BESSEMER TRUST

Estate Planning Current Developments and Hot Topics

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Introduction

The 53rd Annual Philip E. Heckerling Institute on Estate Planning was held in Orlando during the week of January 14, 2019. This summary includes observations from that seminar, as well as other observations about various current developments and interesting estate planning issues.

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 8 below);

(2) Proposed regulations regarding the Section 199A qualified business income deduction and the Section 643(f) multiple trust rules (see Item 7 below);

(3) Another speedbump for domestic asset protection trusts (*Toni 1 Trust*) (see Item 28 below);

(4) The proposed "anti-clawback" regulations (see Item 4 below);

(5) Crunch time for intergenerational split-dollar arrangements (*Cahill*, *Morrissette*) (see Item 13 below);

(6) State taxation of QTIP trusts at the surviving spouse's death (*Taylor*, *Seiden*) (see Item 26 below);

(7) Travails of family limited partnerships (*Straightoff*, *Turner III*) (see Item 12 below);

(8) Inclusion of the value of GRAT assets in the gross estate (*Badgley*);

(9) Trust flexibility versus "dead hand" control (*Horgan*, *Shire*) (see Item 20 below); and

(10) Spotlight on trust beneficiaries' rights to be informed (*Forgey*).

2. Legislative Developments

2018 was a year of quiet (or is it NO) federal legislative tax developments. Various technical corrections have been discussed, but coming to agreement on technical corrections of the totally non-bipartisan Tax Cuts and Jobs Act (the "2017 Tax Act") is politically charged and not as straightforward as might normally be expected for technical corrections. Tax extenders are still under discussion.

Elimination of the sunset in 2026 of the individual provisions of the 2017 Tax Act was discussed prior to the November 2018 elections, but have stalled since then. The sunsetting provisions were included in the 2017 Tax Act (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. Republican leaders in 2018 considered a "second round of Trump tax cuts," sometimes

referred to as "Trump Tax Cut 2.0." Central to the proposal would have been removing the sunset of the individual tax cuts in the 2017 Act that will otherwise occur in 2026, including continuing the increased $10 million (indexed) transfer tax exclusion amounts and the §199A deduction for qualified business income. The staff of the Joint Committee on Taxation released a report that H.R. 6760 passed by the House in September 2018, which would have extended most of the individual tax cuts permanently, would have resulted 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 bill, or a net additional deficit of $545.1 billion (even after taking into account estimated economic growth resulting from the extension). A report from the Joint Committee on Taxation almost a year later (JCS-1-19, July 8, 2019)) estimates a cost of nearly $920 billion for 2020-2029 for making the individual portions of the 2017 Act permanent, as proposed by the President's fiscal 2020 budget proposal. By far the most expensive provision is making the individual income tax brackets permanent, representing $747 billion. Other big ticket items are increasing the individual AMT exemption amounts and phase-out thresholds ($396 billion) and the Section 199A qualified business income deduction ($251 billion). Doubling the estate, gift, and GST exemption amounts costs $44 billion. Interestingly, the cost of increasing the standard deduction ($425 billion) and modifying the child tax credit ($284 billion) is almost exactly offset by repealing the deduction for personal exemptions (-$700 billion).

The Congressional Budget Office estimated in a report released on June 25, 2019 that if future legislation "prevented a cut in discretionary spending in 2020 and an increase in individual income taxes in 2026, then debt held by the public would [reach] 219% of GDP by 2049" (up from 78% of GDP in 2019).

Having a Democratic majority in the House no doubt has changed the calculus of anticipated tax legislation, including legislation relating to the transfer tax. Proposals have already been made in the current legislative session to repeal the estate tax (S. 251, the bill that is introduced by Senator Thune every year, and H.R. 218) at one end of the spectrum, and on the other end of the spectrum, to increase the estate tax dramatically. Examples of a few of the proposals made by Democratic Presidential candidates are briefly noted below.

For an excellent overview of the Democratic Presidential candidates' proposals for taxing wealth (including capital gains), see Richard Rubin*, Democrats' Idea: Tax Wealth, Not Just Income*, Wall Street J. A-1, A-8 (August 28, 2019).

Former Vice President Joe Biden proposes ending the step-up in basis at death (which he says would raise $17 billion a year), raising the corporate tax rate from 21% to 28%, taxing capital gains as ordinary income (his prior statements would make this change just for taxpayers having income over $1 million and that may still be his position; also he would still allow middle-income taxpayers a capital gains break on profits from home sales), and eliminating the cap on the Social Security payroll tax (so that the 7.65% tax [6.2% Social Security, 1.45% Medicare] would apply on all wages, not just up to the $132,900 limit [for 2019]). *See* Cooper*, Biden Seeks Boost in Capital Gains, Corporate Tax Rates,* TAX NOTES (Oct. 24, 2019); Nitti, *Reviewing The Democratic Candidates' Tax Plans: Joe Biden*, FORBES (Sept. 30, 2019).

Senator Elizabeth Warren proposes a 2% *annual* levy on wealth in excess of $50 million and 3% on wealth above $1 billion. Economists with her campaign estimate that the system would generate $2.75 trillion over a decade from 75,000 households, representing a 6% increase in revenues from under 0.1% of households. (Other economists have estimated that the system would raise only about half that much revenue.)

