deducted by the recipient trust under §67(e)? Presumably not, because §67(e)(1) seems to refer to expenses incurred in the administration of the estate or trust claiming the deduction. However, if the IRS should decide to treat expenses as having the same "character" under §67(e) for beneficiaries as for the original estate or trust, that same analysis would presumably apply for trust beneficiaries as well as for individual beneficiaries.

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The limit on deducting excess deductions at the termination of an estate or trust may have implications for trust decanting. Some decanting private rulings have treated a trust decanting as a continuation of the original trust (e.g., PLRs 200736002 & 200607015). In addition, the Uniform Decanting Act allows decanting without transferring assets; in effect it is treated as an amendment of the trust by the trustee. However, if decanting to another trust is treated as a termination of the original trust, any excess deductions may be lost.

(f) **Alternative Minimum Tax.** The Act increases the AMT exemption for individuals, but not for trusts and estates. The exemption amounts for trusts and estates will likely be slightly lower than the previously announced amounts for 2018 because of the Act's requirements to use chained CPI indexing.

(g) **Section 691(c) Deduction for Estate Taxes Attributable to Income in Respect of a Decedent.** New §67(g) does not suspend the §691(c) deduction for estate tax attributable to income in respect of a decedent because the §691(c) deduction is one of the items listed in §67(b) as *not* being a miscellaneous itemized deduction "for purposes of this section," which would include new §67(g).

(h) **Electing Small Business Trusts.**

(1) **NRA as Permitted Potential Beneficiary.** The Act allows a nonresident alien (NRA) individual to be a potential current beneficiary of an electing small business trust (ESBT).

(2) **Charitable Deduction Allowed Under §170 Rather Than §642(c).** The charitable contributions deduction for trusts is governed by §642(c) rather than §170, which governs the charitable deduction for individuals. Several restrictions that apply under §642(c), but not under §170, are that the distribution must be made from gross income and pursuant to the terms of the governing instrument (and the governing instrument requirement has been applied strictly). In addition, no carryover of excess contributions is allowed for trusts. The Act provides that the charitable contribution deduction of an ESBT is determined by rules applicable to individuals under §170, not the rules applicable to trusts under §642(c), effective for taxable years beginning after 2017. This will be favorable in various respects for charitable contributions made by the portion of an ESBT holding S corporation stock. Eliminating the gross income requirement means that a charitable deduction would be available for gifts of property, the same as for individuals. The governing instrument requirement will no longer apply. Excess charitable deductions can be carried forward for five years. Possible negative effects of applying §170 rather than §642(c) to ESBTs are that the percentage limitations (but also the carryforward provisions) applicable to individuals will apply to charitable contributions made by the portion of an ESBT holding S corporation stock, and the substantiation requirements that apply to individuals under §170 will also be applicable to ESBTs, effective for taxable years beginning after 2017.

(3) **No Sunset.** The changes described above for ESBTs are permanent and do not sunset after 2025.

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(4) **Section 199A Deduction.** ESBTs qualify for the §199A deduction, discussed in Item 2.f.(2)(c) below.

(21) **Sunset after 2025** – Almost all of the individual income tax changes will expire after 2025. This includes (among the many individual tax changes) the deduction for business income from pass-through entities, individual rate cuts, expanded child tax credit, expanded standard deduction, repeal of personal exemptions, and increases in the transfer tax exclusion amounts. A few (very few) of the individual income tax changes do not sunset after 2025, including the use of the chained CPI (which has the effect of moving taxpayers into higher brackets in future years as compared to the current indexing approach), alimony and §682 repeal, recharacterization of Roth IRA conversions, and the life insurance settlement provisions.

The sunsetting provisions were included (1) to meet the \$1.5 trillion deficit limit authorized in the budget resolution authorizing the reconciliation act in 2017, and (2) to avoid the Byrd rule which would have been triggered if the act had the effect of producing additional deficits outside the 10-year budget window of the 2017 Tax Act.

The Trump administration and some Republican congressional leaders are supporting a “second phase of tax cuts,” a top priority of which is to make the individual cuts in the first tax bill permanent. Various other areas may also be included, such as retirement savings, education, extending the child tax credit and increasing charitable contribution deduction limitations. Some have suggested a political motivation of keeping an active legislative agenda that will excite voters even if the passage of such legislation is unlikely before the midterm elections in November, 2018. See Allyson Versprille & Laura Davison, *‘Phase Two’ Tax Cut Talk Seen Boosting GOP Odds in 2018 Elections*, BLOOMBERG DAILY TAX REPORT (March 16, 2018). Passing a tax bill is a top priority for House leadership, but Senate Republicans have showed no sign they want to pass such legislation before the mid-term elections. See Kaustuv Basu and Allyson Versprille, *More Than One Bill in Tax Cut 2.0 Package: Brady*, BLOOMBERG DAILY TAX REPORT (June 27, 2018). Senator Corker has indicated that he does not support making permanent individual tax cuts, because of the impact on the deficit. Kevin Drawbaugh, David Morgan, & Jonathan Oatis, *U.S. Republicans Target Elections With More Deficit-Boosting Tax Cuts*, RIA Checkpoint Newsstand (July 16, 2018). See Item 2.h below for discussion about the Tax Cut 2.0 package.

Even without the additional legislation, the Congressional Budget Office estimates that the 2017 tax legislation will increase primary deficits by \$1.854 trillion through 2028, after taking into consideration the law’s effect on debt-service costs from changes in federal borrowing and changes in interest rates. Allyson Versprille, *Hill Briefs: Tax 2.0 Would Worsen Fiscal State, Report Says* BLOOMBERG DAILY TAX REPORT (June 27, 2018) (describing June 26, 2018 report from Congressional Budget Office). The CBO estimates that “in addition to the \$1.9 trillion cost” of the 2017 tax act, “extending the expiring individual tax provisions (including those affecting pass-through businesses) would cost an additional \$650 billion over the next decade, with the costs exploding over time.” Allyson Versprille & Kaustuv Basu, *Hills Briefs: Tax Law Technical Corrections; Historic Tax Credit Bill*, BLOOMBERG DAILY TAX REPORT (June 14, 2018). Indeed, the deficit in the first two months of the 2019 fiscal year has been 51% greater than in the prior fiscal year, up from \$202 billion to \$305

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billion. See Howard Schneider & Paul Simao, *U.S. Government Posts \$205 Billion Deficit in November*, RIA CHECKPOINT NEWSSTAND (Dec. 14, 2018).

**(22) “Five Year Rule” On Mandatory Distributions From Qualified Plans and IRAs Not Included.** The Senate Finance Committee on September 21, 2016 unanimously approved the Retirement Enhancement and Savings Bill of 2016, which among other things would have required that distributions from qualified plans and IRAs be made within five years of the death of the participant, with limited exceptions (one being for a surviving spouse) to the extent all of an individual’s plans exceed \$450,000. Despite Congress’s focus on finding revenue to offset the tax cuts in the Act, this provision was not included in the 2017 Tax Act.

The issue will likely arise again at some point; the Retirement and Enhancement Savings Act of 2018 was re-introduced in early 2018 as S.2526. For a further discussion of the provisions in that Retirement and Enhancement and Savings Bill of 2016, see Item 2.g of the Estate Planning Current Development and Hot Topics Summary (October 2017), found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

f. **Business Tax Matters; Reduced Top Corporate Rate and Section 199A Deduction for Qualified Business Income from Passthrough Entities; Other Miscellaneous Business Tax Matters.**

**(1) Reduced Top Corporate Rate and Overview of §199A Deduction for Qualified Business Income From Passthrough Entities.** The top corporate tax rate is 21% under the Act, effective beginning in 2018. This reduced top income tax rate applies to any entities that are subject to income taxation under Subchapter C.

A complicated provision in new §199A provides tax-favored treatment of business income from passthrough entities (sole proprietorships, partnerships, limited liability companies, or S corporations) that are not subject to taxation under Subchapter C and that will be taxed at the individual tax rates of the owners, which could be as high as 37%. The deduction under §199A reduces the wide discrepancy (21% vs. 37%) in the top rates at which business income would be taxed, depending on whether the business is taxed as a C corporation or as a proprietorship or passthrough entity. Very generally (but with various limitations and exceptions), the §199A deduction is a deduction for the individual owner’s tax calculation equal to 20% of the individual’s qualified business income; the 20% deduction results in an effective top rate of  $(1 - 0.20) \times 37\%$ , or 29.6%. This deduction is subject to various limitations, the most important of which apply to taxpayers with taxable income over a certain threshold amount and are (1) based on the wages paid by the business or wages plus the basis of its property, or (2) in certain specified service businesses (designed to prevent converting what would otherwise be normal service income into business income). The deduction is allowed to individuals, trusts and estates.

The IRS estimates that 22-24 million taxpayers will be eligible for the §199A deduction, and that 95% of those eligible taxpayers will fall below the \$157,500/\$315,000 threshold and will not be subject to the wage and capital

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limitation or the specified service business restriction. See Robert Lee, *IRS Sheds Light on Pass-Through Deduction*, BLOOMBERG DAILY TAX REPORT (Nov. 14, 2018).

(2) **Temporary, Through 2025.** The §199A provision is in Subtitle A of the 2017 Tax Act addressing individual tax reform, and like most of the individual tax provisions in the Act, applies only through 2025.

(3) **Proposed Regulations.** The IRS on August 8, 2018 issued 184 pages of proposed regulations (including a 104 page preamble) to §199A and the multiple trust rule under §643. In addition, Notice 2018-64 was issued in conjunction with the proposed regulations and addresses alternative methods for calculating W-2 wages as used in the computations under §199A. The issuance of complicated detailed proposed regulations to this complex Code section within only about eight months of the passage of the Act is amazingly fast.

A short comment period was established and a hearing regarding comments was held in early October. The goal is to finalize the regulations by the end of December, 2018. See Lydia O’Neal & Allyson Versprille, *IRS Reconsidering Parts of Pass-Through Write-Off Rules: Official*, BLOOMBERG DAILY TAX REPORT (Nov. 15, 2018).

The separate sections of the proposed regulations cover the following general topics-

§1.199A-1 Definitions and operational rules-General rules for computation of deduction, trade or business, loss carryover rules

§1.199A-2 W-2 wages and unadjusted basis immediately after acquisition

§1.199A-3 Guidance regarding various terms including qualified business income, allocation among multiple trades or businesses

§1.199A-4 Aggregation

§1.199A-5 Specified service trades or businesses and performing services as employee

§1.199A- 6 Guidance regarding computational and reporting rules for “relevant passthrough entities” and regarding trusts and estates (including an anti-abuse rule)

§1.643(f)-1 Multiple trusts.

(4) **Abbreviations.** The proposed regulations employ a number of abbreviations, which no doubt will become part of tax lingo, and are used in this summary. The abbreviations include the following.

<b>QBI</b>	Qualified business income
<b>RPE</b>	Relevant passthrough entity
<b>SSTB</b>	Specified service trade or business
<b>UBIA</b>	Unadjusted basis immediately after acquisition (of “Qualified Property”)
<b>PTP</b>	Publicly traded partnership
<b>REIT</b>	Real estate investment trust

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## (5) General Computation Formula for Deduction.

(a) **Threshold Amount.** The threshold amount is taxable income, determined without considering the §199A deduction itself, of \$157,500 for taxpayers other than joint return filers and \$315,000 for married couples filing joint returns, indexed for inflation for tax years beginning after 2018. Prop. Reg. §1.199A-1(b)(11). (For 2019, the indexed threshold amounts are \$160,700 for single and head of household taxpayers, \$160,725 for married filing separate returns, and \$321,400 for married taxpayers filing joint returns, Rev. Proc. 2018-57, §3.27.) The \$157,500 (indexed) threshold is *taxable* income, which would be calculated after considering the individual's allowable deductions or the \$24,000 standard deduction, if a larger amount (and all adjustments allowed in arriving at adjusted gross income, which would include 50% of self-employment tax). Low income taxpayers (with taxable income below the threshold amount) are not subject to the "W-2 and UBI limitation" or the specified service trade or business limitation (both of which are described below). Those limitations are phased in for the next \$50,000 /\$100,000 (i.e., other than joint return/joint return taxpayers) of taxable income.

### (b) Individuals with Taxable Income Not Exceeding Threshold Amount.

Deduction = Lesser of:

- (1) 20% of QBI {including QBI of SSTBs} + 20% of (qualified REIT dividends + qualified PTP income); or
- (2) 20% x (taxable income – net capital gain). Prop. Reg. §1.199A-1(c).

The last element means that the deduction cannot exceed taxable income reduced by the taxpayer's net capital gain for the year. In effect, the 20% deduction cannot exceed 20% of the taxpayer's ordinary income. That same overall limit on the deduction applies for individuals with taxable incomes exceeding the threshold amount (described immediately below).

### (c) Individuals with Taxable Income Exceeding Threshold Amount.

Deduction = Lesser of:

- (1) QBI component + 20% of (qualified REIT dividends + qualified PTP income); or
- (2) 20% x (taxable income – net capital gain). Prop. Reg. §1.199A-1(d).

QBI component = sum of the following for each separate trade or business--

Lesser of:

- (1) 20% of QBI for that trade or business, or
- (2) What is referred to in this outline as the "W-2 wages or UBI limitation" (or sometimes as the "W-2 wages or capital limitation") which is the greater of the individual's allocable share of
  - (i) 50% of W-2 wages for that trade or business, or

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(ii) 25% of W-2 wages for that trade or business + 2.5% of UBI of qualified property for that trade or business,

Subject to a special rule for SSTBs, which is that QBI, W-2 wages, and UBI of qualified property of a SSTB are not taken into account, and

Subject to a phase-in rule if taxable income is in the “phase-in range.” Prop. Reg. §1.199A-1(d).

**Phase-In Range.** For taxpayers with up to \$50,000 (\$100,000 for joint returns) over the threshold amount, the W-2 wages or UBI limitation is applied proportionately by the amount that the excess bears to \$50,000 (or \$100,000, as appropriate). Prop. Reg. §1.199A-1(d)(iv)(B).

The REIT dividends and PTP income provisions in the first element of the basic deduction formula in effect means that the wage limitation and limitation of SSTB income does not apply to those types of income.

(6) **Qualified Business Income.** QBI “means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under the rules of §1.199A-3(b) [which also requires that the income be effectively connected with a U.S. trade or business].” Prop. Reg. §1.199A-1(b)(4). (Observe that credits attributable to trades or businesses are not considered.)

(a) **Trade or Business.** Section 199A(d)(1) describes a “qualified trade or business” as any trade or business other than an SSTB or the trade or business of performing services as an employee. (The exception for an SSTB does not apply to taxpayers with taxable income under the threshold amount. §199A(d)(3)(A)(i).)

The proposed regulations adopt the definition of a trade or business under §162. Substantial case law and rulings have developed regarding whether the management of real estate rental property constitutes a trade or business; operating under a triple net lease may not qualify as a trade or business (although the proposed regulations refer to an example of an individual leasing land to suburban airports for parking lots with no suggestion that it may not be a trade or business, Prop. Reg. §1.199A-1(d)(4)Ex.1). See Alan Gassman and Kelsey Weiss, *Is it Possible for a Triple Net Lease to be Considered a “Trade or Business” for Section 199A Purposes*, LEIMBERG INFORMATION SERVICES INC. TAX PL. NEWSLETTER #161 (Nov. 8, 2018) (“under the classic definition of a triple net lease, the lessor would not qualify for the 199A deduction” but the lessor could do things to increase its level of activity with the rental in ways that might cause the arrangement to qualify).

The proposed regulations add a helpful special rule for purposes of §199A—the rental of property to a related trade or business is treated as a separate trade or business if the two separate businesses are commonly owned, meaning the same persons directly or indirectly own 50% or more of each business (applying attribution rules attributing ownership from an individual’s spouse, children, grandchildren, and parents). Prop. Reg. §1.199A-1(b)(13), referring to §1.199A-

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4(b)(1)(i) & §1.199A-4(b)(3)(family attribution). The exception is very helpful because business owners often segregate rental property from operating businesses. (If desired, the taxpayer could aggregate the two businesses under the aggregation rules of §1.199A-4 if the requirements of that section are satisfied.)

(b) **Trade or Business of Performing Services as an Employee.** A business of serving as an employee is not eligible for the §199A deduction. §199A(d)(1)(B). The proposed regulations include several special rules to discourage current employees from becoming independent contractors in an attempt to qualify for the deduction. First, the employer's Federal employment tax classification of the employee as a non-employee is immaterial. Prop. Reg. §1.199A-5(d)(2). Second, if an employee becomes an independent contractor while providing substantially the same services as before, a presumption arises that the person is an employee for purposes of §199A. The presumption may be rebutted by showing that the individual is performing services in a capacity other than as an employee. Prop. Reg. §1.199A-5(d)(3) (including three rather detailed examples). This presumption provision purportedly applies to taxable years ending after December 22, 2017 (after the regulations are finalized). Prop. Reg. §1.199A-5(e)(2)(i). Observe that no contrary presumption exists providing that an independent contractor is presumed to remain an independent contractor, leaving open the possibility of an independent contractor converting to employee status if more W-2 wages are needed for owners to be able to use the §199A deduction.

(c) **Specific Items Included and Excluded from QBI.** QBI is generally the net amount of income, gain, deduction, and loss from an active trade or business within the United States, including §751 gain, but not including certain types of investment income (short or long term capital gains or losses including gains or losses under §1231 treated as capital gains or losses, dividends or interest unless the interest is allocable to a trade or business but interest attributable to the investment of working capital is not included), annuity income not received in connection with the business, net gain from foreign currency transactions and commodities transactions, and income from notional contracts. In addition, QBI does not include reasonable compensation paid to the taxpayer, any guaranteed payment under §707(c), or payment to a partner for services under §707(a). Prop. Reg. §1.199A-3(b).

(d) **No Imputed Reasonable Compensation From Partnerships.** Reasonable compensation concepts are applied to S corporations to prevent avoidance of self-employment tax abuses, but no tax rules require partnerships to pay their active owners a guaranteed payment (treated as compensation). The proposed regulations do not require a partnership to pay reasonable compensation for purposes of §199A. Preamble to §1.199A proposed regulations at 39-40.

(e) **Losses; Multiple Businesses.** If a taxpayer has multiple businesses, the QBI must be determined for each separate business. If any business has a negative QBI, that loss is netted against the QBI from businesses with positive

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QBI. The loss is allocated across businesses with positive QBI proportionately based on the amount of QBI in each such business with positive QBI, and that allocation is made before the individual applies the limitations based on W-2 wages and UBI of qualified property. The net QBI of each business, after considering apportioned losses is then compared with the W-2 wages and UBI limitation for each business. The W-2 wages and UBI from a business with a negative QBI are not taken into account for other businesses and are not carried over to subsequent years for that business. Prop. Reg. §1.199A-1(d)(2)(iii)(A).

If the net QBI for all businesses in a year is a negative number, the negative amount is treated as QBI from a separate business, and is carried over to subsequent years to offset the positive QBI of businesses in subsequent years. Prop. Reg. §1.199A-1(d)(2)(iii)(A).

Net operating losses are generally not considered attributable to a trade or business and are not taken into account in computing QBI because the items giving rise to the loss were allowed in computing taxable income in the year incurred. If some losses that were disallowed by §461(l) in determining income give rise to an NOL, the disallowed deductions will not be included in the QBI computation in the year incurred, and the NOL attributable to that business will constitute QBI in later years. Prop. Reg. §1.199A-3(b)(1)(v).

(7) **W-2 Wages.** The taxpayer's pro rata share of the total W-2 wages paid by the business (including wages paid to the taxpayer) is considered in determining the W-2 wages or UBI limitation.

(a) **General Rules.** W-2 wages includes wages as defined in §3401(a) subject to wage withholding, and also include elective deferrals (under §402(g)(3)), and deferred compensation (under §457), and Roth contributions. Prop. Reg. §1.199A-2(b)(2)(i). Amounts are considered only if they are properly included on a Form W-2 and W-3 filed with the Social Security Administration by the 60th day after the due date (generally January 31 of the following calendar year), including extensions, for such returns. §199A(b)(4)(C). If a corrected return is filed after that 60<sup>th</sup> day date, any increase in reported wages is ignored but any decrease must be taken into account in determining the business's W-2 wages. Prop. Reg. §1.199A-2(b)(2)(iii).

Procedures are included for determining W-2 wages for short years (arising from the acquisition or disposition of a business interest by the taxpayer). Prop. Reg. §1.199A-2(b)(2)(iv)(C).

Three alternative methods are provided for calculating W-2 wages in Notice 2018-64, issued in conjunction with the proposed regulations. These are (i) the unmodified box method (lesser of Boxes 1 and 5 for all employees' W-2 forms, the simplest approach, but that may not be as large a number as the other approaches), (ii) the modified Box 1 method (Box 1 less some amounts that are not wages for withholding purposes and totals in Box 12, Code D, E, F, G, and S relating to elective deferrals), and (iii) the tracking wages method (all wages subject to withholding and totals in Box 12, Code D, E, F, G, and S relating to elective deferrals). The effect is that W-2 wages include most pension plan

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contributions (including elective deferrals), health insurance costs, and various other items of compensation.

(b) **Management Company Exception.** The proposed regulations add a regulatory rule providing relief for situations in which the employees for various separate businesses are employed by a central management company. For example, real estate investors often form separate LLCs to own separate real estate investments, and each separate business pays a management fee to a central management company that hires employees to provide management services for all of the separate businesses. Prop. Reg. §1.199A-2(b)(2)(iii). Without this rule, the businesses would have no W-2 wages to apply for determining the W-2 wages and UBIA limitation applicable to those businesses. The proposed regulation is very succinct, simply providing that a taxpayer can take into consideration any W-2 wages paid by another person “provided the W-2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE.” *Id.*

(c) **Allocation of Wages among Businesses and to QBI.** If an employee is used in multiple businesses, the W-2 wages are allocated among those businesses in the same manner that expenses are allocated among the businesses under §1.199A-3(b)(5). The wages allocated to each business is then further allocated to determine the wages properly allocated to QBI for each business. Prop. Reg. §1.199A-2(b)(3)-(4). (An RPE must identify and report associated wages to its partners or shareholders. Prop. Reg. §1.199A-6(b).)

(d) **Guaranteed Payments Not W-2 Wages.** For S corporations, compensation paid to shareholders is treated as W-2 wages. Owners of partnerships or LLCs, however, receive guaranteed payments rather than wages. Guaranteed payments are deductible, so reduce QBI (and therefore reduce the 20% of QBI deduction), but do not count as W-2 wages. For §199A purposes, guaranteed payments are not desirable and result in a whipsaw of reducing QBI but not being counted as wages to help in satisfying the wage limitation to take full advantage of the 20% deduction that is available from the remaining QBI. A possible alternative is to contribute the partnership interest into an S corporation and have wages paid by the S corporation. Or perhaps have the owners of another entity drop their interests into a lower tier entity and have the lower tier entity pay wages to the employee and get W-2 treatment at the lower level. The *owner* of a partnership does not receive W-2 wages but instead receives K-1 income, so have wages paid from an entity not owned by the employee.

(8) **UBIA Limitation (Sometimes Referred to as the “Capital Limitation”).**

(a) **Code Description.** The wages limitation was relaxed in the Conference Agreement by adding that the wage limitation is the greater of (a) 50% of W-2 wages, or (b) the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition, of qualified property (generally meaning all tangible property subject to depreciation) for the useful life of such property. This separate “real estate exception” based largely on the basis of property in the business could be very beneficial to real estate companies.

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(b) **Qualified Property.** Qualified property is tangible depreciable property held at the close of the tax year that is used at any time during the year for the production of QBI and for which the depreciable period has not ended before the close of the individual's or RPE's taxable year. Prop. Reg. §1.199A-2(c)(1)(i). Raw land and inventory are not depreciable, so do not count.

An addition or improvement to property is treated as separate qualified property placed into service on the date of the addition or improvement. (This is important for purposes of determining how long the basis of the property can be counted as UBIA.) Prop. Reg. §1.199A-2(c)(1)(ii).

Businesses cannot simply acquire property briefly at the end of the year to "beef up" the UBIA amount. Property that is acquired within 60 days of year-end and disposed of within 120 days without being used in the business at least 45 days is not qualified property. Prop. Reg. §1.199A-2(1)(iv).

(c) **Depreciable Period.** The depreciable period starts when the property is placed in service and ends on the later of (i) 10 years later, or (ii) the end of last full year of the applicable recovery period under §168(c). Prop. Reg. §1.199A-2(c)(2). The business will need to keep track of this period as well as the period of actual depreciation.

(d) **Unadjusted Basis Immediately After Acquisition.** Using the "unadjusted" basis means that depreciation, bonus depreciation, §179 depreciation etc. have no impact on this number.

**Like-Kind Exchanges.** For like-kind exchanges, the date of service of the relinquished property applies, but the adjusted basis at the time of the exchange (which may reflect depreciation or other downward basis adjustments during the intervening period) becomes the new unadjusted basis, in effect applying the worst rule for both issues from the taxpayer's perspective (but exceptions to that general rule apply). Prop. Reg. §1.199A-2(c)(2)(iii). The non-recognition provisions in §1031 are mandatory, but a taxpayer may specifically structure a transaction so that it does not qualify as a like-kind exchange under §1031. This position has led some commentators to suggest that the "real estate exception" (i.e., the capital limitation) will not be helpful to many real estate owners who have participated (or will participate) in like-kind exchanges. Joe Light, *Tax Break Seen Helping Trump Isn't as Sweet Thanks to IRS Rules*, BLOOMBERG DAILY TAX REPORT HIGHLIGHTS (Oct., 12, 2018).

**Non-Recognition Contributions to an RPE.** Similarly, if assets are contributed to a new taxable entity in a nontaxable exchange (for example contributions to a partnership under §721 or contributions to an S corporation under §351), the worst of both worlds applies—the original life continues but the adjusted basis at the time of the contribution (which may reflect prior depreciation deductions or other downward basis adjustments) becomes the new unadjusted basis. Prop. Reg. §§1.199A-2(c)(2)(iv); 1.199A-2(c)(3) (in conjunction with the additional explanation in the Preamble); 1.199A-2(c)(4)Ex.3. Comments from ACTEC to the IRS and Treasury about the proposed regulations recommend that the UBIA

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of property contributed to a partnership or S corporation be determined without regard to §723 for a partnership or §362 for an S corporation “so that the UBIA of the qualified property in the hands of the contributing partner or shareholder will carry over to the RPE.”

**Section 754 Election.** Basis adjustments under §§734(b) and 743(b) of property held in an RPE with a §754 election in effect are not counted (such basis adjustments “are not treated as qualified property”). Prop. Reg. §1.199A-2(c)(1)(iii).

(9) **Aggregation.**

(a) **Significance.** The proposed regulations adopt an approach of allowing taxpayers (not the passthrough entity) to aggregate separate businesses that meet certain tests, which results in combining the QBI, W-2 wages and qualified property of the aggregated separate businesses. This can be very helpful, for example, if some businesses have little wages or qualified property (for the UBIA limitation) and other businesses have a relative abundance of W-2 wages or qualified property. This is somewhat similar to the concept of “grouping” under the passive activity loss rules, but the rules are different, and a particular taxpayer may choose to aggregate businesses for purposes of §199A in a different manner than the same taxpayer groups businesses for passive activity loss purposes. Aggregation is at the option of the taxpayer, and all of the owners of a business do not have to make the same aggregation decision.

Under the proposed regulations, aggregation is allowed at the individual owner level. Some commentators have strongly encouraged the IRS to allow aggregation at the entity level to simplify compliance. See Lydia O’Neal & Allyson Versprille, *IRS Reconsidering Parts of Pass-Through Write-Off Rules: Official*, BLOOMBERG DAILY TAX REPORT (Nov. 15, 2018) (summarizing comments of Laura MacDonough, executive director of National Tax Private Client Services at Ernst & Young LLP).

(b) **Requirements.** Businesses may be aggregated if—

- (i) The same person or group of persons, directly or indirectly, owns 50% or more of each business being aggregated (i.e., 50% or more of the shares of an S corporation or 50% of more of the capital or profits of a partnership);
- (ii) The ownership exists for a majority of the taxable year;
- (iii) All of the items attributable to each business are reported on returns having the same taxable year, not considering short taxable years;
- (iv) None of the businesses is an SSTB; and
- (v) The businesses satisfy at least two of the following three factors (based on all the facts and circumstances):

- (A) The businesses provide products and services that are the same or are customarily offered together;
- (B) The businesses share facilities or significant centralized business elements (such as personal, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); and

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(C) The businesses “are operated in coordination with, or reliance upon, one or more businesses in the aggregated group (for example, supply chain interdependencies).” Prop. Reg. §1-199A-4(b)(1).

(c) **Common Ownership Test.** Common ownership is determined after applying an attribution rule attributing ownership by an individual’s spouse, children, grandchildren, or parents. Prop. Reg. §1.199A-4(b)(3). There is no attribution between siblings or from non-grantor trusts to a beneficiary (as there is under the common ownership rule for purposes of the anti-cracking and packing rule for SSTBs). The failure to provide for attribution among siblings creates a huge problem for second generation businesses in which the business has been divided among more than two children, with none of them owning 50% of the business. Comments from ACTEC to the IRS and Treasury about the proposed regulations recommend that the broader attribution rule of §267(b) or 707(b) be applied for this purpose.

The taxpayer does not have to own more than 50% of each aggregated business, as long as *someone* owns 50% or more of the aggregated businesses.

(d) **Consistency.** Once the taxpayer elects to aggregate businesses, the taxpayer must consistently report the aggregated businesses in all subsequent years. A newly created or newly acquired business may be added to the aggregated group assuming the requirements are satisfied; or if facts have changed so that a prior aggregation no longer satisfies the requirements, the aggregation will no longer apply and the individual may determine a new permissible aggregation (if any). Prop. Reg. §1.199A-4(c)(1).

This consistency requirement means that taxpayers must very carefully decide what businesses to aggregate. Conditions may change in the future making the aggregation undesirable (for example, if one of the aggregated companies has a loss that has the effect of offsetting the QBI of other businesses, in effect “wasting” use of some or all of the W-2 and UBA of those other businesses).

(e) **Disclosure.** The taxpayer must disclose the aggregation on each year’s return by attaching a statement containing information required in the regulations, and the IRS may disaggregate the businesses if the taxpayer fails to attach the required disclosure statement. Prop. Reg. §1.199A-4(c)(2).

The aggregation requirements would seem to require the RPE to report sufficient information to all owners about who the other owners are and their relationships so that each owner can decide whether the entity qualifies for aggregation with other RPEs in which the owner has an interest. The proposed regulations do not currently require that information to be reported, and the comments to the IRS and Treasury from ACTEC recommend “that each Schedule K-1 from an RPE be required to list all of the RPE’s owners and their respective ownership percentage.” Comments to the IRS and Treasury about the proposed regulations from the American Society of CPAs recommend that RPEs be allowed to make the aggregation election at the entity level in order to forego any necessity of providing that kind of ownership information; under that

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proposal an election to aggregate at the entity level would be binding on the owners.

(f) **Examples.** The proposed regulations contain 14 detailed examples illustrating the aggregation rules.

(10) **Specified Service Trades or Businesses (SSTBs).**

(a) **General Rule.** The deduction does not apply for specified service businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investment management, trading services, dealing in securities, partnership interests, commodities, or any business where the principal asset is the reputation or skill of one or more of its employees (by reference to §1202(e)(3)(A), except for engineering or architecture). §199A(d)(2). This provision decreases the incentive of specified service businesses to pay low compensation income for the service-provider employees and claim that most of the income from the business is qualified business income entitled to the 20% deduction.

The listed service fields are generally based on service fields in §1202 (for qualified small business stock), and almost no case law or rulings exists as to the meaning of those terms. The proposed regulations generally apply those terms broadly, but give specific examples of types of businesses that are or are not included. The proposed regulations do not apply a bright-line licensing rule.

(b) **Reputation or Skill of Employee as Principal Asset.** The proposed regulations interpret this term narrowly, as applying only to businesses receiving income from: (1) endorsing products or services, (2) using an individual's image, likeness, name, signature, voice, trademark, or other symbols associated with the individual, or (3) appearing at an event or on radio, television or other media format. Prop. Reg. §1.199A-5(b)(2)(xiv). This position avoids a concern that almost any business closely associated with a particular individual (such as "Tony's" restaurant) could be treated as an SSTB.

(c) **Mixed Businesses—De Minimis Rule If Little SSTB Income and Recommendation for Other Mixed Businesses.** If a business has income from the specified service fields and also has other income, the business will not be treated as an SSTB if less than 10% of its gross receipts are from the specified service field (or 5% if it has gross receipts over \$25 million). Prop. Reg. §1.199A-5(c)(i).

Comments from the American Bar Association Tax Section to the IRS and Treasury about the proposed regulations state that while this rule appears to be a safe harbor, "the rule was intended to be a 'cliff' such that exceeding the threshold would cause all of the trade or business to be treated as SSTB income." Instead the ABA Tax Section recommends that the final regulations "allow an individual or RPE to bifurcate in a reasonable manner the QBI, W-2 wages, and UBIA of Qualified Property between the gross receipts" attributable to the SSTB and non-SSTB activities, but "if more than 80% of the gross receipts are attributable to services in an SSTB field, the entire trade or business should be considered an SSTB."

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Some commenters observe that the 5% threshold (for businesses with gross receipts of at least \$25 million) “is extremely harsh” and will encourage pass-through owners to split up their businesses if that have specified service activities slightly over the 5% threshold. See Lydia O’Neal & Allyson Versprille, *IRS Reconsidering Parts of Pass-Through Write-Off Rules: Official*, BLOOMBERG DAILY TAX REPORT (Nov. 15, 2018).

(d) **Cracking and Packing.** Soon after the passage of §199A, commentators discussed possible “cracking and packing” transactions in which business would be structured to “crack” apart as much ancillary activity income as possible (for example, for administrative functions) from the service business, or to “pack” other qualifying businesses into the service business to transform the business into one that is not primarily in the designated service field. See Avi-Yonah, Batchelder, Fleming, Gamage, Glogower, Hemel, Kamin, Kane, Kysar, Miller, Shanske, Shaviro, & Viswanathan, *The Games They Will Play: An Update on the Conference Committee Tax Bill* (December 22, 2017) (excellent discussion of specific strategies including “cracking” and “packing” strategies for specified service companies). The proposed regulations limit this type of activity; planning alternatives remain but will require more maneuvering.

**50% and 80% Tests.** The proposed regulations add that an SSTB includes any business (i) with 50% or more common ownership (directly or indirectly, with attribution), and (ii) that provides 80% or more of its property or services to an SSTB. Prop. Reg. §1.199A-5(c)(2)(i). For example, if the marketing, billing, and payroll administrative functions are structured in a separate entity to provide such activities for the service business in return for a fee, if 50% common ownership exists between the administrative entity and the service entity, and if the administrative entity provides at least 80% of its services to the service entity, the administrative entity will be treated as part of the service entity, and the entire entity will be an SSTB.

Common ownership is determined for purposes of this “anti-cracking and packing” rule after applying the attribution rules of §267(b) or §707(b). Prop. Reg. §1.199A-5(c)(2)(iii). Generally, this includes attribution among trusts and their grantors and beneficiaries, and includes family attribution among siblings, spouses, ancestors and descendants. (The attribution rule applied for purposes of the aggregation rule discussed above is much narrower, including just family attribution from an individual’s spouse, children, grandchildren, and parents.)

**Meeting Only 50% Test.** If a business (that is not otherwise an SSTB) does not provide 80% of its product or services to an SSTB but 50% common ownership exists between the business and an SSTB, the business is not treated as an SSTB in its entirety, but the portion of the business that provides property or services to the 50% commonly-owned SSTB is treated as part of the SSTB. Prop. Reg. §1.199A-5(c)(2)(ii).

Comments to the IRS and Treasury about the proposed regulations from the American Society of CPAs recommends that the “50 percent/80 percent rule” is not necessary and keeping just the 50% common ownership test satisfies the

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government's concern of abuse. Even if less than 20% of the revenues comes from non-SSTB activities, the revenue from non-SSTB activities would qualify as non-SSTB QBI.

**Business Incidental to SSTB.** If a non-SSTB business entity that would not otherwise be an SSTB (i) has 50% common ownership (applying attribution under §267(b) and §707(b)) with a separate SSTB entity, (ii) shares expenses with the SSTB, and (iii) accounts for 5% or less of the combined gross receipts of the business and SSTB, the business is treated as incidental to and part of the SSTB for purposes of §199A. Prop. Reg. §1.199A-5(c)(3) (including an example of a dermatologist that provides medical services through an LLC disregarded entity that also sells skin care products representing no more than 5% of the combined gross receipts of the LLC).

**Anti-Abuse Provisions Effective Currently.** The cracking and packing and incidental business rules described above purportedly apply to taxable years ending after December 22, 2017 (after the regulations are finalized). Prop. Reg. §1.199A-5(e)(2)(i). The preamble discusses that §7802(b)(2) provides that regulations issued within 18 months of the date of the enactment of the statutory provision to which they relate are not prohibited from applying to taxable periods prior to the issuance of the final regulations, and §7805(b)(3) provides that any regulation may take effect or apply retroactively to prevent abuse. (The various anti-abuse rules in the §199A proposed regulations that are effective immediately are listed on page 80 of the preamble to the regulations.)

**Planning Alternatives.** The primary planning alternatives for segregating some of the income of a service business to qualify as QBI will involve avoiding the 50% common ownership test. For example, three law firms might enter into a venture to have marketing, billing, and payroll services provided by a separate administrative company owned by the owners of the three firms, with each group owning far less than 50% of the administrative entity. The firms might have the separate entity hire all of the administrative employees and enter into an employee leasing arrangement. Such structures may be rather unwieldy.

(11) **Trusts.** The deduction is available to non-corporate taxpayers, including trusts and estates. (The Senate version would not have made the deduction available to trusts and estates.) References to trusts below also apply to estates.

(a) **Threshold Amount.** For trusts, the threshold amount (for purposes of determining whether and to what extent the W-2 wages and UBIA limitation and the SSTB limitation applies) is \$157,500. §199A(e)(2)(A); Prop. Reg. §1.199A-6(d)(3)(iii). (This indexed amount is increased to \$160,700 in 2019, Rev. Proc. 2018-57, §3.27.) Surprisingly, the proposed regulations take the position that in determining whether the trust's taxable income exceeds the threshold amount, the taxable income before taking into consideration the distribution deduction is used. Prop. Reg. §1.199A-6(d)(3)(iii).

(b) **Allocation among Trust and Beneficiaries.** A trust computes its §199A deduction based on the QBI, W-2 wages, UBIA qualified REIT dividends and qualified PTP income that are allocated to the trust, and beneficiaries take into account their allocated share of such items in computing their deductions under §199A. Prop. Reg. §1.199A-6(d)(1).

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The QBI (including any negative amounts at the trust level), W-2 wages, UBIT of qualified property, qualified REIT dividend and qualified PTP income are allocated among the trust and the beneficiaries based on the relative proportion of the trust's DNI that is retained or distributed to each. For that purpose, the DNI is determined taking into account the separate share rule of §663(c) but is determined without regard to §199A. If a trust has no DNI for the year, all of those items are allocated entirely to the trust. Prop. Reg. §1.199A-6(d)(3)(ii).

(c) **Calculation at Trust Level.** The proposed regulations provide detail about how the trust calculates its QBI, including how to allocate qualified items of deduction for determining QBI. Prop. Reg. §1.199A-6(d)(3)(i). A very detailed two-page example of the rather complicated calculation process is provided. Prop. Reg. §1.199A-6(d)(3)(vi).

(d) **Grantor Trusts.** To the extent that the grantor (under §§671-677 & 679) or another person (under §678) is treated as the owning all of part of the trust, such person computes its §199A deduction as if the person directly conducted the activities of the trust as to the portion owned by the grantor or other person. Therefore, the grantor (or other deemed owner for a §678 trust) would include all attributable items directly in the grantor's or deemed owner's return in determining his or her QBI, W-2 wages, UBIT limitation, etc. This treatment suggests that the anti-abuse rules (described below) do not apply to grantor trusts. See Gassman Shenkman, Keton, Denicolo & Crotty, *Proposed Regulations for 199A – The Good, The Bad, the Taxpayer-Unfriendly*, LEIMBERG INFORMATION SERVICES INC. TAX PL. NEWSLETTER #152 (Aug. 13, 2018) ("This means that a grantor could establish a trust considered as owned by a named beneficiary pursuant to Section 678, and the individual beneficiary will be considered to be the owner of the Section 199A interest without application of the anti-abuse rules that would apply to a non-grantor ("complex") trust").

(e) **ESBTs.** The statute and legislative history do not specifically address the availability of the §199A deduction for electing small business trusts (ESBTs). Uncertainty existed regarding the availability of the §199A deduction for ESBTs because §641(c) describes the manner in which the taxable income and the tax is determined for ESBTs, and §641(c)(2)(C) states that only certain items of income, loss, deduction, or credit may be considered in determining the tax for ESBTs. The few allowed items include "[t]he items required to be taken into account under section 1366," and §1366 describes the passthrough of items to S corporation shareholders, which would include the passthrough of business income that would be reported on the Schedule K-1 from the S corporation. Therefore, an argument can be made that ESBTs are entitled to the deduction under the statutory provisions, but the answer is far from clear.

Without even referring to this statutory ambiguity, the proposed regulations provide that ESBTs are entitled to the §199A deduction. Prop. Reg. §1.199A-6(d)(v). The regulations do not clarify whether the S component and the non-S component of the trust (for example if the trust owns an S corporation with a business and owns other businesses in partnerships) each would have a \$157,500 threshold amount.

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(f) **Section 199A Anti-Abuse Rule for Trusts.** The statute authorizes the IRS and Treasury to adopt regulations implementing certain aspects of §199A, but none of those provisions specifically refer to the treatment of trusts.

Nevertheless, the proposed regulations adopt an anti-abuse rule for trusts specifically with respect to §199A (and, as discussed below, also adopt a separate general multiple trust rule under proposed regulations to §643).

The proposed regulations include the following short (but very important) anti-abuse rule for trusts (which, as discussed above, likely applies only to non-grantor trusts). “Trusts formed or funded with a *significant* purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A. See also §1.643(f)-1 of the regulations.” Prop. Reg. §1.199A-6(d)(3)(v) (emphasis added).

Section 199A does not specifically authorize regulations regarding the treatment of trusts under §199A, and the proposed regulation refers to the new proposed regulation under §643(f) (discussed below), suggesting that the IRS is acting under the authority of §643 to adopt regulations treating two or more trusts as one trust if (1) the trusts have substantially the same grantors and primary beneficiaries and (2) a principal purpose of the trusts is the avoidance of income tax.

The anti-abuse rule saying a trust will not be respected if a significant purpose is to receive a §199A deduction could apply to situations not covered by §643(f). For example, it could apply to the creation of a single trust, or it could apply to multiple trusts that clearly have different primary beneficiaries and therefore would not be covered by §643(f). An individual with income above the threshold amount may own interests in businesses that do not have sufficient W-2 wages or UBIT of qualified property to qualify for any §199A deduction to the individual; alternatively, the individual may own interests in SSTBs for which no §199A deduction would be available to the individuals with taxable income over the threshold amount. The individual may want to give interests in the business to a trust for the individual’s child, but the individual is motivated to “pull the trigger” and make the transfer now in large part so that the trust could be structured to have taxable income under \$157,500 and therefore not be subject to W-2 and UBIT limitation or the limitation on SSTBs. “A significant” purpose is of the trust receiving a §199A deduction, so the proposed regulation might apply, despite the fact that §643(f) clearly does not apply. The maximum tax savings from the §199A deduction alone would not exceed approximately \$157,500 (the threshold amount for the trust is \$157,500) times a 20% §199A deduction times a 37% rate, or \$11,655. (In round figures, the savings for the trust would be about \$150,000 x 20% x 40%, or \$12,000.)

The individual may have a number of children and grandchildren. If the individual transfers interests in the businesses to 5 separate trusts, each having a different primary beneficiary, the savings could be 5 times \$11,655, or \$58,275.

The regulation does not indicate what it means by saying that the trust “will not be respected.” Is the trust ignored or are multiple trusts aggregated or are the

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beneficiaries or the grantor substituted as the taxpayer in lieu of the trust? See Gassman Shenkman, Ketro, Denicolo & Crotty, *Proposed Regulations for 199A – The Good, The Bad, the Taxpayer-Unfriendly*, LEIMBERG INFORMATION SERVICES INC. TAX PL. NEWSLETTER #152 (Aug. 13, 2018).

The trust anti-abuse rule for §199A described above to avoid exceeding the threshold amount purportedly applies to taxable years ending after December 22, 2017 (after the regulations are finalized). Prop. Reg. §1.199A-6(e)(2)(i).

(g) **Proposed Regulations Regarding Multiple Trusts Under §643(f).** As discussed above, §643(f) authorizes the IRS to adopt regulations treating two or more trusts as one trust if certain conditions are satisfied. However, §643(f) applies “under regulations prescribed by the Secretary” and no such regulations have ever been issued. In *SIH Partners v. Commissioner*, 150 T.C. No. 3 (January 18, 2018), the Tax Court addressed the validity of regulations that were adopted in response to §956(d) referring to a tax effect for controlled foreign corporations that would apply “under regulations prescribed by the Secretary” and §956(e) providing that “[t]he Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section ....” In that case the taxpayer “contends, and respondent does not dispute” that §956(d) “is not self-executing” and that the amount of income inclusion at issue “can be determined only by reference to regulations....” Without regulations, does §643(f) have any substantive effect?

Proposed regulations under §643(f) issued in conjunction with the proposed regulations to §199A provide an anti-abuse rule regarding multiple trusts, but those regulations are not effective until they are adopted as final regulations. Prop. Reg. §1.643(f)-1(d). The proposed regulations reiterate the general rule of §643(f) that two or more trusts will be aggregated and treated as a single trust (i) if they have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (ii) if a principal purpose for establishing the trusts or for contributing additional property to the trusts is the avoidance of Federal income tax. Prop. Reg. §1.643(f)-1(a).

Paragraph (b) of the proposed regulation addresses the principal purpose requirement and provides that “[a] principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts.” Prop. Reg. §1.643(f)-1(b).

The regulations include two examples. One is of a rather unusual situation in which an individual transfers a pizzeria and gas stations to three trusts for the grantor’s sisters and brothers after reading an article suggesting that transferring business interests to multiple identical trusts for family members can avoid the wage limitation of §199A. The trusts are not identical, but a lot of similarities exist regarding the beneficiaries of the trusts. The facts state that the trusts would not have been funded but for the enactment of §199A. The example concluded that the three trusts should be aggregated and treated as a single trust. Prop. Reg. §1.643(f)-1(c)Ex.1.

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The second example is a more typical situation in which two trusts are created for two children. The first trust is for one child with a mandatory income interest and the other trust is for the other child with a discretionary distribution standard for education, support, and maintenance, and also allowing payment of the first child's medical expenses. The second child is the remainder beneficiary of both trusts. The example concludes that significant non-tax differences exist between the substantive terms of the trusts, so tax avoidance will not be presumed as a principal purpose for the creation of the trusts. Even though the two children are beneficiaries of both trusts to some degree, sufficient differences existed to avoid the presumption. If the trusts clearly have different beneficiaries, the case should be even easier to find that the presumption under the regulation does not apply. Prop. Reg. §1.643(f)-1(c)Ex.2.

The second example raises questions about the meaning of trusts having the "same primary beneficiaries." The presumption provided in the regulation helps satisfy the second leg of §643(f)—that a principal purpose of the multiple trusts is to avoid Federal income tax. The example might have been resolved readily if the trusts did not meet the first leg of §643(f) because they did not have the same primary beneficiaries. The trusts seem to provide primarily for different beneficiaries—though some overlaps exists of the beneficial interests in the two trusts. The last sentence of the example saying that "absent other facts or circumstances that would indicate that a principal purpose for creating the two separate trusts was income tax avoidance, the two trusts will not be aggregated and treated as a single trust" suggests that aggregation could occur under the regulation, meaning that the trusts must be deemed to have the same "primary beneficiaries" even though the trusts seem to provide primarily for different beneficiaries. The example seems to take the position that relatively little crossover of beneficiary interests will be enough to say that the trusts have the same "primary beneficiaries," but no regulations purport to delineate what is required for trusts to have the same "primary beneficiaries."

The Joint Committee on Taxation General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 states that trusts will not be treated as having different primary beneficiaries under the new multiple trust rule "merely because the trusts have different contingent beneficiaries" and includes an example that is fairly similar to Example 2 in the Proposed Regulations but reaches the conclusion that the multiple trusts should not be aggregated. In the example in the Joint Committee Report, son is the mandatory income beneficiary of trust 1. Daughter is the discretionary beneficiary of income of trust 2 for education support, and maintenance and son is also a discretionary beneficiary of trust 2 of income or corpus for his medical expenses. Daughter is the remainder beneficiary of both trusts. While the Joint Committee Report concludes that the separate trusts would not be aggregated, it reaches that conclusion not because the trusts have different primary beneficiaries but because "there are substantial independent purposes, and tax avoidance is not a principal purpose for the existence of separate trusts." (Another example in the Joint Committee Report created four trusts for four children, with a "round robin" selection of only three of the children as discretionary beneficiaries of a particular trust, and each of the children were discretionary beneficiaries of three

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of the four trusts. One child is strategically eliminated from each of the trusts to create the appearance of differences, but the trustee has the discretion to distribute income among any of the three beneficiaries of each particular trust, and each child is a discretionary beneficiary of three of the trusts. This is somewhat of a reciprocal trust arrangement, and the practical effect is almost the same as if a single trust had been created for the four children. Without a concept of addressing that type of reciprocal arrangement, the “different primary beneficiary” test would become somewhat meaningless.)

The ambiguity created by the second example in the §643(f) proposed regulation and the seemingly contrary conclusion reached in a similar example in the legislative history suggests that a more detailed description is needed of who is the “primary beneficiary” of a trust for purposes of §643(f).

The §643(f) multiple trust regulation purportedly applies to taxable years ending after the date that the proposed regulations was published in the Federal Register (August 16, 2018). Prop. Reg. §1.643(f)-1(d). If the regulation is finalized in 2018, it will be in effect for calendar year 2018 and tax years thereafter. The preamble (unsupported by language in the regulation itself) offers relief for pre-existing trusts, stating that the regulation applies only to “any arrangement involving multiple trusts entered into or modified on or after [August 16, 2018].” However, for potential multiple trust arrangements “entered into or modified before [August 16, 2018], the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f),” and the preamble states that before final regulations are published, the Treasury and the Service contend that proposed regulation section 1.643(f)-1 reflects Congressional intent concerning multiple trusts “that are appropriately subject to treatment under section 643(f).” The net effect might be interpreted to apply the reasoning of the proposed regulation to multiple trusts existing before August 16, 2018.

(12) **Fiscal Year Entities.** Planners have wondered how income from a fiscal year entity, with a fiscal year ending in 2018, would be treated for QBI purposes. Section 199A applies to taxable years beginning after 2017 and before 2026. The regulations will generally apply for fiscal years ending after the date they are adopted as final regulations. Prop. Reg. §1.199A-6(e)(1). The proposed regulations take the very taxpayer friendly position that “[f]or purposes of determining QBI, W-2 wages, and UBI of qualified property, if an individual receives any of these items” from a fiscal year entity with a fiscal year ending after 2017, “such items are treated as having been incurred during the individual’s taxable year in which or with which such RPE taxable year ends.” Prop. Reg. §1.199A-6(e)(2)(ii).

The phrase “receives any of these items” is ambiguous, but presumably that refers to income and expenses reported to the owner on the Schedule K-1 from the entity for the fiscal year ending after 2017. This means that income actually earned by an entity in 2017 but during the fiscal year ending in 2018 will qualify as QBI in 2018 for which the owner may receive a 20% deduction. This good news will lead to some practical problems in implementation, particularly for fiscal years ending in 2018.