Senator Sanders released his version of an annual wealth tax in September, 2019. The rate would start at 1% on net worth above $32 million and would increase in increments to 8% for net worth over $10 billion. The respective rates and net worth ranges are: 1% ($32-$50 million), 2% ($50-$250 million), 3% ($250-$500 million), 4% ($500 million to $1 billion), 5% ($1 to $2.5 billion), 6% ($2.5 to $5 billion), 7% ($5 to $10 billion), and 8% (over $10 billion). His proposal would apply to about 180,000 households and raise an estimated $4.35 trillion over a decade. His plan would bolster reporting requirements, create a national wealth registry, increase IRS funding, and require the IRS to audit 30% of wealth tax returns for Americans in the top one percent net worth bracket and 100% of billionaires.

Presidential candidates Beto O'Rourke and Pete Buttigieg have also backed or said they would consider an annual wealth tax. An annual wealth tax would require tens of thousands of complex IRS examinations each year, compared to the once-per-lifetime estate tax audits, and would entail substantial administrative and enforcement difficulties. *See* Jonathan Curry, *Making a Wealth Tax Work May Require 'Rough Justice,'* TAX NOTES (Sept. 30, 2019). An annual wealth tax would face constitutional challenges because the Constitution provides that any "direct tax" must be structured so that each state contributes a share of the tax proportional to the state's share of the population, but whether a wealth tax would be a "direct tax" is unclear.

Sen. Cory Booker proposes a refundable tax credit to help low- and middle-income Americans cap rental costs at 30% of their income, and would pay for the proposal by "restoring 2009-era estate tax rules and closing loopholes that allow wealthy households to avoid paying taxes on investments held at death." Asha Glover, *Booker Proposes Estate Tax Hikes to Pay for Housing Plan*, TAX NOTES (June 10, 2019). Pete Buttigieg and Senator Warren would also reduce the estate tax exemption amount to $3.5 million.

Senator Ron Wyden has proposed taxing the annual increases in the value of taxpayers' assets under a "mark-to-market" system, but he would exempt primary residences and 401(k) plans from that system. He also would raise the rates on capital gains to the rates on ordinary income.

Presidential candidate Julian Castro also recently proposed a mark-to-market system to tax annual increases of taxpayers' assets, but for assets that are not publicly traded, tax would be imposed only on the sale of assets, with a charge applied to limit the benefits of tax deferral.

Senator Sanders on January 31, 2019 introduced S. 309 titled "For the 99.8 Percent Act" that reduces the basic exclusion amount to $3.5 million (not indexed) for estate tax purposes and to $1.0 million (not indexed) for gift tax purposes and increases the rates: 45% on estates between $3.5 and $10 million, 50% on $10 million - $50 million, 55% on $50 million - $1 billion, and 77% over $1 billion. (The GST rate is not specifically addressed, so presumably it would be the highest marginal estate tax rate of 77% under §2641(a)(1).)

In addition, the bill would make ***major*** dramatic changes to the transfer tax system (seemingly enacting much of the IRS's legislative wish-list over the last decade) including:

- Reducing the **gift exclusion amount** to $1 million (not indexed);
- Adding a statutory anti-clawback provision for both estate and gift taxes;
- Increasing the potential reduction of the value for farm property under the §2032A special use valuation rules from $1.16 million currently to $3 million (indexed);
- Increasing the potential estate tax deduction for conservation easements from $500,000 to $2 million but not exceeding 60% of the net value of the property);
- Applying basis consistency provisions (and accompanying reporting requirements) for gifts;
- Valuing entities by treating nonbusiness assets and passive assets as owned directly by the owners (and valuing them without **valuation discounts**), with look-thru rules for at least 10% subsidiary entities;
- Eliminating **minority discounts** for any entity in which the transferor, transferee, and members of their families own either control or a majority ownership (by value) of the entity (proposals restricting valuation discounts for family-held assets were first introduced in the Clinton Administration);
- 10-year minimum term for **GRATs** with a remainder interest valued at the greater of 25% of the amount contributed to the GRAT or $500,000 (up to the value of property in the trust);
- Major changes for **grantor trusts** –
    - Estate inclusion in grantor's gross estate,
    - Distributions are treated as gifts from the grantor,
    - Gift of entire trust if it ceases to be a grantor trust during the grantor's life,
    - Those 3 rules apply for (1) grantor trusts of which the grantor is the deemed owner, and (2) third-party deemed owner trusts (§678 trusts) to the extent the deemed owner has sold assets to the trust in a non-recognition transaction, including the property sold to the trust, all income, appreciation and reinvestments thereof, net of consideration received by the deemed owner in the sale transaction,
    - The initial gift to the trust is also a gift, but a reduction will apply in the amount of gifts or estate inclusion deemed to occur under the first three rules) by the amount of the initial gift,
    - These rules apply to trusts created on or after the date of enactment, and to the portion of prior trusts attributable to post date-of-enactment contributions and sales in nonrecognition transactions with the prior trust;
- Regardless of GST exemption allocated to a trust, a trust will have a GST inclusion ratio of 1 (i.e., fully subject to the GST tax) unless "the date of termination of such trust is not greater than 50 years after the date on which such trust is created;" this provision applies to post date-of-enactment trusts and prior trusts would have the inclusion ratio reset to one 50 years after the date of enactment; the provision

is more aggressive than the Obama Administration proposal which had a limit of 90 rather than 50 years, and which merely reset the inclusion ratio to one after the 90-year term rather than applying an inclusion ratio of one from the outset if the trust did not have to terminate within the maximum allowed time; and

- The **annual exclusion** is "simplified" by providing a $10,000 (indexed) exclusion not requiring a present interest (but still requiring an identification of donees), but each donor is subject to a cumulative limit of twice that amount (2 times the current $15,000 amount, or $30,000) for gifts in trust, gifts of interests in pass-through entities, transfers subject to a prohibition on sale, or any other transfer that cannot be liquidated immediately by the donee (without regard to withdrawal or put rights).
- In addition to incorporating these IRS proposals, the bill would also increase the estate and gift tax rates to 45% - 77%.