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This means that an individual could receive a 2017 Schedule K-1 from a passthrough entity whose fiscal year ends on January 31, 2018 and the individual can include the entire 12 months income from the passthrough entity as QBI on his or her 2018 Form 1040, despite that 11 months of the income was earned before January 1, 2018.

The IRS's decision was probably based on a desire for simplicity and administrability. However, the proposed regulations failed to address how the individual would determine its share of QBI, W-2 wages, or UBI of qualified property from the passthrough entity's Schedule K-1 when the entity is not required to report those items to its partners and shareholders until years beginning on or after the date the final regulations are published in the Federal Register. Until further guidance is issued, partners and shareholders of fiscal year passthrough entities may just have to use any reasonable method to determine their share of these QBI items." Carol Cantrell, *Mastering the New Qualified Business Income (QBI) Rules and Avoiding Penalties*, TEXAS Soc'Y OF CPAs 2018 Adv. Est. PL CONF. at 21-22 (August 2018).

**(13) Reporting Requirements for Passthrough Entities.** Partnerships and S corporations involved in any trade or business will have to make additional computations and provide additional information to their owners. The §199A deduction is not available to the RPE, but applies to the owners of the RPE on their individual returns. "The RPE must determine and report the information necessary for its direct and indirect owners to determine their own section 199A deduction." Preamble, at 74. The RPE must make various computations. It must (i) determine if it is engaged in one or more trades or businesses and whether any of those are SSTBs, (ii) determine the QBI of each business engaged in directly, (iii) determine the W-2 wages and UBI of qualified property for each business engaged in directly, and (iv) determine whether it has any REIT dividends or PTP income directly or through another RPE or PTP. Prop. Reg. §1.199A-6(b)(2).

After making those determinations, the RPE must report on the Schedule K-1 issued to its owners the QBI, W-2 wages, and UBI of qualified property attributable to each separate trade or business and whether any of the businesses are SSTBs. The RPE must report on a statement attached to Schedule K-1 those items reported to it by another RPE in which the RPE owns an interest. Prop. Reg. §1.199A-6(b)(3).

If the RPE fails to "identify or report" that information on the Schedule K-1, the owner's share of any QBI, W-2 wages and UBI of qualified property will be presumed to be zero. Prop. Reg. §1.199A-6(b)(3)(iii).

Accordingly, each partnership or S corporation engaged in a trade or business has a serious responsibility to determine and report information to owners so that they have the information to claim the §199A deduction with respect to the entity's trade or business activities.

**(14) Impact of §199A on Tax Calculation and Other Taxes.**

**(a) No Reduction of AGI; Deduction Available to Non-Itemizers.** The deduction reduces taxable income, but not AGI (so the deduction does not affect limitations throughout the Code based on AGI). The deduction is available to both itemizers and non-itemizers. (In other words, the deduction is available in addition to the standard deduction.)

On the draft Form 1040 for 2018, the qualified business income deduction appears at the bottom of page 1 of Form 1040 after the lines for adjusted gross

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income and the standard deduction. It is neither an “above the line” deduction in arriving at adjusted gross income nor an itemized deduction.

(b) **Effect of Deduction for Partners or S Corporation Shareholders.** The §199A deduction is applied to the owner’s individual income tax, not at the partnership or corporation level. It has no effect on the adjusted basis of partner’s interest, the adjusted basis of an S corporation shareholder’s stock, or an S corporation’s accumulated adjustments account. Prop. Reg. §1.199A-1(e)(2).

(c) **Self-Employment Tax.** The §199A deduction does not reduce self-employment income under §1402. §199A(f)(3); Prop. Reg. §1.199A-1(e)(2).

(d) **Net Investment Income.** The §199A deduction does not reduce net investment income under §1411. §199A(f)(3); Prop. Reg. §1.199A-1(e)(2).

(e) **Alternative Minimum Tax.** The QBI deduction is the same for both regular tax and AMT purposes. Prop. Reg. §1.199A-1(e)(4).

(15) **Penalties.** The 2017 Tax Act amended §6662 to provide that the 20% penalty for substantial understatement of income tax will apply if the understatement exceeds the greater of \$5,000 or 5% (rather than 10%) of the tax required to be shown on the return if the individual claims a §199A deduction. §6662(d)(1)(C). Therefore, if an individual claims merely \$1 of deduction under §199A, the standard for applying the understatement penalty is 5% rather than 10%, regardless of whether the understatement is attributable to QBI. As always, the penalty does not apply if the taxpayer has “substantial authority,” Reg. §1.6662-4(d)(3)(i), or if the taxpayer has a “reasonable basis” for the position. §6662(d)(2)(B).

(16) **Resources Regarding §199A Proposed Regulations.** Some excellent resources regarding the new proposed regulations include the following. Carol Cantrell, *Mastering the New Qualified Business Income (QBI) Rules and Avoiding Penalties*, TEXAS SOC’Y OF CPAs 2018 ADV. EST. PL CONF. at 21-22 (August 2018); Gassman Shenkman, Kotron, Denicolo & Crotty, *Proposed Regulations for 199A – The Good, The Bad, the Taxpayer-Unfriendly*, LEIMBERG INFORMATION SERVICES INC. TAX PL. NEWSLETTER #152 (Aug. 13, 2018); Tony Nitti, *IRS Provides Guidance On 20% Pass-Through Deduction, But Questions Remain*, FORBES (August 9, 2018).

(17) **Increased Section 179 Expensing.** Under pre-Act law, taxpayers could generally deduct the cost of depreciable tangible personal property and certain real property purchased for use in a trade or business, but only up to \$500,000 (indexed) reduced by the cost of qualifying property placed in service during the year in excess of \$2 million (indexed). The balance of the cost is depreciated over an applicable period of years. The Act increases the allowed expensing levels to \$1 million, and the phase-out threshold amount is increased to \$2.5 million.

(18) **100% Expensing for Qualifying Business Assets.** Under pre-Act law, an additional first-year depreciation deduction is allowed equal to 50% of the adjusted basis of qualified property placed in service before 2020 (subject to various qualifications). The Act allows 100% expensing for qualified property (generally, depreciable assets other than buildings) that is acquired and placed in service after September 27, 2017 and before 2023 (before 2024 for “longer production period”

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property and certain aircraft), and extends the expensing to the acquisition of used as well as new property. A 20% per year phase-down of full expensing will apply for property placed in service after 2022 and before 2027.

(19) **Interest Deductions for Businesses.** Interest deductions for businesses with average annual gross receipts over \$25 million for the three prior years generally are limited under the Act to 30% of the corporation's adjusted taxable income computed before interest, taxes, depreciation, amortization or depletion deductions ("EBITDA") or any deduction under new §199A for qualified business income of a pass-through entity for taxable years beginning after 2017 and before 2022, and for later taxable years from a smaller amount (still without considering any deduction under §199A), earnings before interest and taxes (EBIT). Disallowed interest can be carried forward indefinitely. Various complicated detailed rules and exceptions apply in determining the interest deduction limitation, but the limitation will be significant.

(20) **Corporate Alternative Minimum Tax Repealed.** The corporate alternative minimum tax is repealed. A planning implication is that one of the possible disadvantages of having corporate owned life insurance to fund an entity-purchase buy sell agreement will be removed, which could impact the decision of whether to use an entity-purchase or cross-purchase arrangement for corporate buy-sell agreements.

(21) **Like-Kind Exchanges Limited to Real Property.** Like-kind exchanges are permitted for property held for use in a trade or business or for investment. Under pre-Act law, like-kind exchanges are permitted for real or personal property. Under the Act, like-kind treatment will be limited to real property.

(22) **Entertainment Expenses.** No deduction will be allowed for expenses of a trade or business related to entertainment, amusement, or recreation activities or for membership dues to any club organized for business, pleasure, recreation, or other social purposes. The 50% limitation on deductions continues to apply for meals associated with operating the trade or business. The Joint Explanatory Statement gives this example: "(e.g., meals consumed by employees on work travel)."

(23) **Net Operating Losses.** Net operating losses (NOLs) are deductible only up to 80% of taxable income (determined without regard to the deduction). Under pre-Act law, they were fully deductible. NOLs cannot be carried back to prior years, as was permitted under pre-Act law, but indefinite carryforwards will continue to be allowed.

(24) **Qualified Stock Options.** Employees who receive stock options or restricted stock for the performance of services may defer recognition of income for up to five years upon exercise of the options (or earlier when the qualified stock becomes transferable or readily tradable on an established securities market). The special deferral provision does not apply to a 1% owner of a corporation, a CEO or CFO, any of the four highest compensated officers for any of the 10 preceding years, and family members of a 1% owner, CEO, or CFO.

(25) **Carried Interest.** A 3-year holding period will apply in order for certain partnership interests received in connection with the performance of services to be taxed as long-term capital gain. The 3-year holding period requirement applies notwithstanding the rules of §83 or whether a §83(b) election was made.

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(26) **Deemed Partnership Termination.** A sale of 50% or more of the capital and profits of a partnership will no longer result in a technical termination of the partnership.

(27) **Repeal of §199 Deduction for Domestic Production Activities.** The deduction under §199 for domestic production activities (which included the domestic manufacture of tangible personal property or computer software and energy generations from renewable energy projects) is repealed. The repeal is effective for C corporations after 2018 and for other businesses after 2017.

g. **Tax-Exempt Organizations.**

(1) **UBTI Determined Separately For Each Activity.** New §512(a)(6) provides that the unrelated business taxable income (including for purposes of determining any NOL deduction) is determined separately for each trade or business activity. A loss from one activity cannot offset the income from another activity in determining the organization's UBTI, but a loss from an activity in one year can offset the income from the same activity in another year. (This provision has been troubling for some non-exempt organizations. See Item 4.a below.) Under a special transition rule, NOLs that arise in taxable years beginning before 2018 that are carried over to a later year are not subject to this new limitation. See Notice 2018-67 for a discussion of some of the issues that the IRS is grappling with about new §512(a)(6).

(2) **Excise Tax for Certain Private Colleges and Universities.** A 1.4% of net investment income excise tax applies to private colleges and universities that have more than 500 students, assets of at least \$500,000 per full-time student, and 50% of tuition paying students located in the United States. This provision will apply to only a very limited number of private colleges and universities.

h. **Trump Tax Cut 2.0 Package.** Republican leaders are considering a "second round of Trump tax cuts," sometimes referred to as "Trump Tax Cut 2.0." Central to the proposal would be removing the sunset of the individual tax cuts in the 2017 Act that would otherwise occur in 2026, including continuing the increased transfer tax exclusion amounts and the §199A deduction for qualified business income. The Congressional Budget Office released a long-term budget outlook on August 8, 2018 estimating that if the provisions set to expire in 2026 are continued, the federal debt would be 148% - 165% of the gross domestic product (under three assumed scenarios), compared with 118% in an earlier projection.

Three bills constitute the House Republicans' tax package, one of which would make permanent most of the individual tax cuts in the 2017 Tax Act, including the increase of the basic estate tax exclusion from \$5 million to \$10 million indexed, and eliminating § 2001(g)(2), which directed the Treasury to provide regulations addressing any difference in the basic exclusion amount at the time of death and at the time of any gifts made by the decedent. For links to the three bills, see Sullivan, *Panel Releases Text of Republicans' Tax Cut 2.0 Package*, BLOOMBERG DAILY TAX REPORT (Sept. 11, 2018). The Joint Committee on Taxation estimates that the bills would cost more than \$657 billion over a decade. See Versprille, *Hills Briefs: Ways*

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*and Means to Act on \$657 Billion Tax 2.0 Package*, BLOOMBERG DAILY TAX REPORT (Sept. 12, 2018). H.R. 6760, which extends most of the individual tax cuts permanently, is estimated to result in an increased deficit of \$630.9 billion over ten years, offset by \$86.0 billion resulting from a macroeconomic analysis of the effects of the Act, or a net additional deficit of \$545.1 billion (even after taking into account estimated economic growth resulting from the extension). Macroeconomic Analysis of H.R. 6760, The “Protecting Family and Small Business Tax Cuts Act of 2018” as Reported by the Committee on Ways and Means, Prepared by Staff of the Joint Committee on Taxation (September 26, 2018). Two of the bills were approved by the House on September 27, and H.R. 6760 was approved on September 28, 2018. The Senate did not act on the bills prior to the mid-term elections in November and is not expected to act on the bills in 2018.

The administration and Republican leadership in the House proposed a 10 percent tax cut for middle-class Americans before the mid-term elections, see Laura Davison, *Trump Says He’s Open to Raising Tax to Pay for Middle-Class Cut*, BLOOMBERG DAILY TAX REPORT (Nov. 7, 2018) (expressing willingness to include corporate rate increase to offset middle-class tax cut), but the administration has backed off that position and instead will focus on “fixing mistakes in the 2017 overhaul.” Laura Davison, *Mnuchin Backs Off Trump’s Promise of 10% Middle-Class Tax Cut*, Bloomberg BNA Law News (December 18, 2018).

### **3. Estate Planning Considerations In Light of New Legislation and Inherent Uncertainty Arising From 2026 Sunset**

- a. **Déjà Vu on Steroids.** Planning alternatives that were considered in 2013 following the passage of ATRA, when the gift tax exclusion amount increased from \$1 million to \$5 million have resurfaced in light of the doubling of the gift tax exclusion.  
Indeed many of the detailed planning issues summarized in the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners) are highly relevant for 2018.
- b. **Paradigm Shift.** The increased \$10 million (indexed) estate and gift tax basic exclusion amount for every individual means that estate and gift taxes are irrelevant for most clients. Concepts that have been central to the thought processes of estate planning professionals for their entire careers are no longer relevant for most clients – even for “moderately wealthy” clients (with assets of over several million dollars). For example, structuring trusts to qualify for the gift tax annual exclusion may be unnecessary for many clients who will *never* have any gift or estate tax concerns (though professional advisers must still advise them of the requirement to file gift tax returns reporting any taxable gifts that do not qualify for the annual exclusion). Structuring testamentary charitable trusts to qualify for the estate tax charitable deduction under §2055 will no longer be important for many clients. It is hard for “old dogs to learn new tricks,” and planners will constantly have to be sensitive to the major paradigm shift resulting from the Act.
- c. **Small Percentage of Population Subject to Transfer Taxes.** The Joint Committee staff estimate that only about 1,800 of 2018 decedents will have to pay estate tax

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(with an estate tax exclusion amount of about \$11.2 million), down from about 5,000 decedents in 2017 (when the estate tax exclusion amount was \$5.49 million). About 2.7 million people died in the U.S. in 2017; thus about 0.067% of decedents pay estate tax, or about 1 in 1,500 decedents. See Heather Long, *3,200 Wealthy Individuals Wouldn't Pay Estate Tax Next Year Under GOP Plan*, Washington Post (Nov. 5, 2017) (based on analysis of Joint Committee on Taxation). The \$10 million (indexed) gift tax exclusion amount also means that many individuals have no concern with lifetime gifts ever resulting in the payment of federal gift taxes. Wealthy clients still exist, though, and the wealthy are getting wealthier.

- d. **Non-Resident Alien Individuals.** The exclusion amount has NOT increased for non-resident alien individuals (NRAs). The exclusion amount remains at \$60,000 (see §2102(b) (unified credit of \$13,000, which is the amount of tax on a \$60,000 estate)). Do not be lulled into thinking that federal estate tax concerns have vanished for NRAs because of the large increase in the exclusion amount that applies to citizens or residents of the United States.
- e. **Cannot Ignore GST Tax.** Even low to moderate-wealth individuals cannot ignore the GST tax. Without proper allocation of the GST exemption (also \$10 million indexed), trusts created by clients generally will be subject to the GST tax at the death of the beneficiary unless the trust assets are included in the beneficiary's gross estate. Sometimes the allocation will occur by automatic allocation, but the planner must be sure that proper GST exemption allocation is made to long-term trusts (unless the trust assets will be included in the beneficiary's gross estate) even though the purpose of the trusts is not to save transfer taxes. The planner might specifically structure trusts that will not qualify for automatic allocation so that the assets will be included in a beneficiary's gross estate if the beneficiary dies before the termination of the trust, if the planner anticipates that the beneficiary will have sufficient estate tax exclusion amount to eliminate estate tax for the beneficiary even with the trust assets included in the estate (and the inclusion of those assets would also be helpful for basis adjustment purposes, as discussed in Item 3.i.(2) below).  
Grantors who have previously created irrevocable trusts that are not fully GST-exempt may want to allocate some of the increased GST exemption amount to the trust. Presumably this is permitted, but the increased estate and gift tax exclusion amount (which is also the GST exemption amount under §2631(c)) applies to "estates of decedents dying and gifts made after December 31, 2017," and the mere allocation of GST exemption to an existing trust is neither of those things.
- f. **Review Formula Clauses.** Review formula clauses in existing documents. For example, a classic bequest to a credit shelter trust of the maximum amount possible without incurring estate taxes may become a bequest of the entire estate if the decedent's estate is less than the \$10 million (indexed) basic exclusion amount. Confirm that is the client's intent. Having all of the estate pass to a credit shelter trust may also generate state estate taxes at the first spouse's death, as discussed in Item 3.g.(10) below. Planners may want to send letters to clients warning them that plans should be reviewed in light of the major impact that the substantial increase in the transfer tax exclusion amounts can have on estate plans.

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- g. **Testamentary Planning.** What testamentary planning approaches are preferred for couples with combined assets well under the approximately \$22 million estate tax exclusion amounts available to the spouses?

As an overview of general planning themes depending on the size of the estate of a married couple:

- (1) Couples with assets under \$5.5 million – address whether assets will be left outright to the surviving spouse or in trust, and cause estate inclusion at the surviving spouse's subsequent death to receive a basis adjustment;
- (2) Couples with assets over \$5.5 million but less than \$11 million – make use of the first decedent-spouse's exclusion amount with an outright gift with disclaimer planning or a QTIPable trust approach, creating flexibility through the manner in which the portability election is made (the portability election could create the possibility of using both spouses' exclusion amounts but allowing a basis adjustment of all of the estate assets at the second spouse's death); and
- (3) Couples with assets over \$11 million – same as category 2 but also consider gifts using some of the increased gift exclusion amount to save estate tax in case the exclusion amount is subsequently reduced back to \$5.5 million and consider making transfers in a way that one or both spouses have potential access to some of the transferred assets for clients making large transfers.

These themes are addressed in more detail below. The alternatives begin with the simplest approaches, from a client perspective, but *not necessarily the preferred approaches.*

(1) **Outright-to-Spouse.** For clients who want simplicity and do not want to take advantage of the opportunities available with trust planning, the first decedent-spouse's assets could be left outright to the surviving spouse at the first spouse's death. Before employing this "maximum simplicity" approach, the planner should make sure that the client is aware of important planning opportunities that will be lost by not using trust protections for the surviving spouse. (The outright-to-spouse plan can also be disadvantageous in states with state estate taxes with exemptions low enough that the state estate tax might apply at the second spouse's death.)

(2) **Make Clients Aware of Trust Advantages.** Planners should make sure that clients are aware of various advantages of trusts even if the client has no federal transfer tax concerns. Potential advantages that will be important to some clients are opportunities to provide for appropriate management of assets, to place appropriate limitations on how assets can be used for beneficiaries, to allow the settlor to lock-in who will receive trust assets at the termination of the trust, to protect trust assets from claims of the beneficiaries' creditors, and to protect trust assets from claims of divorcing spouses or ex-spouses of beneficiaries. In addition, trusts may result in significant state transfer tax or state income tax savings.

Trust structuring should incorporate planning for flexible provisions to react to future conditions. Powers of appointment are becoming increasingly popular for various reasons in facilitating future flexibility.

(3) **Outright Bequest with Disclaimer to Trust.** The first decedent-spouse's assets could be left outright to the surviving spouse with a disclaimer provision

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causing the disclaimed assets to pass into a trust with the spouse (and perhaps others) as discretionary beneficiaries.

Several significant disadvantages may result from relying on the disclaimer approach. The most important is that the spouse may refuse to disclaim assets (or may be incompetent or may die before disclaiming), even though a disclaimer would be appropriate based on the tax situation. Another significant disadvantage to the disclaimer approach is that the surviving spouse cannot retain a nontaxable 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, the risk exists that the surviving spouse inadvertently accepts benefits, making a disclaimer impossible. 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 will be treated as disallowed transfers for Medicaid qualification purposes.

In states with a state estate tax, the surviving spouse could disclaim an amount that would not be subject to state estate tax at the first decedent-spouse's death. This decision may be made in a more granular manner by disclaiming assets that either will be held for a very long time period after the surviving spouse's life expectancy, or that are not likely to have significant appreciation potential (again keeping in mind that the income tax cost of not getting a basis step-up at the second spouse's death may outweigh the potential state estate tax).

**(4) Direct Bequest to Discretionary Trust For Spouse (And Perhaps Others) for Combined Estate Under \$5 Million.** If the surviving spouse wants to take advantage of opportunities available with trusts, the first decedent-spouse's assets might be left directly to a trust permitting discretionary distributions to the surviving spouse (and perhaps other beneficiaries, as well). If the combined estate is under \$5 million, so that no estate tax will result at the second spouse's death even if the second spouse dies after the increased estate tax basic exclusion amount has sunset back to \$5 million (indexed), the trust could be designed to include any provisions desired by the clients, without the necessity of assuring that the trust qualifies for the estate tax marital deduction. A method for causing estate tax inclusion at the second spouse's death may be important to achieve a basis adjustment for the trust assets at the second spouse's death. (See Item 3.i.(2) below.)

**(5) Taking Advantage of First Decedent-Spouse's Exclusion Amount for Combined Estate Over \$5 Million.** For the couple with over \$5 million, being able to make use of the first decedent-spouse's estate exclusion may be important (if the second spouse dies after the time that the exclusion has declined back to \$5 million (indexed)). That can be accomplished either by leaving assets into a trust that can act as a traditional credit shelter trust or by making the portability election following the first spouse's death. If the portability approach is used, the assets should pass in a manner that qualifies for the marital deduction, or else little DSUE may be available for the surviving spouse even if the portability election is made.

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(6) **Increased Importance of Portability.** If the first spouse dies before 2026 while the estate tax basic exclusion amount is still \$10 million (indexed), making the portability election should leave the surviving spouse with a DSUE of that full amount even if the basic exclusion amount later decreases in 2026. See Reg. §20.2010-2(c) (describing computation of DSUE amount).

Unless strong reasons exist to use credit shelter trusts in \$10 million and under estates, relying on portability to take advantage of the first spouse's estate exclusion amount is increasingly helpful. The decision of whether to create a bypass trust following the first spouse's death can be delayed until after the first spouse has died using a disclaimer approach (Item 3.g.(2) above) or using a QTIPable trust (Item 3.g.(7) below), so that the tax law situation at that time can be considered (e.g., whether the exclusion amount has returned to or is still likely to return to \$5 million (indexed) in 2026, and whether basis adjustment at the second spouse's death is important to eliminate gains on assets that will be sold after the spouse's death).

A tax advantage of relying on portability rather than creating a bypass trust is that the surviving spouse has both spouses' exclusions to cover any estate taxes that might apply, 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 and the federal estate tax might apply to the surviving spouse's estate, (ii) a state estate tax, (iii) a younger client scenario (in which remarriage of the surviving spouse is likely), and (iv) 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 (although the surviving spouse may be able to receive trust distributions from a QTIP trust and make gifts to younger family members as desired in light of the increase gift tax exclusion amount). The credit shelter trust may also be advantageous for various reasons in blended family situations, as discussed in Item 8.d the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners). Inequities can arise with a QTIP trust in blended family situations. The first decedent-spouse's assets passing to the QTIP may end up "overpaying" estate tax (for example if the surviving spouse makes gifts utilizing the DSUE amount or even if the spouse makes no gifts but has his or her own assets that are large enough to cause the payment of estate taxes even if the QTIP trusts were not included in the estate) where the assets in a credit shelter trust would pass to the first decedent-spouse's family free of estate tax. Alternatively, reverse fact scenarios could arise in which the surviving spouse's family would be disadvantaged and pay more than their fair share of the estate tax due at the surviving spouse's death if the surviving spouse waives the reimbursement right (for example, if the QTIP trust is funded with assets larger than the first decedent-spouse's exclusion amount).

If the QTIP approach is used in connection with portability, in light of the wide ranging factors that must be considered and the inherent uncertainties involved with the portability decision, documents should provide broad exculpation to the fiduciary who must make the QTIP election.

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(7) **Flexible QTIP Trust Approach.** A favored approach of many planners for testamentary planning will be the use of QTIP trusts, and the approach can be used for any size of estate if the clients want to use trust planning after the first spouse's death. The significant tax advantage of using a QTIP trust and relying on portability to utilize the first decedent-spouse's exclusion amount is that the QTIP assets will receive a basis adjustment at the surviving spouse's subsequent death. QTIP planning could use a single QTIP plan, or multiple QTIP trusts (for example, if a state estate tax applies with an exemption different than the federal estate tax exclusion amount, as discussed in Item 3.g.(10) below). An advantage of the single QTIP drafting approach is that the client (hopefully) can understand it and realize that it leaves a great deal of flexibility after the first spouse has died.

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 §2652(a)(3)), and a bypass trust approach would be used if a partial QTIP election is made.

The trust could include a Clayton provision allowing more flexible terms if the QTIP election is not made, as discussed in the "Flexibilities" discussion below.

Alternatively, the unelected QTIP trust could remain as a single-beneficiary mandatory income trust for the spouse. The amount of income paid to the spouse could be managed by the asset selection for the trust.

**Estates under \$5 Million.** The approach could be used for combined estates under \$5 million as a way of creating a trust that would be entitled to a basis adjustment at the surviving spouse's subsequent death—but an estate tax return would have to be filed following the first spouse's death to make the QTIP election, as discussed immediately below.

For estates that are small enough that an estate tax return would not be required at the first spouse's death, a disadvantage of the QTIP trust approach is that an estate tax return would have to be filed at the first spouse's death to make the QTIP election. Perhaps the trust could build in the possibility of causing the surviving spouse to have a testamentary general power of appointment at the surviving spouse's subsequent death, or to give the spouse a testamentary nontaxable power of appointment that could be exercised in a manner to trigger the Delaware tax trap, so the option would exist to avoid filing an estate tax return following the first spouse's death to make the QTIP election. In that case, while a basis adjustment would not apply at the second spouse's death because the trust is a QTIP trust (see §1014(b)(10)), it would apply for other reasons.

**Estates over \$5 Million.** This approach could also be helpful for combined estates in the \$5-\$10 million range because qualifying for the marital deduction is important for those estates, in case the surviving spouse dies after the basic exclusion amount has reverted to \$5 million (indexed).

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

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- The executor has up to 15 months to decide whether to make the QTIP election and over what portion of the trust.
  - The QTIP election could be made by a formula, thus providing a “savings clause” to assure that no estate tax would be paid at the first spouse’s death (if his or her assets are over the new \$10 million basic exclusion amount – or \$5 million exclusion amount after the increased exclusion amount has sunset).
  - If the QTIP election is made, the executor could make the “reverse-QTIP” election and allocate the decedent’s GST exemption to the trust.
  - If the state recognizes a “state only QTIP election,” having assets in the QTIP trust may make the planning easier to fully utilize the first spouse’s exclusion amount without paying any state estate taxes at the first spouse’s death.
  - Any unelected portion could pass to a standard bypass trust under a “Clayton” provision. 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. Commentators generally believe 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 concerning whether a gift results and whether that causes §2036 inclusion issues for some portion of the credit shelter trust. But keep in mind the paradigm shift resulting from the huge \$10 million exclusion amount. Many clients will have absolutely no risk of owing gift tax and may be unconcerned about potential gift risks of having the surviving spouse serve as the executor with a Clayton provision. A disadvantage of including a Clayton provision is that leaving the unelected portion in a trust with “QTIPable terms” (including a mandatory income interest for spouse as the exclusive beneficiary) would facilitate getting a “previously taxed property credit” under §2013 if the surviving spouse were to die shortly after the first spouse to die if the estate is large enough to have estate tax concerns. But many clients like being able to make transfers to children and like the income-shifting effect of distributions to the children.
  - The surviving spouse can have a testamentary nontaxable power of appointment over the assets in the QTIP trust (or the Clayton bypass trust).

(8) **QTIPable Trust With Delayed Power of Withdrawal.** If the clients want to have the flexibilities afforded by using a QTIP trust (e.g., to have 15 months to decide what QTIP election to make, to make a formula QTIP election, etc.) but still want the spouse to have an unlimited withdrawal power, consider creating a standard QTIP trust but including 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.

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§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 estate tax filing date. Any limitations desired on the amount of the withdrawal right could be added (e.g., up to 20% each year). Professor Jeff 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.)

(9) **Creative Flexible Approaches Using Both Disclaimers and QTIP Trusts.** A possible approach involving a QTIP trust and disclaimers is as follows.

- The executor would have 15 months to decide whether to make the QTIP election over all or a portion of the QTIP trust. Any unelected portion could pass to a bypass trust under a "Clayton" provision. If the QTIP election were made, the portability election would be made for the decedent's unused exemption amount.
- If the spouse disclaims an interest in the QTIP trust, the disclaimed assets would pass outright to the surviving spouse. This "reverse-disclaimer" approach has the significant advantage of allowing the surviving spouse to have a testamentary limited power of appointment over both the QTIP trust and the bypass trust.
- This is a twist from the typical operation of a disclaimer, but the disclaimer rules do not seem to preclude this sort of approach in which the disclaimant receives a greater interest in the property than under the bequest that was disclaimed. Under §2518(b)(4)(A), the disclaimed assets can pass to the surviving spouse.
- Potential concerns are (1) that the disclaimer would not be "qualified" because the spouse would own the assets and direct who receives them, and (2) the spouse might be treated as making a gift if the spouse does not disclaim. These concerns and possible responses are discussed at Item 8.h of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).
- An alternate approach is to provide that disclaimed assets would pass to a credit shelter trust.

(10) **State Estate Tax Planning Issues.** For clients that may be subject to state estate taxes, various issues must be considered in addition to the planning considerations described above.

**State Exemption Amounts.** Seventeen states plus the District of Columbia have a state estate or inheritance tax. Various states are scheduled to adjust their state exemptions to the amount of the federal estate tax exclusion amount (Hawaii and Maine in 2018, and Connecticut in 2020). New York will move its exemption amount to \$5 million (indexed) in 2019 (to match what the federal basic exclusion amount would have been under pre-Act law). States may not have contemplated an \$11.2 million basic exclusion amount, however, in adopting those provisions, and some states may back off from increasing their state exemptions to the federal basic exclusion amount. See Ashlea Ebeling, *Where Not to Die in 2018*, Forbes (Dec. 21,

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2017). When the federal exclusion amount reverts back to \$5 million (indexed) after 2025, those state exemptions would adjust back to that amount as well.

**Formula State Exemption Bypass Trust, Balance Outright to Spouse.** Because disclaimers sometimes don't happen as a practical matter, the clients may want to mandate that the bypass trust will be funded with the state exemption amount at the first spouse's death.

**QTIP Trust Planning.** For clients subject to a state estate tax, flexible QTIP trust planning could result in (i) a "standard" QTIP trust for the excess over the federal basic exclusion amount, (ii) a QTIP trust effective only for state purposes (sometimes referred to as a "gap trust") for the amount in excess of the state exemption amount but less than the federal exclusion amount if the state allows a "state-only QTIP election," and (iii) a Clayton QTIP that has expanded into broader terms for up to the state exemption amount. This has the advantage of effectively having a federal bypass trust for an amount up to the full federal exclusion amount, but there is an obvious loss of distribution flexibility since all of the net income of a QTIP trust must be distributed annually to the surviving spouse, although the amount of net income that must be distributed could be managed, to a large degree, by the asset selection for the trust.

**Formula State Exemption Bypass Trust, Balance to QTIP Trust.** Some states (like New York and New Jersey) provide that the federal QTIP election (or nonelection) is binding for state estate tax purposes as well. Leaving the balance above the state exemption amount to a QTIP trust would have the advantage of using trust planning for non-tax purposes for all of the estate at the first spouse's death.

- h. **Emphasis on Flexibility.** In light of the remaining inherent uncertainty regarding whether the basic exclusion amount will be reduced back to \$5 million (indexed) after 2025, building in flexibility to trust arrangements will be important, particularly for estates in the \$5-\$22 million range. Provisions included in trusts to avoid estate taxes may be unnecessary (and not desirable) for settlors or beneficiaries who have no estate tax concerns. Some of the ways of adding considerable flexibility are:
  - using nontaxable powers of appointment;
  - providing broad distribution standards by independent trustees;
  - granting substitution powers to the settlor; and
  - providing special modification powers to trust protectors (see Item 3(h)(8)-(11) of the Current Developments and Hot Topics Summary (November 2017) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners) for a more detailed discussion of powers and limitations that can be added for trust protectors to provide flexibility).
- i. **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 exclusion will continue to be important to permit a basis adjustment at the beneficiary's death without generating any added estate tax. Indeed,

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incorporating planning for the flexibility to cause estate inclusion is more important than estate tax planning for most clients because most clients will not owe estate tax. The following summary lists a few ideas for basis adjustment planning. For a more detailed discussion of these and various other ideas, see Item 5 of this summary, below.

**(1) Basis Adjustment for Settlor.**

- A very flexible alternative to cause estate inclusion for the trust settlor would be to give an independent party the authority to grant a power to the settlor that would cause estate inclusion, such as a testamentary limited power of appointment, which would cause estate inclusion under §2038 and result in a basis adjustment under §1014(b)(9). (But the IRS might conceivably argue that the settlor is deemed to hold the power under a §2036 regulation even if the limited power is not actually granted to the settlor. See Item 5.e.1 below.)
- The settlor might purchase assets from a grantor trust or exercise a substitution power to reacquire low basis assets that would receive a basis adjustment at the settlor's death.

**(2) Basis Adjustment for Beneficiary.** Possible strategies to allow a basis adjustment at a trust beneficiary's death 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 nontaxable power of appointment, but beware that granting an inter vivos power of appointment exercisable during the settlor's lifetime might cause the trust to be a grantor trust, see §§ 674(a), 674(b)(3));
- to have someone grant a general power of appointment to the beneficiary that possibly could be exercisable only with the consent of some other non-adverse party (but not the grantor); however, the IRS might conceivably argue that it is a power exercisable "in conjunction with another person," making it a general power under §2041(b)(1)(C) even though never granted, see Item 5.f.(4) below;
- to use a formula general power of appointment (perhaps adding that a non-adverse party could modify the power of appointment to add flexibility, see Item 5.f.(5)(e) below);
- to the extent that general powers of appointment are used for basis adjustment purposes, bear in mind that the existence of the general power may have creditor effects, but the actual exercise of a testamentary general power of appointment may be more likely to subject the assets to the decedent-beneficiary's creditors than if the general power is not exercised; or
- to trigger the Delaware tax trap by the exercise of a nontaxable power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment.

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(3) **Upstream Gifts.** Many parents of clients (or other individuals) will have no federal estate tax concerns, even if the parents live past 2025 when the exclusion amount returns to \$5 million (indexed). Gifts may be made to individuals who have no estate tax concerns in hopes of getting a basis increase at the individual's death, and taking steps to avoid §1014(e) in case the donor should die within one year of the gift. A GRAT may be used to make upstream transfers without requiring a significant taxable gift by the client. For further discussion about upstream transfer planning, see Items 4.j.(10) and 5.h below.

- j. **Transfer and Freeze Planning.** Transfer and freeze planning can (i) assist in shifting wealth to save estate tax for clients with assets in excess of the basic exclusion amount, (ii) provide creditor protection planning, (iii) assist in moving assets downstream during life, which is becoming more important as people have longer life expectancies and inheritances are long-delayed, and (iv) provide income shifting by transferring wealth to family members who may be in lower income tax brackets. The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.

(1) **Window of Opportunity.** The gift tax exclusion amount will sunset back to about \$5.5 million in 2026 (unless changed by Congress prior to 2026). Gifts making use of the doubled gift tax exclusion amount are available for eight years through 2025.

Gifts utilizing the \$11 million exclusion amount can reduce federal estate tax if the donor dies after the basic exclusion amount has been reduced to \$5 million (indexed), assuming clawback does not apply. As an extremely unrealistic example to illustrate the point, a couple with \$20 million of assets may have about \$10 million of assets subject to estate taxes if they die after the exclusion amount has been reduced to \$5 million (ignoring indexing of the exclusion amounts), resulting in \$4 million of estate tax. The \$4 million of estate tax could be avoided entirely by making \$20 million of gifts utilizing each of the spouses' \$10 million (indexed) gift tax exclusion amounts. (Of course, in that circumstance, the grantor would want to take steps to be potential recipient of at least some portion of the transferred amounts, as explored in Item 3.j.(6)-(8) below.)

To take advantage of the window of opportunity, in case the exclusion amount is later decreased, the donor must make a gift in excess of the \$5 million indexed amount, at least under current law. For example, if a donor who has not previously made a taxable gift makes a gift of \$5 million, and if the donor dies after the exclusion amount has been reduced to \$5 million (indexed), the donor effectively will be treated as having used the \$5 million of the exclusion amount, and the donor will not have made any use of the extra \$5 million (indexed) of exclusion amount available in 2018-2025. Some planners thought that the Treasury might conceivably exercise its authority under new §2001(g)(2) to issue regulations as necessary or appropriate to address any difference in the basic exclusion amount at the time of a gift and at the time of death by issuing regulations providing that gifts come "off the top" of the \$10 million (indexed) exclusion amount, leaving the bottom \$5 million of exclusion after the exclusion has reverted to \$5 million (indexed). (By analogy, the portability regulations provide that a surviving spouse "shall be considered to apply [the] DSUE

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amount to the taxable gift before the surviving spouse's own basic exclusion amount." Reg. §25.2505-2(b).) But the anti-clawback regulation did not include any discussion of that matter. See Item 2(d)(3) above for further discussion of this issue.

Consider not making the split gift election, so that all gifts come from one spouse, utilizing that spouse's excess exclusion amount that is available until 2026. Another alternative is to defer making large gifts until we know whether the IRS will adopt the special ordering rule provision in regulations. The guidance under the §2001(g)(2) project is expected sometime in 2018.

(2) **Cushion Effect.** Perhaps the most important advantage of the increased gift tax exclusion amount for many individuals will be the "cushion" effect – the ability to make gifts in excess of \$5 million, but considerably less than \$11 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even for assets whose values are very uncertain). Clients who have been reluctant to implement transfer planning strategies in the past because of fear of the possible assessment of a current gift tax will be much more comfortable making transfers with the cushion effect of the \$11 million gift tax exclusion amount.

(3) **Significance of Defined Value Transfers.** Because of the substantial cushion effect of the very large gift tax exclusion amount, clients making transfers significantly less than the full exclusion amount will have much less incentive to add the complexity of defined value transfers to gift transactions. However, clients wanting to use most of the \$10 million (indexed) exclusion amount will likely plan to use a defined value transfer to minimize the risk of having to pay gift tax. For a discussion of defined value clauses, see Item 14 of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

(4) **Specific Gift Opportunities.**

- Gifts to dynasty trust to utilize \$10 million (indexed) GST exemption (or making a late allocation of GST exemption to previously created trusts if the donor does not want to make further gifts);
- Forgiveness of outstanding loans to children;
- Gifts to grantor trusts, and leveraging grantor trusts with loans or sales from the grantor;
- Equalizing gifts to children or grandchildren;
- Gifts to save state estate taxes (very few states treat gifts as reducing estate exemption amounts, even for gifts made within three years of death in gross estates);
- GRATs (GRATs will continue to be advantageous even with the \$10 million (indexed) gift tax exclusion amount);
- Life insurance transfers (including the ability to "roll out" of split dollar arrangements);
- Deemed §2519 transfers from QTIP trusts (for further discussion see Item 3.j.8 below, and for an outstanding detailed discussion of planning by a

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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)); and

- Nonqualified disclaimers (depending on state law treatment of disclaimers).

These specific gift strategies are discussed in more detail in Item 5.o-aa of the 2012 Heckerling Musings and Other Current Developments Summary found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

(5) **Trust Sales.** For mega-wealthy clients, trust sales can be magnified on (super steroids) using the increased gift tax exclusion amount. Using a rule of thumb of having 10% equity to support a sale to a trust, spouses could fund grantor trusts with \$22 million of assets and sell nine times that, or almost \$200 million of assets to the trusts in return for notes bearing interest at the AFR (although the IRS may question if that interest rate is sufficient).

For a pre-existing sale to grantor trust transactions, additional gifts could be made to the trust if needed to bolster the equity value of the trust (and to reduce the necessity of relying on guarantees) to support the bona fides of the sale transaction, and to reduce the risk of a §2036 attack against the grantor's retained interest via the note from the trust. In several recent cases, the IRS has taken the position that §2036 applies to sales to grantor trust transactions. For some previously completed sales transactions, gifts to trusts may be sufficient to repay the notes entirely (or the notes could be forgiven) to remove any §2036 risk, at least if the repayment/forgiveness occurs at least three years prior to the grantor's death. Avoiding the risk of a protracted audit and litigation over the §2036 issue could be a significant perceived advantage.

See Item 8.f and Item 11 of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners) for a more detailed discussion of sales to grantor trusts.

(6) **Transfers with Possible Continued Benefit for Grantor or Grantor's Spouse.** Couples with \$22 million of gift tax exclusion amount may significantly reduce their potential estate tax liability by making gifts to utilize the increased exclusion amount, particularly if either or both spouses die after 2025 when the estate exclusion amount is scheduled to decline to \$5 million (indexed). But the couples making such large transfers will likely want some kind of potential access to or potential cash flow from the transferred funds.

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

- Spousal limited access trust ("SLAT") and/or exercise by beneficiaries of nontaxable powers of appointment (discussed in more detail in Item 3.j.(7) below);
- "Non-reciprocal" trusts;
- Self-settled trusts established in asset protection jurisdictions (and the more conservative approach may be to allow a third party to appoint assets to the

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- settlor under a non-fiduciary power of appointment rather than including the settlor as a discretionary beneficiary under fiduciary standards);
- Transferring a residence to trust or co-tenancies between grantor/spouse of grantor and trust (for example, a home could be transferred to a trust in a state providing protection for domestic asset protection trusts, making it a grantor trust, and the grantor could, if desired, rent the home to transfer more value to the trust);
  - Preferred partnership freeze;
  - Payment of management fees to the grantor;
  - Inter vivos QTIPable trust; and
  - Retained income gift trust.

Possible alternatives that do not shift value to the transferor but at least provide possible cash flow or a way to access specific trust assets include:

- Borrowing of trust funds by grantor;
- Sale for a note or annuity rather than making a gift of the full amount to be transferred, resulting in continued cash flow to the transferor; and
- “Reverse grantor trust” transaction in which the donor purchases (including through the exercise of a substitution power) or borrows assets gifted to trust.

Each of these alternatives is discussed in more detail in Items 14-24 of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

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

Could the donee-spouse exercise a power of appointment to leave the assets into a trust with the original donor-spouse as a potential discretionary beneficiary if the donee-spouse predeceases without causing estate inclusion under §§2036 or 2038? The issue under §2036 is whether the IRS could establish the existence of an implied agreement that the donor would become a beneficiary if the donee-spouse predeceases. Under §2038, retention is not required at the time of the original transfer, and the donee-spouse must be careful not to give the donor-spouse anything that would rise to the level of a right to alter, amend, revoke, or terminate. For example, the donor-spouse could not have a testamentary power of appointment by reason of the exercise.

Another important issue if the original settlor should become a discretionary beneficiary if the spouse predeceases is whether the settlor’s creditors could reach

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the trust assets under applicable state law. Some possibility exists that the trust may be treated as a “self-settled trust” and subject to claims of the donor’s creditors under what has been called the “relation back doctrine.” The creditor issue could be avoided if DAPT laws apply to the trust or if state spendthrift trust law specifically protects against the settlor’s creditors in the “surviving settlor” scenario. A number of states have such statutes for QTIP trusts, and some states have extended that coverage to other trusts as well. *E.g.*, TEX. PROP. CODE §§112.035(d)(2) (settlor becomes beneficiary under exercise of power of appointment by a third party), 112.035(g)(1) (marital trust after death of settlor’s spouse), 112.035(g)(2) (any irrevocable trust after death of settlor’s spouse), 112.035(g)(3) (reciprocal trusts for spouses). Accordingly, even couples in non-DAPT states may nevertheless be able to transfer substantial assets (up to \$22 million using reciprocal/non-reciprocal trusts) to trusts that may benefit one of the spouses that may be protected from the creditor claims of both spouses.

If the state does not have a DAPT statute or a statute negating the “relation back” doctrine, consider not including the original donor as a discretionary beneficiary directly, but giving a trust protector the power to add (or delete) the original donor as a discretionary beneficiary.

In addition to avoiding estate inclusion, the trust also provides protection against creditors, elder financial abuse, and identity theft. Over time, the trust can accumulate to significant values (because it is a grantor trust, the client will pay income taxes on the trust income out of other assets) and can provide a source of funding for retirement years. (As with any inter-spousal transfers, clients should be aware of potential implications of the transfers on divorce.)

To maximize the creditor protection feature of SLATS (i) the trustee should have the ability to sprinkle distributions among various beneficiaries, (ii) at least one independent trustee should consent to distributions, (iii) any named trust protector should be someone other than the settlor, and (iv) the trustee should be authorized to permit beneficiaries to use assets (rather than having to make distributions for them to enjoy benefits of the trust).

If a non-grantor trust SLAT is desired for income tax savings features (obtaining multiple SALT deductions, §199A deductions, etc.), an ING-type arrangement would be needed. See Item 3.o below.

For a detailed discussion of SLATs and “non-reciprocal” SLATs, including a discussion of the §§2036 and 2038 issues and creditor issues, see Items 16-17 of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

(8) **Section 2519 Deemed Transfer.** A type of transfer that offers the ability to take advantage of the increased \$10 million (indexed) gift exclusion amount in the event that the exclusion amount later sunsets back to \$5 million (indexed) while still leaving cash flow for a surviving spouse who is the beneficiary of a QTIP trust is to make a §2519 transfer. The tax effects are summarized below.

- The surviving spouse could release a small portion of the income interest (say 1%).

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- The spouse would be making a gift of the value of the 1% income interest that is released.
  - The spouse would also be treated as making a gift of the entire *remainder* interest under §2519.
  - If §2702 applies (i.e., if the remainder beneficiary is a “member of the family” as described in §2704(c)(2), as referenced in §2702(e)), “100% of the QTIP Trust is treated as a deemed gift.” Richard Franklin & George Karibjanian, *Portability and Second Marriages – Worth a Second Look*, BNA ESTATES GIFTS & TRUSTS J. (Sept. 11, 2014). See Reg. §25.2519-1(g) Ex. 4 (addressing the application of §2702 in a §2519 disposition).
  - If the portability election has been made for the predeceased spouse, the surviving spouse will first apply the DSUE before utilizing his or her own gift exclusion amount. Reg. §25.2505-2(b). Therefore, in order for the surviving spouse to make use of his or her own gift exclusion amount (before the exclusion amount returns to \$5 million indexed after 2025), the deemed gift would need to equal the remaining unused DSUE as well as the spouse’s own gift exclusion amount.
  - Because the spouse retains 99% of the income, 99% of the QTIP assets would be included in the estate under §2036 (rather than having the QTIP assets included in the surviving spouse’s estate under §2044), which would mean that the 99% of the §2519 gift of the remainder interest that is included in the gross estate under §2036 would be excluded from the adjusted taxable gifts in the estate tax calculation. §2001(b)(last sentence); Reg. §20.2044-1(e), Ex.5.
  - Even though the deemed gift of the remainder interest is not added back into the tentative estate tax base as an “adjusted taxable gift” in the estate tax calculation, the amount of gift tax that would have been payable (using the date of death rates and the date of gift exclusion amount) “with respect to gifts made by the decedent after December 31, 1976” is still subtracted from the estate tax calculation. §2001(b)(2). (This result is confirmed by the preamble to the clawback proposed regulation, which states that the hypothetical gift tax payable is determined for “all post-1976 taxable gifts, whether or not included in the gross estate.”) The effect is that the date of gift value portion of the amount of the remainder interest that is included in the gross estate under §2036 is offset by the “gift tax payable” subtraction with respect to that amount, so only the net appreciation is effectively subjected to estate tax—thus making use of the gift exclusion amount that was available at the time of the gift.
  - 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 surviving spouse is willing to do in terms of making gifts.)

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If the QTIP trust is larger than the gift that the spouse wants to make, the QTIP trust can be divided into two separate QTIP trusts under state law, and the §2519 deemed transfer could be made from only one of the severed trusts. See PLR 20171006.

From a drafting perspective, consider revising the spendthrift clause for QTIP trusts to permit an assignment of a 1% income interest (or greater interest) to descendants of the settlor/testator (or other family members). However, the “release” of 1% of the income interest probably does not violate the typical spendthrift provision. See RESTATEMENT (THIRD) OF TRUSTS §58 cmt (2003) (“Even the release of an interest in a spendthrift trust … is permissible and serves to terminate the beneficiary’s interest even though the release is treated for other purposes as a transfer”); UNIFORM TRUST CODE §502 cmt (2010 amendments) (“Releases and exercises of powers of appointment are also not affected because they are not transfers of property”). See Richard Franklin & George Karibjanian, *Portability and Second Marriages – Worth a Second Look*, BNA ESTATES GIFTS & TRUSTS J. (Sept. 11, 2014).

(9) **Transfers to Non-grantor Trusts.** Some transfer planning may involve transfers to non-grantor trusts for income tax savings reasons. See Item 3.o below.

(10) **Upstream Gifts or Other Gifts to Moderate Wealth Individuals; §1014(e).**

Many parents of clients will have no federal estate tax concerns, even if the parents live past 2025 when the exclusion amount returns to \$5 million (indexed). While the gift tax exclusion amount is \$10 million (indexed), 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 under §1014(e) 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. For a detailed discussion of this planning alternative, see Item 7.c of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

If the client wants to use an upstream transfer but does not want to use the client’s gift tax exclusion amount in doing so, a GRAT could be used with the remainder interest passing to an upstream trust for the client’s parents. Alternatively, the client might make a “seed gift” to an upstream grantor trust and sell assets to the trust in return for a note. For a stronger argument that the full gross value of the assets, and not just the net value of the trust assets, would be included in the parent’s estate for a basis adjustment under §1014, consider having the parent guarantee the obligation. See Treas. Reg. §20.2053-7 (“But if the decedent’s estate is not so liable [for debt in respect of property in the gross estate], only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate.”) But see *Crane v. Commissioner*, 331 U.S. 1 (1947) (suggesting that basis increase is based on the fair market value of property regardless of associated debt). The basis consistency proposed regulations and the instructions to Form 8971 suggest that the gross value of property subject to non-recourse indebtedness qualifies for basis adjustment, not just the net value. Prop.

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Reg. §§1.1014-10(a)(2), 1.1014-10(e) Ex. 4. The September 2016 revised Instructions to Form 8971 clarify that values to be reported on Schedule A are the estate tax values, without reflecting any post-death adjustment in value, and are the full gross values of property, unreduced by “mortgages, non-recourse indebtedness, or other decreases in equity.” For a discussion of the alternative of leveraging the amount of assets that can achieve a basis step-up at the parent’s death by using a sale to an upstream trust, see Turney Berry, *Planning and Drafting for the Married Couple in an Era of Mobility, Portability and Liability*, 50<sup>TH</sup> ANN. HECKERLING INST. ON EST. PL. ch. 10, at 33-38 (2016).

Similarly, gifts may be made to other individuals who have no estate tax concerns in hopes of getting a basis increase at the individual’s death, and taking steps to avoid §1014(e) in case the donor should die within one year of the gift (for example, by having the assets pass into a discretionary trust for the original donor’s benefit rather than passing outright to the original donor, *cf.* PLR 90036036). For a detailed discussion of planning issues surrounding §1014(e), see Item 8.c of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

**(11) Be Very Careful Before Making Lifetime Gifts of Low Basis Assets.** The estate tax savings of gifts are offset by the loss of a basis step-up if the client dies no longer owning the donated property. 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 ( $\$1,469,135 \times 40\%$ ) – if the estate tax is not repealed – to start to offset the loss of basis step-up ( $\$2,469,135 \times 23.8\%$  for high bracket taxpayers). The required appreciation will be even more if state income taxes also apply on the capital gains.