This proposal will not be enacted in the current Congress, but could portend future transfer tax considerations if Democrats secure control of both the House and Senate in future years. Remember 2012? The mad rush could be 10 times as bad if this bill starts getting serious consideration.

The **SECURE Act** proposal (H.R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019) would make various changes regarding retirement benefits. The bipartisan proposal was unanimously approved by the House Ways and Means Committee and passed the House by a vote of 417-3. It is now being considered by the Senate and is being held up by five Senators who have placed "holds" on the bill (for reasons unrelated to the retirement provisions in the bill) to prevent passage by unanimous consent. Similar proposals have been introduced in the Senate (S. 972, introduced by Senators Grassley (R-Iowa) and Wyden (D-Oregon) and S. 1431, introduced by Senators Portman (R-Ohio) and Cardin (D-Md)). Among the proposed changes in H.R. 1994 are the following:

- Deferring the minimum required beginning date age to age 72 rather than age 70½ (effective for individuals who reach age 70½ after December 31, 2019) (costing $8.86 billion over 10 years) (A similar Senate proposal would extend the required beginning date age to 75 and remove it entirely for pensions worth up to $100,000);
- Eliminating the prohibition on contributions to an IRA after age 70½;
- Allowing pooled plan providers (costing $3.42 billion over 10 years);
- Requiring that long-time part-time workers be included in 401k plans;
- Allowing a participant to withdraw $5,000 in the year after a child is born to or adopted by the participant;
- Permitting expanded uses of Section 529 plans including for certain apprenticeship programs and payments on certain qualified education loans, but provisions in the initial program expanding §529 plan benefits to homeschooling expenses were deleted from the provision passed by the House;
- Requiring annual disclosures of estimated projected lifetime income under annuity elections;

- Mandating that distributions from defined contribution plans (and IRAs) be made within 10 years following the death of the participant, with exceptions for a beneficiary that is a spouse, a minor child (distributions would have to be made within 10 years after the child reached majority), a disabled or chronically ill person, or a person not more than 10 years younger than the participant (saving $15.7 billion over 10 years); the 10-year distribution rule would apply whether or not distributions to the participant had begun before the participant's death, and would apply to participants who die after December 31, 2019.

The 10-year mandatory payout provision after death is more generous than a 5-year limit that was proposed in prior similar proposals. The mandatory payout provision following death generally pays for the remaining provisions in the proposal. The Joint Committee on Taxation on May 22, 2019 released estimates that the Act would have a net revenue impact over 10 years of a negative $389 million, or relatively revenue neutral.

A small handful of Republican Senators have expressed concern over various provisions (or omissions) from the proposal. Until those conflicts are resolved, Majority Leader McConnell has indicated he is unlikely to schedule the bill for floor debate in the Senate. *See* Warren Rojas, *Disgruntled GOP Senators Block Bipartisan Retirement Bill*, BNA BLOOMBERG DAILY TAX REPORT (June 4, 2019).

For individuals still wanting a stretch IRA, a possible planning alternative is to have the IRA payable to a charitable remainder trust that would last for the lives of one or more beneficiaries, with remainder to charity (and the remainder must be at least 10% of the value contributed to the trust). Because the CRT is tax exempt, no income tax would be due upon the payment of the IRA to the CRT.

3. Bluebook for 2017 Tax Act

The "Joint Explanatory Statement" that was released in conjunction with consideration of the Tax Cuts and Jobs Act (the "2017 Tax Act") was not produced by the Joint Committee on Taxation, which produces what is known as the official "Bluebook" for significant tax legislation. The Joint Explanatory Statement of the Committee of Conference (of the House and Senate managers at the conference) was a joint explanatory statement to the House and Senate explaining the action agreed on by managers and recommended in the accompanying conference report.

The staff of the Joint Committee on Taxation published the Bluebook ("General Explanation of Public Law 115-97") on December 18, 2018, almost a year after the 2017 Tax Act was passed. The Bluebook makes interesting comments about several items of interest to estate planners.

a. **Allocation of GST Exemption to Prior Transfers.** Due to the wording of the effective date provision in 2017 Tax Act, technical issues existed as to whether someone could allocate increased GST exemption to transfers before 2018. The Bluebook has a detailed example making clear that GST exemption can be allocated to pre-2018 transfers. Bluebook to 2017 Tax Act at 89, n.372. The American Bar Tax Section has requested the IRS to confirm this conclusion in official guidance.

b. **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 Bluebook discusses ambiguities in the Kiddie tax in light of changes made in the 2017 Tax Act and technical corrections that are needed, especially regarding the earned income of children. Bluebook to 2017 Tax Act at 7.

c. **60% Deduction Limitation on Cash Gifts.** The 2017 Tax Act continued to provide that charitable contributions are deductible, with an increased percentage limitation for cash contributions to public charities – i.e., 60% of the "contribution base" (generally AGI with a few modifications), up from 50%. Many 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 have taken the position that the legislation language 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.) Section 123 of H.R. 6760 (the Protecting 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 clear that the 60% limit for cash contributions is applied after (and reduced by) the amount of noncash contributions. For example, if an individual with contribution base of $100,000 makes a contribution of unappreciated property with a fair market value of $50,000 and a $10,000 cash gift to a public charity, the $50,000 contribution of unappreciated property is accounted for first, using up the entire 50% limit, but leaving $10,000 in allowable cash contributions under the 60% limit for cash contributions.