**(12) Report Transactions on Gift Tax Returns With Adequate Disclosure.** Many planners encourage clients to file gift tax returns to report gift or non-gift transactions to start the statute of limitations. Otherwise, the possibility of owing gift tax on an old transaction is always present. The historic rate for auditing gift tax returns is about 1%, and this rate has not been rising in recent years (although more gift tax returns may be reviewed in the future as the number of taxable estates decreases).

In order to start the statute of limitations, the return must meet the adequate disclosure requirements of Reg. §301-6501(c)-1(f). See e.g., LAFA (Legal Advice Issued by Field Attorneys) 20172801F (requirements not satisfied but no details of what disclosure was lacking); Field Attorney Advice 20152201F (no adequate disclosure where (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”); PLR 201523003 (adequate disclosure can foreclose later attacks on issues other than valuation such as whether a split gift election was properly made). These rulings are

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reminders that the IRS looks for opportunities to take a second look at returns, often years later in an estate tax audit. Err on the side of very complete and thorough disclosure on the 709.

For a detailed discussion of the background and planning issues around the adequate disclosure rules see Item 20 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

(13) **Emphasis on Flexibility.** Flexibility will continue to be a focus point for planning.

- **Limited Powers of Appointment.** Liberal uses of limited powers of appointment provide flexibility. Turney Berry has stated “We sprinkle powers of appointment like pixie dust.”
- **Broad Discretion Over Distributions.** Allowing broad discretionary distributions of trust assets to a broad class of beneficiaries by an independent trustee adds flexibility. Even more flexible is a limited power of appointment that could be exercised in a non-fiduciary capacity.
- **Substitution Powers.** Use non-fiduciary substitution powers to cause grantor trust status (which also yields great flexibility for the donor to purchase favored or low-basis assets from the trust) and include provisions authorizing someone other than the donor to remove the substitution power. This will be balanced against a desire in some situations of using non-grantor trusts, to utilize the exemptions and thresholds available for purposes of the state and local taxes deduction (with its \$10,000 limit per taxpayer) and the §199A deduction (with its exceptions applicable for taxpayers with income below \$157,500 (\$315,000 for joint returns)(indexed).
- **Trust Protectors.** Consider giving an independent person (sometimes referred to as a “trust protector”) broad flexibility to modify the trust based on changes in tax laws or if the donor’s “net worth drops below a certain level that is unforeseen and independently significant.” Alan Gassman, Christopher Denicolo, Kenneth Crotty & Brandon Keton, *The Reversible Exempt Asset Protection (“REAP”) Trust for 2017 Planning*, LEIMBERG ESTATE PLANNING NEWSLETTER #2500 (January 11, 2017) (hereinafter “Gassman et al, “REAP Trust”).
- **Trust Protector Causing Inclusion in Grantor’s Estate.** The trust could also give a trust protector (with the limitations described above) the power to grant a power to the donor that would cause inclusion in the grantor’s gross estate (such as a limited power of appointment, which would cause estate inclusion under §2038 if the estate tax is not repealed). See Martin Shenkman & Jonathan Blattmachr, *Not So Hard to Figure: The Critical Importance of Current Continuous Estate Planning*, LEIMBERG ESTATE PLANNING NEWSLETTER #2491 (Dec. 19, 2016). Possible caveats, however, are discussed at Item 5.e.(1) below.

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- **Trust Protector Adding Donor as Beneficiary; DAPT States.** Considering giving a trust protector the ability to add the donor as a discretionary beneficiary if the trust is established under the laws of a domestic asset protection trust state “if described conditions are satisfied, such as the donor’s net worth dropping below a certain level, if the federal estate tax is repealed, or the protector determines that the estate tax is no longer a concern to the donor’s family.” *Id.* The grantor might include himself or herself as a discretionary beneficiary of the trust from the outset if the grantor resides in a self-settled trust (DAPT) state, though being a possible appointee under a non-fiduciary power of appointment may be a more conservative alternative. If the grantor lives in another state and attempts to apply the laws of a DAPT state, the laws of the domicile state may nevertheless apply under the “strong public policy” exception from being governed by the choice of law provision in the trust agreement. In addition, a debate is ongoing about comment 2 under §4 of the Uniform Voidable Transactions Act (formerly the Uniform Fraudulent Transfer Act), which may cause a transfer by a person from one state that has no legislation regarding self-settled trusts to a trust governed by the laws of a DAPT state as being voidable *per se*.
  - **Limitation on Trust Protector Powers.** The “REAP Trust” article suggests including various limitations on the trust protector and protector powers:
    - Use a committee of at least three trust protectors (trusted individual or financial institutions) with appropriate checks and balances in place between them;
    - Provide a mechanism for the succession and possible replacement of trust protectors;
    - The donor should not have the power to remove and replace any of the trust protectors or exercise any of their powers;
    - Trust protector powers should not be conditioned on approval of the donor or any individual related or subordinate to the donor;The trust protector powers should be exercisable only in their sole and absolute discretion. Gassman et al, “REAP Trust.”
- k. **Avoiding 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 may want 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). For various planning strategies, see Item 6.c of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).
- l. **Revised Charitable Planning Paradigms.** Because no necessity would exist for an estate tax charitable deduction if the estate tax will not apply because of the

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increased basic exclusion amount, a new paradigm would apply to charitable dispositions at death for decedents with assets under the increased basic exclusion amount who are likely to die before sunsetting occurs in 2026.

- In a family with unified goals about charitable transfers, consider making bequests to individual family members and allowing them to make lifetime gifts to the same desired charities, giving the individuals an income tax deduction. Alternatively, the desired amount of charitable bequest could be funded out of mandatory annual distributions from a trust over various years, structured so that the §642(c) charitable deduction would offset taxable income of the trust.
  - Charitable bequests to trusts would no longer have to be in the form of a qualified interest. Assets could be left to a trust providing that all income would be paid to charity, which would allow the trust to receive a §642(c) income tax deduction, thus, reducing the trust's DNI to zero, meaning that trust distributions to others would not carry out income to them.
- m. **State Tax Planning; Domicile.** State estate and income tax planning will continue to be important. Domicile planning (to eliminate or reduce contacts with high-tax states) can be significant to minimize state taxes and may be especially important in light of the Act's limiting the SALT deduction to only \$10,000 per year.
- n. **Selection of Entity and Business Restructuring.** The Act raises new factors in the selection of entity decision for businesses and may lead to business restructuring efforts to make maximum use of the new §199A deduction for qualified business income. These issues include whether the entity should be structured as a C corporation (to take advantage of the lower tax rate on current income, but realizing that a subsequent dividend tax applies as dividends are withdrawn by shareholders), and whether a business in a "specified service" industry taxed as a pass-through entity should be divided so that a separate firm, having less than 50% common ownership, would provide ancillary administrative support (such as secretarial services, accounting, document management, information technology support, etc.) that would charge the "specified service" company for its support services. See Item 2.f.(10)(d) for a discussion of the provisions in the §199A proposed regulations that strive to minimize "cracking and packing" strategies for specified service companies

A common issue for real estate owners as well as other owners of multiple investment vehicles is that owners often have the various investments in separate entities owned by a holding company, and the holding company or a separate management company provides operational services for the various entities. Each separate business is considered separately for purposes of the §199A deduction, but each separate business does not have wages (because all of the services are provided by the holding company or management company). The §199A proposed regulations include a taxpayer-friendly provision recognizing that wages paid by a management company in this context could be allocated among the underlying businesses. See Item 2.f.(7)(b) for a discussion of Prop. Reg. §1.199A-2(b)(2)(ii). Alternatively, a management agreement with each separate entity could be structured so that each entity directly bears a portion of the wages paid to

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employees. *Cf. Lender Management LLC et al. v. Commissioner*, T.C. Memo. 2017-246 (LLC providing investment management and financial planning services to various other family entities in return for profits interest entitled to §162 deductions for expenses as a trade or business).

- o. **Non-Grantor Trusts for Income Tax Savings; Multiple Trusts.** The increased gift tax exclusion amount may afford the practical ability for some clients to fund non-grantor trusts for income shifting purposes and for other income tax reasons. See Blattmachr, Shenkman & Gans, *Use Trusts to Bypass Limit on State and Local Tax Deduction*, EST. PL. (April 2018). The non-grantor trusts may be helpful for various purposes, including (i) to take advantage of the separate \$10,000 SALT deduction limit that would be available to each trust, (ii) to have separate taxpayers with qualified business income that are below the \$157,500 taxable income threshold to qualify for the exceptions to the wage limitation and specified service company rules for the §199A deduction, (iii) to make deductible charitable contributions (if the client could not otherwise use charitable deductions because of the standard deduction), (iv) to take advantage of the qualified small business stock 100% gain exclusion for up to \$10 million of gains (see Item 19.b below), and (v) for state income tax savings purposes.

The separate trusts should have different primary beneficiaries because the trusts would be subject to the anti-abuse provisions for multiple trusts under §643(f) for trusts having substantially the same grantors and primary beneficiaries if the principal purpose of the trusts is to avoid income tax. Proposed regulations issued on August 8, 2018 address the multiple trust rule, but those regulations are not effective until they are issued as final regulations. Prop. Reg. §1.643(f)-1. One of the examples in the proposed regulations suggests that trusts that are for the current primary benefit of different beneficiaries may nevertheless be treated as having the same “primary beneficiaries” for purposes of the multiple trust rule of §643(f) (which would result in the separate trusts being “aggregated and treated as a single trust for Federal income tax purposes.”) Prop. Reg. §1.643(f)-1(c)Ex.2). See Item 2.f.(11)(g) above for a discussion of the §643 proposed regulation.

To the extent that the grantor wished to be a discretionary beneficiary of the trust, the general structure of an ING-type trust could be used (except it would be a completed gift trust), or a SLAT could be structured with ING-type provisions. *E.g.*, IRS Letter Rulings 201832005-201832009, 201744006-008 (examples of the many rulings that have addressed “DING” trusts).

The separate non-grantor trusts may result in substantial income tax savings in some situations. See Item 2.f.(11)(f) above for a discussion of the amount of income tax savings that could result from using non-grantor trusts to facilitate obtaining a 20% deduction for qualified business income under §199A. The tax savings from estate planning structuring often occurs years in the future; this is a way that planners could structure trusts in some situations that would result in immediate tax savings to offset the legal expense of the estate planning services.

A disadvantage of placing property non-grantor trusts is that no basis adjustment will occur at the client’s death (unless steps are taken to leave the flexibility of causing

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the trust assets to be included in the client's estate for estate tax purposes in order to achieve a basis adjustment under §1014).

- p. **Undoing Prior Planning.** If the estate tax had been repealed, some clients may have wanted to undo prior planning that was implemented to avoid the estate tax. That will be less significant in light of the fact that the doubling of the basic exclusion amount only lasts eight years. See Item 6.I of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and Item 6 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners) for a discussion of possible issues about undoing prior planning.)
- q. **Partnerships with Preferred Partnership Interests.** A donor may create a partnership and retain the right to a preferred return (in a manner that complies with §2701) and give to an irrevocable trust the common interest that has the right to excess return and appreciation. The preferred return may end up being much of the income produced by the partnership; in effect the donor is making a gift of future appreciation (to the extent the partnership grows above the preferred return) but *gets to keep much (if not all) of the income* produced by the partnership. Only the preferred interest is included in the estate (plus cumulative payments on the preferred interest that have not been consumed). *See Estate of Boykin v. Commissioner*, 53 T.C. Memo 297 (1987) (decedent gave voting common stock and retained nonvoting preferred stock; IRS argued that the gifted voting stock was included in the gross estate under §2036(a)(1) because the decedent retained "nearly all the income from the transferred property"; court disagreed because the "only rights decedent retained were those accorded to the ... nonvoting shares he retained, which were separate and distinct rights from the rights enjoyed by the voting shares that he transferred"). *See also Hutchens Non-Marital Trust v. Commissioner*, 66 T.C. Memo 1993-600 (1993) (interest that the decedent held in his family-owned corporation prior to recapitalization was not includable in his gross estate under §2036 because the decedent received adequate consideration for the pre-recapitalization stock, the decedent retained no interest in stock surrendered in the recapitalization, and the decedent's post-recapitalization control and dividend rights came from new and different forms of preferred stock that he received in the recapitalization). Alternatively, a noncumulative preferred interest (that does not comply with §2701) could be retained and the common stock could be given. The preferred stock would have a zero value, and the client would need enough gift exemption to cover the common stock. If the estate tax is not repealed at the client's death, the full value of the preferred stock (presumably its liquidation value at par) would be included in the gross estate (resulting in a basis step), but in calculating the estate tax, the use of the unified credit caused by valuing the preferred at zero would be restored under Reg. §25.2701-5(a)(3). The noncumulative retained preferred interest permits some flexibility in the cash flow that will actually be paid to the client (although substantial compliance with the partnership agreement is preferable to avoid potential gift or §2036 consequences.) *See Michael N. Gooen & Tracy A. Snow, Tasty Freeze: Preferred Partnership Tax Recipe*, 42 ESTATE PLANNING 5 (May 2015) and Christopher Pegg and Nicole Seymour, *Rethinking I.R.C. § 2701 in the Era of Large Gift Tax*

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*Exemptions*, 87 FL. BAR J. 9 (Nov. 2013). See Item 10.c of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners) for an example by Ellen Harrison of this planning alternative.

Using preferred partnerships is a sophisticated strategy requiring customized provision in the partnership agreement and requiring a special appraisal of the preferred and common. [Lou Harrison (Chicago, Illinois): "These are good, but I will use GRATs 99% of the time."]

- r. **Testamentary Discount Planning Not As Important.** Even though the estate tax was not repealed, planning to produce valuation discounts at an individual's death has diminishing savings. The estate tax may be lower, but the basis will also be lower, resulting in higher income taxes at some point when the beneficiary ultimately sells the assets (or sooner if the assets can be depreciated). With a 40% estate tax and a 23.8% income tax on capital gains (or higher if the state has a state income tax), the savings may be fairly low. For estates that have assets below the estate tax exclusion amount, discount planning can actually be disadvantageous in reducing the amount of basis adjustment under §1014. See Item 5.d below for a discussion of ways to avoid discounts.
- s. **Many Planning Issues beyond Federal Estate Tax Planning.** Remember all the many things that estate planners do beyond planning for the federal estate tax. Following the passage of ATRA, Lou Mezzullo, then President of the American College of Trust and Estate Counsel, sent a letter to ACTEC Fellows reminding them of the many services that professionals provide to clients other than federal transfer tax planning. He provides the following list, not meant to be exhaustive, of some of those items (quoted with his permission).
  - 1. Planning for the disposition of the client's assets at his or her death.
  - 2. Asset protection planning.
  - 3. Planning for disability and incompetency.
  - 4. Business succession planning (without the estate tax to blame for failure of a business).
  - 5. Planning for marital and other dissolutions.
  - 6. Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, would not be affected at all).
  - 7. Life insurance planning (other than to provide funds to pay taxes).
  - 8. Fiduciary litigation (enhanced because more to fight over).
  - 9. Retirement planning.
  - 10. Planning to pay state death taxes (in many states).
  - 11. Planning to avoid or minimize gift taxes (and client desires to gift more than the \$5 million (indexed) basic exclusion amount for gift tax purposes).

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12. Using business entities to accomplish nontax objectives.
  13. Planning for children with disabilities.
  14. Planning for spendthrift children.
  15. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax).
  16. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.
  17. Planning for nonresident aliens with assets in the U.S. or who plan to move to the U.S.
  18. Planning for citizens who intend to change their citizenship.
  19. Planning for possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates.
  20. Planning to pay education expenses, including contributing to I.R.C. §529 plans.
  21. Planning to deal with non-tax regulatory issues, such as the Patriot Act, HIPAA, and charitable governance reform.
  22. Identifying guardians for minor children, if and when needed.

All of these issues (and various other non-tax issues) would still be important for clients.

- t. **Keep Perspective.** Michael Graham (Dallas, Texas) reminds planners of the importance of estate planning beyond saving estate taxes, pointing out that planners assist broadly in the “transporting” of capital from one generation to the next.

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#### **Michael observes:**

I continue to maintain that not a single less person will die needing at least a Will, not a single less person will have, or be married to, children from a prior marriage. There will continue to be children of great promise and children faced with great challenges. The fact that my lovely wife June would not need to worry about the marital deduction any more doesn't mean she would give everything outright to me at her death. She knows me too well after 47 years of marriage.

Even now, the truth is that for most of our planning, divorce is more likely than death. I did an Ethics presentation for the annual NAEPA meeting this year on representing H and W. The statistics are that 70% of second marriages in which there are children from a prior marriage will end in divorce within 5.5 years. Think about that. Even now, we are drafting in anticipation of divorce, not death.

We are not the railroad unless we treat ourselves as such. We are transportation. We assist in transporting capital from one generation to the next.

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#### **4. Treasury-IRS Priority Guidance Plan and Miscellaneous Guidance From IRS**

- a. **Overview of IRS Priority Guidance Plan.** Four new items were added on the Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015.
  - “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 4.b, 4.c, 4.d, and 4.e of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

The **2016-2017 Priority Guidance Plan** was published August 15, 2016 included two new items dealing with (1) spousal support trusts under §682 (whether references to income are to taxable income or fiduciary accounting income), and (2) irregularities in the administration of split interest trusts.

The 2016-2017 Plan deleted two GST items that had been on the plan for a number of years (including the allocation of GST exemption at the end of an ETIP, and extensions of time to make GST exemption allocations).

A focus of the Trump administration is cutting down on the burden of regulations and reducing complexity and taxpayer burden. The Trump administration placed a temporary freeze on regulations projects in an executive order signed January 20 (which is typical for a new administration). The Administration on January 30, 2017 also signed Executive Order 13771 establishing a “one-in, two-out” system for regulations, requiring that for each new regulation, agencies must find at least two to repeal in order to reduce the net regulatory costs. The Treasury is still working with the Office of Management and Budget (OMB) to address how that order applies to transfer tax regulations. Treasury Deputy Tax Legislative Counsel Krishna Vallebhaneni has “demurred” in responding to whether EO 13771 applies to regulations implementing tax reform or subregulatory guidance such as notices and revenue procedures. *See Alison Bennett, Tax Law Interest Limitation Notice Due Soon: Treasury Official*, BLOOMBERG DAILY TAX REPORT (Feb. 21, 2018). (A lawsuit challenging that Executive Order was dismissed for lack of jurisdiction. Public Citizen, Inc. et al v. Donald J. Trump, President of the United States et al (DC Dist. Col. Feb. 26, 2018).)

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Executive Order 13789, issued on April 21, 2017, directed Treasury to review all “significant tax regulations” issued on or after January 1, 2016, and Notice 2017-38 identified eight proposed, temporary and final regulations that may impose an undue financial burden on taxpayers or add undue complexity to the tax laws; the §2704 proposed regulations were included in that list of eight. The IRS published its Second Report on October 2, 2017 that, among other things, recommended withdrawing the §2704 proposed regulations (with rather startling harsh language including a reference to the proposed regulations as applying “fanciful assumptions”). The §2704 proposed regulations were formally withdrawn on October 17, 2017. REG-163113-02, FR Doc. 2017-22776, filed 10/17/2017 for publication 10/20/17.

The Treasury issued its **2017-2018 Priority Guidance Plan** on October 20, 2017, in a somewhat different format than prior years to conform to the directions of Executive Order 13789. It lists only projects that the Treasury hopes to complete prior to June 30, 2018.

- Part 1 addresses the eight regulations identified in the Notice 2017-18, and among other things includes the withdrawal of the §2704 proposed regulations (and those proposed regulations have now been formally withdrawn).
- Part 2 describes certain projects “identified as burden reducing” and includes the basis consistency regulations, final regulations under §2642(g) regarding extensions of time to make GST exemption allocations, and guidance under §301.9100 regarding relief for late regulatory elections.
- Part 3 deals with partnership audit regulations.
- Part 4 is similar to prior years’ plans. The “Gifts and Estates and Trusts” section includes only three items:
  1. Guidance on basis of grantor trust assets at death under §1014.
  2. Final regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011.
  3. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.”

Dana Trier, previously the Treasury deputy assistant secretary for tax policy, has added that the Treasury department “is also looking at some 200 rules identified as outdated....The true number was closer to 300, but 200 was chosen as a more conservative number in an October 2 department report, he said.” John Herzfeld, *Treasury Officials a ‘Bridge’ in Tax Reform*, BLOOMBERG DAILY TAX REPORT (October 24, 2017).

As a practical matter, though, the IRS’s resources for regulatory projects will be focused for the next year (or more) on essential regulations implementing a variety of provisions in the 2017 Tax Act (including, among many others, the §199A deduction for qualified business income from passthrough entities).

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On February 7, 2018, the IRS issued a second-quarter update to the 2017-2018 Priority Guidance Plan that adds a new Part 1 titled “Initial Implementation of Tax Cuts and Jobs Act (TCJA)” and renames each of the remaining Parts of the Plan that was published on October 20, 2017. (Did the IRS not notice that the “TCJA” name was removed from the 2017 tax legislation?) Part 1 lists 18 projects that are “*near term priorities* as a result of the Tax Cuts and Jobs Act legislation;” several of particular interest are:

7. Computational, definitional, and anti-avoidance guidance under new §199A.
10. Guidance on computation of unrelated business taxable income for separate trades or businesses under new §512(a)(6).
16. Guidance on computation of estate and gift taxes to reflect changes in the basic exclusion amount.

Item 16 addresses the clawback issue summarized in Item 2.d.(2) above, and is rather surprising as being a “near term priority.” In any event, the anti-clawback proposed regulation was released on November 20, 2018.

The 2017-2018 Priority Guidance Plan was last updated in the fourth quarter update issued August 17, 2018. That update did not make significant changes to the projects that impact estate planners other than to make references to relevant Notices that have been issued.

Item 10 is a topic that has been very concerning to exempt organizations. Under the 2017 Tax Act, UBTI must be determined for each trade or business activity. (See Item 2.f.(1) above.) An organization may invest in a variety of fund of funds and each of them may have hundreds of portfolio companies. Does the organization somehow have to trace down to each the activity of each separate company? Or for a debt-financed portfolio, is each separate security in the portfolio treated as a separate activity? See Robert Lee, *New Business Income Guidelines Baffle Tax-Exempt Groups*, BLOOMBERG DAILY TAX REPORT (Feb. 7, 2018).

New §512(a)(6) provides that the unrelated business taxable income (including for purposes of determining any NOL deduction) is determined separately for each trade or business activity. A loss from one activity cannot offset the income from another activity in determining the organization’s UBTI, but a loss from an activity in one year can offset the income from the same activity in another year. Under a special transition rule, NOLs that arise in taxable years beginning before 2018 that are carried over to a later year are not subject to this new limitation. See Notice 2018-67 for a discussion of some of the issues that the IRS is grappling with about new §512(a)(6).

A document entitled Fall 2018 Unified Agenda of Federal Regulatory and Deregulatory Actions was released on October 17, 2018. See Ron Aucutt, *The 2018-2019 Tax Regulatory Agenda*, ACTEC CAPITAL LETTER No. 44 (Oct. 22, 2018). The Unified Agenda has been used in prior years, but has not been given significant attention as to the status of pending tax guidance projects.

The Treasury-IRS **Priority Guidance Plan for 2018-2019** was published November 8, 2018.

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- Part 1 of the Plan addresses implementation of the 2017 Tax Act and increases the list of projects that were mentioned in the February 7, 2018 update (summarized above) from 25 to 62.
    - One of the new items is the deductibility of expenses described in §67(b) and (e) of estate and non-grantor trusts, which makes reference to Notice 2018-61 (discussed in Item 2.e.(2)(e) above).
    - The item about §199A has been expanded to four separate items, two of which deal with “cooperatives and their patrons.”
    - The item dealing with clawback was reworded as follows: “Regulations under §2010 addressing the computation of the estate tax in the event of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor’s date of death.” The anti-clawback regulation was released on November 20, 2018.
  - Part 3 of the Plan, titled “Near-Term Burden Reduction in the 2018-2018 Plan and simply as “Burden Reduction” in the 2018-2019 Plan reduces the number of projects in light of some projects that have been completed, and adds no new projects. This “burden reduction” section continues to list final regulations regarding the basis consistency and discretionary extensions of time to make GST exemption allocations (suggesting a likely relaxation of some of the controversial provisions in the proposed regulations for those matters).
  - Part 5 contains the traditional general projects in a variety of subject areas. Four items are in the “Gifts and Estates and Trusts” section. The first three are the same as in the 2017-2018 Plan, which include projects dealing with (1) the basis of grantor trust assets at death under §1014, (2) alternate valuation date matters under §2032(a), and (3) the deductibility of certain administration estate administration expenses under §2053. The fourth new project is: “Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests.” The project is likely to update the §7520 actuarial tables based on updated mortality information, which must be done every ten years and which was last done effective May 1, 2009.

For a general discussion of and commentary about the 2018-2019 Priority Guidance Plan, see Ronald Aucutt, *The 2018-2019 Priority Guidance Plan*, ACTEC CAPITAL LETTER NO. 45 (Nov. 13, 2018).

- b. **Basis Consistency.** The inclusion of finalization of the basis consistency proposed regulations in Part 2 of the Priority Guidance Plan among the projects “identified as burden reducing” has led some to believe that the IRS may be considering relaxing some of the requirements in the basis consistency proposed regulations. Karlene Lesho, senior technician reviewer in Branch 4 of the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) has stated that the IRS is particularly re-examining the controversial “zero basis rule,” observing that comments to the proposed regulations called the rule unnecessarily burdensome and that it could impose penalties on unknowing beneficiaries. In addition, the IRS is also taking a

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fresh look at the 30-day rule for reporting property to the IRS as well as the “subsequent transfer rule,” which requires reporting to the IRS and recipient for subsequent transfers. See Allyson Versprille, *IRS Lifts Moratorium on Generation-Skipping Trust Changes*, BLOOMBERG DAILY TAX REPORT (March 12, 2018).

- c. **Guidance on the Basis of Grantor Trust Assets at Death Under §1014.** This issue first appeared on the No Ruling list in the 2015 Rev. Proc. (June 29, 2015): “whether the assets in a grantor trust receive a section 2014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includable in the gross estate....” This No Ruling position continued in the 2016 and 2017 No Ruling Revenue Procedures. *E.g.*, Rev. Proc. 2018-3, §5.01(8).

PLR 201544002 (issued one day after the 2015 Rev. Proc. announcing this project) held that assets in a revocable trust created by FOREIGN grantors for their US citizen children would receive a stepped basis under §1014(b)(2). This item first appeared on the Priority Guidance Plan ONE MONTH later with the 2015-2016 Plan (issued July 31, 2015). Planners assumed this item on the Priority Guidance Plan would deal with that narrow foreign trust matter.

Based on comments by IRS representatives at the AICPA National Tax Conference in November, 2017, indications are that the intent is to address broadly when grantor trust assets get a step up in basis. Examples of issues that the project might address reportedly include: assets subject to the grantor’s power of substitution, the treatment of notes given to the grantor in a sale to a grantor trust, self-cancelling installment notes, and elective community property (Alaska, South Dakota, Tennessee) for residents of other states.

Some planners maintain that assets in a grantor trust should receive a basis step-up at the grantor’s death because until that time the assets were deemed owned by the grantor for income tax purposes (See Rev. Rul. 85-13), and after the grantor’s death they are “acquired from a decedent” by someone else. See e.g., Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death*, 97 J. TAX’N 149 (Sept. 2002). Section 1014(b)(9) is the “included in the decedent’s gross estate” subsection of §1014(b), 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.) Another commentator suggests that the IRS might use §1015(b) as a rationale for the position that the basis of assets in a grantor trust are not adjusted to fair market value at the grantor’s death. Austin Bramwell & Stephanie Vera, *Basis of Grantor Trust Assets at Death: What Treasury Should Do*, Tax Notes at 793 (Aug. 6, 2018).

- d. **Alternate Valuation Date Regulations.** The “anti-Kohler” re-proposed regulations (portions of Prop. Reg. §§20.2032-1(c) & 20.2032-1(f)) include various examples of

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transactions that will be prohibited under the regulations to reduce artificially the value of assets during the 6-month alternate valuation period. The examples include a contribution of assets to a limited partnership or the dilution of a decedent's interest in an entity to a noncontrolling interest are treated as accelerating transactions. Also, multiple distributions or sales of interests during the 6-month period are treated as proportionate distributions without applying a fractionalization discount attributable to the fractionalized interests thereby created.

- e. **Guidance Under §2053 Regarding Personal Guarantees and the Application of Present Value Concepts.** The regulation project will address the deductibility as administration expenses under §2053 personal guarantees of the decedent and may address applying present value concepts to the deductibility of administration expenses (so that only the amount of expenses, discounted to the date of death or perhaps the due date of the estate tax return, could be deducted under §2053). If the proposed regulations adopt that approach, they could restrict or eliminate the deductibility of interest on Graegin notes.
- f. **Closing Letters.** In a June 16, 2015 update to the "Frequently Asked Questions on Estate Taxes" on the IRS website, the IRS indicated 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 of the fact that a closing letter does little good for returns filed solely to elect portability (because the statute of limitations on that return for determining the DSUE amount 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 new procedure has been widely criticized by planners. The IRS responded by describing a procedure by which the taxpayer could obtain an account transcript which would serve the purpose of a closing letter. In early December 2015, the IRS added a webpage entitled "Transcripts in Lieu of Estate Tax Closing Letters" describing the process. Notice 2017-12, dated January 23, 2017, provides guidance on the methods available to confirm the closing of an examination of the estate tax return. The notice states that an account transcript with a transaction code of "421" and explanation "Closed examination of tax return" can serve as the functional equivalent of an estate tax closing letter for third persons.

Estate tax transcripts supposedly now can be accessed online through the IRS website (IRS.gov) by typing "estate tax closing letters" in the search box in the upper-right-hand side of the homepage, and then selection "Transcripts in Lieu of Estate Tax Closing Letters." See Allyson Versprille, *Estate Tax Account Transcripts Now Available on IRS.gov*, BLOOMBERG DAILY TAX REPORT (May 15, 2018).

Some practitioners have had great difficulty in becoming qualified to access the IRS transcript system and acquiring the account transcript for an estate. IRS officials are still encouraging practitioners to use the transcript system, however.

- g. **Same-Sex Marriage; Notice 2017-15 Allowing Recovery of Applicable Exclusion Amount and GST Exemption Allocation.** In light of the constitutional findings

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regarding same-sex marriage in the *U.S. v. Windsor* and *Obergefell v. Hodges* Supreme Court cases, the IRS has issued several rulings addressing the tax effects of same-sex marriage.

Rev. Rul. 2013-17 clarified that for federal tax purposes (1) terms relating to marriage include same-sex couples, (2) a place of celebration standard is applied if a same-sex couple moves to a state that does not recognize same-sex marriages, and (3) the ruling does not apply to domestic partnerships or civil unions.

Notice 2017-15 clarifies that an individual who made a gift to a same-sex spouse that should have qualified for a marital deduction, but for which the statute of limitations has run on obtaining a refund of the gift tax paid, may recalculate the remaining applicable exclusion amount as a result of recognizing the individual's marriage to his or her spouse. The Notice describes various procedures and limitations.

For further details about these rulings, see Item 5.h of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

- h. **Relief Procedure for Extension of Time to File Returns to Elect Portability, Rev. Proc. 2017-34.** Section 2010(c)(5)(A) requires that the portability election be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse. Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014 and Rev. Proc. 2017-34 provides a relief procedure through the later of January 2, 2018 or the second anniversary of the decedent's date of death in certain cases if the estate was not otherwise required to file an estate tax return. See Item 16.d of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).
- i. **Section 6166 Guidance.** The IRS has been working on new comprehensive proposed regulations under §6166. A primary issue is the requirement of security in making a §6166 election, but the existing regulations will be restated and replaced with new regulations.
- j. **GST Trust Modification Rulings Suspended But Now Resumed.** Cathy Hughes (with the Treasury Department) has announced beginning in the fall of 2016 that the IRS temporarily suspended considering GST rulings for trust modifications until further notice. This was not added to the "no-rule" list in Rev. Proc. 2017-3 because it was not a permanent change. The reason for this change was that the IRS does not have sufficient resources to continue considering these requests, which are often accompanied by a huge stack of documents. Requests that were filed before this change of policy were still considered; future submitted requests would be returned.

Government officials have informally indicated (in June 2017) that the temporary suspension of GST trust modification rulings has now been lifted, and the IRS will again entertain these ruling requests. *See also* Allyson Versprille, *IRS Lifts Moratorium on Generation-Skipping Trust Changes*, BLOOMBERG DAILY TAX REPORT (March 12, 2018) (quoting Melissa C. Liquerman, Branch 4 chief, as lifting the moratorium on GST modification rulings and pre-submission conferences, observing

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that the simplified procedure in Rev. Proc. 2017-34 for obtaining an extension to request portability has significantly reduced the private ruling requests in Branch 4).

- k. **Report from Treasury Inspector General For Tax Administration Regarding Estate and Gift Tax Return Examination Process.** The Treasury Inspector General for Tax Administration (TIGTA) released a report on September 26, 2017 titled "Improvements Are Needed in the Estate and Gift Tax Return Examination Process" (Reference Number: 2017-30-081). The report reviewed the audit processing of estate and gift tax returns during Fiscal Year 2016. The report included the following conclusion:

TIGTA's review of the classification, prioritization, and inventory assignment processes identified improvements that are needed in the Internal Review Manual (IRM) guidance, classification sheet documentation, and managerial oversight. TIGTA found that:

- There is minimal IRM guidance for case classification, prioritization, and inventory assignment processes.
- Some classification sheets, when filled out by classifiers, are difficult to read or are incomplete.
- A single employee prioritizes cases selected for examination during classification sessions and assigns these cases to the field for examination, and a lack of documented managerial reviews over the processes poses risks.

Also, case documentation guidelines were not followed in 18 (47 percent) of 38 randomly sampled estate tax examinations and in 17 (46 percent) of 37 randomly sampled gift tax examinations.

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TIGTA made several recommendations to improve the examination of estate and gift tax returns, including the creation of a legible classification sheet; revisions to the IRM; strengthening of internal controls; and develop guidance on the circumstances in which it is advisable to propose and issue inconsistent notices of deficiency in estate and gift tax examinations.

In response to the report, IRS officials agreed with the recommendations and plan to take appropriate corrective actions.

- l. **Administration's Fiscal Year 2018 and 2019 Budget Proposals.** The administration releases a budget proposal each year (historically in a report titled "General Explanations of the Administration's Fiscal Year \_\_\_\_ Revenue Proposals" that is often referred to as the "Greenbook"), and during the Obama years, a number of estate and gift tax proposals were included. The budget proposals from the Trump administration have not included specific tax legislation proposals. The FY 2019 budget, titled "An American Budget," was published February 12, 2018. The Treasury's Office of Tax Policy has indicated that it will release a full proposal next year after giving officials a chance to evaluate the new tax law.

- m. **Coordinated Review of Certain Regulations With OMB.** The Office of Management and Budget (OMB) and the Treasury Department have agreed, in a Memorandum of Agreement dated April 11, 2018, to a process granting the OMB's Office of Information and Regulatory Affairs (OIRA) greater review of tax regulations, which have been largely exempt from the review process for 35 years. Tax regulations will be subject to review if they are likely to (1) create a serious inconsistency or otherwise interfere with an action taken or planned by another agency, (2) raise novel or policy issues, or (3) have an annual non-revenue effect on the economy of \$100 million or more. The "non-revenue effect" phrase refers to the

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burden of compliance or planning rather than the revenue raised by the tax provision. For each regulation that falls within these categories, Treasury will be required to provide to the OIRA a draft of the regulation, a description of the need for regulatory action, and an assessment of its costs and benefits. In addition, for regulations that have a non-revenue impact of \$100 million or more, the Treasury also must include a detailed assessment of the regulation and an analysis of the costs and benefits of potentially effective and reasonably feasible alternatives. To assist in identifying regulations that fall within these categories, Treasury must submit a quarterly notice of planned tax regulations, describing the regulations, identifying significant policy changes, and articulating the basis for determining whether each is subject to OIRA review. *See OMB and Treasury Announce New Coordinated Review of Certain Tax Regs*, RIA CHECKPOINT NEWSSTAND (April 13, 2018).

The OIRA review generally will be completed within 45 days, subject to extensions agreed to by Treasury and OMB, but certain regulations implementing the 2017 Tax Act may be subject to expedited review within 10 business days. Treasury officials have expressed concern that giving the OMB greater authority to review tax regulations could slow the issuance process and could inject more political bias. Some have been concerned that the additional layer of review could create a backdoor for lobbyists to appeal to OMB, in addition to the IRS, regarding regulations. The significance of the negotiations have intensified in light of who will have the final say in regulations implementing the 2017 Tax Act. Some GOP senators had expressed concern that Treasury would not implement the law as Congress intended. *See Allyson Versprille & Laura Davison, Tax Rules Unlikely to Stall Under New Review Process: Officials*, BLOOMBERG DAILY TAX REPORT (April 13, 2018).

Regulations implementing the §199A regulations may be among regulations implementing the 2017 Tax Act that could be subject to the review process.

## 5. Basis Adjustment Planning

The increase of the estate tax exclusion amount to \$5 million (indexed) under the 2010 Act and to \$10 million (indexed) under the 2017 Tax Act means that almost all of the population will have no estate tax concerns, but will be entitled to basis adjustments to the date of death value under §1014. Some refer to this as “free-basing,” to obtain a “free” basis adjustment without any offsetting estate tax. Basis adjustment planning takes on added significance in light of the greatly enhanced \$10 million (indexed) exclusion amount under the 2017 Tax Act.

- a. **Asset Classes Benefitting the Least and Most From Basis Adjustment.** Assets that receive no benefit from basis adjustment under §1014 include IRD items and IRAs. Assets receiving minimal to moderate benefit from basis adjustment include qualified small business stock (because a 100% exclusion of gain up to a generous limit is available in any event under §1202), and high basis stock. Assets receiving the most benefit include “negative basis” real estate, assets taking bonus depreciation on qualified property under §168(k) (the recapture of 100% upfront expensing is all ordinary income), and creator-owned copyrights, trademarks, patents, and artwork.

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- b. **Swap or Purchase of Grantor Trust Assets.** To the extent possible, the grantor should consider swapping high basis assets in return for low basis from the grantor trust (the low basis assets owned by the grantor at death would receive a basis adjustment under §1014). The most conservative is for the settlor to transfer cash, or high basis assets. If the grantor does not have ready cash, consider borrowing cash from a third party lender to use to pay the trust. Following the grantor's death, the trust could use the cash to repay the grantor's estate, which could then repay the bank.

If none of those are available, the grantor might consider giving the trust a promissory note in return for low basis assets. The trust's basis in the note is unclear. In the partnership context, a number of cases have held that a partner who contributes a note to a partnership gets no increased adjusted basis in his or her partnership interest. *E.g., VisionMonitor Software, LLC v./ Commissioner*, T.C. Memo. 2014-182. In the corporate context, a shareholder contributed real property encumbered by debt in excess of basis, which would ordinarily result in gain recognition, but the shareholder also contributed a note equal to the excess liabilities, and the court treated the note as having basis to offset the gain recognition. *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1997). (Other corporate cases have reached a contrary result.) The note given to the grantor trust may have a basis equal to the basis of the property received in return. The result is unclear. Paul Lee makes the following argument to support a theory that the note does have basis:

It can validly be argued that none of the authorities mentioned above are on point. For example, if creditor loans \$1 million to debtor and creditor is deemed to have zero basis in the promissory note, then why is there no income or gain when the creditor is paid back in full or why is the creditor entitled to realize a loss if the debt is not paid back in full? Furthermore, in the installment sale to IDGT context, if the death of the grantor is treated as a sale immediately after the date of death, then a zero basis in the note would be a taxable gain event. Yet, very few practitioners believe that should be the case. As such, there is a clear argument for giving the IDGT a basis in the note equal to the basis in the assets sold. Paul Lee, *Putting It On & Taking It Off: Tax Basis Management Today (For Tomorrow)*, at 44 (2018).

- c. **Sale to Grantor Trust; Avoiding “Crane” Gain From Deemed Transfer of Assets With Liabilities In Excess of Basis.** The IRS may have given up on arguing that a sale recognition event occurs at death if the grantor still holds a note from the grantor trust at death. Chief Counsel Advice 200923024 concluded that converting a trust from nongrantor to grantor trust status was not a taxable event. An interesting statement in the CCA is relevant to the commonly asked question of whether there is gain recognition on remaining note payments at the death of the grantor if the grantor has sold assets to a grantor trust for a note. In addressing the relevance of “Example 5” (Reg. § 1.1001-2(c) Ex. 5), *Madorin*, and Rev. Rul. 77-402, the CCA observed:

“We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner **which is generally not treated as an income tax event.**” (emphasis added)

The IRS has not, however, necessarily given up on making a traditional *Crane* argument that a deemed transfer of assets from the grantor to the trust at the

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grantor's death (when the trust becomes a non-grantor trust) with an associated liability (the note from the trust) in excess of basis results in gain under the *Crane* doctrine. Paul Lee suggests that a possible approach to avoid that argument is to create an LLC and have the grantor trust and the grantor each contribute assets. The LLC is a disregarded entity. The LLC owns the assets subject to the note, and also owns the grantor's note that has been transferred to the LLC. Because the same entity owns both the liability and the associated receivable, the liability disappears. Because this was done in a disregarded entity, no taxable event should result. On the grantor's death, the LLC is converted to a partnership rather than a disregarded entity, because there is no longer a single member for income tax purposes. The deemed transfer should be treated as an asset purchase and contribution, providing a full basis adjustment.

- d. **Avoiding Valuation Discounts for FLPs.** One approach to avoid valuation discounts for assets and an FLP is to argue that the assets are included in the decedent's gross estate under §2036(a)(2) under the reasoning of *Powell v. Commissioner*, 148 T.C. 392 (2017). See Item 6.e of this summary below.

Another approach is amend the limited partnership agreement to remove transfer restrictions as much as possible, but that probably cannot result in totally eliminating discounts.

A preferable approach is to convert the limited partnership to a general partnership. If the partners are concerned about liability on the underlying assets, the partners could initially transfer their partnership interests to wholly-owned disregarded entity LLC, and then convert the limited partnership to a general partnership. The state law exception under §2704(b)(3)(B) for restrictions imposed by state law would not apply because state law does not restrict a partner from withdrawing from a general partnership. A person has the power to disassociate as a partner from a general partnership at any time (Uniform Partnership Act §602(a)), and upon disassociation, the partnership is required to purchase the person's interest in the partnership for a price that is the greater of liquidation value or the value based on a sale of the entire business as a going concern without that partner (UPA §701(a)-(b)). At a partnership's death, the partnership interest would be stepped up to full value (without discounts) and a §754 election would be made to get a basis adjustment on the inside basis of the partnership assets.

- e. **Preserving Basis Adjustment Upon Death of Donor/Settlor.**

(1) **Basis Adjustment for Trust Settlor by Granting Limited Power of Appointment.** A very flexible alternative to cause estate inclusion for the trust settlor would be to give an independent party the authority to grant a power to the settlor that would cause estate inclusion, such as a testamentary limited power of appointment, which would cause estate inclusion under §2038 and result in a basis adjustment under §1014(b)(9).

Does this work? Might the settlor be treated as having such a power even if never granted? The key issue is whether the decedent would be treated as having retained a §2036(a)(2) power to designate persons who could enjoy the property. No

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prearranged understanding should exist for the grant of such a power to defend against an argument that the decedent indirectly retained the power so that §2036(a)(2) could apply (because that section requires that the power be retained by the decedent at the time of the transfer). Reg. §20.2036-1(b)(3) provides that §2036 applies even if a power is merely exercisable in conjunction with other persons (whether or not adverse) and regardless of whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death. That arguably would apply to the permitted grant to the settlor of a limited power of appointment even if it was never actually granted. *See Rev. Rul. 73-21, 1073-1 C.B. 405* (decedent's reserved power to name a successor trustee including himself upon the death, resignation or removal of the trustee triggered inclusion under §2036(a)(2) even though a vacancy had not occurred by the time of the decedent's death); *Estate of Farrel v. U.S.*, 553 F.2d 637 (Ct. Cl. 1977); but see *Estate of Kasch v. Commissioner*, 30 T.C. 102 (1958) (contingent power to determine who enjoys property or the income from property is not subject to §2036(a)(2), based on an interpretation of the predecessor statute in the 1939 Code).

Section 2036, however, applies only to powers to designate who can possess or enjoy income or property "during the decedent's life." Reg. §20.2036-1(b)(3). Therefore, §2036 would not apply to a testamentary limited power appointment.

A testamentary limited power of appointment to designate who can receive property after the decedent's death could trigger §2038. *See Reg. §1.2038-1(a)*, However, the provision about powers subject to a contingency beyond the settlor's control that did not occur before death is not included in the regulations under §2038. *See Reg. §20.2038-1(b)* ("However, section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death... See, however, section 2036(a)(2) for the inclusion of property in the decedent's gross estate on account of such a power.")

The court in *Estate of Skifter v. Commissioner*, 468 F.2d 699 (2d Cir. 1972), addressed a fact scenario in which the decedent had transferred a life insurance policy on his life to his wife who years later left the policy under her will to a trust for her daughter with the decedent as the trustee. The analysis analogized §2042 to §§2036 and 2038, and reasoned, in dictum, that §2036 would not apply because the power over the policy was not "retained by the grantor ... when he transferred it to another" (without addressing the potential application of Reg. §20.2036-1(b)(3)). The court reasoned that §2038 would not apply to a power conferred on the decedent "by someone else long after he had divested himself of all interest in the property subject to the power," but suggested that §2038 would apply if the power were actually granted to the decedent and if the grant was pursuant to authority "that the decedent created at the time of transfer in someone else and that later devolved upon him before his death." If the grantor authorized a third party to grant a limited power of appointment to the grantor, and the third party actually granted that power to the grantor, then §2038 would apply under this analysis.

Whether the settlor will be treated as having an inter vivos power of appointment causing inclusion in the gross estate even if the limited power of appointment is never actually granted to the settlor by the third party is not clear. The regulation

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under §2036 is very broad and potentially applies to the situation, and the discussion in *Skifter* is dicta (because the court addressed a §2042 issue and merely discussed §§2036 & 2038 by analogy and even that analysis did not mention the §2036 regulation). If the independent party merely has the power to grant to the settlor a *testamentary* limited power of appointment, however, estate inclusion should not result if the power is not actually granted. The problematic regulation under §2036 about powers subject to a contingency that did not occur before the settlor's death would not apply because §2036 applies only to powers that can be exercised during the settlor's life and not testamentary powers, and while §2038 can apply to testamentary powers, it does not apply to powers subject to a contingency beyond the decedent's control that did not occur before death.

(2) **Repurchase Appreciated Assets From Grantor Trust.** See Item 5.b. above.

(3) **Donor Use of Property.** The donor uses trust property in some way that would reflect an implied agreement of retained enjoyment to cause estate inclusion under §2036 (such as using property without paying adequate rent). (The court rejected the IRS position, however, that the decedent's continued occupation of a residence without paying rent following the end of the term of a QPRT required inclusion under §2036(a)(1) where the estate demonstrated an intention to pay rent that had not been completed before the decedent died. *Estate of Riese v. Commissioner*, 2011 T.C. Memo. 60.)

(4) **Move Trust Situs.** If the donor is a discretionary beneficiary of the trust in a domestic asset protection (DAPT) state, move the trust situs to a state that does not have DAPT provisions.

(5) **Sell Loss Assets to Grantor Trust.** Sell loss assets to a grantor trust to avoid a step-down in basis at the grantor's death (because the loss assets would not be owned by the grantor at death).

f. **Basis Adjustment for Beneficiary.** Possible strategies to allow a basis adjustment at a trust beneficiary's death include the following.

(1) **Broad Trust Distribution Powers.** Give the independent trustee broad authority to make distributions to the surviving spouse (or other beneficiary) in the absolute discretion of the trustee. (Even a "best interests" standard for a particular beneficiary might limit distributions for the purpose of allowing the beneficiary to make gifts.) An advantage of this approach is its simplicity, but possible fiduciary concerns in exercising the authority to make outright distributions of all or most of the trust assets to the beneficiary might frustrate this planning. Consider providing a broad exculpatory provision for the fiduciary, and express in the trust agreement client's intentions as to whether the settlor is comfortable with the trustee distributing a large portion of all of the assets to the beneficiary if the trustee, in its sole discretion, determines that to be appropriate.

An example of the fiduciary issues that arise in making these broad distribution powers is illustrated by *Smith v. First Community Bancshares, Inc.*, 575 S.E.2d 419 (Sup. Ct. W. Va. 2002). A QTIP trust contained this distribution provision:

I direct the said Trustee to pay to my said wife, out of the principal of the aforesaid trust estate, upon her request therefor in writing, such sum or sums as may be required to meet

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any need or condition which may arise or develop and which in the judgment of the Trustee justifies invading the corpus of the trust estate.

The surviving spouse, with the approval of the trustee, transferred over \$2 million of stock to a CRUT, which resulted in substantial estate tax savings at her death. After her death, the remainder beneficiaries of the marital trust sued the trustee and the spouse's estate planning attorney who assisted with the CRUT structuring. The court concluded that the language of the trust did not require the trustee to consider other financial resources of the spouse to provide for her own needs.

In sum, we find that whether the corpus of the marital trust could be invaded for the purpose of avoiding excessive estate taxation depends on the terms of the trust as set forth in Mr. Tierney's will .... [T]he language used by Mr. Tierney is very broad. First, "any need" is indicated. The word "need" is not expressly limited to the comfort, support, maintenance, or welfare of the beneficiary. Also, "need" is not limited by any specific exigency of the beneficiary such as a health, medical, or financial crises. In addition, the will provides that the trust corpus may be used to meet not only a "need" but also a "condition." ... Moreover, it is remarkable that the phrase "any need or condition" is not limited by the phrase "of the beneficiary." By its express terms, the corpus of the trust may be used for "any need or condition" perceived by Mrs. Tierney with the approval of the trustee, apparently including a "need or condition" of the corpus of the trust itself. Finally, we believe that the appellees adduced sufficient evidence below that the distribution from the principal of the marital trust was necessary in order to mitigate estate tax consequences upon the death of Mrs. Tierney.

The court's detailed construction analysis to reach the conclusion that the trustee was authorized to make the distribution suggests the wisdom of including extremely broad authority of the trustee to make distributions (e.g., "any purpose the trustee determines appropriate") if that is the testator/settlor's intent.

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 (distributions made from "general power of appointment marital trust" to descendants while surviving spouse was competent and consented were recognized even though instrument did not authorize the distributions; distributions made after spouse was incompetent and when neither she nor a guardian for her consented were not recognized because the Pennsylvania court would likely have allowed her to set aside those distributions, so those distributed assets were included in the surviving spouse's gross estate under §2041); *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278 (beneficiary-trustee's distribution of trust assets to herself contrary to the standards in the trust instrument [and the subsequent sale of those assets for a private annuity] were not excluded from the beneficiary's gross estate merely because of the presence of ascertainable distribution standards in the trust instrument).

**(2) Distributions Pursuant to Non-Fiduciary 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 surviving spouse. 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.

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### (3) General Powers of Appointment; Limitations on “Inappropriate” Exercise of General Power of Appointment.

The following paragraph address various uses of general powers of appointment to cause estate inclusion in a beneficiary’s estate. Planners must be mindful of various state law issues that may impact general powers of appointment as well as the tax effects. See *Griffin H. Bridgers, Basis Step-Up Planning: A Double-Edged Sword*, 32 PROBATE & PROPERTY 24 (July/August 2018).