   In the face of this uncertainty, the Bluebook states that "the 60-percent limit for cash contributions is intended to be applied after (and reduced by) the amount of noncash contributions …." An example is provided of an individual with a contribution base of $100,000 making a $50,000 gift of appreciated securities and a $10,000 cash gift. The $50,000 contribution is accounted for first, using up the individual's entire 50% contribution limit under §170(b)(1)(A) and leaving $10,000 in allowable cash contributions under the 60% limit under §170(b)(1)(G). However, a footnote observes that "[a] technical correction may be needed to reflect this intent. In the absence of a technical correction, there is a concern that some might interpret the provision as requiring that the 50-percent limit for noncash contributions under section 170(b)(1)(AA) be applied after (and reduced by) the amount of cash contributions allowed under the 60-percent limit of section 170(b)(1)(G)." Bluebook to 2017 Tax Act at 51, n.253.

4. Anti-Clawback Regulation

a. **Legislative Authorization**. The 2017 Tax Act amended §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:

> (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 provided no further guidance as to the intent of §2001(g)(2), this provision appeared 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.

b. **Technical Issues Raising the Clawback Problem.** The calculation procedure described in the Instructions to the Form 706 would result 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). §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, §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 deceased spousal unused exclusion (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 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.

c. **Anti-Clawback Regulation Introduction**. 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) apply only to 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.

d. **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).

e. **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).

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

g. **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 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 (Step (4) of the estate tax calculation process described in the preamble) rather than revising the determination under §2001 of the hypothetical gift tax (Step (2) of the estate tax calculation process described in the preamble) 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).

The preamble to the proposed regulation clarifies that the BEA applied in gift tax credits is taken into consideration on "post-1976 gifts, whether or not included in the gross estate." Preamble to Proposed Regulation at 13.

h. **Simple Explanation of Regulation's Approach**. A news 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, whether or not included in the gross estate (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).

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.

i. **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).

j. **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. …
>
> 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.*

Comments that Mr. Evans filed with the IRS dated February 21, 2019, regarding the proposed regulation urge that the IRS change the approach to make adjustments in the hypothetical gift tax calculation to avoid clawback rather than adjusting the unified credit amount applied in the last step of the estate tax calculation. He suggests providing that the hypothetical gift tax (in Step 2 of the estate tax computation as described in the preamble to the proposed regulation) be determined using the inflation adjusted BEA amount that would have been effect if the $10 million BEA had never been enacted. With that approach, clawback would be avoided and inflation adjustments after the date of the gift could be utilized (either with later gifts or at death with the inflation adjusted estate tax unified credit).

k. **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.

l. **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, the DSUE is calculated based on that larger exclusion amount, and 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.

> (c) **Computation of the DSUE amount**
>
> (1) **General rule**. Subject to paragraphs (c)(2) through (4) of this section, the DSUE amount of a **decedent with a surviving spouse** is the lesser of the following amounts –
>
> (i) The basis exclusion amount in effect **in the year of the death for the decedent**; or
>
> (ii) The excess of –
>
> (A) The decedent's applicable exclusion amount; over
>
> (B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent's estate is determined under section 2001(b)(1). Reg. §20.2010-2(c)(1).

In determining the DSUE, a limit is the BEA in the "year of the death of the decedent." Is that referring to the year in which the first spouse died or the year in which the surviving spouse died? This regulation refers to a "decedent with a surviving spouse," making clear that the "decedent" as referred to in this provision is the first decedent-spouse, not the surviving spouse. Furthermore, subparagraph (c)(4) refers to making adjustments to the DSUE amount upon the occurrence of certain events before or at the death of the surviving spouse if property passes into a QDOT, but even then the DSUE amount is redetermined by still using the BEA in effect in the year in which the first decedent spouse died. Reg. §20.2010-2(c)(5), Ex. 3. After the DSUE amount is determined following a decedent's death, the only adjustments to that amount that are referred to in the regulations are for valuation adjustments or correction of an error in calculation (Reg. §§20.2010-3(c)(1)(ii) & 20.2010-3(d)), lifetime transfers (Reg. §20.2010-3(b)), survivorship of another spouse (Reg. 20.2010-3(a), or final distribution or termination of a QDOT that was funded by the decedent (Reg. §20.2010-2(c)(4)). Thus, for various reasons, the regulations seem to make clear that the DSUE amount is not adjusted for other occurrences, including a decrease in the BEA after the first decedent-spouse's death.

Furthermore, the preamble to the June 2012 temporary 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 position.

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"*). For further support of this viewpoint, see Mike Jones & DeeAnn Thompson, *Jones and Thompson on the Disappearing BEA*, LEIMBERG ESTATE PLANNING NEWSLETTER #2708 (March 14, 2019).

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.

The American Society of CPAs has submitted a letter to the IRS dated February 15, 2019 urging that the anti-clawback final regulation address the portability issue and make clear that the DSUE amount based on the BEA at the time of the first spouse's death would be available to the surviving spouse, even after the BEA has reduced to a lower amount. The letter points to the ambiguity in the statute as the reason for needing clarification (without noting that the portability regulations already make clear to use the BEA at the first spouse's death despite the statutory language).

m. **Comments to IRS Recommending Not Allowing Unified Credit Increase for Exclusion Used in Prior Gifts That Are Included in the Gross Estate**. For an individual who wants to take advantage of the "window of opportunity" available with the $10 million (indexed) gift and estate exclusion amount before it reverts to $5 million (indexed) in 2026 but without really giving up rights with respect to the gifted asset, one alternative is to make a gift of an asset while retaining the income from or use of the asset (in a manner that does not satisfy §2702). The gift will be a completed gift of the full value of the transferred asset if §2702 is not satisfied and if the donor's creditors cannot reach the assets. The asset will be included at its date of death value in the gross estate under §2036(a)(1), but the date of gift value will not also be included in the estate tax calculation as an adjusted taxable gift. §2001(b) (last sentence). The effect is that the asset has been given to someone else, the date of death asset value is included in the gross estate, but is offset by the estate tax unified credit, which is increased by the amount of exclusion applied against lifetime gifts if that amount exceeds the exclusion amount available at death (for example, due to a decrease in the basic exclusion amount in 2026). The post-gift appreciation in the asset is all that is effectively subject to estate tax.

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

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

In addition, the comments point out a similar effect might result under §2701 from a gift of common stock while retaining preferred stock in the entity, which could leave the donor with "the right to earnings and income of the entity through the retention of preferred interests." If the Service wishes "to limit the benefits of locking in temporarily increased exclusion amount," the Section recommends "that the Treasury and Service study the problem further." The NYSBA Tax Section comments are available at **http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2019/1410_Report.html**. See Item 10.j below for a description of some of these alternatives for "locking in" use of the increased gift exclusion amount.

The proposed regulations permit the anti-clawback adjustment for gifts that are included in the gross estate. Indeed the Preamble to the proposed regulations explicitly acknowledges that they apply in that circumstance, referring to the BEA applied against the gift tax payable "on the decedent's post-1976 taxable gifts, **whether or not included in the gross estate."** That approach has some support in the statutory language of §2001(b)(2) which, in the estate tax calculation process, provides for a subtraction of the hypothetical gift tax on all "gifts made by the decedent after December 31, 1976" not just on "adjusted taxable gifts," which would exclude gifts that are includible in the gross estate (§2001 last sentence). Whether the IRS is considering adjusting the anti-clawback regulations as suggested by the New York State Bar Tax Section is unknown (but Treasury has taken longer than many planners expected to finalize the anti-clawback regulations, although that might be explained by a general slow-down in issuing guidance). The IRS might finalize the proposed regulations with little change, or might issue final regulations making the adjustment, or might issue a new round of proposed regulations making this adjustment. Planners should be cautious in using these approaches as a way of making use of the increased gift exclusion amount until final anti-clawback

regulations have been issued, and we know whether the IRS adopts the recommendation not to extend the anti-clawback adjustment to gifts that are included in the gross estate.

5. Other Administrative Guidance Regarding 2017 Tax Act Changes

a. **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. "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). Miscellaneous itemized deductions are all itemized deductions *other than* those specifically listed in §67(b). 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)).

Executor and trustee fees and miscellaneous trust expenses 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).

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).
- 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.

b. **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 a 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 of the estate or trust) should be treated similarly for 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." The current regulations are inconsistent with that result, however, because they provide that the §642(h)(2) excess deduction "Is not allowed in computing adjusted gross income." Treas. Reg. §1.642(h)-2(a).

Despite the inconsistent regulation, the 2018 Form 1041, Schedule K-1, and the related instructions appear to allow beneficiaries to treat excess deductions carried out to beneficiaries following the final year of an estate or trust as miscellaneous itemized deductions not subject to the §67(g) suspension of miscellaneous itemized deductions through 2025. The instructions for Box 11, Code A of the 2018 Schedule K-1 directs beneficiaries to report their share of excess deductions on line 16 of the 2018 Form 1040 Schedule A for miscellaneous itemized deductions that are still allowed. Interestingly, the Form 1040, Schedule A, line 16 instructions list several other types of "other deductions" (without mentioning excess deductions on the termination of a trust or estate) and states that "only the expenses listed next can be deducted on line 16." An official with the IRS Chief Counsel's Office has advised Vince Lackner (Pittsburgh, Pennsylvania) that unless the regulations are changed, excess deductions may not be claimed by beneficiaries on Schedule A of Form 1040 for 2018-2025, reasoning that "the regulations trump [any contrary form] instructions" (i.e., the Form 1041 Schedule K-1 instructions).

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.

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.

c. **State and Local Taxes Deduction**. After considerable negotiation in the 2017 Tax Act, 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 was 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 final regulations, published in the Federal Register on June 13, 2019, 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 regulations are based on the generally recognized "quid pro quo" rationale of not allowing a charitable deduction to the extent that the donor receives a benefit from the donation. Under the 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. 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 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. 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. 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. 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. 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 made 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 regulations should be invalidated (but the chances for success of that litigation are dim, and a divided Congress is unlikely to revisit the cap).