Possible ways of limiting the broad manner in which a general power of appointment could be exercised are (i) to require the approval of a non-adverse party, and (ii) to limit the exercise to creditors of the powerholder.

(a) **Consent of Non-Adverse Party.** The possibility of requiring the consent of a non-adverse party, which would still result in the power being a general power, Section 2041(b)(1)(C)(ii) provides that a power exercisable “in conjunction with” a non-adverse party is still a general power of appointment. The non-adverse party could even be someone that owes fiduciary duties to the beneficiary. Treas. Reg. §20.2041-3(c)(2), Ex. 3; *Estate of Jones v. Commissioner*, 56 T.C. 35 (1971); *Miller v. U.S.*, 387 F.2d 866 (3rd Cir. 1968).

(b) **Limiting Power to Appoint to Creditors.** As an example, the power of appointment might limit appointees to persons related to the powerholder by blood, marriage or adoption or to any charities of the powerholder or of the powerholder’s estate. See §2041(b)(1); Treas. Reg. §20.2041-3(c)(2).

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 the powerholder’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. If the power is limited to the amount of the debt, the general power of appointment might not extend to many assets (though no tax cases have so limited the treatment of a power to appoint to creditors as being a general power of appointment over all of the assets subject to the power).

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

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answer." When told that a lot of people think the answer is different, Prof. Langbein responded "There are a lot of stupid people."

(4) **Independent Party With Power to Grant General Power of Appointment.** The trust agreement could give an independent party the power to grant a general power of appointment to the surviving spouse. Advantages of this approach compared to making distributions to the beneficiary are (1) the mechanics may be much easier by merely having the independent party sign a one-page document granting the spouse a general power of appointment rather than distributing and re-titling assets, and (2) the individual may be elderly and have management issues with respect to outright ownership of the assets, or may be susceptible to pressure to make transfers to family members or caregivers. A basis adjustment would result under §1014(b)(9).

One commentator raises 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. 20<sup>th</sup> 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. Stated differently, if the power is never granted to the beneficiary, is it treated as a power exercisable upon the occurrence of an event which never happened and thus not a general power of appointment under Reg. §20.2041-3(b), or is it a power exercisable "in conjunction with another person," making it a general power under §2041(b)(1)(C) even though never granted?

If there are concerns as to how the power holder might exercise a general power of appointment, it might be limited to an appointment in favor of the power holder's creditors, or it might be exercisable only with the consent of a non-adverse party (that is still a general power of appointment, §2041(b)(1)(C)(ii)). To protect the third party from an argument that the party must continually monitor whether to grant or change powers of appointment, the trust could provide that the third party has no authority to grant a general power of appointment until requested by one of various specified family members to do so. In addition, in light of the fiduciary issues that could arise in granting such a general power of appointment, consider using an extremely broad exculpatory clause for the third party. ("Why didn't you realize that giving a \$5 million general power of appointment to my dad increased the value of the estate for purposes of determining the elective share? You actually caused \$1.6 million to pass to the step-monster.")

The following sample clause is by Ben Pruett (Bessemer Trust, Washington, D.C.):

The trustee of any trust hereunder, other than any trustee who is a beneficiary or otherwise interested in such trust, is authorized, with respect to all or any part of the trust property, in its sole discretion and by an instrument in writing filed with the records of the trust, to create in a beneficiary a testamentary general power of appointment, within the meaning of Section 2041 of

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the Code (including a power, the exercise of which requires the consent of some person other than the person creating such power or any person with a substantial interest in the trust property that is adverse to the beneficiary's exercise of the power in favor of the beneficiary's estate or creditors) or to eliminate or modify any such power previously created hereunder, or to release the foregoing power in whole or in part.

The settlor intends that the foregoing power be available to the trustee whenever the exercise of such power will or may result in some significant tax or other benefit to the beneficiaries such as, for example, the reduction of aggregate federal and state wealth transfer taxes, or the ability to allocate a beneficiary's unused GST exemption to trust property, or to facilitate an adjustment to the capital gains tax basis of such property.

The trustee shall be under no duty to exercise the foregoing power, to inform any beneficiary or other person of the potential benefit of exercising the power, or to monitor any fact or circumstance to determine whether to exercise such power, regardless of whether, or the extent to which, the trustee may have previously undertaken any such exercise, informing, or monitoring. The settlor's expectation is that each beneficiary will engage in responsible estate planning and will alert the trustee whenever the exercise of such power may be beneficial, but that the final decision rest with the trustee. The Trustee shall incur no liability to any person for its exercise of such power or its refusal or failure to exercise such power, absent willful misconduct proved by clear and convincing evidence in the court with primary jurisdiction over the administration of such trust.

The trustee shall distribute to the beneficiary's estate or directly to the appropriate taxing authority, as the trustee may determine, the amount by which the wealth transfer taxes imposed upon the beneficiary's estate exceed the amount of such taxes that would have been imposed, had the trustee refrained from granting a general power of appointment hereunder.

Any legal expenses, fees, or other expenses incurred by the trustee in connection with the exercise of the power granted hereunder shall be borne by the trust to which the exercise of such power relates.

NOTES:

<sup>1</sup> Treas. Reg. 2041(b)(1)(C)(i) provides that any power of appointment that is exercisable only with the consent of the creator of the power is not a general power of appointment. Therefore, it is important that the person with the power to consent be someone other than the person with the authority to grant the general power.

<sup>2</sup> This is a strong exculpation provision expressly designed to relieve a trustee of any duty to monitor or determine whether to exercise the power to confer a general power of appointment, and this provision recognizes that imposing any such duty on the trustee would be an unreasonable burden.

(5) **Formula General Power of Appointment.** To avoid the risk that the third party never "gets around" to granting the general power of appointment, could it be granted by formula in the trust from the outset under a formula approach? The fact that the general power comes into existence only at the beneficiary's death clearly does not preclude it from being a general power of appointment, Reg. §20.2041-3(a)(2), and a basis adjustment is triggered under §1014(b)(9).

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 benefit from a basis adjustment under §1014.) The sample clause in Item 5.(f)(4)(b) below refers to and describes "Appreciated Property" in a

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way that would result in a basis increase under §1014, which necessarily would only include non-IRD appreciated property.

To provide flexibility, the formula general power of appointment could be combined with giving a non-adverse party a power of appointment to amend the power of appointment. See subparagraph (e) below.

- (a) **Validity of Conditional General Power of Appointment Equal to Beneficiary's Remaining Exclusion Amount Less Beneficiary's Taxable Estate.** A formula based on the individual's remaining federal estate tax exclusion amount would seem straightforward, but potential issues could arise as to its validity for tax purposes. Arguably the beneficiary may have a general power of appointment over the full amount of the gift exemption amount at the time the formula power of appointment is granted even if the beneficiary later makes gifts "using up" the gift exemption amount—if it were determined that making a gift was not an act of independent significance. Furthermore, if the formula is 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 significance of "acts of independent significance" is summarized in the discussion below of the *Kurz* case.)

Several private letter rulings have concluded that formula general powers of appointment equal to a beneficiary's remaining estate exclusion less the value of the beneficiary's other estate assets were effective in causing estate inclusion of the trust assets up to that amount. PLRs 200403094 ("having a value equal to (i) the amount of my wife's remaining applicable exclusion amount less (ii) the value of my wife's taxable estate determined by excluding the amount of those assets subject to this power"); 200604028 ("equal to the amount of Husband's remaining applicable exclusion amount set forth in § 2010 of the Internal Revenue Code ('Code') minus the value of Husband's taxable estate (determined by excluding the amount of those assets subject to this power)"). Those rulings addressed other issues as well, but the rulings clearly reasoned that the assets were included in the deceased beneficiary's gross estate.

- (b) **Sample Formula General Power of Appointment of Amount That Will Not Increase Beneficiary's Estate Tax.** The following sample clause is by Lester Law (Naples, Florida) and Howard Zaritsky (Rapidan, Virginia) from the 2017 Heckerling Institute on Estate Planning.

**Spousal Testamentary General Power of Appointment.**

I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the Appreciated Assets (as such term is defined hereunder). The fractional share and other terms applicable to the power are as follows:

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A. **Fractional Share.** The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death. The denominator of the fraction shall be the value of the Appreciated Assets as of my spouse's death.

B. **Appreciated Assets.** The Appreciated Assets shall mean those assets owned by the By-Pass Trust upon my spouse's death the income tax basis of which may increase (and not decrease) pursuant to Code § 1014(a), if such assets passed from my spouse within the meaning of Code § 1014(b).

C. **How Exercised.** My spouse may exercise the power by appointing the said fractional share of the Appreciated Assets of the By-Pass Trust free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment.

(c) **Acts of Independent Significance.** If the surviving spouse (or other beneficiary) has the power to impact the amount that would be subject to the general power of appointment under the formula, the IRS might argue that the beneficiary has a general power of appointment to that maximum extent. See *Kurz v. Commissioner*, 101 T.C. 44 (1993), aff'd, 68 F.3d 1027 (7th Cir. 1995). However, *Kurz* makes clear that contingencies that would have independent significant non-tax consequences are to be ignored. Those contingencies prevent the decedent from having realistic unfettered control to access the trust assets.

As to the possibility of a marital or charitable bequest increasing the amount of the general power of appointment under the formula, such bequests would seem to be acts of independent significance. However, to avoid that argument, the formula could refer to an amount "determined for this purpose without regard to any available charitable or marital deduction" as in the sample formula clause in Item 5.(f)(4)(b) above.

For a more detailed discussion of the *Kurz* case and the possible implications for formula general powers of appointment, see Item 7.e of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

(d) **Identifying Specific Assets Subject to General Power of Appointment.** A power of appointment over part of a trust is probably generally considered as being over some fractional part of trust. As long as the amount of the general power of appointment is determined objectively by a formula, perhaps a third party (such as a trustee) could be given the authority to determine which particular assets would be subject to the general power. (Query whether that would be recognized for tax purposes?) Alternatively, the formula could specify objectively which particular assets are subject to the general power of appointment formula amount.

An example of a clause exercising a power to appointment to trigger the Delaware tax trap could be modified to define the scope of a formula general power of appointment:

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The foregoing exercise does not apply to the following assets held by the Trust: (i) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (ii) property that constitutes income in respect of a decedent as described in Code Section 1014(c); (iii) any interest in any Roth IRA accounts or Roth variants of other retirement plans, such as Roth 401(k)s, 403(b)s, 457(b)s, and the like; and (iv) any interest in any property that has a cost basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of my death (the "Excluded Assets"). If, after eliminating the Excluded Assets, the inclusion of the value of the other assets in the Trust in my taxable estate for federal estate tax purposes would not increase the federal estate tax and state death taxes payable from all sources by reason of my death, this power of appointment shall apply to all remaining assets of the Trust other than the Excluded Assets (the "Included Assets"). However, in the event that the inclusion of the value of all of the Included Assets in the Trust in my taxable estate for federal estate tax purposes would increase the taxes so payable, the assets of the Trust appointed by this Section 2.3 shall be further limited as follows: The Trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of my death to the cost basis immediately prior to my death first (the "Gain Ratio"). The Trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, as such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in my estate's federal or state estate tax liability as described above, my appointment pursuant to this Section 2.3 shall be limited to that fraction or percentage of that Included Asset that will not cause any federal or state estate tax liability, and all lower ranked Included Assets shall be excluded from the exercise of this power of appointment.

Mickey Davis & Melissa Willms, *All About That Basis: How Income Taxes Have Reshaped Estate Planning*, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES (April 2017) (the clause is loosely adapted from Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust*).

For other examples of formula clauses see Appendices A-C of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners). For various form suggestions for formula general powers of appointment, see Ed Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust* (April 2017)(available at <http://dx.doi.org/10.2139/ssrn.2436964>); Lester Law & Howard Zaritsky, *Portability: Lots of Questions, Few Easy Answers*, Heckerling Inst. on Estate Pl. (Fundamentals Program) (2017); Al Golden, *Back to the Future – The Marital Deduction from Before ERTA to After ATRA*, STATE BAR OF TEXAS ADVANCED ESTATE PLANNING COURSE at p.17 (2013); HOWARD ZARITSKY, PRACTICAL ESTATE PLANNING IN 2011 AND 2012 (various forms and excellent analysis); James Blase, *Drafting Tips That Minimize the Income Tax on Trusts—Part 2*, ESTATE PLANNING (Aug. 2013).

**(e) Preferred Alternatives; Formula Power of Appointment Combined with Power to Amend.** Some planners are concerned with the inherent uncertainty of whether a specified formula will be most efficient years later, and prefer to give someone the ability to fashion a general power of appointment at a later time after the trust has been created. See Item 5.f.(4) above. A problem with that approach is that the third party may never "get around" to granting the general power of appointment or making a decision about the appropriate formula to use in order to grant a formula general power of appointment.

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To avoid the concerns of (i) the inability to fashion a “perfect” formula that will always be appropriate, or (ii) the risk of relying on a third party to grant a general power of appointment at a later time, some planners prefer to get something in place (even if imperfect) but leave flexibility by including a formula general power of appointment when the trust is created, but give a non-adverse party the ability to amend the general power of appointment (in effect, another power of appointment) to make adjustments as appropriate if that becomes necessary.

- (6) **Creditors’ Rights Regarding Property Subject to General Power of Appointment.** The mere existence of the authority of someone to create a general power of appointment does not by 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 Uniform Power of Appointment 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 Uniform Power of Appointment 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

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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.

#### **(7) Beneficiary Exercise of Limited Power of Appointment to Trigger 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.)

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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/professionalpartners](http://www.bessemer.com/professionalpartners). (That summary includes a discussion of using the Delaware tax trap in states that have abolished their rule against perpetuities. See Robert Kolasa, *Problems in Springing the Delaware Tax Trap*, TRUSTS & ESTATES 12 (April 2018). In that situation, a possible strategy suggested by some planners is to provide that the original trust lasts for 1,000 years, but that the power can be exercised to create a trust that could last for 1,000 years after the power is exercised. In this manner, the vesting of the property could be postponed for a period “ascertainable without regard to the date of the creation of the first power.”)

g. **Achieving Basis Adjustment at First Spouse’s Death Regardless of Which Spouse Dies First; Limitations Under Section 1014(e) If Donee Dies Within One Year.**

Alternatives for achieving a basis increase at the first spouse’s death include the following. All of these alternatives are discussed in considerably more detail in Item 8 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

(1) **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). 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, South Dakota, 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/professionalpartners](http://www.bessemer.com/professionalpartners).

(2) **Joint Trusts.** Some planners have attempted, with varying degrees of success to use joint trusts as a way of achieving a basis increase whichever spouse dies first. E.g. PLR 200101021(denying basis increase because of §1014(e)). The strategy has been refined with an alternative that has been termed the Joint Exempt Step-Up Trust (“JEST”).

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**(3) Section 1014(e) Limitation if Donee of Gifted Appreciated Assets Dies Within a Year and the Assets Pass Back to the Donor.** 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). That provision likely does not apply, however, if the assets do not return "to" the donor.

**(4) 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, and providing that H retains the right to terminate the trust prior to W's death and have the assets distributed to W. The assets would be includable in H's estate under §2038 if he dies first (because of his power to terminate the trust early), and would be includable in W's estate under §2031 if she dies first (because the assets would be payable to her estate). For a further discussion of the Section 2038 Marital Trust, see Item 8.e of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

- h. **Upstream Gifts.** 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. For a discussion of what Melissa Willms has referred to as the "accidentally perfect grantor trust," see Item 7.c of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners). See Mickey Davis & Melissa Willms, *All About That Basis: How Income Taxes Have Reshaped Estate Planning*, ALI-CLE Planning Techniques for Large Estates (April 2018); Turney Berry, *The "Hook" of Increased Income Tax Basis*, TRUST & ESTATES 10 (April 2018).

"BDOT" provisions (described in Item 15 below) could be incorporated into the upstream trust planning, to assure that the trust would continue to be treated as the deemed owner of the trust the trust for purposes of the grantor trust rules, whether or not the parent exercises the general power of appointment.

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.

"BDOT" provisions could be used to treat the parent or the future beneficiary of the trust as the deemed owner under §678.

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- i. **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).

## 6. Family Limited Partnership and LLC Planning Developments; *Powell v. Commissioner*; *Estate of Straightoff v. Commissioner*; *Estate of Turner v. Commissioner* (*Turner III*)

- a. **Overview of §2036 Issues.** The most litigated issue is whether assets contributed to an FLP/LLC should be included in the estate under §2036 (without a discount regarding restrictions applicable to the limited partnership interest). About 39 reported cases have arisen.

(1) **Section 2036(a)(1).** The IRS typically argues that assets should be included under §2036(a)(1) as a transfer to the FLP/LLC with an implied agreement of retained enjoyment. The 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 that no retained enjoyment under §2036(a)(1) applied as to gifts of limited partnership interests.) The key is whether "legitimate and significant nontax reasons" existed for using the entity. Having tax reasons for creating entities is fine, but the test is whether "a" legitimate and significant nontax reason applied as well. For a listing (with case citations) of factors have been recognized in particular situations as constituting such a legitimate nontax reason and see Item 8.g of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

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

(2) **Section 2036(a)(2).** In a few cases, the IRS has also made a §2036(a)(2) argument, that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the property contributed to the entity. Two cases have applied §2036(a)(2) where the decedent had some interest as a general partner *Strangi* and *Turner*.

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

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The law regarding applying §2036(a)(2) to FLPs and LLCs has been turned on its head in *Powell v. Commissioner*, discussed below.

- b. **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*).
- c. **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. That chart is included in Item 6.g below (updated with the result from the recent *Streightoff* case).
- d. **Section 2036(a)(1) Cases in 2015-2016; *Purdue, Holliday, Beyer*.** *Purdue v. Commissioner*, T.C. Memo. 2015-249, held that §2036(a)(1) did not apply to assets contributed to an LLC, relying on the bona fide sale for full consideration exception and focusing on the management of the consolidated family assets as a legitimate and significant nontax reason for the LLC. The *Purdue* case also ruled that gifts of LLC interests qualified for the gift tax annual exclusion and that interest on “*Graegin* loans” was deductible.

*Holliday v. Commissioner*, T.C. Memo 2016-51, and *Beyer v. Commissioner*, T.C. Memo. 2016-183, both concluded that §2036(a)(1) did cause estate inclusion of assets contributed to an LLC and FLP, respectively.

For a detailed summary of the *Purdue*, *Holliday*, and *Beyer* cases, and a planning checklist for structuring the proper formalities for FLPs and LLCs, see Items 10 and 29 of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

- e. **Estate of Powell v. Commissioner – FLP Assets Includable under §2036(a)(2).**

## Overview

*Estate of Powell v. Commissioner*, 148 T.C. 392 (May 18, 2017) is a “reviewed” Tax Court decision that may be the most important Tax Court case addressing FLPs and LLCs since the *Bongard* case (124 T.C. 95 (2005)) 12 years ago. The Tax Court breaks new ground (1) in extending the application of §2036(a)(2) to decedents owning only limited partnership interests, and (2) in raising the risk of double inclusion of assets under §2036 and a partnership interest under §2033, which may (in the court’s own words) result in “duplicative transfer tax.” (The case was decided on cross motions for summary judgement, and is not an opinion following a trial.)

The facts involve “aggressive deathbed tax planning,” and the fact that the taxpayer lost the case is no surprise. But the court’s extension of the application of §2036(a)(2) and the extensive discussion of possible double inclusion for assets contributed to an FLP or LLC are quite surprising (but whether a majority of the judges would apply the double inclusion analysis is not clear).

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The combination of applying §2036(a)(2) even to retained *limited partnership* interests and the risk of “duplicative transfer tax” as to future appreciation in a partnership makes qualification for the bona fide sale for full consideration exception to §§2036 and 2038 especially important. In one respect, this means that *Powell* does not reflect a significant practical change for planners, because the §2036 exception has been the primary defense for any §2036 claim involving an FLP or LLC.

This case is appealable to the Ninth Circuit Court of Appeals, but is not being appealed.

*Estate of Powell v. Commissioner*, 148 T.C. 392 (May 18, 2017) (Halpern [Senior Judge], joined by Vasquez, Thornton, Holmes, Gustafason, Morrison, Buch, and Ashford, with Foley and Paris concurring in the result only) (concurring opinion by Lauber, joined by Marvel, Gale, Kerrigan, Nega, and Pugh).

For an excellent discussion of the *Powell* case, see Todd Angkatavanich, James Dougherty & Eric Fisher, Estate of Powell: *Stranger Than Strange and Partially Fiction*, Tr. & Ests. 30 (Sept. 2017) and Mitchell M. Gans & Jonathan G. Blattmachr, *Family Limited Partnerships and Section 2036: Not Such a Good Fit*, 42 ACTEC L.J. 253 (Winter 2017).

For a detailed discussion of the facts and court analysis in *Powell*, see Item 15.g of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

## Facts

The decedent’s son, acting on her behalf under a power of attorney, contributed about \$10 million of cash and marketable securities to a limited partnership (FLP) in return for a 99% limited partnership (LP) interest. Her two sons contributed unsecured notes in return for the 1% general partner (GP) interest. The partnership agreement allowed for the partnership’s dissolution with the written consent of all partners. The same day, the son who was the agent under the power of attorney (acting under the power of attorney) transferred the decedent’s 99% LP interest to a charitable lead annuity trust (CLAT) paying an annuity to charity for the decedent’s life with the remainder passing to the decedent’s two sons (the remainder was valued by assuming a 25% discount for lack of control and marketability of the 99% LP interest). (A problem with the transfer to the CLAT was that the power of attorney only authorized gifts to the principal’s issue up to the federal gift tax annual exclusion amount. The taxpayer argued that gifts were authorized under the power of attorney under general state case law where the gifts were consistent with the estate plan.)

The decedent died 7 days later. [Counsel has indicated that the decedent was recovering nicely from a broken hip, and the CLAT was planned during that recovery, but the decedent contracted an infection after she had been cleared for a hospital discharge and died shortly thereafter from ensuing sepsis. At the time the FLP was funded and the CLAT was funded, counsel indicates that the serious infection had not yet occurred, the decedent was expected to be discharged from the hospital, and a medical opinion was received reflecting a greater than 50% likelihood of surviving a year.]

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The IRS claimed that the \$10 million of assets contributed to the FLP were includible in the decedent's estate (without a discount) under §§2036(a)(1) (retained enjoyment or income), 2036(a)(2) (retained right in conjunction with any person to designate who could enjoy the property or its income), or 2038 (power to alter, amend, revoke, or terminate the transfer at the decedent's death), or under §2035(a) (transfer of property within three years of death that otherwise would have been included in the estate under §§2036-2038 or 2042) if the transfer to the CLAT was valid. The case indicates that the taxpayer did not contest the application of §2036(a)(2) [counsel has reportedly stated that he did *not* concede that issue], or contest that the bona fide sale for full consideration exception to §2036 was not applicable. The taxpayer argued that §§2036 and 2038 could not apply because the decedent no longer owned the LP interest at her death (despite the fact that the interest had been transferred within 3 years of her death and §2035(a) would then apply).

Counsel has indicated that the parties attempted to settle the case. Even when the taxpayer agreed to settle with no estate discount but not paying gift tax with respect to the CLAT transfer, in making the estate calculation the IRS treated the gift to the CLAT as an adjusted taxable gift that was added back to the tentative tax base (despite the express provision in §2001(b) that "gifts includible in the gross estate" are not treated as adjusted taxable gifts for this purpose). The taxpayer ultimately concluded that it had to file a Tax Court petition in order to get the estate tax calculation error corrected.

## Court Analysis

### (1) Section 2036(a)(2) Issue

The majority and concurring opinions both agreed that §2036(a)(2) applied (though the concurring opinion did not address the reasoning for applying §2036(a)(2)). The majority opinion reasoned (1) that the decedent, in conjunction with all the other partners, could dissolve the partnership, and (2) that the decedent, through her son as the GP and as her agent, could control the amount and timing of distributions. The opinion adopted the analysis in *Strangi* as to why the "fiduciary duty" analysis in the Supreme Court *Byrum* case does not apply to avoid inclusion under §2036(a)(2) under the facts of this case because any such fiduciary duty is "illusory."

The §2036(a)(2) issue is infrequently addressed by the courts; it has only been applied with any significant analysis in four prior cases (*Kimbell* and *Mirowski* [holding that §2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that §2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 50% interest in the corporate general partner). *Powell* is the **first case to apply §2036(a)(2) when the decedent merely owned a limited partnership interest**. In this case the decedent owned a 99% LP interest, but the court's analysis drew no distinction between owning a 99% or 1% LP interest; the court reasoned that the LP "in conjunction with" all of the other partners could dissolve the partnership at any time. (Whether the court would have applied §2036(a)(2) had the decedent owned only a small LP interest is not known, but the court's reasoning does not draw any distinction based on the amount of LP interest owned by the decedent.)

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Because §2036(a)(2) applied, the court did not address §2036(a)(1) or §2038.

## (2) “Double Inclusion” Issue

The majority opinion raised, on its own with no argument or briefing from any party, how §2036 or §2038 operate in conjunction with §2043 ostensibly to avoid double inclusion. The consideration received in return for the contribution to the FLP (i.e. the 99% LP interest) is subtracted under §2043 from the amount included in the gross estate under §2036. In effect, the value of the discount is included under §2036/2043 (i.e., the value of the assets contributed to the FLP minus the value of the 99% LP interest considering lack of control and marketability discounts). The opinion refers to this amount as the “doughnut hole.” In addition, the 99% LP interest itself is included in the gross estate (if the gift is not authorized under the power of attorney) or is included in the gift amount if the gift is recognized, and the court referred to this as the “doughnut.” That analysis avoids double inclusion IF the assets have not appreciated (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, footnote 7 of the “majority” opinion acknowledges that “duplicative transfer tax” would apply because the date of death asset value is included in the gross estate under §2036 offset only by the *date of contribution* discounted value of the partnership interest. The date of death value of the LP interest would also be included under §2033, so all of the post-contribution appreciation of the assets would be included under §2036 AND the discounted post-contribution appreciation also would be included under §2033. As a result, more value would be included in the gross estate than if the decedent had never contributed assets to the FLP. (Similarly, footnote 17 acknowledges that a “duplicative reduction” would result if the assets depreciated after being contributed to the FLP.) Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument), in a case in which the majority’s analysis is applied is (hopefully) doubtful, but the majority opinion did not even hint that the court would refuse to tax the same appreciation twice in that situation.

The concurring opinion (joined by seven judges) reasoned that the inclusion of the partnership assets in the gross estate under §2036 meant that the partnership interest itself was merely an alter ego of those same assets and should not also be included in the gross estate. That approach has been followed by the prior FLP cases in which §2036 was applied, and indeed even in this case the IRS did not argue that the asset value/partnership value should be included under both §2036 and §2033, offset by the partnership value at the date of the contribution. (That argument would have been meaningless in this case [because the date of contribution values and date of death values were the same], but the IRS has not made that argument in *any* other FLP cases even though substantial additional estate tax liability would have resulted in situations involving significant appreciation of partnership assets.)

The opinion leaves uncertainty, particularly as to the double inclusion issue, because the “majority” opinion (that espoused the double inclusion analysis) was joined by only 8 judges (one of whom was Judge Halpern, who is a Senior Judge and not one

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of the 16 current “regular” Tax Court judges), a concurring opinion (that rejected the double inclusion analysis) was joined by 7 judges, and 2 judges concurred in the majority opinion in result only.

The fact that eight judges adopted the double inclusion analysis may embolden the IRS to take that position in future cases, even though we do not yet know how a majority of the Tax Court judges would rule as to that issue. This raises a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer merely retains the assets.

### (3) **Rejection of Gift to CLAT**

The court concluded that the gift to the CLAT was not valid, and therefore denied the IRS’s additional gift tax deficiency and also the addition to the gross estate of additional gift tax on the gift made within three years of death.

#### **Observations**

(1) **“Overly Aggressive Deathbed Tax Planning.”** The court’s refusal to allow valuation discounts is not surprising. The case involves a number of bad (or at least suspicious) factors:

- Funding of the entity only by the soon-to-be decedent;
- With only cash and marketable securities;
- A mere 7 days before death;
- By the decedent’s son acting under a power of attorney;
- With a subsequent transfer to a CLAT and a retained charitable annuity for the life of the apparently soon-to-die donor, resulting in a substantial value shift to the agent and his brother.

That the taxpayer lost the case is not surprising.

(2) **Significant Extension of Application of §2036(a)(2) to Retained Limited**

**Partnership Interests.** The §2036(a)(2) issue is addressed infrequently by the courts; it has been applied with any significant analysis in only four prior cases (*Kimbell* and *Mirowski* [holding that §2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that §2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 47% interest in the corporate general partner). *Powell* is the **first case to apply §2036(a)(2) when the decedent merely owned a limited partnership interest.** In this case the decedent owned a 99% LP interest, but the court’s analysis drew no express distinction between owning a 99% or 1% LP interest (although the distinction from *Byrum*’s limitation on the application of §2036(a)(2) because of fiduciary duties would not be as strong if other significant partnership interests existed, particularly if they were unrelated parties, and any fiduciary duties were not “owed to herself”). The court reasoned that the LP “in conjunction with” all of the other partners could dissolve the partnership at any time. (Whether the court would have applied §2036(a)(2) had the decedent owned only a small LP interest is not known, but the reasoning allowing the ability to dissolve the entity by acting “in conjunction with” other partners would not change based on the amount of LP interest owned by the decedent.)

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The net effect is that, under this analysis, §2036 will apply to almost all FLPs/LLCs, whether or not the client retains a general partner or managing member interest, unless the bona fide sale for full consideration exception to §2036 applies.

Furthermore the same reasoning would seem to apply to practically any enterprise or investment involving other parties. For example, interests in C corporations, S corporations, or undivided interests in real estate would be subject to the same reasoning that the decedent could join with the other shareholders/co-owners (perhaps even if unrelated?) and dissolve the entity/co-ownership, with all parties receiving their pro rata share of the assets.

(3) **Bad Facts Make Bad Law.** To a degree, this may be a “bad facts make bad law” case. The court may have stretched to find that §2036(a)(2) applied to avoid estate tax discounts for this deathbed transaction that lacked any non-tax purposes, even though the decedent received only limited partnership interests, because of the difficulty of applying §2036(a)(1) when the decedent did not intend to retain ANY interest in the FLP. A consideration of “sham transaction” or “void partnership” theories may have involved fact issues that would have precluded a summary judgment.

The IRS’s real concern is that the transaction was merely a gimmick to produce discounts and lacked economic substance, but the Tax Court had previously rejected the authority of the IRS to merely disregard transfers to partnerships because of the decedent’s “subjective intentions” as long as the partnership was validly formed and changed relationships between the decedent and his heirs and creditors. *Estate of Strangi v. Commissioner*, 115 T.C. 478, 486-87, *rev’d on other grounds*, 293 F.3d 279 (5th Cir. 2002).

(4) **Increased Significance of Bona Fide Sale for Full Consideration Exception to §2036.** The combination of applying §2036(a)(2) even to retained *limited partnership* interests and the risk of “duplicative transfer tax” as to future appreciation in a partnership makes qualification for the bona fide sale full consideration exception to §§2036 and 2038 especially important. Make sure that a legitimate and significant nontax purpose for creating the FLP/LLC exists to satisfy the bona fide prong of the exception, but also be sure that proper capital accounts are maintained to satisfy the full consideration prong of the exception as interpreted by *Stone, Kimbell and Bongard*. See *Estate of Beyer v. Commissioner*, T.C. Memo. 2016-183 (full consideration prong of §2036 exception did not apply because of the failure to maintain proper capital accounts).

In one respect, this means that *Powell* does not reflect a significant practical change for planners, because the §2036 exception has been the primary defense for any §2036 claim involving any FLP or LLC. Almost all of the taxpayer victories against a §2036 claim have been based on the bona fide sale for full consideration exception to §2036. (Several exceptions are *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73 and *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74, which both refused to apply §2036 to gift transactions that did not qualify for the full consideration exception. In addition, *Kimbell v. U.S.*, 371 F.3d 257, 268 (5th Cir. 2004), refused to apply §2036 to transfers to an LLC without addressing whether the bona fide sale for full consideration exception applied to those transfers.)

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**(5) Elimination of Unanimous Partner Approval Requirement for Dissolution.**

The partnership agreement in *Powell* “allows for the partnership’s dissolution with the written consent of all partners.” Would the omission of this explicit requirement of unanimous consent for dissolution in the partnership or LLC agreements provide an argument against applying §2036(a)(2) under *Powell*? That would provide a factual distinction from *Powell*, but the court’s reasoning for applying §2036(a)(2) made no reference whatsoever to the unanimous consent requirement for dissolution in the partnership agreement. The court made reference various times to the decedent’s “ability to dissolve” the partnership in conjunction with her sons, but never made reference to the fact that the partnership could *only* be dissolved with her consent.

If the partnership agreement is silent regarding dissolution, the Revised Uniform Limited Partnership Act provides various events that can cause the dissolution of the limited partnership, one of which is “the affirmative vote or consent of all general partners and of limited partners owning a majority of the rights to receive distributions as limited partners at the time the vote or consent is to be effective.” REV. UNIF. LTD. PTNSHIP. ACT §801(a)(2). If the decedent owns a majority of limited partnership interests, the decedent would have the ability to act with others to dissolve the partnership in any event under the Uniform Act (unless the partnership agreement negated that provision). This same provision is included in the California limited partnership act. CALIF CODE CORPORATIONS §15908.01.

If none of the permitted events that would cause dissolution of the partnership involve action by the limited partner, the argument that the decedent could dissolve the partnership in conjunction with others is more tenuous. For example, under the Revised Uniform Limited Partnership Act, if the partnership agreement does not address limited partnership consent regarding dissolution and if a decedent owned less than a majority of the limited partner interests entitled to distributions, the decedent would have no way to participate in the decision to dissolve the partnership. However, the decedent as a limited partner always could join with all the other partners to amend the partnership agreement and add provisions allowing the dissolution of the partnership. *Id.* at §406(b)(1) (affirmative vote or consent of all partners is required to amend the partnership agreement). If a court were inclined to employ common sense limitations in applying the “in conjunction with” phrase (see paragraph 17 below), the ability to join with other partners in amending the partnership agreement seems more remote than an explicit direct ability to join with others in dissolving the partnership.

Indeed, the court in footnote 4 suggests that the application of §2036(a)(2) might have been avoided by a change in drafting of the partnership agreement. (Footnote 4 includes the following clause: “had NHP’s limited partnership agreement been drafted in a way that prevented the application of sec. 2036(a)(2).”) How that drafting would have been accomplished under the court’s reasoning is not clear. If the agreement had been silent regarding dissolution, the general partner and a majority of the limited partners (which would have included the decedent) could have dissolved the partnership under California law. Perhaps the court was suggesting that the partnership agreement could have provided that the limited partners would have had no input into the decision to dissolve.)

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(6) **Avoid Having Decedent's Agent as General Partner.** One of the court's reasons for applying §2036(a)(2) was that the son could make distribution decisions and also owed duties to the decedent under the power of attorney from the decedent, thus she had the ability through her agent to determine the amount and timing of distributions. That argument could be removed by having someone serve as general partner other than the decedent or an agent for the decedent under a power of attorney

(7) **Special Voting Interests to Make Liquidation/Dissolution Decisions.** One planning alternative may be to have a special partnership or member interest that would have the *exclusive* ability to vote on liquidation or dissolution decisions. The first rationale of the court's reasoning under §2036(a)(2) would then no longer apply—the decedent could not participate with anyone in deciding when to dissolve the partnership/LLC. That is not a complete answer to the court's reasoning however; under state law, all of the partners/members presumably could agree to change the underlying formation documents any way they wanted, including the omission of the special voting interest. But having significant factual differences may be important if a court looks for ways to distinguish the *Powell* holding.

(8) **Trust Owners with Independent Trustee.** If all of the partners/members were irrevocable trusts with independent trustees, any dissolution proceeds would pass to the irrevocable trusts, and the decedent could not join with the trustee in making distribution decisions, so the court's "in conjunction with" analysis would no longer give the decedent the ability to designate who could receive the income or property contributed to the partnership/LLC. The decedent's interest could be held in an "incomplete gift" trust (for example if the trust was for the sole benefit of the decedent and the decedent had a testamentary power of appointment), but most clients would likely not be willing to be subject to that inflexibility.

(9) **Transfer All Interests During Life.** Some clients have created FLPs/LLCs with the contemplation that some or most of the limited partner/member interest would be retained until the client died, and valuation discounts would apply to those interests for estate tax purposes. In light of the result in *Powell* suggesting that §2036(a)(2) will always apply unless the bona fide sale for full consideration exception is applicable, clients in the future may consider only contributing to entities an amount for which the client would contemplate eventually giving or selling all of the retained interests (and having the foresight to do so at least three years before death). Appropriate discounts should apply in valuing the gifts or in determining sale prices, and §2036 would not apply to include the entity's assets in the estate (without a discount) under §2036.

(10) **"Claim Victory" and Dissolve FLP/LLC with Prior Successful Transfers.** If a client has previously created an FLP/LLC and has made gifts or sales of interests in the entity to trusts that have experienced substantial appreciation, consider dissolving the entity so that the trusts would own the value apart from the FLP/LLC, thus negating any possible §2036 taint. Value attributable to interests that have been transferred at least three years earlier should not be subject to §2036(a)(1) if no implied agreement of retained enjoyment exists (see the *Jorgenson*, *Kelly*, and *Rosen* cases), but §2036(a)(2) might continue to apply to gifts of interests over which the decedent has a continued ability (in conjunction with others) to determine the amount or timing of distributions.

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(11) **Rationale for Estate Inclusion for Basis Adjustment Purposes.** If a decedent dies without estate tax concerns and the estate would like to include the FLP assets in the estate without a discount for basis adjustment purposes, the *Powell* reasoning provides a rationale for including the assets in the estate (at least as to interests retained by the decedent or transferred within the prior three years) as long as the transfer to the partnership did not qualify for the bona fide sale for full consideration exception to §2036.

This position may run into IRS objections, with the IRS arguing that the bona fide sale for full consideration exception prevents the application of §2036(a)(2). In Tech. Adv. Memo. 9515003, the grantor argued that voting stock that had been transferred to an irrevocable trust should be included in the grantor's estate under §2036(b), presumably in order to get a basis adjustment under §1014, because of an oral understanding that the trustee would consult with the grantor and abide by the grantor's decisions regarding voting the stock. The IRS observed that the form of the transaction involved an irrevocable transfer of voting stock in which the grantor clearly and unambiguously relinquished any and all of his rights in the stock, including the right to vote the stock or how determine how it would be voted by the trustee. The IRS refused the taxpayer's right to assert substance over form "where the governing instrument is clear on its face and the estate seeks to disavow the unambiguous instrument based on agreements and information only available to the estate and the executrix and within the estate's control to make part of the record." The IRS also observed that the gift tax return filed by the donor did not report any retained interest in the transferred stock and contained no reference to any retained voting rights. The IRS did not believe that "the estate can gain a tax advantage by now disavowing the form of the transaction." *See also Mowry v. Commissioner*, T.C. Memo. 2018-105 ("Generally taxpayers are bound by the form of the transaction that they choose unless they can provide "strong proof" that the parties intended a different transaction in substance. *Schulz v. Commissioner*, 294 F.2d 52, 55 (9th Cir. 1961), *aff'g* 34 T.C. 235 (1960); see also *Vandenbosch v. Commissioner*, T.C. Memo. 2016-29, at \*19-\*20. There is no proof that either petitioner or G. Mowry intended an arrangement different from that which they agreed to and reported consistently on their tax filings.")

Under the *Powell* analysis, however, the fact that the partnership can be dissolved by the decedent with some percentage or all of the other partners (either under the terms of the partnership agreement or under local law) is absolutely certain, and does not depend on facts known only to the taxpayer. Therefore, the rationale in TAM 9515003 for denying the taxpayer's position that assets should be included in the gross estate should not apply—the issue turns on whether *Powell* is correct, not on implied or side agreements of the taxpayer known only to the taxpayer and not the IRS.

Regulations clarify that the basis adjustment under §1014 is permitted even though no estate tax return is filed and no estate tax is paid. Treas. Reg. §1.1014-2(a)(2). Therefore, the basis adjustment to 100% of the proportionate asset value (that 15 of the 17 Tax Court judges would include in the estate under §2036(a)(2)) should be allowed even if the estate is under the filing requirement and does not file an estate tax return.

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This approach should only be considered if the taxpayer is not relying on the marital deduction for avoiding estate tax payments. If partnership interests qualify for the marital deduction, the IRS may make the “marital deduction mismatch” argument, claiming that the undiscounted value of the partnership assets are included in the gross estate, but that only the undiscounted value of the partnership interests that pass to a spouse (or qualifying trust) qualifies for the marital deduction (as noted in dicta in *Estate of Black*, 133 T.C. 340 (2009) and *Estate of Shurtz*, T.C. Memo. 2010-21).

(12) **Double Inclusion Analysis.** The majority opinion’s summary of how §2043 applies in the context of §2036 FLP cases is similar to what Professor Jeffrey Pennell has been telling planners for the last decade. See e.g., Pennell, *Recent Wealth Transfer Developments*, ABA REAL PROP., PROB. & TR. LAW SECTION 14<sup>TH</sup> ANN. EST. PL. SYMPOSIUM, at 21-23 (2003). Up to this point, however, the IRS and all of the prior §2036 FLP cases have avoided that technical analysis by merely including assets contributed to an FLP in the estate under §2036 and not *also* including the retained partnership interest itself in the estate under §2033. (Indeed, even in this case, the IRS did not argue that the assets should be included under §2036 and that the 99% interest should also be included under §2033 to the extent the transfer under the power of attorney was not valid (because gifts were authorized only up to the annual exclusion amount).)

The IRS has previously ruled that life insurance proceeds received by a partnership should be not includable in the gross estate *both* under §2042 and under §2033 as to the decedent’s partnership interest under the reasoning that “unwarranted double taxation” would otherwise result. Rev. Rul. 1983-147 (quoted below). Similarly, the regulations regarding GRATs state that if the GRAT assets are included under §2036, the retained annuity interest payments that are payable after the decedent’s death are not also included under §2033 “because they are properly reflected under this section.” Reg. §20.2036-1(c)(1)(i).

**Dictum.** The analysis is not central to the conclusion that §2036(a)(2) applies, and in that respect may be treated as *dictum*.

**Appreciation.** The big distinction of applying the §2036/2043 and §2033 inclusion analysis is that future appreciation of assets contributed to the FLP/LLC will result in double taxation. See Paragraph 6 above of the Analysis of the Majority Opinion. More value may be included in the gross estate than if the decedent had never contributed assets to the FLP. That issue was not raised in this case, because the parties stipulated that the date of contribution value and the date of death value (7 days later) were the same. Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument), in a case in which the majority’s analysis is applied is (hopefully) doubtful. For example, in Revenue Ruling 1983-147, the IRS refused to include life insurance proceeds payable to a partnership both as part of a partner’s interest in the partnership and under §2042 as a result of incidents of ownership attributed to the decedent as partner of the partnership, because doing so would result in “unwarranted double taxation”:

In *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), acq. in result, 1959-1 C.B. 4, aff’d on another issue 244 F.2d 436 (4<sup>th</sup> Cir. Cir.), cert denied, 355 U.S. 827 (1957), a partnership held 10 policies on the decedent’s partner’s life, at his death.... The court found that the decedent, in his

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individual capacity, had no incidents of ownership in the policies, and held that the insurance proceeds were not includable in the gross estate under the predecessor to section 2042(2) of the Code. The Service acquiesces in the result of *Estate of Knipp* on the basis that in that case the insurance proceeds were paid to the partnership and inclusion of the proceeds under the predecessor of section 2042 would have resulted in the **unwarranted double taxation** of a substantial portion of the proceeds because the decedent's proportionate share of the proceeds of the policy were included in the value of the decedent's partnership interest. See also section 20.2042-1(c)(6) of the regulations (which adopts a similar rule with regard to life insurance proceeds paid to or for the benefit of a corporation). (Emphasis added)

**Judge Counting.** Not counting Judge Halpern (who is no longer one of the 16 "regular" Tax Court judges), an equal number of judges (seven) joined the plurality and concurring opinions. Therefore, we do not yet know how a majority of the Tax Court judges would rule regarding the double inclusion issue.

**Emboldened IRS?** The opinion may embolden the IRS to take up the double inclusion position in future cases, raising a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer merely retains the assets.

(13) **Reduced Emphasis on Not Retaining Any Interest as General Partner or Manager.** As a result of concerns raised by the *Strangi* and *Turner* cases applying §2036(a)(2) when the decedent held an interest as general partner or manager, planners have discouraged clients from keeping any interest as a general partner or manager of an FLP or LLC. If a client insists on having some participation in management of the FLP/LLC, planners have encouraged the client to minimize the interest as general partner or manager as much as possible. The importance of eliminating or minimizing management participation by the client may be reduced under *Powell*, to the extent it is interpreted as applying §2036(a)(2) in any event as long as the client continues to hold any limited partnership or member interest in the FLP/LLC. All seventeen of the judges participating in the *Powell* decision agreed that §2036(a)(2) should apply in a situation in which the decedent held NO interest as general partner. One possible approach in light of this result is to emphasize reliance on the bona fide sale for full consideration exception rather than avoiding "strings" that could trigger the application of §2036(a)(2). (However, the transferor's retention of substantial control of the FLP/LLC may color the court's perception of whether a legitimate and significant nontax reason existed for creating the FLP/LLC, depending on the nontax reasons for which the entity is created.)

(14) **Basis Implications.** To the extent that partnership assets are included in a decedent's estate under §2036, the assets should receive a basis adjustment inside the partnership "to reflect the value of the property that was included in ... the estate" even without a §754 election for the partnership. *Hurford Investments No 2, Ltd. v. Commissioner*, Tax Court Docket No. 23017-11 (Order dated April 17, 2017); Letter Ruling 200626003. See Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, ¶ II.Q.8.e.iii.(b) at 928 n.3635 (June 2017).

Prof. Elaine Gagliardi has observed that differing basis results could occur under Judge Halpern's analysis (including the amount of the discount under §2036(a)(2) and including the discounted value of the partnership interest under §2033) and under Judge Lauber's concurring opinion analysis (including all of the partnership asset

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value under §2036(a)(2) and not also including the partnership interest because it is “an alter ego” of the partnership assets). See Elaine Gagliardi, *Planning With Family Limited Liability Entities in 2018 and Beyond*, SEATTLE 63<sup>RD</sup> ANN. EST. PL. SEMINAR, ch. 5 at 5-21 to 5-27 (November 2018).

- Judge Lauber approach (the traditional approach): The partnership **assets** included in the estate without a discount should receive a basis adjustment under §1014(b)(9) (for the undiscounted value of assets included in the decedent’s gross estate). The retained partnership **interest** should also be adjusted to the date of death value of the interest (reflecting any appropriate discounts). Even though the interest is not included in the gross estate for estate tax purposes, it is still property owned by the decedent under state law and that is “acquired from” the decedent, so the basis is adjusted under §1014(b)(1). (See Rev. Rul. 84-139 & General Counsel Memo 39320 (1985) (foreign property not in the U.S. gross estate still entitled to basis adjustment under §1014(b)(1)). Prof. Gagliardi raises the interesting issue of how the “zero basis rule” announced the basis consistency proposed regulations, Prop. Reg. §1.1014-10(e), would be applied in this context, in which the partnership interest is not also included in the decedent’s gross estate.). Thus, the estate’s share of the “inside basis” of partnership assets may be greater than the estate’s “outside basis” in the partnership interest, suggesting that a §754 election should not be made if that can be avoided. Prof. Gagliardi applies these results to a simplified example, assuming the decedent had transferred assets worth \$100 and having a basis of \$40 to the partnership in return for a partnership interest worth \$75 (25% discount). The inside basis of the estate’s interest in the partnership assets would be \$100, and the outside basis in the partnership interest would be \$75.
- Judge Halpern approach: In determining the inside basis of partnership **assets**, only the portion of the assets attributable to the discount on the date of the transfer is included in the estate under §2036(a)(2). That portion of the assets is adjusted to the date of death value, but the balance of the assets attributable to the decedent’s interest keep the same basis as before death. The estate’s outside basis in the partnership **interest** is the discounted fair market value of the partnership interest at death. Applying this result to Prof. Gagliardi’s simplified example, the inside basis of the estate’s interest in the partnership assets would be comprised of two elements. The \$25 amount included in the estate under §2036(a)(2) would have a basis of \$25, and the remaining 75% of the assets would have a proportionate basis of \$30 (75% of the original \$40 basis), for a total of \$55 (\$25 + \$30). The outside basis of the estate’s partnership interest would be \$75. (In that situation, a §754 election would be desirable, to step up the inside basis of the estate’s interest in partnership assets to \$75.)

(15) **Prior Cases That Have Limited the Broad Application of the “In Conjunction with” Phrase in §§2036 and 2038.** Section 2036(a)(2) was enacted with almost identical “in conjunction with” language as in §2038. Several §2038 cases have limited the application of this provision in determining whether a decedent held a joint power to terminate a trust. For example, a power conferred by state law to revoke or terminate a trust with the consent of all beneficiaries is not taxable.

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*Helvering v. Helmholz*, 296 U.S. 93 (1935), *aff'g* 75 F.2d 245 (D.C. Cir. 1934) (reasoning that this power exists under state law in almost all situations, and to hold otherwise would cause all trusts to be taxable). (This exception seems analogous to the power under state law of all partners to agree to amend the partnership agreement or to cause the liquidation of the partnership.) Another example is *Tully Estate v. Commissioner*, 528 F.2d 1401 (Ct. Cl. 1976). In *Tully*, decedent was a 50% shareholder. The corporation and decedent entered into a contract to pay a death benefit to the decedent's widow. Even though the beneficiary designation was irrevocable, the IRS argued that it could be amended for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary. The court's analysis is analogous to the broad extension of §2036(a)(2) to FLPs:

In light of the numerous cases where employee death benefit plans similar to the instant plan were held not includable in the employee's gross estate, we find that Congress did not intend the 'in conjunction' language of section 2038(a)(1) to extend to the mere possibility of bilateral contract modification. Therefore, merely because Tully might have changed the benefit plan 'in conjunction' with T & D and DiNapoli, the death benefits are not forced into Tully's gross estate. 528 F.2d at 1404-05.

A possible distinction of applying the logic of these §2038 cases to the "in conjunction with" language in §2036(a)(2) is that the regulations under §2038 specifically state that a settlor's ability to act in concert with all donees/beneficiaries is not a retained power under §2038, but the analogous provisions in the regulations under §2036 regulations do not include that same statement. See Reg. §§20.2038-1(a)(2) ("§2038 does not apply "[i]f the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law"); 20.2036-1(b)(3). However, applying the "in conjunction with" clause in a different manner in those two situations does not seem supportable under any policy rationale.

(16) **Summary of §2036 FLP/LLC Cases (14-22, With 2 on Both Sides).** Of the various FLP cases that the IRS has chosen to litigate, fourteen have held that at least most of the transfers to an FLP qualified for the bona fide sale exception —

- (1) *Church v. United States*, 2000-1 USTC ¶60,369 (W.D. Tex. 2000) (preserve family ranching enterprise, consolidate undivided ranch interests);
- (2) *Estate of Eugene Stone v. Commissioner*, T.C. Memo 2003-309 (partnerships to settle family hostilities);
- (3) *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), *vacating and rem'g* 244 F. Supp. 2d 700 (N.D. Tex. 2003) ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests);
- (4) *Bongard v. Commissioner*, 124 T.C. 95 (2005) (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts);

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- (5) *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126 (maintaining buy and hold investment philosophy for family du Pont stock);
  - (6) *Estate of Mirowski v. Commissioner*, T.C. Memo 2008-74 (joint management and keeping a single pool of assets for investment opportunities);
  - (7) *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (continue investment philosophy and special stock charting methodology);
  - (8) *Keller v. United States*, 2009-2 USTC ¶60,579 (S.D. Tex. 2009) (protect family assets from depletion in divorces);
  - (9) *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 BL 223971 (W.D. Ark. Oct. 2, 2009) (centralized management and prevent dissipation of family "legacy assets");
  - (10) *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) (maintaining buy and hold investment philosophy for closely held stock);
  - (11) *Estate of Shurtz v. Commissioner*, T.C. Memo 2010-21 (asset protection and management of timberland following gifts of undivided interests);
  - (12) *Estate of Joanne Stone v. Commissioner*, T.C. Memo 2012-48 (desire to have woodland parcels held and managed as a family asset and various other factors mentioned);
  - (13) *Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (ensuring equal estate distribution, avoiding potential litigation, and achieving effective asset management); and
  - (14) *Estate of Purdue v. Commissioner*, T.C. Memo 2015-249 (centralized management and other factors).

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

Interestingly, six of those fourteen cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the *Miller*, *Joanne Stone*, and

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*Purdue* cases and authored the Tax Court's opinion in *Bongard*. Judge Chiechi decided both *Stone* and *Mirowski*. (Judge Wherry decided *Schutt*, Judge Halpern decided *Black*, Judge Jacobs decided *Shurtz*, Judge Foley decided *Kelly*, and *Church* and *Kimbell* were federal district court opinions ultimately resolved by the Fifth Circuit. *Keller* and *Murphy* are federal district court cases.)

Including the partial inclusion of FLP assets in *Miller* and *Bongard*, 22 cases have applied §2036 to FLP or LLC situations: *Estate of Schauerhamer v. Commissioner*, T.C. Memo 1997-242, *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000), *Estate of Harper v. Commissioner*, T.C. Memo 2002-121, *Thompson v. Commissioner*, T.C. Memo 2002-246, aff'd, 382 F.3d 367 (3d Cir. 2004), *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, aff'd, 417 F.3d 468 (5th Cir. 2005), *Estate of Abraham v. Commissioner*, T.C. Memo 2004-39, *Estate of Hillgren v. Commissioner*, T.C. Memo 2004-46, *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005) (as to an LLC but not as to a separate FLP), *Estate of Bigelow v. Commissioner*, T.C. Memo 2005-65, aff'd, 503 F.3d 955 (9th Cir. 2007), *Estate of Edna Korby v. Commissioner*, T.C. Memo 2005-102, aff'd, 471 F.3d 848 (8th Cir. 2006), *Estate of Austin Korby v. Commissioner*, T.C. Memo 2005-103, aff'd, 471 F.3d 848 (8th Cir. 2006), *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115, *Estate of Erickson v. Commissioner*, T.C. § of Rector v. Commissioner, T.C. Memo 2007-367, *Estate of Hurford v. Commissioner*, T.C. Memo 2008-278, *Estate of Jorgensen v. Commissioner*, T.C. Memo 2009-66, aff'd, 431 Fed. Appx. 544 (9th Cir. 2011), *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (as to transfers made 13 days before death but not as to prior transfers), *Estate of Malkin v. Commissioner*, T.C. Memo 2009-212, *Estate of Holliday v. Commissioner*, T.C. Memo 2016-51, *Estate of Beyer v. Commissioner*, T.C. Memo 2016-183, and *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (2017). In addition, the district court applied §2036 in *Kimbell v. United States* but the Fifth Circuit reversed.

- f. ***Estate of Turner v. Commissioner (Turner III) – Marital Deduction Not Reduced by Estate Taxes (and Interest) on Lifetime Nonmarital Gifts Included in Gross Estate Under §2036.***

**Synopsis.** *Turner I* held that assets in a limited partnership were includable in the decedent's estate under §§2036(a)(1) and 2036(a)(2), and that the bona fide sale for full consideration exception did not apply. *Turner II* held that the partnership assets so included in the gross estate under §2036 that are attributable to limited partnership interests given to family members other than the surviving spouse did not qualify for the marital deduction.

The most recent case, *Turner III*, holds that the marital deduction that is allowed with respect to partnership interests owned by the decedent at death is not reduced by estate taxes on the assets attributable to limited partnership interests that had been given away to family members other than the spouse (included in the gross estate under §2036). The court reasoned that the executor has the right to recover estate taxes on §2036 property from persons who received the property during the decedent's lifetime, and the decedent's will express an intent that the marital deduction should not be reduced by estate tax liabilities.

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In addition, *Turner III* holds that the marital deduction is not increased by the amount of post-death income on the marital deduction property. *Estate of Turner v. Commissioner*, 151 T.C. No. 10 (November 20, 2018) (Judge Marvel).

**Basic Facts.** The decedent and his wife transferred marketable securities and investment assets to a family limited partnership in return for the 1% general partnership interest and 99% limited partnership interests (owned equally by them). They retained assets outside the partnership, the income from which was sufficient to provide their living expenses. In late 2002 and early 2003, the decedent and his wife each made gifts of 21.7446% limited partnership interests to family members. The decedent and his wife paid themselves management fees of \$2,000 per month although they provided few if any management services. After the gifts of partnership interests were made, no distributions were made to the family members prior to the decedent's death, but various payments were made to the decedent and his wife (although they were treated as repayment of advances made by the decedent and not as distributions). The decedent used partnership funds for personal uses (making gifts, making insurance premium payments, and paying estate planning legal fees).

At the decedent's death, he owned a 0.5% general partnership interest and a 27.7554% limited partnership interest. These were reported in the estate tax return after applying lack of marketability and lack of control discounts at \$1,608,984 (as opposed to a pro rata share value of the partnership's assets equal to \$2,681,074, based on total asset value of \$9,488,714 as used in the government's computation for entry of decision). The decedent's will contained a standard formula marital deduction bequest, and the estate tax return reported that an 18.8525% limited partnership interest was allocated to the surviving spouse and an 8.9020% limited partnership interest to a bypass trust. The estate claimed a marital deduction of \$1,072,000 for the 18.8525% interest allocated to the spouse.

**Turner I.** In the initial decision, T.C. Memo. 2011-209 (2011), the court (Judge Marvel) concluded that one-half of the partnership assets (representing the decedent's one-half of the assets contributed to the partnership) were included in the decedent's estate under §2036. (This initial decision is referred to as *Turner I*.) The bona fide sale exception to §2036 did not apply. The court rejected the purported nontax reasons urged by the estate: asset consolidation and centralized management, resolving family disputes, and asset protection for one grandchild. The court pointed to various factors in concluding that §2036(a)(1) applied even though the decedent and his wife had retained assets outside the partnership that were sufficient to pay their living expenses. In addition, the court listed several reasons for concluding that §2036(a)(2) also applied. For a discussion of *Turner I*, see Item 10 of Estate Planning Current Developments (December 2011)

found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

**Turner II.** The court's supplemental opinion, 138 T.C. 306 (2012), responds to taxpayer's motion for reconsideration that (i) the findings in connection with the application of §2036 should be modified and (ii) that the marital deduction should apply against the full value of assets included in the decedent's estate under section 2036, and therefore Mr. Turner's estate would have no additional tax liability. (This

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supplemental opinion is referred to as *Turner II*.) The court held: (1) The bona fide sale exception to §2036 does not apply; the estate did not demonstrate any manifest error of fact in the original determination denying the availability of the bona fide sale exception to §2036; and (2) Marital deduction is not allowed with respect to the portion of partnership assets included in the gross estate that is attributable to partnership interests that had been given to children and grandchildren during the decedent's lifetime (and that did not "pass" to the surviving spouse). The court observed but did not rule of what has been referred to as the "marital deduction mismatch" issue when the (discounted) value of limited partnership interests passing to a surviving spouse is less than the "undiscounted" value of partnership assets included in the gross estate under §2036. The court did not have to rule on that issue because the government's calculation allowed a marital deduction with respect to the full undiscounted value of assets included in the estate under §2036 attributable to the limited partnership interest owned by the decedent at his death that had not been given to family members. For a discussion of *Turner II*, see Item 16 of Estate Planning Current Developments (December 2011) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

***Turner III Analysis.*** The most recent opinion supplements *Turner I* and *Turner II*. 151 T.C. No. 10 (November 20, 2018) (Judge Marvel) (referred to as *Turner III*). The court observed that the decedent's will created a residuary nonmarital trust for the decedent's children and grandchildren, with a formula marital deduction bequest to the surviving wife; however, the nonmarital trust was not created because the §2036 assets attributable to the lifetime gift to family members used up all of the estate's available unified credit amount. The will expressed an intent to leave assets to his surviving wife "undiminished by any estate, inheritance, succession, death or similar taxes" and to leave her assets having a value "equal to the maximum marital deduction." The government argued that because the nonmarital trust was not created, the marital bequest is the residue and is the only source to pay the estate tax, so the marital deduction had to be reduced by the amount of the estate tax. The court disagreed, pointing out that under §2207B(a) the executor is entitled to recover from persons receiving property includable in the gross estate under §2036 estate taxes attributable to those transfers. "Accordingly, [the court held] that the estate need not reduce the marital deduction by the amount of Federal estate and State death taxes it must pay because the tax liabilities are attributable to the section 2036 assets, the estate has the right to recover the amount paid under section 2207B, and the estate must exercise that right to recover to give effect to [the decedent's] intention that [the surviving wife] receive her share of the estate undiminished by the estate's tax obligation." (Observe that the court held that the marital deduction did not have to be reduced by state estate taxes because of the right of recovery under §2207B, but that section does not refer to reimbursement for state death taxes.)

The court also held that the estate could not increase the marital deduction by the amount of post-death income generated by the marital deduction property.

The taxpayer may have been fortunate that the court did not treat the §2207B recovery as coming from the partnership (because the assets included in the gross estate under §2036 were contributed to the partnership and it was the transferee of

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the assets), rather than coming directly from recipients of lifetime transfers of the partnership interests to family members. If the partnership had to pay the §2207B reimbursement amount, query whether that would have proportionately reduced the value of the partnership interest passing to the spouse or whether it would have been applied entirely against the interests of the family members that produced the estate tax? (The IRS had conceded that the value included in the gross estate under §2036 for the partnership interests owned at death that passed to the surviving spouse was offset in its entirety (i.e., the full undiscounted value) by the marital deduction.) Ronald Aucutt has observed the potential questions raised by this issue:

*Turner* / provided that the value of the assets Clyde Sr. transferred to the partnership in April 2002 was included in his gross estate, not the value of the gifts of partnership interests he made on December 31, 2002, and January 1, 2003. Who then is “the person receiving the property” from whom section 2207B(a)(1) gives his executor a right of recovery? Isn’t it the partnership? If so, how is recovery obtained? And wouldn’t recovery from the partnership reduce the value of all interests in the partnership, including, after all, Jewell’s interests? Or was the “transfer” contemplated by section 2207B(a)(1) not complete until and to the extent of Clyde Sr.’s gifts, so the recovery, if it comes from the partnership, must somehow come from the partnership interests of those transferees? Wouldn’t that be contrary to the recent application of section 2036 in family limited partnership cases even to the assets represented by the partnership interests the partner retains until death? Ronald Aucutt, *Top Ten Estate Planning and Estate Tax Developments of 2018*, ACTEC CAPITAL LETTER No. 47 (January 2, 2019).

g. ***Estate of Streightoff v. Commissioner – Valuation of Limited Partnership Interest (Allowing 18% Lack of Marketability Discount).***

**Synopsis.** *Estate of Streightoff v. Commissioner* valued a limited partnership interest that the decedent had transferred to the decedent’s revocable trust as a limited partnership interest rather than as an assignee interest as submitted by the estate. The partnership owned publicly traded marketable securities and fixed-income investments. The court reasoned that the transfer to the revocable trust satisfied all of the requirements under the partnership agreement for the revocable trust to be recognized as a substitute limited partner rather than merely as an assignee. The court allowed no lack of control discount (because the 88.99% interest was sufficient under the partnership agreement to remove the general partner, which would have dissolved the partnership). The court adopted the IRS expert’s approach of allowing an 18% lack of marketability discount, highlighting various factors that were recognized in *Mandelbaum v. Commissioner*, T.C. Memo. 1995-255, aff’d, 91 F.3d 124 (3d Cir. 1996). *Estate of Streightoff v. Commissioner*, T.C. Memo. 2018-178 (Judge Kerrigan),

**Basic Facts.** The decedent’s daughter, acting under a power of attorney for her father, formed a limited partnership under the Texas Revised Limited Partnership Act, with an LLC as the sole general partner having the daughter as the manager of the LLC, and transferred marketable securities and fixed-income investment assets to the partnership on October 1, 2008. The decedent, his daughters, his sons, and a former daughter-in-law were the original limited partners (the owners other than the decedent having received their interests by gift).

On that same day, the decedent created a revocable trust for himself, with the daughter as the sole trustee. The daughter, acting under the power of attorney, transferred her father’s 88.99% limited partnership interest in the partnership to the

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revocable trust under an "Assignment of Interest" document that assigned all of his interest in the limited partnership and agreed to execute any further legal documents needed to assign all rights decedent may have had in the property. The trustee of the revocable trust signed the Assignment document, which provided that the assignee agreed to abide by all the terms and provisions in the partnership agreement.

The decedent died May 6, 2011, and his federal estate tax return reported the interest in the partnership on Schedule G as a Transfer During Life. The interest was reported as an assignee interest in an 88.99% limited partnership interest. It was valued on the alternate valuation date at \$4,588,000, applying a 37.2% discount for lack of marketability, lack of control, and lack of liquidity. The IRS examiner allowed an 18% discount in the estate tax audit.

### **Analysis.**

- **Texas Partnership Law and Relevant Provisions of Partnership Agreement.**

Under the Texas Revised Limited Partnership Act, an assignee of a partnership interest is entitled to allocations of income, gain, loss, deduction, credit, or similar items, and to receive distributions to which the assignor is entitled, but is not entitled "to become, or to exercise rights or powers of, a partner." The assignee may become a substituted limited partner, with all rights and powers under the partnership agreement, in the manner that the partnership agreement provides or if all partners consent.

The partnership agreement provided that a transferee who has not been admitted as a substituted limited partner would be an "unadmitted assignee" and would hold the right to allocations and distributions with respect to the transferred interest but would have no right to any information or accounting or to inspect the books or records of the partnership and would not have any of the rights of a general or limited partner (including the right to vote on partnership matters).

The partnership agreement provided that the partnership was a fixed-term limited partnership (terminating on December 31, 2075, unless terminated upon the occurrence of certain events). The partnership agreement provided that 75% or more of the partnership interests held by limited partners could remove the general partner, which would terminate the partnership unless 75% of the limited partners reconstituted the partnership and elected a successor general partner.

The partnership agreement also included restrictions on transfers of partnership interests, but allowed certain permitted transfers.

- **Value as Limited Partnership Interest, Not as Mere Assignee Interest.** As a matter of form, the decedent transferred to the revocable trust a limited partnership interest and not an assignee interest, because all of the requirements under the partnership agreement for becoming a substituted limited partner were met. For a transferee to be admitted as a substituted limited partner under the terms of the partnership agreement, (1) the general partner must consent to the transferee's admission [the daughter signed the agreement as manager of the LLC-general partner and consented to its terms], (2) the transferee must have acquired the

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interest by means of a permitted transfer [which was stipulated by the parties], and (3) the transferee must agree and execute the instruments necessary to be bound by the terms of the partnership agreement [the daughter, as trustee of the revocable trust, signed the Assignment document which provided that the trust agreed to abide by all the terms and provisions of the partnership agreement].

Furthermore, as a matter of substance and economic realities the transferred interest was a limited partnership interest. There would have been no substantial difference before and after the transfer to the revocable trust. While assignees had no rights to information, that distinction made no difference because the daughter was also individually a partner entitled to information and trustee of the revocable trust. Whether the revocable trust held voting rights would have been of no practical significance because there were no votes by limited partners and decedent held the power to revoke the revocable trust which would have reinstated all rights of a limited partner in the decedent.

- **No Lack of Control Discount.** The court agreed with the IRS expert that no lack of control discount should be allowed. The 88.99% limited partnership interest could remove the general partner, which would terminate the partnership. The 88.99% interest had the ability to terminate the partnership unilaterally if the owner did not agree with the management of the general partner. Thus, the interest did not lack control.
- **Lack of Marketability.** The IRS's and estate's experts both relied on factors identified in *Mandelbaum v Commissioner*, T.C. Memo. 1995-255, aff'd, 91 F.3d 124 (3d Cir. 1996), that make an entity more or less marketable. These include:

(1) an analysis of the entity's financial condition, (2) the entity's capacity to pay and history of paying distributions, (3) the nature of the entity and its economic outlook, (4) the management of the entity, (5) the amount of control held by the interest, (6) restrictions on the transferability of the interest, (7) the required holding period for the interest, (8) the entity's redemption policy, and (9) the costs associated with making a public offering.

The IRS's expert relied on restricted stock studies using more recent studies, which considered stocks with shorter holding periods in light of SEC regulations that have shortened the holding periods required for purchasers of restricted stock to resell their interests. The expert observed various factors having a depressant effect on the amount of the marketability discount. The partnership was capable of making distributions in light of its overall financial condition. The assets were highly liquid, and the diversification and high liquidity of the assets would make the interest highly attractive to a hypothetical buyer. The amount of control provided by an 88.99% limited partnership interest and the existence of the right of refusal favored a lower discount.

The court gave less weight to the taxpayer's expert because its report valued the interest as an assignee rather than as a limited partnership interest, and the expert testified that his analysis would have included different considerations if the interest was a limited partnership interest with voting rights.

The court adopted the IRS expert's analysis of an 18% discount for lack of marketability.

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### **Observations.**

- Whether merely transferring a limited partnership interest to a revocable trust can be sufficient to value the interest as an assignee interest rather than a limited partnership interest (assuming, unlike in *Streightoff*, that the requirements for admission as a substitute limited partner were not satisfied) seems unclear at best. If an assignee interest would be valued significantly lower than a limited partnership interest, allowing a mere transfer to a revocable trust to achieve that reduction in value of the transfer tax base seems unwarranted.
  - An 18% marketability discount for a situation in which the decedent had the unilateral ability to force the dissolution of the partnership and a return of the decedent's assets seems very favorable for the taxpayer. The IRS's expert, whose conclusion was adopted by the court, did observe that the amount of control provided by an 88.99% limited partnership interest favored a lower discount.
- g. **Review of Court Cases Valuing Partnership Interests.** Despite the many cases that have addressed the applicability of §2036 to limited partnership or LLC interests, fewer cases have actually reached the point of valuing partnership interests. John Porter, an attorney in Houston, Texas who has litigated many of the family limited partnership cases, summarizes discounts that have been allowed by the courts in these cases as follows (the *Streightoff* case result has been added to the table):

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
<i>Strangi I</i>	securities	Tax	31%
<i>Knight</i>	securities/real estate	Tax	15%
<i>Jones</i>	real estate	Tax	8%; 44%
<i>Dailey</i>	securities	Tax	40%
<i>Adams</i>	securities/real estate/minerals	Fed.Dist.	54%
<i>Church</i>	securities/real estate	Fed. Dist.	63%
<i>McCord</i>	securities/real estate	Tax	32%
<i>Lappo</i>	securities/real estate	Tax	35.4%
<i>Peracchio</i>	securities	Tax	29.5%
<i>Deputy</i>	boat company	Tax	30%
<i>Green</i>	bank stock	Tax	46%
<i>Thompson</i>	publishing company	Tax	40.5%
<i>Kelley</i>	cash	Tax	32%
<i>Temple</i>	Marketable securities	Fed. Dist.	21.25%
<i>Temple</i>	ranch	Fed. Dist.	38%

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<i>Temple</i>	winery	Fed. Dist.	60%
<i>Astleford</i>	real estate	Tax	30% (GP); 36% (LP)
<i>Holman</i>	dell stock	Tax	22.5%
<i>Keller</i>	securities	Fed. Dist.	47.5%
<i>Murphy</i>	securities/real estate	Fed. Dist.	41%
<i>Pierre II</i>	securities	Tax	35.6%
<i>Levy</i>	undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
<i>Giustina</i>	timberland; forestry	Tax	25% with respect to cash flow valuation (75% weighting to cash flow factor and 25% weighting to asset method); BUT reversed by 9th Circuit and remanded to reconsider without giving 25% weight to asset value
<i>Koops</i>	securities	Tax	7.5%; Estate owned 70.42% of vote and could remove limitation on distributions
<i>Gallagher</i>	publishing company	Tax	47%
<i>Streightoff</i>	securities	Tax	0% lack of control discount because the 88.99% LP interest could remove the general partner and terminate the partnership; 18% lack of marketability discount

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

## 7. Intergenerational Split Dollar Life Insurance; Extension of Powell's "In Conjunction With" Analysis for §§2036 and 2038 and Broad Application of §2703 to Contractual Rights, *Estate of Cahill v. Commissioner*

### Synopsis and Settlement

The decedent's revocable trust had advanced \$10 million to an irrevocable trust under a split dollar agreement for the trust to purchase life insurance policies on the lives of the decedent's son and his wife. The estate valued the estate's right eventually to be reimbursed for its advances at only \$183,700, because of the long period of time before the policies would mature at the insureds' deaths. The IRS argued, among other things, that the reimbursement right should have a value equal to the full cash surrender value of the policies (about \$9.6 million) in part because of §§ 2036, 2038, and 2703, and the notice of deficiency asserted penalties for negligence, and either gross or substantial valuation misstatements, with the asserted penalties exceeding \$2.2 million. The court rejected the estate's motion for a partial summary judgment that §§ 2036(a)(2), 2038(a)(1),

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and 2703(a) do not apply and that Reg. §1.61-22 applied in valuing the decedent's reimbursement rights.

The court reasoned that §§ 2036(a)(2) and 2038(a)(1) could apply because the decedent, in conjunction with the irrevocable trust, could agree to terminate the split dollar plan and the decedent would have been entitled to the cash surrender value of the policies (without waiting until the insureds' deaths), and because the advance of the premiums in this situation was not a bona fide sale for full and adequate consideration. (The court cited its recent decision in *Powell v. Commissioner*, 148 T.C. No. 18, which applied § 2036(a)(2) to a decedent's contribution to a partnership in return for a limited partnership interest because all of the partners could agree to terminate the partnership.)

The § 2703(a) issue is whether restrictions on repayment rights under the split dollar agreement are treated as restrictions on the right to sell or use property that must be ignored in determining the value of property that has been transferred. The taxpayer's counter argument is that the right to the receivable under the terms of the split dollar contract is the very property that is transferred (whether during life or at the owner's death), and the terms of the contract are not merely a restriction on the property transferred.

The court in *Cahill* concludes that § 2703(a) applies, to disregard the irrevocable trust's ability to prevent an early termination of the agreement in valuing the reimbursement right, because the provision preventing the decedent from immediately withdrawing his advance was an agreement allowing the third party to acquire or use property at a price less than fair market value (§ 2703(a)(1)), and because the agreement significantly restricted the decedent's right to use his "termination rights" under the agreement (§ 2703(a)(2)).

Reg. § 1.61-22 generally treats the amount transferred each year under a split dollar plan governed by the economic benefit regime as the cost of current life insurance protection in that year. However, that regulation applies for income and gift tax purposes, not for estate tax purposes. Therefore, the regulation does not apply directly in valuing the transfer at the decedent's death benefit rights for estate tax purposes, and is not inconsistent with the application of §§ 2036, 2038, and 2703.

Planners have been concerned that the Tax Court's reasoning in *Estate of Powell*, applying § 2036(a)(2) because the partners could unanimously agree to terminate the partnership, may be extended to other situations involving multi-party transactions in which the parties could agree to "undo" the deal. Indeed, just a little over a year later, *Cahill* has indeed applied that same reasoning in the context of a different transaction other than one involving limited partnership interests. The court also applies the general rule of § 2703(a) broadly, leaving to a subsequent trial the issue of whether one of the exceptions in § 2703(b) might apply. *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018) (Judge Thornton).

The estate tax audit was settled on August 16, 2018, with the estate conceding all of the issues regarding the intergenerational split dollar arrangement (agreeing that the value of the decedent's reimbursement right was the \$9.6 million cash surrender value of the policies) and the imposition of a 20% accuracy-related penalty under § 6662; the IRS

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conceded as to the value of certain notes from family members unrelated to the split dollar transaction.

### **Basic Facts**

1. The transactions involving the funding of the split dollar agreement occurred in 2010, when the decedent was 90 years old and unable to manage his own affairs.
2. The decedent's son was the trustee of a revocable trust for the decedent and was the agent under a power of attorney for the decedent.
3. The son, acting under the power of attorney for the decedent, created an irrevocable trust on September 9, 2010 with the son's cousin and business partner as the trustee. The purpose of the irrevocable trust was to acquire large life policies on the lives of the son and his wife.
4. Later in 2010, the revocable trust borrowed \$10 million, with the loan proceeds being paid directly to the life insurance companies for the purchase of the policies. (The loan had a five-year term with an interest rate based in part on the LIBOR rate, and the bank was not required to extend the loan at the end of the five-year term.)
5. The irrevocable trust was designated as the owner of the policies, and the irrevocable trust and revocable trust entered into a split dollar agreement, providing that the revocable trust would be reimbursed for the \$10 million premium advance. The reimbursement would be made (i) at the termination of the agreement if the two trusts agreed to terminate the agreement early, or (ii) following the deaths of the insureds. The opinion refers to the decedent's reimbursement rights in these two events as the "termination rights" and the "death benefit rights." If the agreement was terminated early, the irrevocable trust could keep the policies and pay the decedent the greater of the premiums paid or the cash surrender values of the policies or could transfer the policies to the bank in full or partial satisfaction of the decedent's obligation to the bank and the decedent would receive any excess of the cash surrender value over the loan balance. Otherwise, at the insureds' respective deaths, the decedent would receive the greater of the loan balance, premiums paid, or cash surrender value.
6. In 2010, the decedent reported total gifts to the irrevocable trust of \$7,578, as determined under the economic benefit regime rules of Reg. § 1.61-22.
7. The decedent died about a year later on December 12, 2011. The decedent's executor is the son, who lives in Washington state (meaning that this case eventually would have been appealable to the Ninth Circuit Court of Appeals).
8. The estate's reimbursement rights under the split dollar agreement, including its termination rights, were valued at only \$183,700 on the estate tax return. (The estate maintains that the termination rights had no value on the date of death because allowing early termination of the split dollar funding arrangement would have made no economic sense for the irrevocable trust, and the irrevocable trust would never have agreed to an early termination.) The IRS valued the reimbursement rights as equal to the cash surrender value of the policies on the date of death, or \$9,611,624. The IRS presents alternative theories applying §§ 2036(a)(2), 2038(a)(1), and 2703(a)(1) and (a)(2). In addition, the IRS assessed over \$2.2 million of penalties under the negligence

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penalty (§6662(a) and (b)(1)) and either the gross (§6662(h)) or substantial (§66662(b)(3)) valuation misstatements penalty.

9. The estate sought summary judgment that §§ 2036, 2038, and 2703 are inapplicable, looking to Reg. § 1.61-22 for support of its position.
10. Following trial and after a final judgment was rendered the decision would have been appealable to the Ninth Circuit Court of Appeals.
11. Following the tax Court's ruling on the motion for partial summary judgment in this case, a settlement was reached. The estate tax audit was settled on August 16, 2018, with the estate conceding all of the issues regarding the intergenerational split dollar arrangement (agreeing that the value of the decedent's reimbursement right was the \$9.6 million cash surrender value of the policies) and the imposition of a 20% accuracy-related penalty under § 6662; the IRS conceded as to the value of certain notes from family members unrelated to the split dollar transaction. See Lee Slavutin, Richard Harris and Martin M. Shenkman, *Intergenerational Split Dollar – Cahill Case Settled – Taxpayer Concedes on Split Dollar Valuation Issue*, LEIMBERG EST. PL. NEWSLETTER #2663 (September 13, 2018).

## **Analysis**

1. **Economic Benefit Regime Applicable.** The court's analysis treats the funding agreement under the economic benefit regime described in the split dollar regulations. Regulation §1.61-22(b)(3)(i) generally treats a split dollar arrangement under the loan regime if a third party owns the policy, but applies the economic benefit regime if the only benefit provided to the donee is current life insurance protection (Reg. § 1.61-22(c)(1)(ii)). The Tax Court approved this treatment in *Estate of Morissette v. Commissioner*, 146 T.C. 171 (2016). Under the economic benefit regime, the amount treated as being transferred by the party advancing the premium payments is, for each year the arrangement remains in place, the cost of current life insurance protection in that year.
2. **Section 2036(a)(2) and Section 2038(a)(1) Applies.** Section 2036(a)(2) provides that if the decedent has made a transfer of property (other than a bona fide sale for adequate and full consideration), the property is included in the decedent's gross estate if the decedent retained "the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property or the income therefrom." Section 2038(a)(1) applies to a transfer of property (other than a bona fide sale for adequate and full consideration) if the decedent had at the date of death the ability in conjunction with any other person to alter, amend, revoke, or terminate the transferee's enjoyment of the transferred property.

The court reasoned that the decedent (actually the revocable trust, but the decedent and revocable trust will be treated interchangeably in this summary) had the power at any time to terminate the split dollar agreement "in conjunction with" the irrevocable trust, because the agreement provided that it could be terminated at any time by written agreement between the revocable trust and the irrevocable trust. The *Cahill* opinion cited the Tax Court's opinion from about a year earlier in *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (2017). The opinion's citation of *Powell* included a

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parenthetical with this quotation from *Powell*: “[D]ecedent’s ability to dissolve ... [her limited partnership] with the cooperation of her sons constituted a ‘right ... in conjunction with ... [others], to designate the persons who shall possess or enjoy the property [she transferred to the partnership] or the income therefrom’, within the meaning of section 2036(a)(2).” The court also cited *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, aff’d, 417 F.3d 468 (5th Cir. 2005).

The taxpayer argued that the decedent held no such right because the right to terminate was held only in conjunction with the irrevocable trust, and as the recipient of the benefit of the arrangement, it could prevent the decedent from terminating the agreement. The court responded that the statute refers to “in conjunction with *any* person” in § 2036(a)(2) and “in conjunction with *any other* person” in § 2038(a)(1). The estate apparently acknowledged that the “in conjunction with” provision could apply if the decedent had been in complete control of the other party who had to agree with the termination, but the court answered that the statute by its terms does not require unilateral control.

The bona fide sale for full and adequate consideration did not apply to the split dollar arrangement. It was not a “bona fide sale” because the son “stood on both sides of the transaction,” and the arrangement was not an arm’s length transaction.

Unresolved factual questions exist as to whether the stated non-tax reason of smoothing the transfer of a business owned by the son to his children at his death was a legitimate business purpose. (The court was skeptical, suggesting that perhaps the purpose was merely to eliminate the cash surrender value from the decedent’s estate rather than to provide liquidity decades in the future, observing that the guaranteed return on the investment in the policies appears to be lower than the interest rate on the loan used to finance the purchase of the policies, and that the loan required a balloon payment of the entire principal amount in only five years.)

In addition, the transfer was not for “full and adequate consideration” because according to the way the estate valued the reimbursement right on the estate tax return, the value of what the decedent received “was not even close to the value of what decedent paid” (i.e., \$183,700 vs. \$10 million, or a discount of over 98%).

### 3. **Section 2703 Applicability.**

a. **Overview.** Perhaps the most problematic part of the opinion to the intergenerational split dollar plan is its § 2703 analysis. The IRS prevailed in its position that the irrevocable trust’s “ability to veto termination of the split dollar agreements should be disregarded under section 2703(a)(1) or (2) for purposes of valuing decedent’s rights in the split dollar agreements.” The court concluded that on the basis of the undisputed facts, “the requirements of section 2703(a)(1) and (2) are each met.”

b. **Statute.**

SEC. 2703. CERTAIN RIGHTS AND RESTRICTIONS DISREGARDED.

- (a) **GENERAL RULE.**—For purposes of this subtitle, the value of any property shall be determined without regard to—

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- (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
- (2) any restriction on the right to sell or use such property.
- (b) EXCEPTIONS.—Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:
- (1) It is a bona fide business arrangement.
- (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
- (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.
- c. **"Property" Transferred for Purposes of § 2703.** The estate contended that the IRS was improperly treating the *policies* as the "property" that was transferred as if they were directly owned by the decedent, and that restrictions on being able to access the policy values should be ignored under § 2703. Instead, the estate argued that the bundle of rights under the split dollar agreement was the "property," and that any restrictions are merely inherent in that bundle of rights. The IRS responded that it was "viewing the property interests owned by decedent in light of all relevant facts and circumstances, including the split dollar agreements," and that the "contractual rights to an amount at least equal to the cash surrender value ... were held by decedent through the split dollar agreements ... and more restricted because the agreement also allowed the [irrevocable trust] to prevent decedent's immediate access to that amount." The court reasoned "that the parties agree that the relevant property interests for purposes of section 2703(a) are the rights held under the split dollar agreements," and that the "decedent did in fact own the termination rights," so the estate's position was ill founded. Therefore, the court proceeded with an analysis of whether § 2703(a) applied to those rights.
- d. **Section 2703 Applicable.** The heading is somewhat of an overstatement. The court merely determined that on the agreed facts, the taxpayer's motion for summary judgment could not be granted. The court's analysis, however, suggests that the taxpayer will have a very difficult time establishing that § 2703 does not apply.
- Section 2703(a)(1) applies because "the split dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value."
- Section 2703(a)(2), addressing any restriction on the right to sell or use property, also applies because "the split-dollar agreements, and specifically [the irrevocable trust's] ability to prevent termination, also significantly restrict decedent's right to

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use the termination rights. The split-dollar agreements, taken as a whole, clearly restrict decedent's right to terminate the agreement and withdraw his investment from these arrangements."

The estate contended that the split dollar agreements are like promissory notes and partnership interests, as to which § 2703(a) does not apply. The court disagreed. The split dollar agreements are not like notes because the irrevocable trust "did not bargain for the split dollar agreement (it provided nothing to fund these arrangements), nor did [the irrevocable trust] agree to repay with interest the money provided by decedent." The split dollar agreements "are therefore entirely unlike bona fide notes."

The court also disagreed with the analogy to partnership interests. The Tax Court in *Estate of Strangi v. Commissioner* held that a decedent's interest in a limited partnership should be valued by taking into consideration the limitations on a limited partner's rights to partnership assets under § 2703(a): "Congress did not intend, by the enactment of section 2703, to treat partnership assets as if they were assets of the estate where the legal interest owned by the decedent at the time of death was a limited partnership or corporate interest." 115 T.C. 478, 488-489 (2000), *aff'd as to this issue, rev'd on another issue sub nom Gulig v. Commissioner*, 293 F.3d 279 (5th Cir. 2002). The court in *Cahill* concluded that analysis does not apply to the decedent's rights under the split dollar agreement because "[n]o state law entity is involved in this case," and because the IRS did not argue in *Strangi* that the "shareholder's agreement should be disregarded... under section 2703(a)."

The court also rejected the estate's arguments that § 2703 applies only to option or buy-sell agreements or to arrangements involving a restraint on alienation.

The court viewed the estate's position as meaning that if § 2703(a) applies to the split dollar agreement, "it would also apply to all sorts of other options, agreements, rights, and restrictions" because "'almost every two-party agreement has a restriction that one party cannot just unilaterally terminate the agreement.'" The court gave no reasons why § 2703(a) would not apply to all two-party agreements that restrict a party from unilaterally terminating in the agreement, but responded that the issue would be whether one of the exceptions in § 2703(b) to the application of § 2703(a) would apply, and particularly whether the arrangement has "terms comparable to similar arrangements entered into by persons in an arms' length transaction."

The § 2703(b) issue about the applicability of exceptions was not before the court in this summary judgment proceeding, so the court did not "consider whether the exception applies in this case."

4. **No Double Counting.** The estate argued that applying §§ 2036, 2038, and 2703 would result in a double counting of gifts and amounts included in the estate, because the cost of current life insurance coverage will continue to be treated as gifts under the split dollar rules after the decedent's death. The court responded that the gifts of current life insurance protection to the irrevocable trust after the

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decedent's death "would not be a gift from decedent but rather from whoever happens to succeed to decedent's interests in the split-dollar agreements."

5. **Split Dollar Regulations Are Not Inconsistent With Applying §§ 2036, 2038, and 2703.** The estate argued that under Reg. § 1.61-22, the only transfer that occurs under the economic benefit regime of the split dollar regulations is the annual cost of insurance protection, and applying §§ 2036, 2038, and 2703 to include the cash surrender value of the underlying policies in the decedent's gross estate is inconsistent with the approach of the regulations.

The court instead viewed the split dollar regulations as explaining the gift tax consequences of transfers from the decedent to the irrevocable trust under the split dollar arrangement, whereas the "estate tax, by contrast, taxes the transfer of the decedent's taxable estate to the decedent's heirs (rather than to a counterparty of the split-dollar arrangement) under a will or by operation of law (rather than under a split-dollar arrangement)."

Indeed, the court turned the consistency argument against the estate. The split dollar regulations treat the donor/owner under an economic regime arrangement as the owner of the cash surrender value (citing Reg. §1.61-22(b)(3)(i), (ii)(B), (c)(1)(ii)(A)(2), (d)(2), (4)(ii)), and the benefit of current insurance protection as a gift from the decedent to the irrevocable trust under the regulations, so "[c]onsistency between the regulations and the estate tax Code sections would therefore demand that the cash surrender value remaining as of decedent's date of death be valued as part of, or included in, decedent's gross estate." The court reasons in footnote 12 that the estate essentially seeks to treat the decedent as the owner of the policy for gift tax purposes but to treat the irrevocable trust as the owner of the policy for estate tax purposes.

### **Observations**

1. **"Hogs Get Slaughtered."** The case exemplifies the "pigs get fat, hogs get slaughtered" mantra. The court's reaction to an attempt of an incompetent 90-year old's son to structure the transfer of \$10 million to a trust and only make a transfer of less than \$200,000 for gift or estate tax purposes is not surprising. Furthermore, the *Cahill* case does not present a sympathetic fact situation. The transaction was implemented by a decedent's son under a power of attorney. The transaction was implemented with an irrevocable trust created by the son under the power of attorney, having the son's cousin (and business partner) as trustee, apparently with no negotiation. The arrangement involved borrowing \$10 million from a third-party lender under a 5-year note, without any assurances of the note being renewed, even though the split dollar arrangement ostensibly would be in place for decades.
2. **Key Issue—Value of Termination Rights.** The case analyzes the decedent's interest under the split dollar agreement as involving "termination rights" (in general, the right to receive the cash surrender value of the policy upon an early termination before the insureds' deaths) and "death benefit rights" following the insureds' deaths (which would likely be decades in the future). The key issue in valuing the decedent's reimbursement rights under the split dollar agreement is whether the

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termination rights have no value because the irrevocable trust would never have agreed to an early termination. The case concludes that the restriction on the decedent's ability to receive the cash surrender value at any time – the requirement of obtaining the irrevocable trust's consent to an early termination – should be ignored for estate tax valuation purposes under §§ 2036, 2038, and 2703.

3. **Important Extension of *Powell* Analysis.** Planners have been concerned that the reasoning of the *Powell* case (decided only about a year before the *Cahill* case) could be extended to almost any arrangement involving multiple parties. *Powell* applied § 2036(a)(2) to the decedent's limited partnership interest to include a pro rata value of the partnership assets in the decedent's estate (without any discount attributable to the limitations on the rights of limited partners under state law) because the decedent "in conjunction with" other partners could at any time vote to dissolve the partnership. A detailed discussion of the *Powell* case, together with an analysis of the prior partnership cases that have addressed § 2036(a)(2), is found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners). Under the *Powell* facts, the partnership agreement provided that the partners could unanimously vote to dissolve the partnership. Even absent that express provision, however, the partners (or the participants in any joint undertaking) could always unanimously agree to undo the partnership or other relationship.

Anecdotal reports are that IRS officials have been asserting a broad application of the *Powell* reasoning in estate tax audits, and *Cahill* is the first reported case applying the *Powell* reasoning, and it is extending the "in conjunction with" analysis to a contractual arrangement rather just applying the analysis to another partnership.

Planners have wondered whether cases that have limited a broad application of the "in conjunction with" phrase in § 2038 might yield a different result. See e.g., *Helvering v. Helmholz*, 296 U.S. 93 (1935), aff'g 75 F.2d 245 (D.C. Cir. 1934) (a power conferred by state law to revoke or terminate a trust with the consent of all beneficiaries is not taxable under the "in conjunction with" clause, reasoning that this power exists under state law in almost all situations, and to hold otherwise would cause all trusts to be taxable); *Tully Estate v. Commissioner*, 528 F.2d 1401 (Ct. Cl. 1976) (decedent was a 50% shareholder; corporation and decedent entered into a contract to pay a death benefit to the decedent's widow; even though the beneficiary designation was irrevocable, court rejected IRS argument that it could be amended for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary, because "Congress did not intend the 'in conjunction' language of section 2038(a)(1) to extend to the mere possibility of bilateral contract modification").

A possible distinction of applying the logic of these § 2038 cases to the "in conjunction with" language in § 2036(a)(2) is that the regulations under § 2038 specifically state that a settlor's ability to act in concert with all donees/beneficiaries is not a retained power under § 2038, but the analogous provisions in the regulations under § 2036 regulations do not include that same statement. See Reg. §§ 20.2038-1(a)(2) (§ 2038 does not apply "[i]f the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under

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local law"); 20.2036-1(b)(3). However, applying the "in conjunction with" clause in a different manner in those two situations does not seem supportable under any policy rationale.

The court may not view the *Helmholz* and *Tully* line of cases as being persuasive, however, in situations in which the decedent specifically structured the transaction with the restriction on the individual's ability to reach valuable assets, and particularly where the "other party" who must join is the very party the decedent intends to benefit. On the other hand, the party being benefitted would likely object to any attempt by the donor to decrease the value of that party's interest.

4. **Eliminating Necessity of Donor Consent to Early Termination.** What if the split dollar agreement had allowed the irrevocable trust to terminate the arrangement early unilaterally? Would that be enough to avoid the "in conjunction with" analysis because the decedent would have no ability to participate in the decision to obtain immediate access to a large value? Even without the explicit right, the donor could still join with the irrevocable trust to revise the arrangement because all of the parties to a contract could always revise or terminate that contract. Furthermore, on these facts, the lender of the \$10 million might require that the borrower be able explicitly to initiate negotiations to terminate the arrangement if the lender became uncomfortable with its financial position and the ability to be repaid.

What if the split dollar agreement were totally silent about what would happen if the irrevocable trust attempted to terminate its obligations under the agreement prior to the insureds' deaths? (A third-party lender would be very uncomfortable with that approach.)

Even if those revisions in the typical split dollar arrangement were adopted, however, that still probably would not avoid the § 2703 analysis, because § 2703 does not depend on any "in conjunction with" language in the statute.

5. **Ramifications of the § 2703(a) Analysis.** Section 2703(a) describes the *general rule* that if any "property" is subject to an agreement or restriction allowing someone to acquire or use the property for less than fair market value or restrict the sale or use of the property, such agreement or restriction must be ignored in valuing the property. Section 2703(b) describes an *exception* to that general rule. The *Cahill* case just addresses the general rule, and appears to apply the general rule in a broad manner in which many if not most multi-party arrangements may be subject to the general rule of § 2703(a), and the determining issue will then be whether the exception applies.

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

The key issue that arises in determining whether § 2703(a) applies to any particular "property" is whether the property being tested under § 2703(a) is an asset with

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inherent characteristics that impact its value or whether the property is an asset subject to some agreement or restriction that allows someone to acquire or use the asset at less than its fair market value or that restricts the right to use or sell the asset, which restriction must be ignored under § 2703(a) in valuing the “property.”

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

The estate argued that the decedent transferred \$10 million in return for a bundle of contractual rights and that any characteristics impacting the value of the bundle of contractual rights were just inherent in the nature of what was acquired. The estate argued that its rights under the split dollar agreements in their entirety was the “property” (rather than having any interest in the policies burdened by restrictions). The court acknowledged that the estate owned contractual rights, but viewed these rights as including a right to terminate the contract (and access the cash surrender value) but only with an agreement and restriction that impacts that value (i.e., the requirement of obtaining the irrevocable trust’s consent), which restriction was subject to § 2703(a). Is that appropriate?

The court viewed the estate as specifically arguing (by its reference to *Estate of Elkins v. Commissioner*) that § 2703(a)(2) applies only where the property interest “exists or is created separately from the restrictions.” This goes to the basic notion that § 2703(a) applies only when some separate restriction impacts a “property” interest. This is similar to the argument that the taxpayer’s bundle of rights under the split dollar agreement should be valued in light of its inherent characteristics that would not be subject to § 2703(a). The court disagreed, responding that “nothing in the statute” suggests that distinction.

One analogy suggested by the estate was to a transfer in return for notes. The court drew factual distinctions between a note and the rights under the split dollar agreement (with the note having bargained terms, interest, and required payments at definite times) and concluded that the split dollar arrangement was unlike bona fide notes. That analysis seems to apply a § 2703(b) analysis (i.e., whether the arrangement is a bona fide arrangement comparable to similar arm’s length transactions) in determining whether the property is within the scope of § 2703(a).

The estate’s next analogy was to partnership interests, because the Tax Court had held in *Estate of Strangi* that a decedent’s limited partnership interests were not subject to § 2703(a), differentiating a right to partnership assets vs. the right to a limited partnership or corporate interest. *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), aff’d as to this issue sub nom *Gulig v. Commissioner*, 293 F.3d 279 (5th Cir. 2002). See also *Church v. U.S.*, 85 AFTR 2d 2000-804 (W. D. Tex. 2000). The court distinguished the *Strangi* holding (and the limited partnership analogy) for two reasons—(i) the split dollar agreement did not involve a state law entity (without discussing why that distinction was relevant), and (ii) the IRS in *Strangi* had not argued that the shareholder’s agreement should be disregarded.

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As to that second reason, various cases have held that restrictions in partnership or LLC agreements are subject to § 2703(a), and many have held that the restrictions failed to meet the § 2703(b) exceptions and should be disregarded in valuing interests in the entity (but restrictions inherent under state law can still be taken into consideration). *E.g., Holman v. Commissioner*, 601 F.3d 763 (8th Cir. 2010) *aff'g* 130 T.C. 170 (2008) (transfer restrictions in the partnership agreement should be disregarded under § 2703 in valuing limited partnership interests); *Fisher v. U.S.*, 106 AFTR 2d 2010-6144 (S.D. Indiana 2010) (right of first refusal allowing payment with long-term notes ignored under § 2703; bona fide business arrangement requirement in § 2703(b) was not satisfied); *Estate of Smith v. United States*, 94 AFTR 2d 5283 (2004), *rehearing on other issues*, 96 AFTR 6549 (W.D. Pa. 2005) (right of first refusal, which allowed payment with notes payable over up to fifteen years with interest equal to the long term AFR, ignored under § 2703).

Relatively few cases focus on the applicability of § 2703(a); most of the § 2703 cases focus on whether the § 2703(b) exception applies. *Cahill* does apply § 2703(a) in a setting other than an agreement or restriction regarding interests in an entity. A step removed from ignoring contractual restrictions in entity agreements, and perhaps a small step removed from the *Cahill* § 2703(a) analysis, is a notion that any restriction on a person's ability to acquire the maximum possible value under a contract would be viewed as a § 2703(a) restriction.

This analysis may result in a general treatment of any contractual limitation on achieving maximum value as a § 2703(a) agreement or restriction, with the key issue being whether the § 2703(b) exception requirements are satisfied. Intergenerational split dollar arrangements in the commercial setting (for example, to fund legitimate buy-sell arrangements for business owners) may be more likely to satisfy the exception under § 2703(b).

## 6. **Section 2703 Analysis Is Particularly Important for Intergenerational Split Dollar**

**Purposes.** Individuals entering into intergenerational split dollar arrangements could avoid the §§ 2036 and 2038 reasoning by making a transfer at some point (at least three years before the individual's death) of his or her rights under the split dollar agreement. Sections 2036 and 2038 apply only for estate tax purposes, but § 2703 applies for estate *and gift* tax purposes. If § 2703 applies, it would apply for valuing the transfer of reimbursement rights for either estate or gift tax purposes, meaning that the individual would never be able to transfer his or her reimbursement rights at a de minimis value if the policy has a substantial cash surrender value.

An argument could be made that the § 2703(a) analysis would not apply if the split dollar plan were structured to give the irrevocable trust the unilateral ability to terminate the split dollar arrangement without the involvement of the donor and not to give the donor the explicit authority to terminate the agreement with the trust's consent (or if the agreement were structured so that no one had the ability to terminate the agreement before the insured's death).

The opinion might be construed to treat the requirement that the trust consent to the donor's termination of the split dollar agreement as a restriction on the donor's ability to reach the cash surrender value of the policies, perhaps suggesting that § 2703(a)

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would not have applied if the donor had no explicit authority under the arrangement to initiate discussions about terminating the arrangement. For example, one sentence of the § 2703(a)(2) analysis reasons that “the split-dollar agreements, and specifically [the irrevocable trust’s] ability to prevent termination, also significantly restrict decedent’s right to use the termination rights.” This might suggest that the “property” as referenced in § 2703(a) is the ability to reach the cash surrender value by terminating the arrangement, and that the requirement of obtaining the trust’s consent is a restriction on the right to sell or use that “property” at less than fair market value (§ 2703(a)(1)) or as a restriction on the right to sell or use such “property” (§ 2703(a)(2)).

On the other hand, the next sentence of the § 2703(a)(2) analysis refers somewhat more broadly to the arrangement in its entirety as restricting the donor from being able to “withdraw his investment from these arrangements.” Furthermore, the court’s analysis of § 2703(a)(1) refers to “provisions that prevent decedent from immediately withdrawing his investment” as being “agreements to acquire or use property at a price less than fair market value.” Even if the decedent had not been able, under the express provisions of the agreement, to initiate a termination of the agreement, the court likely would have viewed the trust’s ability to prevent the donor from reaching the cash surrender value as a § 2703(a) restriction.

7. **Similar Denial of Motion of Summary Judgment Regarding § 2703(a) in *Morrissette v. Commissioner*.** The initial case in *Morrissette v. Commissioner*, 146 T.C. No. 11 (2016) determined that the economic benefit regime applies to the split dollar arrangement in that case. The IRS made arguments under §§ 2036, 2038, and 2703, similar to its arguments in *Cahill*. The estate filed a motion for partial summary judgment that § 2703(a) is inapplicable (but, unlike in *Cahill*, the taxpayer did not request a summary judgment regarding §§ 2036 and 2038). Three days after the entry of the *Cahill* decision, the Tax Court entered an Order in *Morrissette* on June 21, 2018 denied the taxpayer’s motion for summary judgment that § 2703(a) was inapplicable, observing that “the termination restriction prevented the decedent from terminating the split-dollar arrangements unilaterally and receiving repayment of the premium or, if greater, the policy’s cash surrender value,” and concluding that “[t]he restriction on the decedent’s termination rights is a restriction for purposes of section 2703(a)(2).” Order in Docket No. 4415-14 (June 21, 2018 (Judge Goeke)). The Order observed that the IRS had also raised §§ 2036 and 2038 as alternative arguments. The *Morrissette* case is scheduled for trial on May 6, 2019. The IRS filed a motion for partial summary judgment on November 21, 2018, and the court directed the executors to file a response by January 15, 2019.
8. **Interaction of §§ 2036, 2038, and 2703.** The *Cahill* court noted that the same result occurs in this case under any of §§ 2036, 2038, or 2703 (i.e., the cash surrender value would be included in the decedent’s gross estate). The court observed in footnote 10 that it did not need to address the interaction of those sections as it would have if those sections had produced different results.
9. **Brief Background about Intergenerational Split Dollar Insurance.** Under traditional split dollar arrangements, a donor funds premiums on a policy on the donor’s life, and the premium advances are repaid at the donor’s death from the policy death

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proceeds. In contrast, under intergenerational split dollar arrangements, a parent pays premiums on a policy insuring a *child* (or *grandchild's* life), and the premium advances are not repaid until the insured's death, which could be decades in the future. If the reimbursement right is transferred by the parent (by gift or sale or as an asset of the donor's estate at her death), a substantial discount may apply in determining the *present value* of the reimbursement right, which might not be repaid for decades. (The *present value* of the right to a set dollar amount, to be paid decades in the future, would obviously be much smaller than the aggregate payment that would be made many years in the future.)