Notice 2019-12, 2019-27 I.R.B. 57 provides a safe harbor for payments made by certain individuals. Under the safe harbor, an individual who itemizes deductions and makes a payment to a §170(c) entity in return for a state or local tax credit may treat the portion of such payment that is or will be disallowed as a charitable contribution deduction under §170 as a payment of state or local tax for purposes of §164 (i.e., deductible up to $10,000 per year) when and to the extent an individual applies the state or local tax credit to offset the individual's state or local tax liability.

The Joint Committee on Taxation on June 24, 2019 published a document titled "Background on the Itemized Deduction for State and Local Taxes" (JCX-35-19) for use at a House Ways and Means Committee hearing.

The $10,000 limitation on the deductibility of state and local taxes 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 23 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 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).

The IRS received various questions about what rules apply for **businesses** that make payments to §170(c) charities, receive a state and local tax credit, and deduct the payment as a business expense under §162. In response to those questions, Rev. Proc. 2019-12 provides safe harbors for such payments by C corporations and by pass-through entities. C corporations may treat the entire payment as a business expense (even though it is receiving the state credit). Pass-through entity businesses may deduct the payment as a business expense if the credit offsets a state or local tax other than a state or local income tax (such as a property tax or franchise tax). *See* Richard Fox, *IRS Provides Safe Harbors for Business Deductions for Certain Payments to Charity in Exchange for State or Local Tax Credits*, LEIMBERG INC. TAX PL. NEWSLETTER #176 (Feb. 25, 2019).

d. **NRA as Potential Current Beneficiary of ESBT; ESBT S Income Taxed to Trust Instead of Deemed Owner of Grantor Trust if Deemed Owner is NRA**.

(1) **Background**. An ESBT that owns stock of an S corporation, as well as other property, is treated as two separate trusts (S portion and non-S portion, respectively) for income tax purposes. The S portion income is taxed to the ESBT under §641(c)(2) and the non-S portion income is subject to the normal trust income taxation rules that govern simple and complex trusts.

Wholly or partially-owned grantor trusts can make an ESBT election, but the grantor trust taxation rules override the ESBT provisions, so that S corporation income is taxed to the deemed owner of the grantor trust portion rather than being taxed directly to the ESBT.

The 2017 Tax Act provided that if a resident alien potential current beneficiary ("PCB") of an ESBT becomes an NRA, the status of that PCB as an NRA will not cause the S corporation of which the ESBT is a shareholder to fail the eligible shareholder requirement in §1361(b)(1)(C), which otherwise would terminate its S election. While Congress expanded the scope of qualifying beneficiaries of ESBTs, it left unaltered the rule in §1361(b)(1)(C) that an S corporation cannot have an NRA as a shareholder.

(2) **Proposed Regulations**. Proposed regulations prevent the expansion of PCBs of ESBTs to include an NRA from allowing S corporation income attributed to the grantor portion of an ESBT grantor trust that is received by an NRA deemed owner of that portion to escape Federal income taxation, contrary to Congressional intent. Instead, the S corporation income of the ESBT that would otherwise have been allocated to an NRA deemed owner under the grantor trust rules will instead be included in the S portion of the ESBT that is taxed to the ESBT and would continue to be subject to U.S. income tax. Prop. Reg. §1.641(c)-1(b)(1)-(2); §1.641 (c)-1(k) (provision applies to all ESBTs after December 31, 2017) §1.641(c)-1(l)(6), Ex. 6.

6. Treasury-IRS Priority Guidance Plan and Miscellaneous Guidance From IRS

a. **Overview of IRS Priority Guidance Plan.** Among new items added to the Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015 were the following.

> "3. Guidance on basis of grantor trust assets at death under §1014.
>
> …
>
> 5. Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872.
>
> …
>
> 8. Guidance on the gift tax effect of defined value formula clauses under §2512 and 2511."

Items 3, 5, and 8 all related to sales to grantor trusts, suggesting that issues related to sales to grantor trusts are major "radar screen" issues for the IRS. Item 3 has remained on the subsequent Plans. The projects in items 5 and 8 were dropped in later years but presumably are still projects of interest to the IRS when resources are available to address them.

The Treasury-IRS **Priority Guidance Plan for 2019-2020** was published October 8, 2019 (somewhat similar to the revised format of the 2017-2018 and 2018-2019 Plans).

- Part 1 of the Plan addresses implementation of the 2017 Tax Act and lists 52 projects (down from 71 in the fourth quarter update of the 2018-2019 Plan).

- Part 2 deals with identifying and reducing regulatory burdens.
- Part 3 titled "Burden Reduction" increases the number of projects from 14 in the fourth quarter update of the 2019-2019 Plan to 25. This "burden reduction" section, as in the 2017-2018 and 2018-2019 Plans, lists final regulations regarding (1) basis consistency and (2) 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 4 lists seven guidance projects regarding prioritized implementation of the Taxpayer First Act (enacted on July 1, 2019), which made changes regarding various IRS operations including the establishment of a new Independent Office of Appeals.
- Part 5 includes projects regarding partnership audit regulations.
- Part 6 contains the traditional General Guidance 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 estate administration expenses under §2053. The fourth project, added in the 2018-2019 Plan and still in the 2019-2020 Plan, 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 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. The tables were not updated by May 1, 2019, and IRS officials have informally indicated that the IRS is waiting on data from another agency and that they do not know at this point when they will be able to complete the new tables. Presumably, the existing tables can be used until revised tables are published.