Taxing intergenerational split dollar insurance under the economic benefit regime is helpful in supporting a substantial discount on the value of the receivable; under the economic benefit regime, the parent just receives the aggregate premiums paid or cash surrender value if greater (and is treated as making a transfer each year of the current value of life insurance coverage), but under the loan regime, the reimbursement right would be for the premiums paid *plus interest* that would accrue over the many years before the repayment is made.

For an overview of planning issues regarding intergenerational split dollar life insurance, see Lee Slavutin, *A Post-Morrissette Roadmap for Drafting Intergenerational Split Dollar Agreements*, LEIMBERG ESTATE PLANNING NEWSLETTER #2414 (May 12, 2016); Alan Jensen & R. Brent Berselli, *Estate of Morrissette: Unfinished Business*, LEIMBERG ESTATE PLANNING NEWSLETTER #2418 (May 23, 2016) Lee Slavutin & Richard Harris, *Intergenerational Split Dollar Life Insurance; What Can We Learn from Morrissette, Levine and Neff?*, LEIMBERG ESTATE PLANNING NEWSLETTER #2443 (August 9, 2016); Espen Robak, *Intergenerational Split Dollar Valuation Issues*, LEIMBERG ESTATE PLANNING NEWSLETTER #2444 (August 9, 2016).

10. **Major Blow to Intergenerational Split Dollar Plans.** The *Cahill* decision is a major blow to the desired extremely advantageous tax treatment of intergenerational split dollar plans. Treating the person advancing huge premiums under an intergenerational split dollar plan as effectively having reimbursement rights equal to the cash surrender value of the policy would eliminate the possibility of transferring huge amounts to a trust to fund its purchase of life insurance without treating the transferor as ever having made a substantial transfer for gift or estate tax purposes. If the case is not eventually reversed on appeal (assuming it is ever appealed), it will present a major hurdle to the ability to transfer huge economic value under intergenerational split dollar arrangements (at least for economic benefit regime structures) without ever making a significant transfer for gift or estate tax purposes. Future cases will revolve around attempting to distinguish the reasoning of the *Cahill* decision (for example, pointing out distinctions from the *Cahill* reasoning by using loan regime arrangements and by eliminating the explicit ability of the donor/premium advancer to participate at all in the decision to terminate the agreement during the insured's life).
11. **Continuing Litigation about Intergenerational Split Dollar; Other Cases; Potential Attacks.** The denial of the taxpayer's motion for partial summary judgment in *Cahill* means that the case will proceed to trial (unless it is settled by the parties),

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and the case eventually will be appealable to the Ninth Circuit Court of Appeals after final judgment has been entered by the Tax Court.

Two other cases before the Tax Court also involve non-equity intergenerational split dollar economic benefit regime arrangements. *Estate of Morrissette*, Docket No. 4415-14, and *Estate of Levine v. Commissioner*, Docket No. 013370-13. All of these cases involve the determination of the value for estate tax purposes of the value of the decedent's reimbursement rights under intergenerational split dollar arrangements. The *Morrissette* and *Levine* cases have somewhat more sympathetic fact situations than in *Cahill*. For example, in *Morrissette*, the arrangement was used to assist in funding a buy-sell agreement for a closely held business interest at the deaths of the decedent's children, and *Morrissette* did not involve lending from a third party with the decedent owing interest to a third party lender, with interest accruing on the note, even though the decedent was merely entitled to reimbursement of the fixed amount of the advanced premiums (or the cash surrender value if greater) without interest.

In *Morrissette*, the IRS is disputing not only the valuation of the reimbursement right, but also maintains that §§ 2036, 2038, and 2703 apply. Similar issues were raised by the IRS in *Levine*. The *Morrissette* trial is scheduled for May 6, 2019.

The Tax Court trial in *Levine* was held in November, 2017, and the post-trial briefs have been filed. *Levine* may thus be the first reported case deciding the estate tax treatment of intergenerational split dollar insurance in the donor's estate.

The IRS may also be raising other equitable tax doctrine general issues, such as sham/step transaction/duty of consistency types of issues, in these types of cases. These cases can be contrasted from situation in which an investment or arrangement results in a "changed value" (for example, the interests owned by business owners are initially worth less than the cash amounts contributed by them to the entity), as compared to situations resulting in a "split value" (for example, a situation in which the parent's value goes down in value while the children's value increases by a similar amount). The intergenerational split dollar arrangement is a type of split value situation, in which the arrangement results in a substantial decrease in the parent's value and a somewhat offsetting increased value in the younger generation's interest. Courts will likely be less inclined to respect the latter "split value" types of situations to result in removing substantial value from the estate for estate tax purposes.

A variety of potential issues exist regarding intergenerational split dollar arrangements, including:

1. Treatment of insurance coverage following premium payer's death;
2. Section 2703;
3. Sham transaction; lack of business purpose.

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4. Step transaction – this is one of the positions the IRS is taking in *Levine* (“transfer ... constituted gifts ... in a series of interrelated steps with a value equal to the cost of the ... premiums paid”); the Tax Court entered partial summary judgment in favor of the taxpayer on July 13, 2016 in *Levine*, resulting in no gift tax deficiency or penalties, on the basis of the *Morrisette* opinion;
  5. Modification under the split dollar regulations;
  6. Sections 2036 and 2038; and
  7. Duty of consistency.

For a discussion of the IRS attacks under each of these arguments, see Item 27.f.(2) of the Current Developments and Hot Topics Summary (December 2016) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

Intergenerational split dollar arrangements in the commercial setting (for example, to fund legitimate buy-sell arrangements for business owners) will be more likely to survive these attacks, and in particular the sham transaction/lack of business purpose argument and also the § 2703 attack because it will be more likely to satisfy the exception under § 2703(b).

12. **Loan Regime Intergenerational Split Dollar Arrangements.** A general trend is emerging among planners using intergenerational split dollar to prefer the loan arrangement for various reasons. See Lee Slavutin & Richard Harris, *Intergenerational Split Dollar: What Can We Learn from Morrisette, Levine and Neff?*, LEIMBERG ESTATE PLANNING NEWSLETTER #2443 (August 9, 2016) (loan treatment can be assured, loan can be for life of insured allowing lock in of low interest rate, easier to understand, all variables locked in at outset, large history of loan receivables being valued at a discount, and no report of any intergenerational split dollar loan regime cases being audited). The IRS so far generally has not been emphasizing audits of loan regime arrangements. The discounts may not be as large as under the economic benefit regime, but planners suggest that significant advantages may still be available. (For example, significant discounts may still apply because the interest rate on the loan may be much lower than the discount rate that an appraiser will apply in valuing the note.) One planner reports settling an intergenerational split dollar loan under the loan regime with a 65% discount. Other planners acknowledge that discounts are lower under the loan regime approach, but only nominally so.

For a discussion about the ability to discount notes having an interest rate below the commercial rate (even if it is at the AFR) because the IRS has never finalized regulations adopting the concepts of § 7520 for estate tax purposes, see Item 2.c.(2) of the Estate Planning Current Developments Summary (Nov. 2015) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners). If the note is discounted for estate tax purposes, when the note is later paid (possibly decades later), the excess of the payments over the note’s basis (i.e., the discounted estate tax value) will be ordinary income to the recipient, as discussed at Item 4.c.(3) of the Heckerling Musings 2016 and Current Developments (February 2016) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners). But that potential income tax liability would be years (or decades) in the future.

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If the loan regime arrangement could be combined with facts in which the donor does not participate in any way in a decision to terminate the split dollar arrangement, the taxpayer may be able to avoid some of the conclusions in *Cahill* regarding the application of §§ 2036, 2038, and 2703. For a discussion of planning considerations for intergenerational split dollar plans following *Cahill*, see Lee Slavutin, Richard Harris & Martin Shenkman, *Intergenerational Split Dollar-Recent Adverse Decisions in Morrissette and Cahill, Where Do We Go from Here?*, LEIMBERG ESTATE PLANNING NEWSLETTER #2651 (July 17, 2018). The settlement in *Cahill* suggests exercising great caution regarding loan regime (as well as economic benefit regime) intergenerational split dollar arrangements in which the goal is to obtain a large discount on the value of the reimbursement right. See Lee Slavutin, Richard Harris and Martin M. Shenkman, *Intergenerational Split Dollar – Cahill Case Settled – Taxpayer Concedes on Split Dollar Valuation Issue*, LEIMBERG EST. PL. NEWSLETTER #2663 (September 13, 2018) ("Those pursuing loan intergenerational split dollar plans may want to evaluate the possible impact of the Cahill case – can IRC Section 2036, 2038, and 2703 be applied to loan arrangements? The imposition of a 20% penalty in the Cahill case and the IRS's willingness to settle on other issues to win on the split dollar receivable should send a strong message to practitioners.").

13. **Simple Loan Arrangements.** Some of the desired estate tax advantages of intergenerational split dollar arrangements could be achieved much more easily with simple relatively long-term loans to younger generation family members or trusts for their benefit (particularly grantor trusts to avoid recognition of interest payments). Cash loans clearly can use the AFR interest rate without gift consequences under § 7872. If the loans can be discounted at death for estate tax purposes (because no estate tax final regulations adopt the concepts of § 7872), some of the valuation arbitrage effects resulting in reduced estate tax values could be achieved without all the complexity of split dollar arrangements. The loans must still satisfy the requirements of being classified as "debt" rather than an "equity" interest, and very long-term notes are more at risk of being treated as equity interests. (See the discussion in paragraph 12 above regarding the estate and income tax effects of discounting notes.)

## 8. Exercising Trustee Discretionary Distribution Decisions

This summary is based primarily on presentations and materials by Amy K. Kanyuk (Concorde, New Hampshire).

- a. **Trend Toward Greater Discretion.** Trusts traditionally provided income to the current beneficiary, with all remainder passing to the remainder beneficiary. The current trend is to give trustees much more flexibility regarding distributions. Greater discretion provides very helpful flexibility if beneficiaries are getting along, but creates considerable tension if not. Because discretionary powers affect someone's beneficial interest in the trust, they are the most likely trust provisions to result in potential conflict. "Beneficiaries are like cats—they are only happy if you're feeding them."

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- b. **Grantor Intent; Drafting Discretionary Distribution Provisions.** The trustee, above all, must act in accordance with the grantor's intent. **Keep in mind this over-arching target: The goal of the trustee is not to make the beneficiary happy but to carry out the grantor's intent.**

If the trust agreement contains no express statement of intent, the trustee may have little guidance in the exercise of discretionary powers.

Planners often give little thought to words used to guide the trustee's discretion but simply rely upon boilerplate without thoughtfully considering how the provisions will impact a particular family.

Trust agreements often provide no explicit and customized expressions of intent, leaving the trustee to exercise discretionary distribution decisions with no guidance, which can lead to beneficiary claims of abuse of discretion.

No one-size-fits-all in drafting discretionary distribution provisions. The planner must discuss with the client the impact of discretionary powers. The following are examples of potential problem areas.

**Residence.** Who can occupy the residence and under what terms? Is it an exclusive occupancy? Does the beneficiary pay rent or carrying charges? Who pays for improvements?

**Multiple Beneficiaries; Primary Beneficiary.** If the trust includes multiple beneficiaries, is one a primary beneficiary? If so, under what conditions can distributions be made to secondary beneficiaries? The duty of impartiality exists for all trusts, but the duty has heightened immediacy when a trust has multiple current beneficiaries. The grantor should understand that disputes (or at least hard feelings) invariably will result from pot trusts with multiple current beneficiaries. Hugh Magill's Rule About Spray Trusts: "If beneficiaries cannot live together in the same household, they should not live together in the same trust." *See Brown v. Brown*, 2017 Mo. App. LEXIS 576 (2017) (court on summary judgment rejected claim that distributions to decedent's wife were excessive; trust had HEMS distributions standard for distributions to wife and children, but mandated that the trustee give primary consideration to the needs of the income beneficiary [the wife] rather than conservation of the estate for remaindermen).

**Surviving Spouse as Beneficiary.** An alternative is to provide that the surviving spouse is the sole beneficiary and give her a power of appointment to appoint assets to children, rather than including children as direct beneficiaries. If the trust includes multiple beneficiaries, the trustee owes a duty of impartiality to all beneficiaries, and they all have rights to information (and can make the surviving spouse's life miserable).

**Practical Impact of Uncertainty Regarding Grantor's Intent.** If the trustee is uncertain about the grantor's intent, the trustee will likely be conservative in making distributions. **Correcting an underpayment is easier than recovering an overpayment.** The trustee may end up limiting distributions to a person that the grantor intended as the primary beneficiary.

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**Plenary Discretion Regarding Timing of Distributions.** Consider including, in almost all trusts, authority for the trustee to withhold distributions if the trustee believes the delay would be in the beneficiary's best interest. This provides wide discretion to address wide ranging issues, such as substance abuse, creditor issues, a pending divorce, etc. For example, if the trust provides for mandatory distributions at specified ages, consider adding the following clause:

Notwithstanding the above, if the trustee determines, in its sole discretion, that a beneficiary does not have the requisite maturity or financial acumen to manage the assets of his or her trust, or for any other reason that the trustee deems appropriate, then the trustee may retain the assets in trust for the life of the beneficiary or until such earlier time (but no sooner than the ages and in the amounts provided in Paragraphs ... above) as the trustee, in its sole discretion, deems appropriate.

- c. **Abuse of Discretion.** Whether an abuse of discretion occurs depends upon basic fiduciary duties, the trust terms and their proper construction, and the grantor's purposes. An abuse of discretion can result from a trustee (1) acting dishonestly (e.g., accepting a bribe to make distributions), (2) making distributions for a purpose not authorized in the agreement, (3) acting arbitrarily or failing to exercise discretion, or (4) not understanding the terms of the agreement or applicable fiduciary law.

**Practical Pointer.** The trustee should read the entire trust agreement and prepare an abstract of the major terms. That sounds fundamental, but non-professional trustees rarely do that.

**Another Practical Pointer.** If a request is made for an unusually large distribution, the potential exists for an abuse of discretion claim at some point. "Everyone is happy until they are not. Trustees should manage risk when making a sizable distribution. Getting consents and ratifications from the current and remainder beneficiaries is most acceptable. The trustee should consider getting consents on the front and when everyone is still getting along." (Statement from litigator William Hennessey, West Palm Beach, Florida)

**From Years of Experience.** As a young lawyer, the planner drafted with broad flexibility. Following years of experience, the planner now provides as much guidance as possible and prefers having a professional trustee. Discretionary trusts are still preferred, rather than requiring mandatory distributions, but guidance must be given to the trustee. The guidance can be in non-binding precatory language, but it should be sufficient to express the grantor's intent.

- d. **Extrinsic Evidence and Letters of Wishes.** If the trust instrument is clear, the court will look only to that language. If ambiguity exists, the court may review extrinsic evidence. In *Morse v. Kraft*, the trustee requested the Massachusetts Supreme Judicial Court to rule that a common-law right to decant exists. The court allowed the decanting, in part because a post-contribution affidavit was submitted to the court that the grantor intended the trustees to be able to decant (even though the trust was created 30 years earlier). "That seems like a little bit of a stretch to me, but it makes more sense when you realize the "Kraft" in *Morris v. Kraft* is Robert Kraft, owner of the New England Patriots. As we all know, things tend to go the Patriots way, especially when it comes to officiating."

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**Terms of the Trust.** The comment to §103 (18) of the Uniform Trust Code recognizes that the phrase “terms of the trust” is not limited to just the trust agreement, and that oral statements, the situations of the beneficiaries, the purposes of the trust, and rules of construction, all may have a bearing on the trust’s meaning.

**Side Letters.** Side letters or letters of wishes can provide guidance regarding the grantor’s intent. For example, they may address a sensitive topic that the grantor does not want to include in the trust agreement. Such side letters can present difficulties, however. They may be ambiguous, conflict with the trust agreement, contain information that would be hurtful to beneficiaries, or cause adverse transfer tax consequences (are they tantamount to amending the agreement?). Despite the uncertainties, clients really like them. Planners should make sure the clients understand that they are not binding, not enforceable, and may not be discoverable by beneficiaries.

e. **Ascertainable Standards.**

**Mixing Discretion With Ascertainable Standards.** Accompanying a health, education, support and maintenance standard with words enlarging the trustee’s discretion may cause the scope of the standard to become uncertain. Coupling a distribution standard with broad discretion can be confusing and lead to conflict because no one knows what it means. Example: “My trustee *shall* distribute to my son so much of the assets as the trustee, in its *sole and absolute discretion*, determines is necessary for my son’s health, support and maintenance.” Does the standard produce a ceiling or a floor for distributions?

**Creditor vs. Beneficiary Impact.** Both the Restatement (Third) of Trusts (§60) and the Uniform Trust Code (§504) eliminate the distinction between discretionary and support trusts. However, “[e]liminating this distinction affects only the rights of creditors... It does not affect the rights of a beneficiary to compel a distribution. Whether a trustee has a duty in a given situation to make a distribution depends on factors such as the breath of the discretion granted and whether the terms of the trust include a support or other standard.” (Unif. Trust Code §60 cmt.)

**Often Unnecessary.** Unless a beneficiary is serving as trustee, no tax reason exists for limiting distributions to a health, education, support, and maintenance standard. They are often included in trust agreements by draftsmen as a matter of habit. Using such a standard unnecessarily may make the trustee’s job more difficult. Instead, a trust agreement should provide guidance to the exercise of the trustee’s discretion beyond the use of these terms.

**Health.** The regulations do not define “health.” The Restatement (Third) of the Trusts sites no cases defining the term “health.” Permissible distributions for health may include emergency medical treatment, psychiatric treatment, psychological treatment, routine healthcare examinations, dental care, eye care, and health insurance premiums. If anything outside normal healthcare expenses is intended, the trust agreement should say so specifically. (Beneficiaries can be creative about health needs – such as a swimming pool for exercise.)

**Support and Maintenance.** These terms mean the same thing. While the terms do not confer a particularly broad power, they are not limited to the necessities of life. A support and maintenance standard may be coupled with an “accustomed standard of living” modifier, which can be problematic if the trust is too small to permit

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distributions keeping up with the beneficiary's accustomed standard of living. Exhausting the trust would likely violate the trustee's duty of impartiality to remainder beneficiaries.

"Support" may include considering a beneficiary's spouse and minor children. They do not become trust beneficiaries, but a relevant factors in determining what a beneficiary needs for support.

A support and maintenance standard does not allow distributions designed to enlarge the beneficiary's estate or allow the beneficiary to make large gifts. That situation often occurs. For example, if the surviving spouse has children by a former marriage, the spouse will want all current living expenses to be paid by the trust so that the spouse can keep all of his or her assets. (In that situation, the legal question becomes whether the trust may (or must) consider the beneficiary's other resources, as discussed below.)

**Education.** Clarify the level of education intended, how long the benefits will last (for example, an age limit), whether the payment of living expenses and fees are included, the treatment of expenses incurred between college semesters, and whether private education before college is included. Consider the following form language:

In exercising this discretion, it is the Grantor's wish (but not direction) that when possible, the Trustee will make distributions directly to the educational provider(s) instead of to the primary beneficiary himself or herself. For purposes of this Paragraph, the costs of the primary beneficiary's post-secondary education may include, but are not limited to, tuition, fees, room, board, books, supplies and transportation. The Trustee's determination of what expenses constitute costs of the primary beneficiary's post-secondary education shall be final and not subject to question by any person interested in the trust estate.

**Comfort.** No one knows what "comfort" means. Many cases reach conflicting results.

**Welfare and Happiness.** "Happiness" is a very broad term; almost any distribution could be justified. "A distribution for \_\_\_ would make me happy."

**Emergencies.** "Emergencies" are strictly construed to include only extreme needs, but include things such as injury, illness and economic catastrophe, but may also extend to the general inadequacy of resources and earning capacity.

**Best Interest.** Agreements sometimes refer to a "best interests" standard. In *Ebling v. Hasken*, 2017 Iowa App. LEXIS 1176 (2017), the trust agreement did not include that language, but the court observed that while an action by a trustee may be contrary to the *wishes* of the beneficiaries, that may not be against the *interests* of the beneficiaries.

**Resource.** For an outstanding comprehensive discussion of the meaning and impact of various distribution standards, see Christian Kelso, *But What's an Ascertainable Standard? Clarifying HEMS Distribution Standards and Other Fiduciary Consideration for Trustees*, 10 EST. PLAN. & COMM. PROP. J. 1 (Fall 2017).

f. **Tax Considerations; Support Obligations and Removal Powers.**

**Legal Obligations of Support.** If the trust agreement permits a beneficiary-trustee to make a distribution to satisfy his or her legal obligation to support another person, the distribution power is a general power of appointment even if distributions are

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limited to those relating to the health, education, support or maintenance of the beneficiary. Treas. Reg. §§20.2041-1(c)(1) & 25.2514-1(c)(1). Trusts typically include an “Upjohn” provision prohibiting the trustee from making distributions that would satisfy the trustee’s legal obligations of support.

**Removal and Replacement of Trustee.** If a trustee holds tax-sensitive powers, and if a beneficiary has the right to remove the trustee and replace the trustee with someone who is not a related or subordinate party to the beneficiary as defined in §672(c), the IRS position is that the beneficiary holds a general power of appointment. Treas. Reg. §§20.2041-1(b)(1) & 25.2514-1(b)(1); Rev. Rul. 95-58, 1995-2 C.B. 191.

- g. **Scope of Discretion; “Sole and Absolute Discretion.”** Even if a trust agreement grants the trustee “sole and absolute” discretion without an ascertainable standard, the trustee must still act honestly and in the state of mind contemplated by the grantor. The Uniform Trust Code requires that a trustee with the extended discretion exercise its discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

Some planners prefer the flexibility offered by “skinny trusts” merely providing that property shall be distributed to the beneficiaries in the trustee’s sole discretion. Diana Zeydel suggests that “saying less rather than more leads to the greatest flexibility. In some respects, skinny is good.”

- h. **Court Intervention.** A trustee’s exercise of discretion is always subject to judicial review, but courts are often hesitant to review a challenge of the manner in which a trustee exercises its discretion. A decision by a trustee with “extended discretion” (using terms such as sole, absolute, or sole and absolute) will not be overturned unless the exercise is unreasonable. Intervention is not warranted just because the court would have exercised its discretion differently. Although no range of discretion is ever absolute, the greater the grant of discretion, the broader the range that will be afforded the trustee in exercising this discretion.

A court generally will not instruct a trustee *how* to exercise his discretion, but it may intervene following the exercise of a trustee’s discretion in extreme circumstances.

The Uniform Trust Code imposes a *non-waivable* duty that the trustee always must exercise its discretion in accordance with the terms and purposes of the trust and the interests of the beneficiaries. UNIF. TRUST CODE §105(b).

As a practical matter, though, extended discretion makes obtaining court intervention very difficult even when a trustee makes highly conservative judgments as long as they clearly fall within the grantor’s authorized purposes. RESTATEMENT (THIRD) OF TRUSTS §50 cmt. c.

Abuse of discretion claims frequently involve allegations that a trustee acted unreasonably (i.e., beyond the bounds of reasonable judgment). RESTATEMENT (THIRD) OF TRUSTS §87 cmt. c. A court may impose a general standard of reasonableness even if the trust agreement does not expressly provide one. A reasonableness standard is rather “mushy” and gives the court the ability to overrule the trustee’s exercise of discretion. Grantors can override a reasonableness standard of review. Form language:

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The exercise of any Trustee's discretionary power shall be final unless such Trustee has acted in bad faith. The Grantor recognizes and intends that an effect of the preceding sentence is to eliminate the application of the reasonableness standard to the Trustee's exercise (or non-exercise) of this discretion to distribute the property of a fully discretionary trust created hereunder.

i. **Fiduciary Duties When Exercising Discretion.**

**Duty to Act.** The trustee has an affirmative duty to decide whether or not to exercise discretion. The trustee should consider other distribution requests and how the trustee has responded. The trustees should maintain a record of distribution requests. The trustee should have a prescribed **process** of responding to distribution requests. (See the best practices summarized in Item 7.l below.)

**Duty to Be Informed.** The beneficiaries are entitled to know what information the trustee used in making discretionary decisions.

**Duty of Impartiality.** The trustee must consider the interests of all beneficiaries, including both current and remainder beneficiaries. The trustee is not required to treat all beneficiaries equally, but must treat them equitably in light of the terms and purposes of the trust. The trust can instruct the trustee to favor one beneficiary over another, and can even authorize depleting the trust for a beneficiary, leaving nothing for remaindermen. Absent such language, a trustee must exercise its discretion in a way that benefits current beneficiaries without harming the remaindermen. If the duty of impartiality is being waived in the trust instrument, do so very explicitly. "We are hereby waiving the duty of impartiality."

j. **Outside Resources.** Whether the trustee should or may consider outside resources is a frequently litigated issue, but often is not addressed in trust agreements. The general rule is that the trustee must consider other resources but has some discretion regarding what resources should be considered. RESTATEMENT (THIRD) OF TRUSTS §50 cmt. e. (changing the position taken by the Restatement (Second) of Trusts). Cases are inconsistent, however. This general rule can be overridden in the trust agreement.

If the trustee may or must consider outside resources, the trustee must determine which resources to consider. Other resources typically include the beneficiary's income and periodic receipts. In addition, they may also include the beneficiary's personal estate. The Restatement (Third) of Trusts includes the following discussion of what outside resources should be considered.

*What other resources are to be considered?* Where a trustee is to take a beneficiary's other resources into account in deciding whether and in what amounts to make discretionary payments to satisfy a standard, those resources normally include the beneficiary's income and other periodic receipts, such as pension or other annuity payments and court-ordered support payments.

A trustee may have discretion, and perhaps a duty, to take account of the principal of the beneficiary's personal estate, depending on the terms and purposes of the discretionary power and other purposes of the trust. The settlor's relationships and objectives with respect to both the beneficiary in question and the trust's other current and remainder beneficiaries are of particular relevance. Also important are any income, estate, and other tax purposes the trust may serve (see Comment g), as well as the liquidity (including marketability and income-tax basis) of the discretionary beneficiary's assets.

RESTATEMENT (THIRD) OF TRUSTS §50, cmt. e(2).

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Factors that the trustee may decide to consider include:

- whether an unemployed or underemployed beneficiary is unable or simply unwilling to work;
- whether the beneficiary's spouse has financial resources available to the beneficiary; and
- whether the beneficiary's parents have a legal obligation to support the beneficiary.

If a beneficiary's personal estate is considered, the trustee would need to decide whether to consider non-liquid assets, appreciated property, nonmarketable assets, or equity in the beneficiary's home, as well as other types of assets that are more readily available.

If the trustee is considering outside resources, the trustee must act in a reasonable manner to determine those resources, but typically may rely on the beneficiary's representations and on readily available, minimally intrusive information requested of the beneficiary. This would typically include income tax returns, financial statements, balance sheets and budgets. Reliance on information supplied by the beneficiary is inappropriate, however, when the trustee has reason to suspect that the information supplied is inaccurate or incomplete. RESTATEMENT (THIRD) OF TRUSTS §50, cmt. e(1).

If a beneficiary refuses to supply information, the trustee should not make distributions if the instrument or local law requires considering outside resources. Beneficiaries can be very protective of their personal financial information, however, and may refuse to provide financial information and (without reason) sue the trustee for refusing to make distributions. "Keep in mind – Beneficiaries are like cats and they will bite you for no good reason."

- k. **Pattern of Large Distributions That Eventually Will Exhaust the Trust; Process and Disclosure.** A common situation is that a trust authorizes support distributions, perhaps with an express statement to continue the accustomed standard of living. The trust is not large enough, however, to maintain that level of distributions indefinitely. That situation is a common red flag for an eventual potential claim of abuse of discretion. An important part of the process of analyzing discretionary distributions, especially in that type situation, is to analyze the financial impact of the pattern of distributions over a long period of time. Will the trust be able to generate sufficient liquidity at its projected growth rate with a pattern of large cash distributions? Of primary importance in this type of situation is disclosure to the beneficiaries and advisors of the substantial risk that the trust is incapable of accomplishing its purposes, but emphasizing that the trustee wants to work together with the parties to accomplish the grantor's goals as closely as possible. Annual disclosures and updating of financial projections to reflect changes in the market as distributions are being made are critical. The trustee should document risks to the trust and make clear that the trustee is making no guarantees. Consider having a family sign a family agreement to the terms of the distribution plan and investment approach. Review the situation each year – do not just continue making the same

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distributions each year (even though the trust is declining rapidly in value) just because “that’s what we’ve always done.”

- I. **Best Practices.** Best practices regarding the trustee’s exercise of discretion for distributions include the following:
  - adopt policies and procedures;
  - read the trust agreement and letters of wishes;
  - prepare an abstract of the trust terms;
  - if the trust agreement has multiple amendments, create a master document adding amendments in the margin;
  - determine and document the standard, if any, for discretionary distributions;
  - for trusts with multiple beneficiaries, determine whether any beneficiary is “primary;” if so, whether distributions to the primary beneficiary could exhaust the trust (waving the duty of impartiality), and when discretion might be exercised in favor of other beneficiaries;
  - keep complete, accurate and current records of the trust assets (to the extent practicable, including an estimate of the value of illiquid assets);
  - determine whether and which resources of the beneficiary must be considered, and document the procedure for requesting or otherwise obtaining information about resources;
  - document all beneficiary requests for distributions and the trustee’s responses;
  - document whether any conditions must be satisfied before distributions are permitted; and
  - coordinate the trust’s investment policy with required or anticipated distributions.

## 9. Uniform Directed Trust Act Paves Way For Creative and Thoughtful Divided Trusteeship

The directed trust concept is not new; a Harvard Law Review article in the 1960s discussed the concept. It has become increasingly popular, with various states now having adopted directed trustee statutes and culminating with the promulgation of the Uniform Directed Trust Act in 2017.

This summary of the Uniform Directed Trust Act (the “Act” as used in Item 8 of this summary) and its various innovations is based on materials by Prof. Robert Sitkoff and Prof. John D. Morley, who served as the Chair and Reporter, respectively, of the drafting committee that prepared the Act.

- a. **Adoption of Act.** The Act was adopted by the Uniform Law Commission in July, 2017. It provides a host of technical innovations that dramatically improve on existing directed trust statutes, and also provides a guide for drafting directed trusts.
- b. **Scope; Fundamental Definitions.** The Act applies to a “power of direction.” From that follows the definitions of a “directed trust,” “directed trustee,” and “trust director.”

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**Power of Direction.** A power of direction is “a power over a trust granted to a person by the terms of the trust to the extent the power is exercisable while the person is not serving as a trustee.” §2(5) [references in this Item 8 to a “§” are to sections of the Act, unless otherwise indicated]. Thus, the Act applies very broadly to any powers with respect to a trust held by someone other than a trustee (except to the extent that exclusions apply, as discussed below), including a power over the “investment, management, or distribution of trust property or other matters of trust administration.” The comments to the Act include a non-exclusive but highly detailed list of the kinds of specific powers that could be included.

**Directed Trust.** A directed trust is “a trust for which the terms of the trust grant a power of direction.” §2(2).

**Trust Director.** A trust director is “a person that is granted a power of direction by the terms of the trust to the extent the power is exercisable while the person is not serving as a trustee.” §2(9).

**Directed Trustee.** A directed trustee is “a trustee that is subject to a trust director’s power of direction” §2(3).

- c. **Enabling Approach.** The approach of the Act is to authorize the creation of a directed trust that can specify powers of direction, but the statute does not prescribe any specific default powers. This is the approach of the Delaware statute. Some other statutes (such as the South Dakota statute) provide specified powers to certain types of directors (such as an “investment trust advisor” or a “distribution trust advisor”).
- d. **Further Appropriate Powers.** Unless the trust agreement provides otherwise, a trust director “may exercise any further power appropriate to the exercise or nonexercise of a power of direction granted to the director.” §6(b)(1). This is a type of “necessary and proper” clause, granting additional implied powers as appropriate to carry out a settlor’s intent (such as the power to incur reasonable costs, provide accountings, employ advisors, bring litigation to enforce the powers, etc.).

**Litigation.** A director probably has the authority under this provision to direct the trustee to sue or to bring a lawsuit directly to enforce some action within the director’s scope of responsibility (for example, with respect to a particular investment). Indeed, the director has all the duties of trustees in similar situations; a trustee would have a duty to bring a claim to enforce rights as long as it is cost efficient (Uniform Trust Code §811), so a director arguably has not only a power but a duty to bring a lawsuit to enforce claims. Bringing a lawsuit in the name of the trustee (the trust itself is not a legal entity) seems rather odd, but is authorized. The trustee may, for various reasons be delighted not to be directly involved in and controlling the litigation.

- e. **Exclusions.** The powers described below are excluded from being treated as a power of direction. Accordingly, the Act does not apply to the power, and the power holder is not treated as a trust director with fiduciary duties, and the trustee has no oversight responsibility under a willful misconduct standard.

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- (1) **Trustee.** By definition, a power held by trustee is not a “power of direction” and the Act would not apply to general trustee powers.
- (2) **Nonfiduciary Powers of Appointment.** A nonfiduciary power of appointment is not treated as a power of direction subject to the Act. §5(b)(1). A rule of construction provides that a power of someone who is not a trustee to distribute trust assets is presumptively a nonfiduciary power of appointment. §5(c).
- (3) **Power to Appoint or Remove a Trustee or Trust Director.** The power to appoint or remove a trustee or trust director is not treated as a power of direction subject to the Act (§5(b)(2)); therefore, that person is not subject to the fiduciary duties of a trust director under the Act.
- (4) **Power of Settlor Over a Revocable Trust.** The power of a settlor to revoke the trust is not a power of direction to the extent of the portion of the trust over which the settlor has the power to revoke. §5(b)(3). Making a settlor subject to fiduciary duties with respect to the revocable trust would be nonsensical.
- (5) **Power of a Beneficiary.** A power held by a beneficiary that affects only “the beneficial interest of … (A) the beneficiary[,] or (B) another beneficiary represented by the beneficiary [under applicable virtual representation law] with respect to the exercise or nonexercise of the power” is not a power of direction subject to the Act. §2(9).
- (6) **Settlor’s Tax Objectives.** The act excludes “a… power over a trust if… the terms of the trust provide that the power is held in a nonfiduciary capacity… and the power must be held in a nonfiduciary capacity to achieve the settlor’s [federal] tax objectives.” §5(b)(5). Accordingly, a nonfiduciary power of substitution, often used to cause a trust to be a grantor trust, would not be a power of direction under the Act.
- (7) **Medical Professional.** A medical professional who is carrying out some function described in the trust is not excluded from the Act, but the duties section of the Act provides that a trust director who is a medical professional acting in a professional capacity will have no duty or liability under the Act in exercising that power (for example determining a settlor’s mental capacity). §8(b).
- f. **Choice of Law; Prospective Application.** The Act applies to a trust “that has its principal place of administration in this state.” §3(a). Thus, the Act employs the prevailing conflict of laws rules for trusts, keying on the trust’s principal place of administration. The Act further defines the “principal place of administration” as referring to the place of administration designated in a trust if (1) a trustee is located in the designated jurisdiction, (2) a trust director is located in the designated jurisdiction, or (3) at least some of the trust administration occurs in the designated jurisdiction. §3(b).
- The Act applies prospectively to trusts administered in an enacting state regardless of whether the trust was in existence on the effective date of the Act, but it applies only with respect to decisions or actions occurring on or after the effective date. §3(a)(1)-(2).

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- g. **Fiduciary Duties of Trust Director.** A trust director has the same fiduciary duties and liability as a trustee under like circumstances. §8 (a). Whatever duties a trustee would have had holding that same power are also held by the trust director. The duties can be varied to the same extent that the duties of a trustee can be varied. §8(a)(2). For example, under most states laws, a fiduciary's duties cannot be reduced below a gross negligence standard.

The act specifically acknowledges the creation of springing powers, in which event the trust director will have no duties until the power is triggered. For example, "a settlor could grant a trust director a power to direct a distribution, but only if the director was requested to do so by a beneficiary. A director holding such a power would not be under a duty to act unless requested to do so by a beneficiary." §8(a)(1) cmt.

- h. **Fiduciary Duties of Directed Trustee.** The most controversial issue addressed by the drafting committee, after "extensive deliberation and debate" (as described in the Comments to §9 of the Act), is the fiduciary obligation of the directed trustee.

(1) **Willful Misconduct Standard for Whether to Follow Directions.** Three general regimes for the directed trustee's level of responsibility have been used.

(i) **Serious Breach of Fiduciary Duty.** The common law standard, as codified in §808(b) of the Uniform Trust Code, is that if a trust confers a power upon someone other than the settlor of a revocable trust to direct certain actions of the trustee, the trustee shall act in accordance with those directions "unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of fiduciary duty that the person holding the power owes to the beneficiaries of the trust." That standard has been very unpopular, and every state that has adopted a directed trust statute (other than states that adopted the full Uniform Trust Code) has done something different.

(ii) **Full Reliance.** Some states, such as Alaska, New Hampshire, Nevada, and South Dakota, have adopted a "no duty, full reliance" approach. That approach is what many settlors want—they want to specify that particular persons are responsible exclusively for specific fiduciary functions. They trust those persons to carry out those functions, and they do not want to pay other persons to oversee those functions. All basic trust functions are subject to fiduciary duties, but are not subject to "cross fiduciary duties." It is a "why can't I say what I want?" approach.

(iii) **Willful Misconduct.** The third option is a very reduced fiduciary obligation approach, such as a willful misconduct standard that is used in the Delaware statute (as well as in Illinois, Texas, and Virginia).

The Act follows the Delaware "willful misconduct" approach. The directed trustee is not liable for taking "reasonable action to comply with a trust director's exercise or nonexercise of a power of the direction," except that "a directed trustee must not comply with a trust director's exercise or nonexercise of a power of direction... to the extent that by complying the trustee would engage in willful misconduct." §9(a)-(b).

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The committee adopted the willful misconduct standard approach rather than the complete abolition of duty approach for several reasons, expressed in the Comments to §9 of the Act. (i) The willful misconduct approach “is more consistent with traditional fiduciary policy,” preserving a minimum of duty for a trustee to maintain the traditional notion that a trustee is a fiduciary. (ii) The directed trust statute in Delaware with its willful misconduct standard has been popular and “establishes that a directed trust regime that preserves a willful misconduct safeguard is workable and that a total elimination of duty in a directed trustee is unnecessary to satisfy the needs of a directed trust practice.” (iii) The willful misconduct approach may be even more protective than the “no duty” approach if a court were to hold that an implied duty of good faith always exists if a fiduciary duty is not otherwise present.

(2) **Reasonableness Standard for Implementing Direction.** The directed trustee must take reasonable actions to comply and implement the direction. §9(a). **Whether** to implement the direction is subject to a willful misconduct standard, but if the direction does not fail the willful misconduct standard, a reasonableness standard applies in **how** the direction is executed.

(3) **Determining Appropriate Directed Trustee Compensation.** Being a directed trustee is not a “no liability” proposition and the directed trustee’s compensation should be set appropriately. Federal bank regulators are critical of directed trusts by national banks, because they believe they are much riskier than reflected by the typical trustee fee being paid for serving as a directed trustee.

One of the first court cases addressing fees for a directed trustee is *Estate of Zeid*, 2017 IL App (1st) 162463-U (2017), in which the trustee negotiated a flat fee rate of 65 basis points annually, but waived its “miscellaneous, litigation, and closely held asset fees.” The bank-trustee requested information about directed assets (at the request of the surviving spouse so she could decide whether to exercise her rights over the marital trust to compel actions regarding assets that were not productive of income), which the advisor (a son from a prior marriage) refused to provide. The bank became concerned over the advisor’s restructuring of debt between different entities that were part of the special directed assets. The advisor sued the bank to impose a different fee structure and force disgorgement of fees previously taken. The court upheld the negotiated fee as reasonable, pointing to the fact that the directed trustee still had numerous obligations.

(4) **Ability to Seek Court Approval.** The Act specifically authorizes a directed trustee “that has a reasonable doubt about its duty” under the Act to “petition the [court] for instructions.” §9(d).

(5) **Specific Situations.** Interestingly, the drafting committee chose not to provide any guidance as to what constitutes “willful misconduct,” and very little case law exists as to what constitutes willful misconduct. In a special session addressing a variety of case studies, the primary issue that arose repeatedly is whether the trustee’s compliance with the direction in that situation would constitute “willful misconduct,” with the panel frequently concluding that it would be a “close call,” and that a petition for court instructions would be appropriate. The following is a summary of observations of the panelists.

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**Investment Concentrations.** This is by far the most widely used directed trust situation. The settlor wants to maintain a concentrated investment position and appoints a trust director with responsibility over that particular investment (or perhaps all investments). “If willful misconduct means something different than ordinary negligence, relying on a direction about investment concentrations must be ok.” But situations could exist raising concerns. For example, what if the trust director is the chairman of the board of a company that is struggling mightily, or what if the trustee’s investment department has a strong sell order on the particular stock?

**Conflicting Directions.** Multiple trust directors may have conflicting views and give conflicting directions to the directed trustee. A petition to the court for instructions or a trustee resignation may be the only alternatives for the directed trustee.

**Family Business, Director With Conflict of Interest.** A very common situation is for a settlor to name one child as the trust director with respect to a family business owned by the trust. What if trusts for a son and daughter each own 50% of the family business, and the son as trust director directs the trustee to sell one share from the sister’s trust to the son’s trust shortly before the sister’s trust terminates, leave the sister’s trust with a minority interest? The trustee would know that this direction benefits the son to the detriment of the sister. Does that reach the level of willful misconduct? The trustee in this situation should disclose the sale direction to the sister, consider obtaining a release from her, and document that communication. This type of situation highlights the directed trustee’s residual responsibility. Although this type of situation involving a family business is common, planners should anticipate that conflicts eventually will arise.

**Opaque Investment Holdings.** The trust director may direct the trustee to transfer substantial trust assets to a 100% owned LLC, with the director as the manager of the LLC. What if the trustee gets no information about investments within the LLC? Could the director be engaging in transactions unreasonably benefiting himself (such as receiving distributions, loans, or unreasonable compensation)? The LLC may be making distributions to others who are not trust beneficiaries (i.e., charitable contributions). On the one hand, investing trust assets in an LLC managed by the director is just a method of implementing director control of the investments. The more difficult issue is if the LLC becomes a “black box” to the trust.

**LLC as Trust Director.** One planner is aware of LLCs being named as trust directors. That seems to be permitted because any “person” can be a director and under the uniform laws a “person” includes entities. This may skirt local laws that generally restrict entities from serving as a trustee unless they comply with trust company regulatory requirements.

**Conflict of Interest.** Assume a scenario in which one cotrustee (C1) has the exclusive power over the investment of trust property, and C1 directs investment of the bulk of the trust property in a series of fledgling technology startup companies in which C1 is an investor or a member of the Board of Directors or for which C1 provides consulting services. The other cotrustee (C2) is aware of the conflict of interest, that C1 has not undertaken due diligence to support the investments, and that the investments are not prudent in light of the beneficiary’s limited risk

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tolerance. That scenario likely presents a willful misconduct situation, and a petition for court instructions would be appropriate.

- i. **Information Sharing.** The trust director and directed trustee must communicate with each other. For example, a director with a power to amend would have to inform the trustee of any amendment. A trustee responsible for investments must know what cash distributions will be needed for distributions directed by a trust director.

All trust directors have a duty to give information to directed trustees reasonably related to the powers or duties of the trustee, and vice versa. A trust director “shall provide information to a trustee or another trust director to the extent the information is reasonably related both to: (1) the powers or duties of the director; and (2) the powers or duties of the trustee or other director.” §10(a). Section 10(b) imposes a similar duty on a directed trustee to share information with a trust director. These duties include both an affirmative duty to provide information (even if it is not requested) and a responsive duty to reply to requests for information.

A safe harbor is provided for trust directors and trustees who act in reliance on information provided to them as long as the person relying on the information is not engaged in willful misconduct. §10(c)-(d).

The information sharing requirement in the Act applies only between trust directors and directed trustees, and does not extend to beneficiaries. The duty to provide information to beneficiaries is governed by the general trust fiduciary law in the enacting state. Even though the trustee may not be required to report the director’s directions before implementing the direction, the trustee may still have a duty to report the transactions in its normal accounting reports for the trust.

- j. **Cross Monitoring.** A concern raised by the requirement to share information is whether, upon receiving information, a duty would arise to advise anyone else (beneficiaries, other trustees or directors) that the person would have made a different decision. The act specifically provides that “a trustee does not have a duty to... monitor a trust director... or... inform or give advice to a similar, beneficiary, trustee, or trust director concerning an instance in which the trustee might have acted differently than the director.” §11(a). Section 11(b) provides mirror monitoring relief for a trust director as to the monitoring conduct of a trustee or other trust director.
- k. **Adapting the Subsidiary Rules of Trusteeship For Trust Directors.** Various general administrative rules of trusteeship are applied to the trust director relationship as well.

Jointly held powers of direction are generally exercised by majority vote unless the agreement provides otherwise. §6(b)(2).

Section 16 of the Act applies the general rules for trustees to trust directorships with regard to seven administrative issues: acceptance, bond, reasonable compensation, resignation, removal, and vacancy.

The Act also addresses various litigation issues. The limitation periods that would apply to a trustee in a like position and under similar circumstances also apply to trust

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directors. In addition, a trust director may utilize defenses arising from a report or accounting given to beneficiaries, regardless whether the report was made by that director. §13.

Trust directors will be entitled to the same defenses in an action for breach of trust as are available to trustees, including: laches or estoppel; consent, release, or ratification by beneficiary; reasonable reliance on the terms of the trust; and reasonable care in ascertaining the happening of an event affecting administration or distribution.

- I. **Bifurcated Cotrustee Responsibilities.** The traditional trust law rule is that cotrustees must use reasonable care to prevent a cotrustee from committing a breach of trust, even if the settlor limits the role or function of one of the cotrustees. The Act incorporates all of the provisions regarding trust directors and directed trustees for cotrustee arrangements in which cotrustees are assigned specific responsibilities. “The terms of a trust may relieve a cotrustee from duty and liability with respect to another cotrustee’s exercise or nonexercise of a power of the other cotrustee to the same extent that in a directed trust a directed trustee is relieved from duty and liability with respect to a trust director’s power of direction under Sections 9 through 11.” §12.

Accordingly, a settlor could assign specific responsibilities to separate cotrustees, and the reasonable action and willful misconduct standards described in the Act would apply with respect to a cotrustee’s exercise or nonexercise of a power of the other cotrustee. The rules regarding information sharing and cross-monitoring would also apply to bifurcated cotrustee responsibilities.

Whether a particular trust agreement adopts the divided cotrustee responsibilities is a matter of construction. The traditional law of co-trusteeship would apply as the default rule, but the terms of the trust can manifest a contrary intent. §12. For example, if the decision of one cotrustee controls over that of another in the event of a disagreement, or if a trust gives one cotrustee investment powers with respect to certain trust property, the protections under the Act would appear to apply. The controlling trustee as to a particular function would be treated like a trust director, and the non-controlling trustee would be treated like a directed trustee.

## 10. Charitable Planning Observations

- a. **Impact of 2017 Tax Act of Charitable Giving.** The reduction in the individual income tax rates is not expected to have much impact on charitable giving. The charitable community is very concerned, however, about the impact of the doubling of the standard deduction (coupled with removing the personal exemption) on the huge amount of “small” charitable gifts on which many charities rely heavily. The percentage of taxpayers that will itemize is expected to decline from about 30% to about 5%. The charitable community estimates that the loss of any tax benefit for non-itemizers as a result of this change will result in a decrease of charitable gifts of between \$13.1 billion to \$24 billion.

One of the changes in the 2017 Tax Act is to eliminate any deduction for contributions to colleges or universities in order to obtain priority for seating or

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parking at college or university events. Creative alternatives to avoid that rule have not yet surfaced.

- b. **Non-Grantor Trust for Family Charitable Giving.** For a client that is taking the standard deduction and cannot benefit from charitable deductions, Martin Shenkman (Fort Lee, New Jersey) suggests creating a simple non-grantor trust providing that the trustee can make distributions in its discretion to the client's children or to charities (specific charities could be listed if desired). If the client anticipates making charitable contributions of \$10,000 per year, the trust might be funded with \$250,000, which could be expected to produce \$10,000 of income per year (ordinary income plus capital gains). The trust would be entitled to a §642(c) deduction for charitable distributions made from income. Furthermore, the DNI is determined after taking the §642(c) deduction, so any distributions to children would likely have little (if any) DNI carryout to the children.
- c. **IRA Charitable Rollover; Gifts of Appreciated Property.** Particularly for nonitemizers, donors over age 70½ should consider making their charitable donations with IRA charitable rollovers at least up to the amount of the minimum required distribution and up to a maximum of \$100,000 per year. Even though the nonitemizer donor does not get an income tax deduction, the donor at least can avoid recognizing income on the IRS required distributions from the IRA.

Similarly, donors making gifts of appreciated property avoid recognizing capital gains they would have had by selling the property, even if they do not get a charitable income tax deduction.
- d. **Camp Proposals Not Enacted.** On February 26, 2014, Rep. Dave Camp (R-MI), the Chairman of the U.S. House of Representative's Ways & Means Committee, released a discussion draft of a forthcoming "Tax Reform Act of 2014" (the "Draft"). The Draft's broad reforms include major changes regarding charitable deductions. The proposal includes several taxpayer-friendly changes, including the ability to deduct charitable contributions made after the close of the tax year but before the due date of the income tax return for that year (April 15 for calendar year taxpayers). The Draft simplifies the complex percentage limitations by imposing a single 40% of AGI limit for both cash and capital gain contributions to public charities, and a 25% of AGI limit for all contributions to private foundations. Charitable contributions would be deductible only to the extent that they exceed 2% of the donor's AGI, and the deduction for the contribution of appreciated property would generally be limited to the donor's adjusted basis in the property, but certain types of property (including publicly traded stock) would be excepted from that rule. These changes would result in substantial increased revenue; the legislation is drafted, and the proposal could resurface at some point.
- e. **Substantiation Requirements.** Final regulations were issued July 27, 2018 regarding various substantiation requirements that largely followed proposed regulations that were issued in 2008. T.D. 9836. (Reg. §§ 1.170A-14, 1.170A-15, 1.170A-16, 1.170A-17, 1.170A-18, 1.664-1, 1.6050L-1. The Preamble to the regulations clarify that they apply only for income tax deduction purposes under §170, and not to estate or gift tax charitable deductions.

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A variety of cases in 2017 disallowed charitable deductions because of failures in satisfying the substantiation requirements applicable to individual donors under §170(f)(8). *Barnes v. Commissioner*, T.C. Memo. 2016-12 (travel for church inadequately documented); *Oatman v. Commissioner*, T.C. Memo. 2017-17 (no contemporaneous written acknowledgment); *Luczaj v. Associates et al. v. Commissioner*, T.C. Memo. 2017-42 (no records or contemporaneous written acknowledgment); *Ohde v. Commissioner*, T.C. Memo. 2017-137 (no substantiation for gifts of more than 20,000 items to Goodwill Industries); *Izen, Jr. v. Commissioner*, 148 T.C. No. 5 (2017) (failure to comply with special contemporaneous written acknowledgment requirement for contribution of qualified vehicle); *RERI Holdings I, LLC v. Commissioner*, 149 T.C. No. 1 (2017) (Judge Halpern, on his own, declined to allow any charitable deduction because of the failure to include basis information for gift of LLC interest, even though the basis did not affect the amount of the charitable deduction) (on appeal to D.C. Cir.)

A major concern of donors is how complex the tax rules are – not only the tax deduction rules but also more importantly the substantiation rules, with their requirements of qualified appraisals, making sure receipts are received timely, and that each receipt is accurate. Making sure that every “i” is dotted and every “t” is crossed to satisfy all of those detailed rules has become overwhelming.

Michele McKinnon (Richmond, Virginia) focuses her practice on charitable planning and representing major donors. She indicates that one of the most difficult parts of her practice is making sure a donor has everything the donor needs in order to claim a deduction under the substantiation rules. Donors can be very generous – until it comes to paying an appraiser. The IRS is litigating this issue and has been winning fairly consistently. If the appraisal does not meet all of the requirements, or if the receipt is not accurate or it is not received timely, no deduction is allowed, and the IRS does not even need to argue about the valuation. For charitable contributions over \$5,000, generally a qualified appraisal prepared by a qualified appraiser must be obtained, and for contributions over \$500,000, the appraisal must be included with the income tax return, which appraisal the IRS can scour to find any detailed technical omissions. For a description of the detailed appraisal requirements, see IRS Publication 561, Determining the Value of Donated Property.

Astonishingly, Ms. McKinnon indicates that in 30 years of practice she has had exactly one appraisal that she reviewed that met all the substantiation requirement rules the first time she looked at it. When clients do not want to pay to use reputable qualified appraisers, a professional advisor has to struggle to work with the appraiser to identify and negotiate the addition of all the necessary changes required to comply with all the rules. That is the most stressful part of her charitable planning practice—making sure that all of the detailed requirements are satisfied so that a donor is entitled to an income tax deduction. That complexity scares donors, and charities do not like to talk about it (for fear of losing a donation). The donors rely on the charity, though, and Ms. McKinnon finds that in representing institutions, she is doing the incredibly detailed review work even though she doesn’t represent the donors. “It is a really difficult area to navigate.... As much as property gifts are great, there is significant appeal to the simplicity of the Camp proposal.”

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- f. **Donor Advised Funds; Notice 2017-73.** Notice 2017-34 explains that the IRS is considering regulations under §4967 (regarding prohibited benefits from donor advised funds) to provide that purchasing a ticket to enable a donor, donor advisor, or related person to attend or participate in a charity sponsored event results in a more than incidental benefit, even if the individual pays the “non-charitable” portion of the ticket price. The benefit may also constitute an excess benefit under §4958.

In addition, the Notice announced that the Service is considering adopting the position that distributions from a donor advised fund (DAF) that the distributee charity treats as fulfilling a pledge made by the donor, donor advisor, or related person do not result in more than an incidental benefit if the fund makes no reference to the existence of a charitable pledge when making the distribution from the fund (in effect, a “don’t ask, don’t tell” rule). The concern expressed by some commenters to the IRS was that the fund may have difficulty determining whether a pledge exists and whether it is an enforceable pledge. Of course, the donor could not take a separate charitable deduction for the contribution to the charity from the DAF. Query whether a donor’s pledge agreement could provide that distributions from the donor’s DAF would be treated as contributions in satisfaction of the pledge?

For a discussion of planning implications of Notice 2017-73, see Robert Lee, *Regulating Donor-Advised Funds: Not Everyone’s a Fan of IRS Plan*, BLOOMBERG DAILY TAX REPORT (April 2, 2018).

## **11. Estate Planning in Anticipation of a Contest or a Difficult Beneficiary**

The information in this item is based upon information and written materials by S. Andrew Pharies (San Diego, California) and David Baker (Chicago, Illinois).

- a. **Identifying High Risk Cases.** Every client arrives at the attorney’s office wanting a “simple estate plan.” Planners should be sensitive to red flags of high-risk situations: disinheriting a child; unequal distributions among beneficiaries of the same class; multiple marriages with children from different spouses; unequal participation in family businesses by children; elderly or impaired client; impaired beneficiaries; presence of one beneficiary in the estate planning process to the exclusion of others; substantial deviations from prior estate planning documents; and a client having recently left his or her long-time experienced estate planning attorney.

If the document is contested, the planner will be a witness years later. The planner probably will not be the attorney in that contest action, because he or she will be a prime witness. In these situations, a high risk exists that the work product will be closely scrutinized by a litigator who will twist everything that was written down or said to benefit that attorney’s client. Furthermore, all the work that is done after the client dies as a witness, producing documents, determining what is privileged, etc. will probably be uncompensated.

The most important question the attorney will face in the entire case is whether to accept the high-risk case in the first place. If the attorney decides not to take the

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case, “that means you are sane person.” Many good estate planning attorneys will not accept these cases.

b. **Planning in Anticipation of a Contest.**

(1) **Grounds for a Contest.** The major grounds for contesting testamentary documents are lack of capacity (a higher contractual standard of capacity may apply to documents other than a will or will substitute), undue influence, fraud, duress, or mistake.

(2) **Manage Client Expectations.** These are very difficult cases, not just on the lawyer but also on the client. Clients do not understand what “I want to disinherit Johnny” entails. Disinheriting will totally disrupt the relationship between Johnny and his siblings. “Nothing will disrupt sibling relationships more quickly or more effectively than one receiving a larger inheritance than the others.”

Set expectations that the engagement will be expensive. Litigating will contests is incredibly expensive, and planning to avoid contests will also be expensive.

In addition, the client must understand that the planning process will be invasive. The client must lay bare to the world details about his or her health, family, finances, and conflicts that have happened over the years with children. It will not be a pleasant experience.

(3) **Creating the Record.** Habit Two of Stephen Covey’s *7 Habits of Highly Effective People* is: “Begin with the End in Mind.” In this context, the ultimate goal is that a contest never occurs or that the court will uphold the validity of the document drafted, largely because of evidence accumulated in the planning process, thus preserving the client’s testamentary intent. Estate planning in anticipation of a contest or difficult beneficiary involves more than just drafting the document. That is the minor aspect. The engagement is primarily about the planning process of creating evidence that will be used in the trial court or that would be used to forestall having a trial in the first place.

(i) **Competency.** The attorney’s opinion about the client’s competency is not sufficient – the goal is to create evidence for trial.

**Medical Competency Report.** Even if the client is perfectly competent, still consider getting an examination from a professional who can testify when the document is being examined. Use a professional with the skill set to evaluate cognitive deficits, including a neurologist, psychologist, neuropsychologist, or psychiatrist who is trained to identify specific deficits. The physician should review the medical record, administer standard tests, and apply those tests to the legal standard of competency.

As an example, §811 of the California Probate Code lists a series of cognitive functions that must be examined in evaluating contractual capacity, including: alertness and attention; level of arousal; orientation to time, place, and situation; ability to concentrate; memory issues; ability to understand and communicate with others; recognition of objects; ability to reason; and ability to use abstract concepts.

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The physician should be directed to prepare a written report of findings of cognitive functioning and applying the findings to the competency standard applicable to the documents being signed by the client. The report should state that the physician has reviewed the client's medical records and discuss the impact of the medications the client may be taking. The report should be addressed to the estate planning attorney, and appropriate HIPAA and confidentiality waivers should be executed by the client to allow the physician to reveal medical information to the estate planning attorney AND ALSO to allow the estate planning attorney to circulate the report after the client's death.

**Testing at the Time of Execution.** The planner must also establish the client's capacity on the day the estate planning documents are signed. The attorneys should question the client in front of witnesses regarding the various elements of capacity required for the particular documents. After the execution ceremony, the estate planning attorney should prepare a memorandum documenting questions that were asked and the client's responses.

(ii) **Undue Influence Third Party Interview.** The estate planning attorney should isolate any beneficiary who unduly benefits under the plan from participation in the planning process. The person should not be present at meetings or a conduit for communication.

Engaging an independent attorney to perform an in-depth interview to establish the absence of undue influence, duress, fraud, or mistake can be quite helpful in defending against a claim based on one of those grounds. The interview would include examining facts relating to the underlying elements of those claims. California has adopted a statutory list of factors that a court must consider when evaluating an undue influence claim, and that list provides a helpful guide to anybody conducting such a third party interview. The list includes factors relating to the vulnerability of the victim, the influencer's apparent authority, actions or tactics used by the influencer, and the equity of the result. CALIF. WELF. & INST. CODE §15610.70(a)(1) – (4).

An attorney preparing such an interview will understand that he or she will be caught up in the litigation, so the third party interviewing attorney will charge a substantial premium for this type of engagement.

(iii) **Videotape.** Video is very powerful and can overcome reason. In some jurisdictions it is not admissible at all; in others it is admissible as a state of mind exception to the hearsay rule. If a client has ZERO impairments (good appearance, perfectly calm, no strange fright, looks beautiful on video), the planner might consider videotaping the execution. If ANYTHING is off (stage fright, movement issue, speech issue, speech is not as good as it used to be, etc.) stay away from videotape because it can be extremely prejudicial. If video is used, employ a professional videographer.

c. **Taking Steps to Prevent the Contest; In Terrorem Clauses.**

(1) **General Description.** The in terrorem clause is a forfeiture provision— a person who unsuccessfully contests the document is disinherited. For this to be effective, the clause must be baited by leaving the potential contestant something substantial that the individual is reticent to gamble losing in order possibly to get something larger in contest litigation.

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(2) **Define Triggers.** Actions that trigger the clause must be identified specifically. These could include:

- contesting the will or codicil or in the exercise of a power of appointment or transfer of property;
- contesting a revocable trust or other trust; contesting any discretionary action taken by the executor or trustee;
- seeking a declaratory judgment regarding whether any specific anticipated action would violate the clause;
- bringing any tort action against an identified group of persons including the imposition of a constructive trust;
- seeking a court adjudication regarding testamentary or contractual capacity; or
- cooperation in any similar actions brought by any other person.

(3) **What Documents.** The clause should identify specifically what documents that are attacked would trigger the clause (which could include documents outside the testamentary document containing the clause).

(4) **Who.** The clause should identify persons covered, and it could be customized to cover just particular persons or class of persons or to accept out a particular person or to trigger some particular acts as to one person but not as to another person.

(5) **Defense Costs.** The clause should authorize the executor or trustee to defend against any action described in the clause. The executor or trustee should be authorized to retain counsel and pay fees from the property of the trust or estate, and that the contesting person is disqualified from objecting to the defense, payment of fees and expenses, or the selection of counsel.

Consider not requiring reasonable compensation. Parties in litigation use costs as a weapon. Take away that weapon by allowing the fiduciary to hire any counsel desired, regardless of their rate, to be paid under their customary hourly rate (even if that rate is considered unreasonable), and to be paid without prior court approval.

Provide that no one can question or even discover the amount of the fees.

(6) **Allocation of Costs.** Allocate fees defending a contest against any bequest made to the contestant. (Some courts have refused to enforce that type of provision.)

(7) **Probable Cause.** Most states apply a reasonable cause standard, and will not enforce an in terrorem clause if the client had probable cause. Probable cause is an objective standard generally described as evidence that would lead a reasonable person, properly informed and advised, to conclude that a substantial likelihood existed that the challenge would be successful, measured at the time the challenge is filed.

(8) **Strategy to Establish Lack of Probable Cause.** After the client dies, the estate planning documents, along with the competency report and the third-party interview report are sent to the beneficiaries. Distributing the reports has two effects. (1) It provides an argument that the person does not have probable cause. (2) As a

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practical matter, it is an incredible deterrent to a contest. This strategy has been successful in a variety of situations in which the beneficiary had consulted a litigation attorney about filing a contest.

- d. **Planning in Anticipation of Challenge to the Participants in the Planning Process-Tort Claim of Intentional Interference with Testamentary Expectancy.** Some states recognize the tort of intentional interference with testamentary expectancy. These can be scary actions involving punitive damages, and can be used as a weapon against the drafting attorney and other participants in the planning process.

The typical elements of this tort action include (1) a testamentary expectancy, (2) tortious interference with that expectancy, (3) causation – that the interference caused a change of the testamentary disposition, (4) damages, and (5) that no adequate remedy exists in probate.

About all that can be done to avoid this type of challenge is to add such a tort claim as a trigger under the no contest clause. In addition, having the competency report and undue influence report would assist in defending against such a tort claim.
- e. **Preventing Post-Death Modification of Estate Plan.** While actions such as decanting, nonjudicial or judicial modifications, settlement agreements, etc. can provide great flexibility, they also can be used to disrupt the client's intent. Those alternatives may provide very helpful flexibility for plans that last for decades, but may not be needed for plans that will be distributed relatively quickly.
- f. **Planning in Anticipation of Difficult Beneficiaries.** Disgruntled beneficiaries can use "weaponized fiduciary duties" and threats of lawsuits in an attempt to bully the fiduciary. The planning attorney can take steps to mitigate the impact of such claims.
  - (1) **Structure of Gifts.** If the plan leaves a beneficiary a share of the residuary estate, that beneficiary may complain about everything done in the administration. Alternatively, give the beneficiary a specific bequest of a particular property (the beneficiary could complain only about actions with respect to that property), or just give the beneficiary a pecuniary amount (the beneficiary could only complain about the timing of the payment of that pecuniary amount). Structure the plan so that the recipient of the specific bequest or pecuniary bequest would not bear any estate tax (or else the beneficiary could complain about actions that impact the amount of the estate tax).

For gifts in trust, use one of two extremes – give NO discretion regarding distributions (for example, an annuity payout to be paid on specified dates) or will give COMPLETE discretion regarding distributions.

(2) **Modify Fiduciary Duties.** The settlor of a trust can modify the fiduciary duties of loyalty, investing prudently, impartiality, self-dealing, etc. The duties can be

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customized, so that they apply to some beneficiaries and not others, or applied to some fiduciaries and not others. Some duties cannot be waived or modified, such as the duty to account, or the duty to keep beneficiaries informed.

Include a statement about why fiduciary duties are being modified. Precatory language can be very powerful in convincing the court to do something that it would not ordinarily do.

(3) **Exculpation.** An exculpation clause provides that a person who breaches a fiduciary duty still would have no (or a reduced level of) liability. The exculpation clause can be customized to protect the client's favored trustee against the client's disfavored beneficiary.

(4) **Use Business Entities.** Assets can be managed inside an LLC that is owned by the trust. Duties of the managers of business entities are lower than fiduciary duties applicable to trustees and can be modified to a much greater extent. In addition, establishing situs is much easier. Having a Delaware sitused trust likely requires having a Delaware trustee and perhaps other nexus, but having a Delaware LLC merely requires that it be formed in Delaware.

- g. **Limiting Actions By a Successor Trustee.** Trust documents typically provide that a successor trustee has no duty to sue or monitor the actions of a predecessor trustee, but typically do not prohibit a successor trustee from suing a predecessor. The successor trustee may hold the attorney-client privilege of the office of trustee, and typically has standing to sue the predecessor and the predecessor trustee's attorney, which is sometimes done for strategic reasons. The trust document could provide that a successor trustee is prohibited from bringing actions against a predecessor trustee or the trustee's attorneys.
- h. **Mandatory Arbitration Clauses.** Some (but not all) states allow a mandatory arbitration provision in trusts and testamentary documents. These provisions allow the settlor to create the forum in which disputes would be litigated, to pick the arbitrator or establish a procedure for doing so, and to modify the rules of arbitration (for example to provide a particular document will be admissible even though it might not be admissible in a court action).

## 12. Planning for an Aging Population

- a. **Statistics About the Aging Population.** Forty million people in the U.S. are age 65 or older, representing 13% of the population. For individuals who live to age 65, 25% will live to age 90, and 10% will live to age 95. By 2050, the number of people over age 65 will more than double to represent 25% of the population, and the fastest-growing segment of those over 65 will be people over age 85.
- b. **Alzheimer's Disease.** Five million people in the U.S. have Alzheimer's disease. It is not just an old person's disease; 200,000 persons under age 65 have Alzheimer's. The cost is staggering. The cost of caring for Alzheimer's patients is \$260 billion per year (compared to \$66 billion per year for cancer patients). By 2050, the cost will rise to over \$1 trillion per year, and the government pays for over two-thirds of this expense.
- c. **Elder Law Myths.**

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- (1) It won't happen to me. (In reality, 70% of those age 65 will need some form of long-term care, and 50% will need nursing home care.)
  - (2) Even if I need long-term care, Medicare will pay for it. (Medicare pays for acute illness (stroke, heart attack, etc.) but does not pay for chronic disease (Alzheimer's disease, Parkinson's, etc.); Medicare does not pay for custodial care; it will cover only a maximum of 100 days after a hospital stay to assist during short-term recovery.)
  - (3) Long-term care is not that expensive. (The average cost is \$100,000 per year, but in major metropolitan areas can be much higher than that.)
  - (4) At least I won't have to pay for my spouse's care. (With some exceptions, spouses are responsible for the cost of each other's long-term care.)
  - (5) I'll deal with this later. (The ability to make one's financial and medical decisions diminishes with age; failure to make these decisions can result in family conflict and expensive litigation.)

- d. **Assisted Living Facilities.** A signed admissions agreement is typically required prior to admission. These are often nonnegotiable, but beware of provisions regarding personal guarantors. A family member signing on behalf of a resident should sign "as agent" to avoid being personally responsible for costs of the facilities.

The cost of an assisted living facility can range from \$4,000 to more than \$10,000 a month. Be aware that add-ons to the daily rate for special services are common.

- e. **Nursing Home.** Nursing homes participating in Medicare and Medicaid programs must meet certain federal requirements.

Nursing homes cannot require or request a third-party guarantee of payment as a condition of admission or continued stay in the facility. A common ploy has been to require a "resident representative" who can sign the contract without incurring personal liability to provide financial payment from the resident's income and resources. Many nursing home admissions attempt to impose additional liability on the responsible party even though not allowed under federal law.

A nursing home may not require a security deposit for an individual being admitted from a hospital. If a qualifying hospital stay has not occurred, the facility can require payment in advance for the first month's charges and a two-month security deposit (but not more).

Mandatory pre-dispute arbitration provisions are common in nursing home admission agreements. A federal agency announced in 2016 that such provisions were no longer permitted, but a federal district court issued an injunction to prevent enforcement of the ban, and in June, 2017, the agency issued a proposed rule that removes provisions prohibiting binding pre-dispute arbitration agreements.

- f. **Continuing Care Retirement Community.** CCRCs offer independent housing, assisted living, and nursing home care. They are attractive facilities and accommodate spouses with different needs. They can be very expensive, however.

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An entrance fee of \$100,000-\$1 million (or more) is required in addition to a monthly fee of several thousand dollars.

- g. **Long-Term Care Insurance.** Long-term care insurance is difficult to obtain. Most insurance companies have got out of this business because it is expensive, and the policies have been way underpriced. (General Electric was one of the worst performing stocks in 2017, and it was because of the long term care insurance division.) Only a few reputable companies still sell this coverage.

Only 7 million people in the country have long-term care insurance. Sales of this insurance have been flat, and from 2002, sales have declined significantly.

A hybrid long-term care/life insurance product is a newly available product.

Most states charge more for female policies. Claims for females are much higher than for males, because male spouses typically predecease female spouses, and when the female spouse needs long-term care, her husband is not alive to provide in-home care.

- h. **Elder Abuse.** See Item 26 for a discussion of various issues regarding elder abuse, including the ability to sue with respect to activities of a trustee of a revocable trust or an agent under a power of attorney while the settlor or principal is still alive.

### 13. New Partnership Audit Rules Overview

This brief overview summary of the new partnership audit rules is based on materials by Richard Robinson (Denver, Colorado). Partnership and LLC agreements should be amended as a result of the new rules, and the materials contained detailed practical suggestions, with a sample form, for amendments.

- a. **Overview.** The Bipartisan Budget Act of 2015 replaced the existing partnership audit regimes, including provisions under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), with new partnership audit rules that apply to partnership taxable years beginning after 2017. The new rules are meant to assist the IRS in auditing partnerships, and are not designed to increase fairness. They will likely result in more partnership tax audits and more tax revenues collected from partnerships and partners. The general approach is that the audit will occur at, and any adjustment will apply at, the partnership level (particularly for large partnerships). Taxes will be paid by the partnership, not the partners, which will avoid the necessity of a multitude of individual tax audits of the individual partners.
- b. **Partnership Representative.** Every partnership must designate a "partnership representative" on its federal income tax return for each tax year beginning after 2017. The partnership representative has sole authority to make elections and represent and bind the partnership (and the partners) in all administrative and court proceedings involving adjustments to the partnership's federal income tax return. All notices and communications will be sent only to the partnership representative. The individual partners have no right to participate in the audit.
- c. **Partnership Level Determination and Payment of Income Tax.** The general rule is that partnership income tax audits are conducted at the partnership level and any resulting income tax will be paid by the partnership and not by the individual partners.

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Two important exceptions from the general rule are: (1) an “election out” by which an “eligible partnership” can elect to have audits and tax liability conducted at the partner level; and (ii) a “push-out election” by which the partnership representative requires each partner to report its share of any audit adjustments on the partner’s return and to pay any resulting income tax liability.

The partnership level income tax liability resulting from an audit (the “imputed underpayment”) including penalties and interest will be assessed and collected from the partnership for the “adjustment year” in which the adjustments become final, not the “reviewed year” that was audited. This can result in a **huge economic distortion** if the reviewed year partners are not the same as the adjustment year partners.

d. **Eligibility for Election Out; Partnerships With Trusts as Partners Not Eligible.**

Only eligible partnerships may make the election out of the new audit rule regime. Requirements of eligible partnerships include: (1) not more than 100 partners; and (2) the partnership can only consist of eligible partners, including individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic entities, S corporations, and estates of deceased partners (but not including partnerships, trusts, or disregarded entities).

The exclusion of trusts (including revocable trusts, grantor trusts, nongrantor trusts, and charitable remainder trusts) from this list is of vital importance in the estate planning community. As a general rule, the new audit rules apply to large partnerships, and small partnerships can opt out of the new rules. However, family partnerships with trusts or disregarded entities as partners do not have that option available.

The preamble to the regulations implementing the new audit rules explains that the IRS rejected numerous suggestions to exercise its regulatory authority to expand the types of entities that can qualify as eligible partners because that would unduly burden the IRS by increasing the number of partnerships subject to the deficiency procedures that the IRS must follow for partnerships that elect out of the centralized audit regime.

e. **Amendments Needed.** A variety of issues should be covered in amendments to partnership and LLC agreements, including rules governing the partnership representative, the election out decision, imputed underpayments and modifications, the push-out election, economic distortion provisions, and administrative adjustment requests.

The written materials by Richard Robinson have a detailed discussion of each of these issues, together with sample provisions.

#### **14. Fiduciary Accountings to Facilitate Planning and Mitigate Risk**

Trust accountings offer a variety of advantages, but are often not prepared for trusts with non-professional trustees. This summary reflects comments by Scott Ditman (CPA New York, New York) and Josh Rubenstein (New York).

a. **General Description.** Fiduciary accountings reflect the transactions of the estate or trust, and accurately reflect the amount of trust income and principal, as determined

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under state law in accordance with the terms of the trust agreement. A fiduciary accounting may or may not be prepared in accordance with local procedures as to the formatting of information that must be included in an accounting to be filed with a court.

The incremental extra cost of preparing a fiduciary accounting is not great in light of the benefits and protection that it provides, as discussed below.

b. **Potential Benefits.**

(1) **Income Tax Effects.** The amount of fiduciary accounting income can affect the preparation of the fiduciary income tax return in various ways. For example, a trust that distributes more than the fiduciary accounting income in a year is a complex trust. Also, under the tier rules, DNI is allocated first to required distributions of current year fiduciary accounting income. §662(a)(1). Schedule B, Line 9 of the Form 1041 requires listing “Income required to be distributed currently.” If the trust has a mandatory income distribution requirement, that line cannot be completed without a fiduciary accounting to determine the amount of fiduciary accounting income.

(2) **Transparency.** The accounting is a way to communicate with beneficiaries about trust activities. At a minimum, informal accountings should be sent to beneficiaries on an annual basis.

(3) **Communication Opportunity.** Ideally, the trustee and planners would meet with beneficiaries to discuss the accounting and the trust activities. Open communication can resolve many problems that might otherwise arise.

(4) **Fiduciary Protection.** Providing the beneficiaries with complete information about trust activities should begin a statute of limitations to run with respect to breach of duty claims. (Some states have very short statutes of limitations with respect to accountings. Florida provides that the accounting can state at the top that a beneficiary has only 6 months to bring legal action with respect to activities disclosed on the accounting.) The statute of limitations for breach of fiduciary duty claims does not begin to run until the fiduciary accounts or repudiates the obligation to account, and it begins running only as to activities actually disclosed on the accounting.

Providing full information on an annual basis avoids the practical reality that hindsight many years later may suggest that a different course of action would have been preferable from a beneficiary’s standpoint.

(5) **Releases.** On an interim basis, the interested parties may be requested to “sign-off” on the accountings. As with all releases, any such release is valid only as to information disclosed to the signer. Despite this important advantage of accountings, “everybody stands on their heads to avoid accountings. It’s the strangest thing.”

How do you get beneficiaries to agree to sign-off on the accountings? “When beneficiaries are treated with respect and believe that their feelings are heard, they are much more likely to sign-off. This stuff is often not about dollars – it’s about

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respect and communication." "The fight is about principle – "LE," not principal – "AL."

Also, while someone is still alive, there's always moral persuasion (like convincing children not to exercise withdrawal rights over Crummey trusts).

Children sometimes are fearful of the patriarch or matriarch and are unwilling to complain while they are alive and able to retaliate. Children may be much more willing to sign-off on accountings on an annual basis while the parents are still living.

As an example, if distributions are made to the current beneficiary, who is using funds to make gifts to one of her three children, having annual meetings with all of the children to discuss what is being done puts all the children on notice. They won't like it, but they won't object to their mother's ability to make her own decisions.

(6) **Formalizes a Process.** Having annual accountings and disclosing all transactions during the year is a way of formalizing that a *process* exists for making fiduciary decisions. "You don't have to end up having been right. You just have to have a process where you made the analysis."

(7) **Foundation For Various Fiduciary Decisions.** The annual report to beneficiaries and the fiduciary accounting serve a variety of purposes. The fiduciary accounting serves as the books and records for the trust that is used to calculate the annual fiduciary accounting income and to prepare the tax return, to compute the annual trustee commission, to serve as the jump off point for budgeting cash flow in the current year and in the following year, and to readily assist in providing a liquidity analysis.

(8) **Opportunity for Planning With Beneficiaries' Buy-In.** Open communication with full information about the trust activities may also open up planning opportunities. For example, in one situation such open communication allowed all of the beneficiaries to agree on a plan maximizing, within the discretion of trustees under the instrument and state law, the allocation of expenses to income and the allocation of income to depreciation reserves, thus dramatically reducing the amount distributed to the surviving spouse under a mandatory income distribution requirement. Roughly \$60 million of estate tax savings resulted from adopting this approach over the surviving spouse's lifetime (which passed to grandchildren under a GST grandfathered trust).

(9) **Avoiding Enormous Expense Later.** If annual fiduciary accountings are not prepared and if litigation erupts years later regarding the trust, preparing trust accountings to reflect activities over decades will be enormously expensive.

## 15. Portability

- a. **Brief Background.** Legislation in 2010 and 2012 allows portability of any unused applicable exclusion amount 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.

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/professionalpartners](http://www.bessemer.com/professionalpartners).

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For a more detailed discussion of portability planning (including the advantages and disadvantages of various approaches) see Item 8 of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

- b. **Using QTIP Trust Planning With Portability, Rev. Proc. 2016-49, Modifying and Superseding Rev. Proc. 2001-38.** The IRS on September 27, 2016 released Rev. Proc. 2016-49 to modify and supersede Rev. Proc. 2001-38 and clarify that portability can be used in connection with QTIP trusts. For a more detailed discussion, see Item 16.b of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).
- c. **Relief Procedure for Extension of Time to File Returns to Elect Portability, Rev. Proc. 2017-34.** Section 2010(c)(5)(A) requires that the portability election be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse. Rev. Proc. 2017-34 provides a relief procedure through the later of January 2, 2018 or the second anniversary of the decedent's date of death in certain cases if the estate was not otherwise required to file an estate tax return. This is a very helpful relief measure (which avoids the necessity of the taxpayer paying a hefty user fee for a ruling under §301.9100-3 to obtain an extension of the time for filing the return to make the portability election). For a more detailed discussion, see Item 16.d of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).
- d. **Estate of Vose, Court Forces Executor to Make Portability Election Despite Marital Agreement Waiving All of Surviving Spouse's Rights to Decedent's Estate.** The Oklahoma Supreme Court affirmed the lower court's decision forcing the executor to file an estate tax return making the portability election, even though the surviving husband had signed a prenuptial agreement waiving "all claims and rights, actual, inchoate, vested, or contingent" in the estate. *In re Matter of the Estate of Anne S. Vose v. Lee*, \_\_ P.3d \_\_, 2017 WL 167587 (Okla. Jan. 17, 2017). (Observation: The family's pronunciation of "Vose" rhymes with "gross" not "doze.") This is a case of national first impression, addressing (i) whether a prenuptial agreement waiving "all claims and rights" to an estate waived any interest that the surviving spouse had in the DSEU amount if the portability election were made, and (ii) an executor's fiduciary duty to make the portability election where the spouse was not a beneficiary of the estate.

Regarding the prenuptial agreement issue, the court observed that a valid waiver requires "full knowledge of the rights intended to be waived," that §2010 (enacted after the agreement was signed) granted the husband "a potential interest in a part of Decedent's estate," and distinguished the waiver of all "claims and rights" in the estate by concluding that "[t]he portable DSUE is not simple property acquired by one party over the course of the marriage according to existing laws in effect when the agreement was made." This is a case of first impression regarding the reach of a pre-existing prenuptial agreement attempting to waive "all rights" in an estate, whether known or unknown, but that pre-dated the portability election and obviously

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did not mention portability. The case emphasizes the importance of specifically addressing the parties' intentions regarding portability in structuring prenuptial agreements. *See generally* George D. Karibjian and Lester B. Law, *Portability and Prenuptials: A Plethora of Preventative, Progressive, and Precautionary Provisions*, BNA ESTATE, GIFT AND TRUSTS J., (March-April 2013).

The court emphasized that the personal representative had a fiduciary relationship to "all parties that have an interest in the estate," and that the surviving husband is the only person that has "an interest in and the ability to use the DSUE" amount. The personal representative argued that the estate should be able to demand consideration from the surviving husband, but the court focused on the fact that the DSUE would be lost if the election were not made and that the surviving husband agreed to pay any costs associated with filing the return to make the election.

For a discussion of the impact of the *Vose* case, see Lester Law & Howard Zaritsky, *In re Matter of the Estate of Anne S. Vose v. Lee: Court Forces the Portability Election – Is Pandora's Box Open?*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2513 (February 8, 2017).

- e. **Statute of Limitations Not Run on DSUE Amount Following First Spouse's Death.** *Sower v. Commissioner*, 149 T.C. No. 11 (September 11, 2017) concluded, based on the clear words of §2010(c)(5)(B), that the statute of limitations does not run, following the first spouse's death, on the determination of the amount of the DSUE following the surviving spouse's death. The correct amount of the DSUE may be examined on the surviving spouse's estate tax return, even if that is years later.
- f. **Portability for State Estate Tax Purposes.** Hawaii has recognized the portability concept for Hawaii state estate tax purposes from soon after portability was adopted for federal purposes. Maryland added state-level portability for its state estate tax in legislation enacted on April 5, 2018. (The exemption in Maryland is \$4.0 million in 2018 and \$5.0 million beginning in 2019.)
- g. **Planning Considerations.** For a detailed discussion of planning considerations, including major factors in bypass planning versus portability, methods of structuring plans for a couple to maximize planning flexibilities at the first spouse's death, ways of using the first decedent-spouse's estate exemption during the surviving spouse's life, whether to mandate portability, whether to address who pays filing expenses to make the portability election, state estate tax planning considerations, and the financial impact of portability planning decisions, see Item 5 of the Current Developments and Hot Topics Summary (December 2015) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

## **16. Creating Trust With Beneficiary As Deemed Owner Under §678, "Beneficiary Deemed Owner Trust" (BDOT); Application of Letter Ruling 201633021**

### **a. Underlying Statutory Provision**

Section 678 includes these relevant provisions:

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- (a) General Rule. –A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
- (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or
  - (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.
- (b) Exception Where Grantor Is Taxable. Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

b. **Overview Description of BDITs and BDOTs.**

What has been termed the “beneficiary defective inheritor’s trust” (BDIT) by Richard and Steve Oshins, if a trust is not a grantor trust as to the trust’s settlor and if a beneficiary has a Crummey power to withdraw **all of the contributions** to a trust, the beneficiary would be the deemed owner of the trust under §678(a)(1) during the period of time while the withdrawal power exists and arguably under §678(a)(2) after the withdrawal power has lapsed (or within the words of §678(a)(2) has been “partially released” assuming the lapse is treated as a release for §678 purposes). See, e.g., Richard A. Oshins, *The Beneficiary Defective Inheritor’s Trust (“BDIT”): Finessing the Pipe Dream*, CCH Practical Strategies (Nov. 2008); Jonathan Blattmachr, Mitchell Gans & Alvina Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC L.J. 106 (Fall 2009). The approach uses withdrawal powers over the **entire contribution** to the trust and **relies primarily on §678(a)(2)** following lapses of the withdrawal powers. Under this approach, relatively small gift transfers (typically \$5,000) are made to the trust so that the lapse of the withdrawal power does not result in the beneficiary being treated as having made a transfer to the trust, which would cause partial estate inclusion in the beneficiary’s estate. The practical problem with the BDIT is how to leverage a small \$5,000 gift to a trust into a significant size through later transactions with the trust. (See paragraph m below for a further discussion of BDITs and potential planning concerns with BDITs.)

Ed Morrow suggests another approach, in which the beneficiary has the right to withdraw an amount equal to **all of the trust’s taxable income** in any given year (from all of the trust assets) but does **not have the right to withdraw the entire contribution** to the trust. The approach **relies primarily on §678(a)(1)** because the beneficiary holds a withdrawal over taxable income *each year*. This approach does not have the limitation of allowing only small gifts to the trust; gifts of any size could be made to the trust because there is no concern of keeping the entire contribution within the “5 or 5” power amount. Mr. Morrow calls this a “beneficiary deemed owner trust (“BDOT”). For an outstanding summary and analysis of this approach, see Ed Morrow, *IRC 678(a)(1) and the “Beneficiary Deemed Owner Trust” (BDOT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2516 (Sept. 5, 2017).

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- c. **Why the BDOT Works Under §678(1)(1).** Observe the highlighted words below in §678(a)(1):

“A person other than the grantor shall be treated as the owner of **any portion** of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus **or the income** therefrom in himself...”

The BDOT approach is based primarily on the “**OR income**” phrase in §678(a)(1).

It is easy to ignore or misinterpret the “power … to vest … the income” portion of §678(a)(1), since there have been fewer reported cases, ruling and articles on trust structures that only allow withdrawal powers over taxable income, yet dozens of PLRs and articles on withdrawal powers over corpus. Treatise have very little if any discussion of this potential variation.

Yet,

*But there is no reason to ignore the “or the income” in the statute and no requirement under §678(a)(1) that a beneficiary/powerholder have any power over corpus beyond the income attributed to corpus to shift all the income taxation to the beneficiary. Id.*

**“Income” in §678 Means Taxable Income.** The regulations governing the grantor trust rules (§§671-679) clearly provide that the reference to “income” unless specifically limited, refers to income determined for tax purposes and not to income for trust accounting purposes. Treas. Reg. §1.671-2(b). (In contrast, for purposes of the non-grantor trust provisions of Subchapter J (Parts A-D, F), a reference to income generally means trust accounting income. Treas. Reg. §1.643(b)-1.)

**Withdrawal Power Should Exist Over All Taxable Income.** In order for the beneficiary to be treated as the owner of the entire trust for income tax purposes under §678(a)(1), the withdrawal power must apply to all net taxable income during the year, including capital gains. If a trust agreement merely provides that the beneficiary may withdraw “income,” under state law principles that would generally refer to income determined for trust accounting purposes which would not typically include extraordinary dividends or capital gains. To cause the taxable income attributable to the corpus portion of the trust also to be treated as owned by the beneficiary, the withdrawal power must apply with respect to an amount equal to all of the net taxable income. Having the corpus portion of the trust being treated as owned by the beneficiary for income tax purposes is extremely important if the beneficiary wishes to sell assets to the trust and have the transfer treated as a non-recognition event under the reasoning of Rev. Rul. 85-13. **Even if the beneficiary is treated as the deemed owner of the corpus, whether the Rev. Rul. 85-13 analysis would be applied to a beneficiary treated as the deemed owner under §678(a)(1) by reason of the power to withdraw income, rather than having the power to withdraw the entire contribution to the trust, is not certain.**

**Case Law and Letter Ruling Support.** Case law supports the conclusion that a power to withdraw taxable income attributable to trust principal, without the power to withdraw the principal itself, causes the powerholder to be taxable on the taxable income attributable to trust principal. *Campbell v. Commissioner*, T.C. Memo 1979-495 (beneficiaries had the power to cause the trustee to distribute capital gains; beneficiaries did not request and the trustee did not distribute the capital gains

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income to the beneficiaries, but they “were deemed to be the owners of the capital gains income” under §678(a)(1)).

Private letter ruling 201633021 also supports this conclusion. In that ruling, trust #1 had the power to withdraw from trust #2 “any dividends, interest, fees and other amounts characterized as income under §643(b) of the Code” and the net short term capital gains and the net long term capital gains. Trust #1 did **not** have the power to withdraw principal of trust #2 beyond the taxable income. The ruling concluded that all of the taxable income of trust #2, including the net capital gains, were taxed to trust #1 under §678(a)(1).

***Whether Taxable Income Amount Is Actually Withdrawn Is Irrelevant Under***

**§678.** Income is taxable to a powerholder under §678(a)(1) whether or not the amount is actually withdrawn. If it is withdrawn, such withdrawal is generally a non-taxable event because it is not a distribution that is reported under the distribution rules for non-grantor trusts. Rev. Rul. 67-241. Indeed, §678(a)(1) applies if the powerholder is a minor for whom a guardian who could exercise the power has not been appointed. Rev. Rul. 81-6; *Trust No. 3 v. Commissioner*, 285 F.2d 102 (7th Cir. 1060). Failure to withdraw the portion of taxable income that exceeds the greater of \$5,000 or 5% of the trust assets, however, could have an effect for transfer tax purposes and for purposes of creditor access to the trust assets, as discussed below.

- d. **Withdrawal Power Over Net Taxable Income Amount Should be Exercisable From All Trust Assets; Impact of Lapse of Withdrawal Power in Excess of “5 or 5” Power.** The trust agreement may provide that failure to withdraw the taxable income amount in a particular year would lapse and could not be exercised in a later year. If so, and if the lapsed power exceeds the greater of “(A) \$5,000, or (B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied,” the power holder will be treated as having made a gift of the excess amount (unless it is an incomplete gift because of retained powers over the trust) [see §2514(e)], and the portion of the trust attributable to such excess amount would be included in the powerholder’s gross estate for estate tax purposes [see §2041(b)(2)].

For most years, the net taxable income of a trust will be less than 5% of the trust value. To use the full trust value in order to measure the 5% amount, the beneficiary should be able to withdraw the net taxable income amount from all of the trust assets. See Rev. Rul. 66-87 (where beneficiary had the power to withdraw accounting income, the 5% element is calculated based just on the accounting income, not all trust assets, reasoning that “the annual trust income ... is ‘the assets out of which ... the exercise of the lapsed powers could have been satisfied’” and apparently assuming that the trust agreement did not permit the withdrawal power to be satisfied from all trust assets). Indeed, Crummey withdrawal powers of assets contributed to a trust, up to the annual exclusion amount, typically use 5% of the entire trust fund as the appropriate 5% amount for purposes of the lapse exception. However, *Fish v. U.S.*, 432 F.2d 1278 (9th Cir. 1970), held that the 5% amount, when applied to a power to withdraw “all or part of the net income of the trust for that year” was only 5% of the income, not 5% of the trust assets. The taxpayer argued that since the income payable to the decedent, had she demanded

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it, would have been payable either from corpus or income, the entire trust represents "assets out of which, or the proceeds out of which, the exercise of lapsed powers could be satisfied." The court disagreed, observing that

even if the trustee could have satisfied the demand for income out of either corpus assets or income funds, a point which we do not here decide, the distribution would necessarily have been a distribution of income as a matter of federal tax law or as a matter of trust accounting, since the decedent had no power whatever to invade the corpus of the trust.

The court was satisfied from a reading of the statute and legislative history that the appropriate test is 5% of the "trust or fund in which the lapsed power existed" and that the power of appointment existed only with respect to the trust income. The IRS cited *Fish* in Rev. Rul. 85-88, 1985-2 C.B. 201 ("where a power of appointment is limited to annual trust income, the 5 percent test is based on annual trust income, not the amount of trust corpus"). Neither *Fish* nor the Ruling addressed how the 5% portion would be determined trust instrument stated explicitly that the beneficiary had the right to withdraw income, but could withdraw that amount from any of the trust assets.

One possible approach to bolster being able to apply the 5% test amount against the entire trust corpus is to provide that the withdrawal power is the greater of the net taxable income or 5% of the trust corpus and clarify that the withdrawal power can be satisfied out of the entire corpus of the trust.

This should still shift all of the taxable income to the power holder beneficiary under §678(a)(1), but provides access in years of low income/yield and greater assurance that the lapse protection applies to the full 5% of corpus. If the taxable income is less than 5% of the corpus in a given year (which is *very common* in today's investing environment), *the entire amount would remain protected, even if the beneficiary doesn't withdraw a dime*. Thus, if the net taxable income is 4%, and the beneficiary for whatever reason chose not to withdraw this net income and let it lapse and add to corpus, the beneficiary would not be considered to have made a taxable gift transfer under federal law, and would not be considered a settlor of the trust under most state's creditor protection laws, as discussed below. If the trustee triggered some capital gains or had high return investments and the trust had 7% taxable income, but the beneficiary withdrew 2% to spend or reinvest outside the trust or pay their taxes, the same lapse protection of the entire amount would occur. Edwin P. Morrow III, *IRS § 678 and the Beneficiary Deemed Owner Trust (BDOT)*, at 30-31 (2018).

The ability to withdraw the greater of the net taxable income or 5% of the trust would seem to be an amount, and would be analogous to the right to withdraw \$10,000 in the following example in Reg. §25.2514-3:

For example, if an individual has a noncumulative right to withdraw \$10,000 a year from the principal of a trust fund, the failure to exercise this right of withdrawal in a particular year will not constitute a gift if the fund at the end of the year equals or exceeds \$200,000. If, however, at the end of the particular year the fund should be worth only \$100,000, the failure to exercise the power will be considered a gift to the extent of \$5,000, the excess of \$10,000 over 5 percent of a fund of \$100,000. Where the failure to exercise a power, such as a right of withdrawal, occurs in more than a single year, the value of the taxable transfer will be determined separately for each year.

If the amount of the net taxable income that can be withdrawn in a particular year exceeds the "5 or 5" amount and concern remains that the 5% exception amount may just be 5% of the income, the preferred approach would be either (a) for the powerholder to withdraw such excess amounts, or (b) for the withdrawal power to include a "hanging power" so that the amount lapses each year only up to the "5 or

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5" amount. If the beneficiary has continuing aggregate unlapsed powers, the beneficiary's estate would include that full amount in the beneficiary's gross estate at the beneficiary's death.

- e. **Spendthrift Protection Issues.** The beneficiary's creditors ordinarily could not reach assets in a third-party spendthrift trust. Does that change because the beneficiary had the power to withdraw assets from the trust; is the beneficiary treated as a transferor to the trust as to that portion of the trust? If so, the trust may nevertheless be protected from the beneficiary's creditors if a state "self-settled trust" law applies. Even if the trust does not provide creditor protection for all self-settled trusts where the settlor is a discretionary beneficiary, almost all states treat the withdrawal powers that were within the "5 or 5" amount as not causing the beneficiary to be treated as having made a transfer to the trust for creditor access purposes. *E.g.*, Tex. Prop. Code §112.035(e) (lapse in any year not exceeding 5 or 5 amount [or gift tax annual exclusion amount if greater]) & §112.035 (f)(B)(3) (present withdrawal power not exceeding 5 or 5 amount). See Ed Morrow, *IRC 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2516 n.64 (Sept. 5, 2017)(also references a 50-state survey chart prepared by Mr. Morrow regarding trust assets subject to withdrawal powers).
- f. **Not A Grantor Trust as to Settlor.** The normal grantor trust rules typically "trump" §678. Section 678(b) provides that "Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section." The reference in §678(b) to "income" means taxable income (as discussed in paragraph c above), so §678(a) would clearly not apply to a power to withdraw taxable income if the trust is otherwise a grantor trust as to the original settlor of the trust.
- g. **Testamentary Trust of Which Surviving Spouse is Deemed Owner Under §678.** Following a spouse's death, testamentary trusts created for the surviving spouse could be treated as owned by the surviving spouse for income tax purposes, allowing the surviving spouse to enter into sale transactions with the trusts without incurring recognition events and to allow the surviving spouse to pay the ongoing income tax of the credit shelter trust to build more value in the trust that would pass free of estate tax at the surviving spouse's subsequent death. (For a QTIP trust, the withdrawal power should include the greater of the net taxable income or the trust accounting income in order for the trust to satisfy the qualifying income interest for life requirement of a QTIP trust. See §2056(b)(7)(B);Treas. Reg. §20.2056-7(d)(2) making reference to §20.2056-5(f), including §20.2056-f(8) (spouse has the right exercisable at least annually to require distribution to herself of the trust income).  
If both the credit shelter trust and the marital trusts are treated as owned by the surviving spouse for income tax purposes under §678, the credit shelter trust could engage in estate freezing transactions with the marital trust to shift future appreciation from the marital trust to the credit shelter trust (to minimize estate inclusion at the surviving spouse's subsequent death and to maximize accumulations in the GST exempt trust) but without having a current recognition event for income tax purposes.

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h. **Broad Use For Beneficiaries of Testamentary Trusts.** This approach might be used broadly for testamentary trusts, to permit the beneficiary to have the flexibility of entering into transactions with the trusts and to allow the trusts to grow more quickly by having the beneficiary pay income taxes with respect to trust income with the beneficiary's outside assets (to maximize the amount that would be excluded from the beneficiary's estate and to maximize the amount that might accumulate in GST exempt trusts). To the extent that the beneficiary did not want to pay the income tax with outside assets, the beneficiary could exercise the withdrawal power over a sufficient amount to pay the income tax attributable to the trust income.

i. **Use With Inter Vivos Trusts.** The BDOT approach could be used for inter vivos trusts as well. To the extent that the trust is legitimately created and funded by a third party, the trust would be treated as owned by the beneficiary for income tax purposes in future years. Thus, the trust would achieve the general advantages of the BDIT trust, but the severe restrictions on the amount that could be funded into a BDIT would not apply. The BDOT could be funded with a large enough amount so that the beneficiary could sell assets to the trust under a traditional "rule of thumb" approach of having 10% equity in the trust without the necessity of using guarantees or other approaches to justify having the trust purchase substantial assets from the beneficiary in return for large notes from the trust.

Alternatively, a "standard" inter vivos grantor trust could provide that following the grantor's death, the beneficiary would have the withdrawal power over all taxable income or grant a protector the authority to grant such a withdrawal power to a beneficiary. The trust would be a grantor trust as to the original grantor for the grantor's lifetime and thereafter the trust would be (or could be if the protector granted the beneficiary a withdrawal right over taxable income) deemed to be owned by the beneficiary/powerholder under §678.

j. **Use With Upstream Trusts.** 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. See Item 5.h above.

The trust would remain a grantor trust as to the client unless the parent exercises the general power of appointment, in which event 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 Reg. §1.671-2(e)(5). However, if the power of appointment is exercised to leave the assets to a trust in which the client has the power to withdraw all of the taxable income (making it a BDOT), the client would continue to be treated as the deemed owner of the trust under §678.

Similarly, if a beneficiary of a trust exercises a limited power of appointment to appoint the assets to an upstream trust, using a "BDOT provision" could cause the parent to become the deemed owner of the trust under §678 (and the parent could actually withdraw enough to pay the parent's additional income tax attributable to the

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trust), and the parent could exercise the general power of appointment in a way that would cause a future beneficiary to become the deemed owner of the trust under §678.

k. **Administrative Advantage—Eliminate Need to File Fiduciary Income Tax**

**Returns.** If the trust is a grantor trust as to the beneficiary under §678, the trust would not need to file a complete fiduciary income tax return (Form 1041) each year. Some planners may view this as a primary advantage of structuring the trust to be a grantor trust as to the beneficiary.

If a grantor trust files a Form 1041, the form is left blank, and a statement is attached indicating the income and deduction information that has been communicated to the deemed owner for inclusion on the deemed owner's Form 1040. The grantor trust box on the Form 1041 should be checked. In some circumstances, no Form 1041 need be filed (and the trustee of the trust does not need to obtain a taxpayer identification number). See Reg. § 1.671-4(b).

l. **Protector Powers to Afford Flexibility.** To address the concern that a beneficiary might repeatedly actually imprudently exercise the withdrawal power, a protector could have the ability to eliminate the withdrawal power going forward (similar to the provision allowing a donor to the trust to provide that a Crummey withdrawal power would not apply as to particular future gifts to the trust).

m. **Advantage of BDOT Provisions With Trust Planning Under PLR 201633021.** If an existing trust (T1) is not exempt from the GST tax, one planning approach would be for someone (likely the same donor) to create a new trust (T2) that would be almost identical to T1 and that would give the existing non-exempt T1 the ability to withdraw an amount equal to the entire taxable income (including capital gains) from the assets of T2. GST exemption would be allocated to T2. T2 would be funded with enough assets to justify a substantial purchase of assets (i.e., within the "10% equity folklore safe harbor"). T1 might subsequently sell appreciating assets to T2 in return for a fixed relatively low-interest note, to (hopefully) shift value to the exempt T2 over time. The sale would not be a recognition event because T1 would be the deemed owner of T2 under §678. PLR 201633021 (indeed, under the facts of that ruling, T1 only had the power to withdraw taxable income including capital gains income from T2). If T1 had the power to withdraw all of the assets from T2 and did not do so, query whether that would be treated as some type of contribution to the exempt T2 requiring GST exemption allocation to prevent T2 from becoming partially non-exempt. That potential GST exemption allocation issue does not exist if T1's withdrawal power is limited to the taxable income and if the trust has a hanging withdrawal power so that all such withdrawal powers can be lapsed out within the 5 or 5 amounts. In that manner, T1 would never be treated as having made a transfer to T2, thus not raising the issue of a "transferor" allocating GST exemption. See Reg. §26.2652-1(a)(5)Ex.5 (lapse of withdrawal right not exceeding 5 or 5 amount not treated as a transfer to the trust; original settlor is still treated as the transferor to the trust). A complicating factor is that T1 (the non-exempt trust) might have to actually withdraw the taxable income each year from T2 (the exempt trust). The IRS might argue that the "5 or 5" exception is only relevant for gift tax purposes, which relates to transactions by individuals because trusts do not make gifts. Therefore, if T1 does not actually exercise its right to withdraw taxable income each year from T2, that

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might be treated as a deemed contribution to T2 by T1 causing the T2 to no longer have a zero inclusion ratio, and no one would have the ability to allocate GST exemption to cover that deemed contribution.

- n. **Potential Concerns with BDIT Transaction.** A number of IRS private letter rulings treat the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under §678(a)(1) while the power exists and under § 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. *See e.g.* Ltr. Ruls. 201039010, 200949012, 200147044, 200104005, 200022035, 200011058, 200011054 through 200011056, 199942037, & 199935046. Even so, potential technical concerns may arise with BDITs. *See generally* Luke T. Tashjian, *The Use of Beneficiary Defective Trusts in Modern Estate Planning*, 48 REAL PROP., TRUST AND EST. L.J. 353 (Fall 2013).