  An interesting omission of an important project is item 14 under "General Tax Issues" in the 2018-2019 Plan, dealing with final regulations for the 3.8% tax on net investment income under §1411.

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). Commentary about the 2019-2020 Plan is included in Ronald Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes (With Selected Cases)*, (October 2019) available at **www.bessemertrust.com/for-professional-partners/advisor-insights** .

b. **Basis Consistency**. The inclusion of finalization of the basis consistency proposed regulations in Part 3 of the Priority Guidance Plan among the "burden reduction" 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 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 BNA 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 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate…." 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, 1985-1 C.B. 184), 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 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. **Administration's Fiscal Year 2018, 2019, and 2020 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 2020 budget, titled "A Budget for a Better America," was published March 11, 2019.

g. **Inflation Adjustments**. Inflation adjustments for 2020 have been estimated based on information with the release of the Chained Consumer Price Index (C-CPI-U) for August 2019. Daniel Evans (Glenside, Pennsylvania) summarizes that the estimated inflation adjusted amounts for 2020 will be as follows:

- Applicable exclusion amount and GST exemption-$11,580,000 (from $11,400,000 for 2019);
- Estates and trusts taxable income for top (37%) income tax bracket-$12,950 (from $12,750 in 2019);
- Non-citizen spouse annual gift tax exclusion-$157,000 (from $155,000 in 2019);
- Section 6166 "two percent amount"-$1,570,000 (from $1,550,000 in 2019); and
- Special use valuation reduction limitation-$1,180,000 (from $1,160,000 in 2019).

7. Section 199A Qualified Business Income Deduction; Final Regulations and New Proposed Regulation and Notices

a. Overview. The top corporate tax rate is 21% under the Tax Cuts and Jobs Act (the "2017 Tax 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) x 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 ($157,500 single/$315,000 for joint returns, indexed) 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 compensation income into business income). The deduction is allowed to individuals, trusts and estates.

The Joint Committee on Taxation staff issued a summary estimating that nearly 27 million of the 39 million taxpayers who report business income on Schedule C (sole proprietors and single-member LLCs), Schedule E (real estate, partnerships, and S corporations), and Schedule F (farmers) will be entitled to take a deduction under §199A. Of those, only 4.9% will be over the taxable income threshold, but those 4.9% will receive 34% of the tax benefit of §199A. Staff of Joint Committee on Taxation, *Overview of Deduction for Qualified Business Income: Section 199A*, (March 2019).

b. **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.

c. **Regulations Overview**. 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. The proposed regulations were published in the Federal Register on August16, 2018. 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 was amazingly fast.

A short comment period was established and a hearing regarding comments was held in early October. The goal was to finalize the regulations as early as possible so that taxpayers preparing their 2018 returns could use the final regulations.

Final regulations were issued on January 18, 2019, and a slightly revised version making a few corrections was issued on February 1, 2019. The final regulations were published in the Federal Register on February 8, 2019. In addition, Rev. Proc. 2019-11 was issued concurrently to provide additional guidance on the definition of wages, and Notice 2019-07 was issued concurrently to provide a safe harbor in a proposed

Revenue Procedure under which a rental real estate enterprise may be treated as a trade or business for purposes of §199A (and that Revenue Procedure, Rev. Proc. 2019-38, was released on September 24, 2019).

New proposed regulations address various issues not addressed in the final regulations, including the treatment of previously suspended losses (treated as losses from a separate trade or business, Prop. Reg. §1.199A-3(b)(1)(iv)), the availability of the deduction for interests in regulated investment companies (clarifying that qualified REIT dividends of mutual funds can be reported by owners of the funds but reserving for consideration the availability of the deduction for QBI from publicly traded partnerships held by mutual funds, Prop. Reg. §1.199A-3(d)), charitable remainder trusts (the deduction is not available to offset the UBTI excise tax, Prop. Reg. §1.199A-6(d)(3)(v)), split-interest trusts (the general rules applicable to non-grantor trusts apply), and the treatment of separate shares (a trust with substantially separate and independent shares for multiple beneficiaries will not be treated as separate trusts for purposes of applying the threshold amount, Prop. Reg. §1.199A-6(d)(3)(iii)). REG-134652-18 (March 20, 2019).

The separate sections of the final 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," publicly traded partnerships (PTP), and trusts and estates (including an anti-abuse rule)

§1.643(f)-1 Multiple trusts.

d. **Abbreviations**. The 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.