The BDIT transaction is not on the Treasury Priority Guidance Plan, but the IRS has expressed concern with the “BDIT” in two ways. The IRS added the “sale to a BDIT” transaction to its “no-ruling” list for the first time in 2013. Rev. Proc. 2013-3, 2013-1 I.R.B. 113, §4.01 (43, 48-52) (no rulings as to §§678, 2035, 2036, 2037, 2038, and 2042). In addition, the sale to grantor trust legislative proposal that was included in prior administration budget proposals specifically refers to the “deemed owner under the grantor trust rules,” which undoubtedly is a reference to trusts treated as being owned by the beneficiary under §678. This is the IRS’s “shot across the bow” suggesting that the IRS is questioning the BDIT concept, though not expressing reasons why it does not work. A particular focus of the IRS will be to determine how a trust goes from having a value of \$5,000 from an initial trust contribution to having a value of millions of dollars through highly leveraged transactions.

For a more complete discussion of the BDIT transaction, see Item 31 of the Current Developments and Hot Topics Summary (December 2013) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

## 17. Conversion of CLAT to Grantor Trust, PLRs 201730012, 201730017, and 201730018

In PLRs 201730012, 201730017, and 201730018, a CLAT was amended to give the grantor’s brother a substitution power. One of the ruling requests is whether the conversion of the trust from a nongrantor trust to a grantor trust (assuming the substitution power is found to be held in a non-fiduciary capacity) is a taxable transfer from the trust to the grantor. The ruling concluded that the conversion from nongrantor trust to grantor trust status is not a taxable transfer for income tax purposes. The ruling observed that Rev. Rul. 85-13, 1985-1 C.B. 184 involved the conversion of a nongrantor trust to a grantor trust (by the grantor’s acquisition of trust assets in return for a note from the grantor, which the ruling viewed as an indirect borrowing of the trust corpus by the grantor). Rev. Rul. 85-13 concluded that the transfer was not a sale for income tax purposes and the grantor did not acquire a cost basis in the assets. This ruling is consistent with CCA 200923024 which similarly concluded (in a ruling involving an abusive transaction) that the conversion of a nongrantor trust to a grantor trust was not a taxable transaction, noting that treating the conversion as a taxable transaction would have an impact on non-abusive transactions.

The PLRs also concluded that the conversion is not an act of self-dealing under the private foundation rules because the grantor’s brother (who held the substitution power) is not a

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disqualified person under §4946(a). In addition, the trust was not entitled to a charitable deduction because the conversion was not recognized as a transfer at all for income tax purposes.

## **18. New Procedure for Release of Special Automatic Estate Tax Lien**

Prior to June 1, 2016, obtaining a discharge of the automatic estate tax lien under §6324(a) was fairly straightforward; the lien would typically be released with 10 days of sending the Form 4422 to the IRS (or hand delivering it to a local IRS estate and gift tax office). Significant changes in the procedures for estate tax lien discharges were instituted beginning June 1, 2016. The IRS Collections Advisory Group is now handling applications for certificate of discharge of property subject to the estate tax lien; these were formerly handled by the local IRS Estate and Gift Tax Groups. Under the new procedures all sale proceeds must be paid to the IRS or placed in escrow. The only permitted reductions seem to be for amounts needed to satisfy mortgages and “reasonable” selling expenses.

The IRS has issued a revised Form 4422, Application for Certificate Discharging Property Subject to Estate Tax Lien, which must be submitted to the IRS along with the supporting documents described in the instructions to Form 4422.

An internal memorandum dated April 5, 2017, entitled “Memorandum for Director Specialty Collection, Offers, Liens & Advisory - Director Special Examination Estate & Gift Tax” describes some relaxation of the situations in which the lien waiver would be granted including if the estate is not required to file an estate tax return, if the estate appears to be non-taxable, if full estimated tax was paid with an extension request or with the estate tax return, or if the remaining property subject to the lien has a value at least double the unsatisfied amount of estate tax. The memorandum anticipates “that this or similar guidance will be incorporated into the [Internal Revenue Manual].” The IRS may issue a revised Form 4422 with revised instructions.

The revised procedures are useful, but problems will remain. Timing is a serious concern because real estate transactions are time-sensitive.

**Planning Tip:** For older clients who anticipate that real estate will be sold after their deaths to pay administration expenses or state taxes, consider contributing the real estate into a single member LLC prior to death. The estate tax lien applies to the membership interest in the LLC, not to the underlying real estate.

For further discussion of the special automatic estate tax lien and the new procedures for release of the lien (including a more extended discussion of the relief measures announced in the April 5, 2017 memorandum), see Item 26 of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

## **19. Tax Affecting S Corporation Earnings in Valuing S Corporation Stock**

Cases have generally not allowed “tax affecting” the earnings of S corporations that are valued based on earnings in light of the fact that the earnings are taxed to the shareholders. The seminal case was *Gross v. Commissioner*, 272 F.3d 333 (6th Cir. 2001), *aff’g*, T.C. Memo 1999-254 (court concluded that the IRS’s expert used a “preshapeholder-tax discount rate,” so there was no necessity of “tax affecting” the

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earnings). Various cases have followed the *Gross* in not allowing tax affecting. *E.g., Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, modified by T.C. Memo. 2011-244 (LLC taxed as S corporation; “we will not impose an unjustified fictitious corporate rate burden on PMG’s future earnings”).

A case that has been tried in the Tax Court and is awaiting decision will address tax affecting for S corporation stock. *Estate of William Cecil v. Commissioner*, Cause Nos. 14639-14 and 14640-14 (trial held February 2016). In *Cecil*, both the taxpayer AND the IRS’s expert used tax affecting in their analysis. Planners are very interested to see what the Tax Court does with these analyses in light of its firm consistent stance about tax affecting since its 1999 *Gross* case.

## 20. Selected Business Planning Issues

- a. **Selection of Entity and Business Restructuring Issues Under 2017 Tax Act.** The 2017 Tax Act raises new factors in the selection of entity decision for businesses and may lead to business restructuring efforts to make maximum use of the new §199A deduction for qualified business income. See Item 3.n above.
- b. **An Advantage for C Corporations – Qualified Small Business Stock.** Only C corporations can have qualified small business stock. Section 1202(a)(1) (as modified by §1202(a)(4)) generally excludes 100% of the gain (up to \$10 million or 10 times the amount of cash plus the fair market value of property contributed to the corporation in exchange for the stock) for qualified small business stock acquired after September 28, 2010 held at least five years. (Qualified small business stock is stock in a domestic C corporation originally issued after August 10, 1993 in the stock was acquired by the shareholder as compensation or in exchange for money or other non-stock property, but only if the corporation is a qualified small business, generally requiring that the company has had aggregate gross assets of \$50 million or less at all times after August 10, 1993 and before the time immediately after the stock’s date of issuance, §1202(d)(1).) Particularly for a start-up company trying to attract angel investors, who will typically want to sell their stock after the business becomes successful, this can be a huge advantage. Traditionally, the disadvantage of the 35% top corporate rate, when combined with the double tax on dividends was a serious counterbalance to the advantage of the qualified small business stock opportunity. The permanent reduction of the corporate rate to 21% has decreased much of that disadvantage.  
The elimination of §1031 like-kind exchanges for property other than real property does not impact the like-kind exchange of qualified small business stock (within 60 days) that is allowed under §1045(a).
- c. **Changed Paradigm of Payment of Wages for C Corporation Employee-Shareholders.** Traditionally, the paradigm has been to prefer paying wages (deductible to the corporation) rather than dividends to employees who are also shareholders. But the 21% corporate rate has changed that. If profits are distributed as dividends rather than as wages, the tax for the C corporation is 21% to the corporation plus 20% [the rate on qualified dividends] times the remaining 79% to the shareholder on the dividend, or a total of 37%. (This ignores the 3.8% net investment income tax that would apply for taxpayers who have over \$200,000

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[single]/\$250,000 [joint] of taxable income.) But the wages, unlike dividends, would ALSO be subject to employment taxes.

An advantage still exists for the corporation to pay interest to creditor-shareholders (the limit on deducting interest by corporations under the 2017 Tax Act applies only for very high income corporations) or to pay rent to landlord-shareholders.

- d. **Most Popular Types of Partnerships.** Of the 3.46 million total income tax returns by all entities that qualified as partnerships, 65% of them are LLCs, which is clearly the dominant form of the partnership model that is used, terms of numbers of entities. The percentage of returns filed for the remaining entities taxed as partnerships are: general partnerships (16%); limited partnerships (14%); and limited liability partnerships (5%).
- e. **Traditional Advantages of Partnerships Over S Corporations.** Partnerships have two primary tax advantages over S corporations. First, partners have great flexibility in allocating income, even after the end of the taxable year, as long as the allocation has economic reality and is not just an allocation for tax purposes, whereas income must be allocated pro rata to all shareholders of an S corporation. Second, for a partnership that has made a §754 election, at the death of a partnership, the basis adjustment in the deceased partner's partnership interest results in an adjustment under §743 of the inside basis of the partnership assets with respect to persons inheriting the deceased partner's interest. That inside basis adjustment does not apply to any other type of entity (C corporation or S corporation).
- f. **Estate Planning Issues for New Business Venture.** The creation of any business venture is an excellent time for transfer planning, because of the potential huge appreciation opportunity. Some planners prefer using a three-layer system. (1) A client and irrevocable grantor trust invest in (2) a family LLC, and (3) the LLC invests in a separate entity that owns the new operating business. Advantages are: (1) the LLC is transparent from income tax standpoint as a disregarded entity; (2) control can be separated from equity ownership at the family LLC level whereas partners and investors in the business level may not want to have voting and nonvoting interests; (3) the activities of the family LLC are private vis-à-vis other owners of the operating business; and (4) the family LLC is available to invest in other businesses in the future.

Tax issues that may arise with this arrangement include the following.

- (1) **Guarantees.** The IRS sometimes raises issues about the tax treatment of parents guaranteeing a child's loan, and whether that is treated as a gift. However, if the parent guarantees a loan to the operating business as one of the primary owners, that appears as a very traditional business arrangement of principals (rather than third party investors) guaranteeing business loans.
- (2) **Compensation.** Reasonable compensation must be paid to family members for services rendered.
- (3) **Valuation.** Some clients will take the position that the new business venture has no value at start-up. (The planner may respond by offering to buy a 50% interest in the business for \$1,000 if the client really thinks that it has no value.)

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- g. **Transfer Planning Shortly Before a Sale.** A fairly common situation is the client who inquires about transfer planning after having already received a "term sheet" for the sale of the business. If the "ink is not yet on the pages," discounts might still be available. The following article summarizes how to analyze the valuation issue. Radd L. Riebe, *Discounts Before The Deal Is Done*, TRUSTS & ESTATES, at 37 (December 2007). The author suggests the following approach: (1) determine the present value of future payouts under the proposed sale transaction; (2) analyze the expected value of the stock if the sale is consummated and if it isn't, with the non-transactions scenario examining risk factors such as due diligence issues, representations and warranties, and financing contingencies that may sink the deal, to estimate a probability weighted expected value for the deal; and (3) subtract an arbitrage discount to reflect the risk that the two potential outcomes have significantly different results for the hypothetical buyer.
  - h. **Prenuptial Agreement to Address Family Business Interest.** Prenuptial agreements are invariably very sensitive documents. The agreement may be much more acceptable if it just deals with the business interest (the family legacy asset) rather than purporting to deal with all marital assets.
  - i. **Unhappy Family Member Wanting Out of the Business.** The situation of an unhappy family member or family branch that wants to be bought out of the business always hoists tense negotiations into the family relationships. The situation may be resolved much more easily among family members if family meetings beginning when the children came of age dealt not only with the business issues, but also valuation issues – how a business is valued, why discounts apply, what it means to be involved in a business and take additional risks, and the effects of not being in the business to avoid that risk but then holding potentially lower reward assets. These valuation concepts are much better received in early general educational meetings rather than when being first heard in the context of wanting to be bought out.

## 21. Roth IRA Selected Issues

- a. **Beneficiary Selection for Roth IRA.** The best beneficiary designation for a Roth IRA is outright to the surviving spouse. The surviving spouse can rollover the IRA to the spouse's own Roth IRA, and will not have to begin taking distributions at any time during balance of the spouse's lifetime. At the spouse's death, a beneficiary (preferably a young beneficiary) can be named and the payout would be made over that beneficiary's life expectancy. A terrible choice of beneficiary is a charity, because the Roth IRA affords tax-free benefits and the charity would get no tax benefits from the Roth IRA. Another poor choice is a trust for the surviving spouse, because the benefits would have to be paid out over the life expectancy of the spouse.
- b. **Conversion to Roth IRA Is a Way of Taking Advantage of Losses That Would Disappear at Owner's Death.** Various carryforwards (such as the charitable contribution carryforward or the loss carryforward) vanish if they are not used during the person's lifetime or on his final income tax return. An excellent way to make use of a carryforward deduction that will otherwise vanish at death is to convert an IRA to a Roth IRA before the time of death. The conversion causes income recognition, which would be offset by the carryforward.

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## 22. Tax Effects of Settlements and Modifications

The tax effects of court modifications, other trust modifications, decanting, and settlements are summarized in Items 42-51 of the ACTEC 2015 Annual Meeting Musings summary found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners). This Item includes several brief miscellaneous comments.

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

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

Effectively, the IRS seems to be taking the position that a “settlement tax” exists. The IRS is more inclined to give consideration to a court judgment, but totally ignore settlements because they are viewed as collusive transfers. The courts and national office of the IRS typically realize that the four-part analysis applies, but individual examiners are extremely suspicious of collusion in settlements.

- b. **Revenue Ruling 73-142—Pre-Transaction Actions Can Avoid Bosch Analysis.** In Rev. Rul. 73-142, a Settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The Settlor obtained a local court construction that the Settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the Settlor removed the trustee and appointed another, so the Settlor no longer had the removal power. In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred *before the taxing event*, which would have been the Settlor's death. The IRS agreed that it was bound by the court's ruling as well:

In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, *regardless of how erroneous the court's application of the state law may have been*. Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.

Unlike the situation in *Bosch*, the decree in this case was handed down *before the time of the event giving rise to the tax* (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such *date since the decree, in and of itself, effectively extinguished the power*. In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter. Rev. Rul. 73-142, 1973-1 C.B. 405 (emphasis added).

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Get the construction proceeding final order before the taxing event, and the IRS will be bound under Revenue Ruling 73-142. But the prior court order must be obtained *prior to* the event that would otherwise have been a taxable event.

PLRs 201723002 and 201723003 are examples of situations in which this opportunity should apply. The taxpayer reformed his irrevocable trust in a state court action to remove powers that were reserved to the grantor as a result of a scrivener's error, and the reformation was completed before the taxpayer died, which avoided estate inclusion under §§2035, 2036, or 2038. The rulings reasoned that the reformation to correct the scrivener's error was consistent with state law under the *Bosch* doctrine, but the result should have been the same even without the *Bosch* analysis.

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

A reformation modifies a document, and the IRS position is that the reformation generally applies prospectively only. Accordingly, a post-death reformation may not result in an action causing assets to have passed to a surviving spouse or charity as of the date of death to qualify for an estate tax marital or charitable deduction. Some rulings have given reformations retroactive effect, however, in "unique circumstances." *E.g.*, PLR 201807001 (donor intended trust to be a grantor trust, which it was at the time of creation, but §672(f)(1) retroactively caused trust not to qualify as grantor trust; reformation "taken into account" as of date of trust creation). See Item 21.d below.

Planners may be creative in finding an ambiguity that can be used in a construction proceeding, rather than using a reformation/modification proceeding, in light of the more favorable tax treatment resulting from construction actions. In *Hubble Trust v. Commissioner*, T.C. Summ. Op. 2016-67, a trust instrument gave the trustee the authority to use and distribute "[a]ll unused income and remainder of the principal ... as will make such uses and distributions exempt from Ohio inheritance and Federal estate taxes and for no other purpose." The local court entered an order that the trust was ambiguous and that it authorized the trustees to make charitable distributions. The Tax Court agreed with the IRS that no latent ambiguity existed that could be construed by the probate court (even though the drafting attorney believed that the trustees were supposed to be authorized to make charitable distributions), and that distributions did not qualify for an income tax charitable deduction.

- d. **Recent Rulings Regarding Tax Effects of Court Modifications.** A 2016 Chief Counsel Advice refused to give effect to a court modification for purposes of whether or not charitable distributions were made "pursuant to the terms of the governing instrument." CCA 201651013. The trust was modified to give the beneficiary a limited power of appointment in favor of charity. The IRS concluded that if the beneficiary exercised a power of appointment to make distributions to charity, a

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charitable deduction would not be available under §642(c) because the distribution would not be made pursuant to the terms of the governing instrument.

A recent Chief Counsel Advice similarly concluded that assets appointed to charities under a power of appointment granted in a court modification would not satisfy the “pursuant to the terms of the governing instrument” requirement. CCA 201747005 (includes extended discussion of Bosch and Rev. Rul. 73-142). This conclusion seems incorrect; if the governing instrument is effectively modified under state law before the transfer to charity, subsequent transfers would seem to be made pursuant to the terms of the governing instrument in the absence of guidance under §642(c) that it looks only to the governing instrument as drafted, without valid modifications.

A 2018 private letter ruling gave retroactive effect to a trust reformation. The trust was intended to be a grantor trust, and it was a grantor trust when created and funded. However, §672(f)(1) retroactively caused the trust no longer to be a grantor trust. It provides that the grantor trust rules do not apply except to the extent they cause a citizen or resident of the United States to be the deemed owner (and the grantor was not a United States citizen or resident), but an exception described in §672(f)(2)(A)(ii) states that the grantor trust rules can apply if only the grantor or grantor’s spouse can receive distributions. The trust included the grantor’s issue as beneficiaries (as well as the grantor), so the exception did not apply. That statute was passed after the trust had been funded, but it was retroactive to a date that was before the funding date. Based on the grantor’s intent, the retroactive law change, and the fact that no distributions had been made, a reformation removing the grantor’s issue as potential beneficiaries was given effect as of the date of the creation of the trust for the purpose of determining that the trust falls within the §672(f)(2)(A)(ii) exception. PLR 201807001.

### 23. State Income Taxation of Trusts; *Kaestner, Fielding*, and *Wayfair* Cases

- a. **Background.** All of the 43 states plus the District of Columbia that impose an income tax on trusts tax the undistributed income of a non-grantor trust as a “resident trust” based on one or more of the following five criteria: (1) if the trust was created by a resident testator (for a testamentary trust), (2) if the trust was created by a resident trustor (for an inter vivos trust), (3) if the trust is administered in the state, (4) if the trust has a resident fiduciary, and (5) if the trust has a resident beneficiary. Observe that the governing law of the trust is not one of those criteria (except in Louisiana; also in Idaho and North Dakota that is a factor considered along with other factors). A trust included in one of the first two categories is referred to as a “founder state trust” (i.e., the trust is a resident trust if the founder of the trust was a resident of the state).

See Item 20.d of the 2012 Heckerling Musings found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners) for a summary of the court cases that have addressed the constitutionality of state tax systems that tax trusts based on the testator of a testamentary trust or settlor of an inter vivos trust residing in the state. Based on those cases, most commentators believe that taxing a nonresident trust solely because the testator or settlor was a resident is probably unconstitutional.

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However, if that state's court system is utilized, for example, because of a probate proceeding in that state, chances are better that the state does have the authority to tax the trust.

For a very complete survey of the nexus rules in the various states, see the Bloomberg BNA Special Multistate Tax Report, 2017 Trust Nexus Survey, available at <http://src.bna.com/tBG> (published October 2017).

- b. **Significance.** This issue is arising more frequently as (1) states are strapped for revenue and are getting more aggressive, and (2) beneficiaries and individual trustees are more mobile, which may have the effect of changing the tax situs. Beware of naming family members as trustee without considering whether the appointment could cause the trust to be subject to income tax in the state of the trustee's residence. These issues are exacerbated by the trend of splitting up trustee functions among co-trustees, increasing the possible likelihood of having at least one co-trustee in a state that uses the trustee's residence as a basis for taxing trusts.

- c. **Recent Trend of Cases Rejecting Constitutionality of State Trust Taxation**

**Approaches.** Recent cases have held or suggested that Illinois, New Jersey, North Carolina, and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created. *E.g., Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 2018 WL 2937823 (N.C. 2018)(basing taxation of trust solely on beneficiary's residence in North Carolina on the facts of this case violates Due Process Clauses of North Carolina and U.S. Constitutions), *aff'g*, 789 S.E.2d 645 (N.C. App. 2016), *aff'g*, 12 CVS 8740 (N.C. 2015); *Residuary Trust A u/w/o Kassner v. Director, Division of Taxation*, 2015 N.J. Tax LEXIS 11, 2015 WL 2458024 (N.J. Sup. Ct. App. 2015), *aff'g*, 27 N.J. Tax 68 (N.J. Tax Ct. 2013); *Linn v. Dep't of Revenue*, 2013 IL App (4th) 121055 (2013); *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (2013). For further discussion about the details of each of these cases see Item 22.a of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and Item 17.c of the Current Developments and Hot Topics Summary (December 2017) found [here](#) and available at [www.bessemer.com/professionalpartners](http://www.bessemer.com/professionalpartners).

Minnesota joined this trend in the *Fielding* case. In *William Fielding, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, et al., v. Commissioner of Revenue*, (Minn. Tax Ct. May 31, 2017), the court addressed the Minnesota statute providing that an inter vivos trust is treated as a resident trust if the grantor was a Minnesota resident when the trust became irrevocable. The taxpayer paid income tax on all income earned by the trust in 2014, but filed a claim for refund, alleging that Minnesota's taxation of non-Minnesota income merely on the basis of the grantor being domiciled in Minnesota when the trust became irrevocable was unconstitutional, violating the due process clauses of the Minnesota and U.S. constitutions, and the Commerce Clause of the U.S. Constitution. The Commissioner tried to point to other (rather minimal) contacts with Minnesota. While the court reasoned that all contracts with Minnesota would be considered, the court concluded that the only factor that was relevant for consideration was the statute's description of

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the grantor's domicile when the inter vivos trust became irrevocable and whether that basis was sufficient on constitutional grounds. The court concluded that the grantor-domicile sole basis under the Minnesota statute for treating an inter vivos trust as a Minnesota resident trust violated the Due Process clauses of the Minnesota and United States constitutions. Minnesota was not entitled to tax the income from the sale of stock (of a Minnesota corporation) or income from an out of state investment account. The Minnesota Supreme Court affirmed on July 18, 2018, largely following the reasoning of the Minnesota Tax Court.

As cited above, the *Kaestner* North Carolina case found that basing taxation on the beneficiary's residence in North Carolina violated the "minimum contacts" component of the federal and state Due Process clauses. The North Carolina Supreme Court concluded that only the contacts and actions of the trustee or the location of the assets matter for determining nexus. See Ed Morrow, David Berek, & Raj Malviya, *North Carolina Supreme Court's Affirmation of Kaestner and Its Impact on both North Carolina and Other States' Abilities to Tax Trust Income*, Leimberg Inc. Tax PI Newsletter #153 (Aug. 20, 2018).

Another recent relevant case is *T. Ryan Legg Irrevocable Trust v. Testa*, 75 N.E.3d 184 (Ohio 2016), *writ cert. denied*, 2017 U.S. LEXIS 5567 (U.S. 2017). The Ohio Supreme Court upheld imposition of Ohio income tax on a nonresident Delaware trust's sale of Ohio S corporation interests, based on a state statute requiring that nonresidents pay Ohio income tax on taxable gains from the sale of a 20% or greater interest in an Ohio pass-through entity. An earlier Ohio case held that statute was unconstitutional as applied to a seller that had not availed himself of Ohio's protections and benefits in a direct way. The Ohio Supreme Court nevertheless upheld the imposition of the Ohio tax in this case, even though the Delaware trust had not availed itself of Ohio protections and benefits, because the trust's settlor was from Ohio and that same person was the original founder and manager of the pass-through entity (though he had withdrawn from the business before the year in question). The taxpayer petitioned the U.S. Supreme Court for a writ of *certiorari*, partly on the basis that the trust itself had no Ohio beneficiaries and was not involved in the company's business and the trust had no contacts with Ohio other than the settlor being from Ohio. Dana Fitzsimons (Atlanta, Georgia) reports that the taxpayer's brief to the Supreme Court is an outstanding review of the history of cases that have addressed the constitutional issues of taxing nonresident trusts based on the settlor's residency.

The U.S. Supreme Court decision authorizing state sales taxation of internet commerce may also be relevant to the issue of state trust taxation. *South Dakota v. Wayfair*, 138 S. Ct. 2080 (U.S. 2018) overrules *Quill v. North Dakota*, 504 U.S. 298 (1992), which held that the Commerce Clause requires that a seller have sufficient contacts with North Dakota, such as physical store locations or sale representatives, in order for North Dakota to require that out-of-state mail-order sellers collect North Dakota use taxes on sales. *Quill* held that the amount of contacts with North Dakota was sufficient to satisfy the Due Process Clause but not the Commerce Clause. While some of the state trust income tax cases have addressed both the Commerce and Due Process Clauses, most just directly address the Due Process Clause, but a variety of the cases have cited *Quill* for its "substantial nexus" discussion. The overruling of *Quill* could conceivably have an impact of those cases. *Wayfair* says that an essential

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element of the Commerce Clause is that an activity exists “with substantial nexus with the taxing State” which can be established when the taxpayer “avails itself of the substantial privilege of carrying on business in that jurisdiction.”

*Kaestner* quoted *Quill* extensively (even though *Quill* was a Commerce Clause case and *Kaestner* was a Due Process Clause case) regarding the requirement of having a minimum connection with a state. “For taxation of a foreign trust to satisfy the due process guarantee ..., the trust must have some minimum contacts with the State of North Carolina such that the trust enjoys the benefits and protections of the State.”

Despite the importance of *Quill* to many of the state income tax constitutional cases, some commentators predict that *Wayfair* will not likely change the results of these cases.

Remember that, although *Kaestner* was decided on Due Process grounds, these statements (derived from *Quill*, which is a Commerce Clause case) seem significantly similar to standards that *Wayfair* regards as valid. Does *Wayfair*, as a taxing jurisdiction victory, thus throw cases like *Kaestner* into doubt?

Our guess is that it does not. A Due Process evaluation still must find the minimum contacts necessary to allow a state to tax accumulated trust income. In addition, a state court is always free to adopt a more stringent interpretation of Due Process under a Due Process clause in a state constitution.

...

But in terms of the larger picture, there does not appear to be a change in the standards that will apply in the future. *Wayfair*, overruling *Quill*, is meaningful for Commerce Clause purposes, but we believe it is likely that Due Process constraints will continue to protect trusts that carefully are created and administered to limit their state income tax exposure. Also remember that the statute in *Wayfair* required collection of tax only by sellers with substantial, continuous activity in South Dakota [delivering more than \$100,000 of goods or services or engaging in 200 or more separate transactions].

...

In our opinion, the Due Process constraints in cases like *Kaestner* are likely unchanged by the Supreme Court’s *Wayfair* decision. Larry Katzenstein & Jeff Pennell, *How Does South Dakota v. Wayfair Impact a State’s Ability to Tax Undistributed Trust Income?* LEIMBERG INC. TAX PL. NEWSLETTER 148 (July 12, 2018).

## **24. Purchase of GRAT Remainder Interest Did Not Work**

Chief Counsel Advice 201745012 involved a deathbed purchase a remainder from a GRAT. The day before he died, the grantor purchased the remainder from two GRATs with two unsecured promissory notes. The IRS, emphasizing the deathbed nature of the transaction, held that the IRS would completely disregard the remainders as consideration for the purchase, because the remainders would have been included in the grantor’s estate in any event, and purchasing the remainders did not change that. Therefore, the grantor was treated as receiving no consideration, so the transfer of the notes was treated as a completed gift. (The IRS reached a similar result in Rev. Rul. 98-8, in the context of §§2519 and 2044 for a marital trust.) The Chief Counsel also concluded that the notes are not deductible by the estate. In effect, this technique resulted in a phantom net addition to the estate. A gift was made, using applicable exclusion amount, and the decedent owned the remainder interest, but no offsetting deduction was available for the decedent’s estate.

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## 25. Exercise of Substitution Power

Exercising a nonfiduciary power to substitute assets has proved to be no cakewalk, particularly when notes are tendered for the substitution. Three cases have addressed the attempted exercise of substitution powers by giving notes. In two cases the substitution was not effective, *Condiotti* and *Schinazi*, and in one case the court refused to grant summary judgment finding the transaction ineffective, *Benson*.

*In re The Mark Vance Condiotti Irrevocable GST Trust*, No. 14CA0969 (unpublished opinion Col. App. 2015) held that the attempt to exercise a substitution power by offering an unsecured note for a trust asset held ineffective, reasoning that the proposed transaction was an attempt to borrow from the trust, not to substitute assets, so that the trustees could properly reject it. *Schinazi v. Eden*, 729 S.E. 2d 94 (Ga. Ct. App. 2016) involved an attempt to substitute a note for a limited partnership interest that owned valuable pharmaceutical patents. The attempt failed because the note was not equivalent value (some evidence indicated that the value of the partnership interest increased just days after the tender), and the grantor failed to follow the necessary steps under the partnership agreement to complete the acquisition.

The grantor may have been more successful in *Benson v. Rosenthal*, 2016 WL 2855456 (E.D. La. 2016) (slip copy), *mot. for partial summary judgment denied*, 2016 WL 6649199 (E.D. La. 2016). The court refused to grant summary judgement treating proffer of note as ineffective, observing that (1) the trust agreements did not explicitly exclude a promissory note from being used to exercise the substitution power, (2) the notes were assets having value, and (3) the real estate and loan forgiveness that the grantor offered as part of the substitution were further proof that a loan was not intended.

For an interesting discussion of practical problems that arise in implementing and exercising swap powers, see Martin Shenkman & Bruce Steiner, *Swap Powers-Consider Some Often Overlooked Practical and Technical Aspects*, Trusts & Estates 45 (Dec. 2015).

An alternative that would avoid the issue of whether the substitution power could be exercised by a note would be for the grantor to borrow funds from a bank and transfer cash in exchange for the substitution. That would also avoid the possibility of the trust being treated as holding a note with no (or minimal) basis.

## 26. Garnishment Defeats Spendthrift Protection

Spendthrift protection may merely preclude acceleration of a beneficial interest, not attachment of distributions once the beneficiary becomes entitled to them. A proper garnishment order may be applied to enforce a creditor's right to distributions as they are made, essentially mandating the trustee pay directly to the creditor anything that is immediately distributable to the beneficiary. Section 502 (c) of the Uniform Trust Code provides otherwise, but various cases have allowed garnishment actions against spendthrift trusts. *E.g., United States v. Harris*, 854 F.3d 1053 (9<sup>th</sup> Cir. 2017)(citing 28 U.S.C. §3002(12), garnishment under federal law may reach "property," which includes "any present or future interest, whether legal or equitable;" a beneficiary's right to receive discretionary payments from a spendthrift trust was treated as "property" under the statute, and therefore subject to garnishment); *Carmack v. Reynolds*, 391 P.3d 625 (Cal. 2017) (bankruptcy trustee entitled to reach a sum up to the full amount of distributions that are currently due and payable to beneficiary from spendthrift trust).

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## 27. Recurring Elder Abuse Issues

- a. **Standing to Receive Information and Sue Regarding Revocable Trusts.** The traditional rule for a revocable trust is that while the settlor is alive, all right of beneficiaries other than the settlor are subject to the settlor's control, and the trustee's duties run exclusively to the settlor. UNIF. TRUST CODE §603(a). The trustee has no duty to inform or report to beneficiaries other than the settlor of a revocable trust while the settlor is still alive. *Id.* cmt. A practical concern is that this limits the ability to seek redress for perceived abuses by a trustee before the settlor's death, often by one heir as trustee.

This is a troubling issue with strong competing policies of (1) right to autonomy of the individual vs. (2) protecting against overreach by a future greedy heir. Stated differently, (1) the plaintiff will just use the information to "shake down momma" vs. (2) no one is "keeping an eye on the fox in the henhouse."

Approaches that have developed in the cases are (1) remainder beneficiaries have no right to complain at any time about activities during the settlor's life (the traditional rule), and (2) the remainder beneficiaries' right to information or to sue is delayed until after the settlor's life (so as not to interfere with the settlor's autonomy during his or her lifetime). Cases in the second category have generally been very egregious cases.

Bucking this trend of cases and the traditional rule is *Rhea Brody Living Trust v. Deutchman*, 2017 Mich. App. LEXIS 1430 (2017). The settlor's daughter was allowed to sue the trustee of her mother's revocable trust (the trustee was the mother's husband) even though the mother had not been declared incompetent. The court specifically said that it was unnecessary to determine whether the settlor was disabled under the trust terms or whether the trust is revocable to resolve the issue as to the daughter's standing. The court found that the trustee had breached his fiduciary duty and removed him as trustee.

What should a planner do in light of this difficult issue? Ask the client to explore which of the strong polices the client wishes to protect – the rights to this own autonomy or to be protected against potential abuse. (A practical difficulty is that the document is sometimes being prepared at the request of the abuser, or potential abuser.)

- b. **Actions Under Power of Attorney.** In *Hauser v. Hauser*, 796 S.E.2d 391 (N.C. Ct. App. 2017), the court refused to allow a daughter to obtain an accounting from her brother as agent under a power of attorney for her mother, or to pursue allegations of intentional interference with an expected inheritance. The court reasoned that "[w]hile Mrs. Hauser remains living, any claim arising out of a fiduciary relationship between her and Defendants can only be brought by Mrs. Hauser herself or someone legally authorized on her behalf."

The Uniform Power of Attorney Act provides more ability to compel information or to review an agent's conduct, even during the principal's lifetime. UNIF. POWER OF ATTY. ACT §116(a). The comment begins: "The primary purpose of this section is to protect vulnerable or incapacitated principals against financial abuse. Subsection (a) sets forth

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broad categories of persons who have standing to petition the court for construction of the power of attorney or review of the agent's conduct, including in the list a "person that demonstrates sufficient interest in the principal's welfare."

- c. **Power of Attorney Abuse.** Setting aside fraudulent actions under powers of attorney present another case of competing policies: 1) facilitating efficient use of powers of attorney by protecting third persons relying on them, and 2) protecting innocent third-party purchasers VERSUS protecting the innocent defrauded principal—especially where the power of attorney was forged (in a period of heightened sensitivities about elder abuse). The Uniform Power of Attorney Act §119 and a variety of state statutes encourage third persons to rely on actions taken under a power of attorney. Among other things, these statutes require that the power of attorney be acknowledged. *Yi v. Oh*, 2017 WL 3393283 (Cal. Ct. App.) did not protect a third party who acted in reliance on a forged power of attorney. A Comment to the Uniform Power of Attorney Act specifically says that a third party is protected rather than the principal even if the power of attorney is forged, as long as the person "in good faith accepts an acknowledged power of attorney without knowledge that it contains a forged signature or a latent defect in the acknowledgement."

## 28. Developments Regarding Fiduciary Access to Digital Assets.

- a. **Lawful Consent by Personal Representative of Deceased Owner under Stored Communications Act.** The Stored Communications Act 18 U.S.C. §§2701-2712 creates privacy rights to protect contents of certain electronic files from disclosure by online providers. It prohibits an account provider from disclosing the contents/files of electronic to fiduciaries and family members unless an exception applies. If an exception applies, the service provider MAY voluntarily disclose the contents/files. One exception is if "lawful consent" exists, but the Act does not specifically address whether personal representative of a deceased individual can grant "lawful consent."

In *Ajemian v. Yahoo, Inc.*, 2017 WL 4583270 (Mass.), the Massachusetts Supreme Judicial Court initiated transfer of the case from court of appeals on its own motion. The court held that the decedent's personal representative could provide lawful consent on the deceased user's behalf to release the contents of the deceased user's email account. It remanded the question of whether Yahoo's "terms of service" agreement allows Yahoo to refuse access to the account, but hinted that the 15-page terms of service agreement may be UNENFORCEABLE as a contract of adhesion or because there was no meeting of the minds. A footnote raised possible issues of "consistency with public policy or any putative unconscionability of the terms."

- b. **Disclosure of Contacts and Calendar under Revised Uniform Fiduciary Access to Digital Assets Act.** Some of the general rules under the Revised Uniform Fiduciary Access to Digital Assets Act (RUFADA) are:

- A fiduciary can obtain full access to digital assets **other than content** of electronic communications unless the user opts out or the court directs otherwise;

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- 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 [as a practical matter, though, even if the document authorizes disclosure, many vendors still require a court order directing the disclosure; when authorization under the governing document is recognized, many vendors look specifically for the word “consent” in the authorization];
  - If a conflict exists 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; and
  - Under §16(a), if a custodian fails to comply with a request from the PR of a deceased user’s estate to disclose contents, the PR may apply to state court for an order directing the custodian to comply with the request.

*In the Matter of the Estate of Serrano*, 2017 NY Slip Op. 27200, 56 Misc.3d 497 (Surr. Ct. NY County 2017) addressed how RUFADA applies to a PR’s request to obtain access to the decedent’s Contacts and Calendar from a Google account. The court observed that RUFADA requires a disclosure of the catalogue of electronic communications, but not the content without express consent to fiduciary access. The court concluded that the Contacts are within the description of a “catalogue” and therefore must be disclosed. It reasoned that Calendar entries are not a “communication” under the Stored Communications Act because no transfer of information occurs between two or more parties, and that entries in the Calendar are also part of the catalogue, does not contain content of electronic communications, and therefore must be disclosed.

## 29. Electronic Wills Act

Traditionally, wills must be on paper, either typed (or printed) or handwritten. Nevada was the first state to adopt a statute recognizing electronic wills. NEV. REV. STAT. §133.085(1) (2017). In 2017, legislation was passed that would have allowed persons to execute wills electronically without the physical presence of a witness or an attorney, but Governor Scott vetoed the Florida Electronic Wills Act on June 26, 2017. Legislation allowing electronic wills is pending in Indiana, and is being considered in other states as well. A growing trend of interest is appearing in this topic.

The Joint Editorial Board for the Uniform Trusts and Estates Act has recommended that the Uniform Law Commission form a drafting committee to address proposed uniform legislation governing electronic wills. For an excellent overview of the history of electronic wills, legislative proposals being considered, and policy issues that must be addressed, see Bruce Stone, *Technology and Estate Planning – The Machines Are Coming, Will You Be Ready?*, LEIMBERG ESTATE PLANNING NEWSLETTER #2625 (February 6, 2018).

## 30. Decanting Authority and Creditor Effects, *Ferri v. Powell-Ferri*

Litigation in Connecticut and Massachusetts addresses the common law ability to decant in Massachusetts and the creditor effects (in a divorce proceeding) of decanting. *Ferri v. Powell-Ferri*, 72 N.E.3d 541 (Mass. 2017) followed the *Morse v. Kraft* [466 Mass. 92 (2013)] approach in finding that the broad discretion granted to trustees regarding

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distributions as desirable for the beneficiary's benefit and authority to "segregate irrevocably for later payment to" the beneficiary included by inference the power to decant to a new trust for a beneficiary, and the court could consider the affidavit of the settlor in making the determination of intent to allow a decanting power. The issue had been certified to the Massachusetts high court from the Connecticut Supreme Court in a divorce case.

Under a trust agreement created by his father, the beneficiary had the right to withdraw 75% of the trust assets at the time of the divorce proceeding, but the trustees decanted the trust assets into a new trust that did not grant the beneficiary withdrawal rights, apparently so that the trust assets over which the beneficiary had withdrawal rights would not be included as marital property subject to division in the divorce. The Massachusetts Supreme Judicial Court reasoned that the presently exercisable withdrawal right did not negate the power to decant because the trust must be read as a whole to give effect to all of its provisions. So long as the assets were not withdrawn, the assets remained subject to the trustees' authority and stewardship, especially in light of the power to segregate assets irrevocably that extended for "so long as the beneficiary is living" meaning both before and after the vesting of withdrawal rights. Therefore, until assets are actually withdrawn, the trustees could exercise the power to decant if the trustees determined it was in the beneficiary's best interest. A concurring opinion in the Massachusetts case observed that the opinion did not address whether creating a new spendthrift trust for the sole purpose of decanting assets from an existing non-spendthrift trust to deny the beneficiary's spouse's rights to an equitable distribution in a divorce proceeding was contrary to public policy.

The Connecticut Supreme Court then addressed the effect of the authorized decanting in the divorce proceeding. 2017 WL 3386926 (Conn.) It determined that the spouse had standing to question whether the trustee's actions were proper, but held that the new trust was not a self-settled trust as to the beneficiary, and was not subject to the claims of his creditors. It reasoned that the new trust was created and founded via the decanting by the trustees without informing the beneficiary in advance, and without his permission, knowledge or consent. Because the beneficiary had no involvement in the creation and funding of the new trust, it was not self-settled. A beneficiary could only be deemed to be the settlor of a trust if he has some affirmative involvement with the creation or funding of the trust.

### 31. Interesting Quotations

- a. **Legislation.** "I refer to the 2017 Tax Act as a poorly conceived, even more poorly executed, steaming pile of covfefe." — Paul Lee
- b. **Swiss Cuisine.** "Switzerland is one of the most beautiful places on the planet. It is so pretty it looks fake. However, Switzerland has the most unbelievably horrible food you've ever eaten. It's so bad. They eat a lot of horse, and they eat a lot of this really horrible smelly nasty cheese, and they try to divert your attention, and make it seem like it's more fun and more delicious, by putting it in a fondue pot." — Amy Kanyuk
- c. **Beneficiaries and Cats.** "Beneficiaries are like cats. They are only happy if you are feeding them." — Amy Kanyuk

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- d. **Beneficiaries and Cats Redux.** “Keep in mind – Beneficiaries are like cats and they will bite you for no good reason.” — Amy Kanyuk
  - e. **How Much and When.** “How much and when? That is what trust beneficiaries ask when they call. They want to know how much they’re getting and when are they getting it. And the answers are – not as much as you think and when I’m ready.” — Amy Kanyuk
  - f. **Disclaimer.** “As a litigator, what I am about to say and the views I am about to express are not my own, and I reserve the right at any time to change my position and assert the position of the other side. So take what I say with a grain of salt to the extent that this is being recorded.” — William Hennessey
  - g. **Trustee’s Mantra.** “The goal of the trustee is not to make the beneficiary happy but to carry out the grantor’s intent.” — Amy Kanyuk
  - h. **Spray Trusts.** Hugh Magill’s Rule About Spray Trusts: “If beneficiaries cannot live together in the same household, they should not live together in the same trust.” — Hugh Magill
  - i. **Sibling Relationships.** “Nothing will disrupt sibling relationships more quickly or more effectively than one receiving a larger inheritance than the others.” — Andrew Pharies
  - j. **Medicare.** “LBJ described Medicare this way: ‘Every citizen will be able in his productive years when he is earning to ensure himself against the ravages of illness in his old age. No longer will illness crush and destroy the savings that they have so carefully put away over a lifetime so that they might enjoy dignity in their later years.’ If LBJ knew how it has turned out, he would be rolling over in his grave.” — Bernard Krooks
  - k. **Favored Lending Institution.** “They never heard of Citibank and Chase. They only heard of the Bank of Mom.” —Sam Donaldson
  - l. **Oral Contracts.** “Samuel Goldwyn of Metro Goldwyn Mayer said ‘An oral contract isn’t worth the paper it isn’t written on.’” —Josh Rubenstein
  - m. **Trust Disputes and Family Dynamics.** “We’ve talked about complicated intellectual stuff all week at Heckerling. So much of this comes down to feelings and communicating. A lot of trust disputes that we see are all about family dynamics going all the way back to childhood. It had nothing to do with money... They were lashing out from when they were kids and how he behaved as a father to them.” — Scott Ditman
  - n. **Nuclear Families Fight Also.** “People assume that only blended families fight – where children by the first three marriages are older than the surviving spouse, and the surviving spouse has a name like a weather condition (like Wendy or Misty or Stormy or something like that). But nuclear families don’t always love each other either. They are united by someone they all love or sometimes they are united by someone they all fear. So long as the person is competent to retaliate, they all get in line. But as soon as the person dies or becomes incompetent to retaliate, war breaks out.” — Josh Rubenstein

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- o. **Transparency – Just Fess Up.** “There’s no question in my mind that most family litigation, particularly will and trust contests, have at their base a lack of transparency. If the parents only fessed up that they were treating the children differently, the kids could have an opportunity to get angry at the right person to be angry at – dad or mom. The parents would say ‘I hear you but the answer is no.’ The problem is, the issue doesn’t usually come to light until after mom and dad are dead, or not able to explain anymore, and then the child who is treated better gets the joy of stepping into mom and dad’s shoes and everybody is angry at them – only they’re really angry at the person who is dead.” —Josh Rubenstein
  - p. **Get the Spelling Right.** “Very often, family fights are about principle – ‘LE,’ not principal – ‘AL.’ — Josh Rubenstein
  - q. **All About the Process.** “As a fiduciary, you don’t have to end up having been right. You just have to have a process where you made the analysis.” — Josh Rubenstein
  - r. **The Mid-Rich.** “Planning for the mid-rich is very difficult. They are not so poor that they have no estate tax concerns but not so wealthy that they have definite estate tax concerns.” —Jeff Pennell
  - s. **Only Temporary.** “If the Section 199A deduction is the latest crack we can’t do without, Congress may make some of this permanent. But it is now available, like the McRib, for a limited time only.” — Sam Donaldson
  - t. **Wallet v. Ego.** In discussing with clients what level of compensation they must pay from an S corporation to avoid IRS attacks on paying insufficient compensation (to avoid paying employment taxes), Sam Donaldson advises that the only ethical answer is that the client should pay the same salary the client could command from an unrelated employer in that same industry. “It’s wonderful to watch greedy entrepreneurs with an ego have this internal fight. Of course they’re worth millions, but they don’t want to pay themselves millions. So the wallet fights with the ego, and it’s a delight to see to see them twitch.” Sam adds “Perhaps it’s better I’m in academia than to have to work with clients.” — Sam Donaldson
  - u. **2% Does Not Mean 2% In the Code.** The “2-percent” shareholders of S corporations are not entitled to certain perks. “Only in the Code – the Code defines a ‘2-percent shareholder’ as someone who owns more than 2% of the S corporation stock. So if you own 2% of the stock, you are not a 2% shareholder. But if you own 3% of the stock, you’re a 2% shareholder.” — Sam Donaldson
  - v. **The Real Story.** For a partnership that has made a §754 election, at the death of a partner the deceased partner’s interest in the partnership gets a basis adjustment to the estate tax value of the interest, and an adjustment is made under §743 to the inside basis of partnership assets, but that inures only to the benefit of the decedent’s legatees and not the remaining partners. “This adjustment does not inure to the benefit of all partners, so that partners are rooting for the deaths of their partners from a tax perspective. They root for the death of their partners just so they can be the sole surviving partner – and because they never really liked them anyway.” — Sam Donaldson

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- w. **Skinny Trusts.** “The skinniest trust may simply provide that property shall be distributed to the beneficiaries in the trustee’s sole discretion. Saying less rather than more leads to the greatest flexibility. In some respects, skinny is good.” — Diana Zeydel
  - x. **Best Way to Learn.** “We try to learn lessons on how to be a fiduciary or advisor to a fiduciary the best possible way – which of course is through the suffering of other people.” — Dana Fitzsimons
  - y. **Powers of Attorney.** “Powers of attorney are useful and essential planning tools, vastly superior to the alternative of public guardianship, and accurately described as the most effective tool for burglary since the invention of the crowbar.” — Dana Fitzsimons
  - z. **It’s All in the Name.** “I fully understand the ‘Boy Named Sue’ thing –my name is Dana, the translation of which (from BabyNameWizard.com) is ‘woman from Denmark.’” — Dana Fitzsimons
  - aa. **The Other Side.** “I rarely say something is definitively right or wrong because you see enough, and you realize there’s no pancake so thin it doesn’t have two sides.” — Dana Fitzsimons
  - bb. **I Don’t Do Taxes.** In a case in which a CRAT was improperly drafted and a court reformation was not timely commenced, the attorney’s defense was that “the testator never asked for tax advice, didn’t care about paying taxes because he was a patriotic veteran, and he considered his duties connected to the probate, that taxes were outside the scope of his responsibility as counsel for the executor, and even though he carried the estate tax returns to the executor for signature, he was a mere messenger and didn’t even read them.” Dana continues – “As my old boss, Dennis Belcher would say, ‘it’s time to call your carrier.’” — Dana Fitzsimons
  - cc. **Utopia.** “In an ideal world, all families would be functional, love would never die, marriages would never end, trusts would be flexible, my 16-year-old daughter would never date, tax law would remain stable, and we’d all get a puppy.” — Dana Fitzsimons
  - dd. **Questionable Analysis.** “Here’s what you have do to understand the questionable analysis in a recent decanting case. You have to take out your eyeglasses, squint your eyes, turn your head to the right, and it’s like those paintings that we used to look at. If you looked hard enough and if you had enough whiskey to drink, you could see a space shuttle. It’s just like that.” — Dana Fitzsimons
  - ee. **Trust Advice from the Sage.** Dana was working on a difficult trust matter and mentioned to his colleague Ron Aucutt that he didn’t know if anything in the trust agreement covered the issue. “Ron Aucutt, in his Garrison Keillor voice, said ‘Well Dana, you don’t really know what’s in a trust until you shake it a few times and see what falls out of it.’” — Dana Fitzsimons
  - ff. **“Ectors.”** Dana Fitzsimons coined a new term to refer to directors, selectors, protectors, etc. – He refers to all of them as “Ectors.” — Dana Fitzsimons

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- gg. **Most Creative Argument of the Year.** In *Gray v. U.S. Department of Treasury*, 2017 Dist. LEXIS 144615 (2017) the taxpayer learned that you cannot defeat an IRS tax levy by declaring yourself to be held in trust, with your yourself as an asset of the trust and as a beneficiary of the trust, with the Treasury Department as the trustee, and then suing the Treasury Department as trustee for breach because they pursued the levy. Dana Fitzsimons observed, "in the South, we would say 'bless your heart.'" — Dana Fitzsimons
  - hh. **Who Needs a Lawyer?** A testator's estate plan consisted of a pour-over will and revocable trust. After he had a falling out with his son, Lynn (whose nickname was "Butch"), signed various letters and instruments, and the court upheld three of the four letters as amendments to the trust:
    - (1) A typed, signed, and dated document included "I LEON BARRENGER DISOWN LYNN BARRENGER HE IS DISOWNED AND REMOVED FROM ANY INHEARATANCE ALSO I DON'T WANT HIM TO ANY MEMORIAL IF THEY HAVE ONE SIGNED."
    - (2) A typed but unsigned birthday note to his son, Scott, stated "ALSO SKIPPPING BUTCH, S HEISNT GETTING NO MOREMOOLA FROM ME." [This note was held not to be a valid trust amendment.]
    - (3) A partially typed, partially handwritten, and twice signed letter to his daughter, Judy, stated "I AM THINKINGABOUT GETTING AGO CART SO I CAN GO TO THE STORE BY MYSELF" and "I DISENHEARTED BUTCH HE CALLED ME A STUPID IDIOT SO I WILL GIVE HIS SHARE TO THE GANDKIDS AT LEAST IT WON'T BE BUYING HIM BEER."
    - (4) A handwritten and signed note to his grandson, Quinn, stated "Butch got his big mouth going and he talked himself right out of the Barrenger trust fund. Now I can leave you & Kaitlyn \$14,000 a year tax free." — Dana Fitzsimons
  - ii. **Jargon and German Cars.** In discussing the difficulty that clients may have in understanding the complex jargon that attorneys can use in describing estate planning alternatives, Charlie Ratner noted that a life insurance agent might explain "what the Representative from Complexity is trying to say is ...," but observed that "the life insurance agent can sometimes use a little help because his stuff is jargon-laden too. That sounds like a German car – the 'Jargonladen'." — Charles Ratner
  - jj. **Underperforming Life Insurance Policies.** "The client will often say that a life insurance policy is underperforming – no it isn't, it was under-described."  
— Charles Ratner