QBI Qualified business income

RPE Relevant passthrough entity (which includes certain partnerships, S corporations, and trusts and estates; this term is used *repeatedly* throughout the regulations and throughout this summary)

SSTB Specified service trade or business

UBIA Unadjusted basis immediately after acquisition (of "Qualified Property")

PTP Publicly traded partnership

REIT Real estate investment trust

e. **Highlights of Changes Made by Final Regulations**. Changes made by final regulations include the following:

(1) "Net capital gain" includes qualified dividend income (which is important because the QBI deduction is limited to the amount of a taxpayer's taxable income less net capital gains), see Item 7.(g)(2) below;

(2) The computations of the QBI deduction for taxpayers having taxable income in the phase-in range are clarified for the treatment of QBI from an SSTB, and SSTB limitations apply to income from a PTP, see Item 7.(g)(3) below;

(3) Trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of §199A, see Item 7.(h)(5) below;

(4) Property contributed to a partnership or S corporation will have a UBIA based on the transferee's unadjusted basis in the contributed property (less money received by the transferee or plus money paid by the transferee in the transaction) (i.e., the UBIA will not be reduced by depreciation or other adjustments to basis after the property was acquired and before it was contributed to the partnership or S corporation), see Item 7.(j)(5) below;

(5) Replacement property received in a like kind exchange will have a UBIA based on the transferee's unadjusted basis in the relinquished property (i.e., the UBIA will not be reduced by depreciation or other adjustments to basis after the relinquished property was acquired and before it was exchanged) but "decreased by excess boot or increased by the amount of money paid or the fair market value of property not of a like kind to the relinquished property" and the portion of the replacement property having UBIA greater than that of the relinquished property will be treated as separate property placed into service on the date that the replacement property is placed into service, see Item 7.(j)(7) below;

(6) If a §754 election is in effect, §743(b) basis adjustments (at the death of a partner or upon the sale of a partnership interest) are treated as qualified property to the extent that the adjustment reflects an increase in the fair market value of the underlying qualified property) , see Item 7.(j)(8) below;

(7) A taxpayer who transfers his or her interest in an RPE prior to the close of the RPE's taxable year is not entitled to a share of UBIA from the RPE, see Item 7.(j)(2) below;

(8) The UBIA of property acquired from a decedent will be the fair market value of the property on the date of the decedent's death (§1014) and the depreciable period (for §199A purposes) will begin on the date of death, see Item 7.(j)(10) below;

(9) Aggregation will be allowed only if the 50% common ownership exists on the last day of the taxable year (as well as for a majority of the taxable year), see Item 7.(k)(2)(ii) below;

(10) The attribution rule for the common ownership test in the aggregation requirements will be under §267(b) or §707 (which includes family attribution from siblings and attribution from trusts having the same grantors and attribution between a trust and beneficiaries of the trust), see Item 7.(k)(4) below;

(11) Examples clarify when real estate businesses can satisfy the aggregation requirements, see Item 6.(k)(7) below;

(12) An RPE can elect to aggregate separate trades or businesses that are operated directly or through lower-tier RPEs (which election shall be binding on the RPE's owners but which election, if made, will eliminate the complexity of how individual owners determine if separate businesses have 50% common ownership with attribution and satisfy the other aggregation requirements), see Item 7.(k)(3) below;

(13) A taxpayer's failure to aggregate certain businesses will not preclude later aggregation of those businesses, see Item 7.(k)(5) below;

(14) If a business has SSTB activities and if the SSTB activities do not satisfy the de minimis rule (i.e., if the SSTB activities are not less than 10% of the gross receipts if gross receipts are $25 million or less and are not less than 5% of the gross receipts if gross receipts are in excess of $25 million), the entire business is treated as an SSTB rather than treating only a pro rata part of the business as an SSTB, see Item 7.(l)(2) below;

(15) The "anti-cracking and packing" rule is revised to eliminate the 80% test (i.e., that the business provides 80% or more of its goods or services to a commonly owned SSTB); instead, if a business provides property or services to a 50% or more commonly owned SSTB, the portion of the business providing property or services to the SSTB will be treated as a separate SSTB with respect to related parties, see Item 7.(l)(3) below;

(16) The "incidental to an SSTB" rule is eliminated, meaning that a business (that would not otherwise be an SSTB) that is 50% or more commonly owned with an SSTB does not have to worry that it will become an SSTB if it shares expenses with the SSTB and has gross receipts representing less than 5% of the combined gross receipts of the business and SSTB, see Item 7.(l)(4) below;

(17) The presumption that an employee who becomes an independent contractor while providing substantially the same services is nevertheless an employee is relaxed somewhat, see Item 7.(h)(2) below;

(18) The reporting rules are relaxed by providing that *all* of an RPE's items related to §199A (including QBI, wages and UBIA) should not be presumed to be zero because of a failure to report one item; instead only the

unreported item of positive QBI, wages or UBIA is presumed to be zero, and items may be reported on an amended or late return as long as the period of limitations remains open, see Item 7.(o)(2)-(3) below;

(19) ESBTs may continue to qualify for the §199A deduction (as in the proposed regulations) but the separate S and non-S portions of the ESBT are not treated as two separate trusts for purposes of applying the income threshold test, see Item 7.(m)(5) below;

(20) A trust's taxable income, for purposes of determining whether the trust's taxable income exceeds the threshold amount, is calculated after deducting any distribution deduction under §§651 or 661, see Item 7.(m)(1) below;

(21) The §199A Anti-Abuse Rule applies if a trust (even a single trust) was created with a principal (rather than significant as in the proposed regulation) purpose of avoiding or using more than one threshold amount, and the effect is that the trust will be aggregated with the grantor or other trust(s) from which it was funded for purposes of determining the threshold amount, see Item 7.(m)(6) below;

(22) The multiple trust rule regulation is revised by eliminating a definition that converted principal purpose to avoid income tax into a significant non-tax (or non-income tax) purpose that could be achieved only with creation of the separate trusts and by eliminating two examples of trusts bearing on when trusts have substantially the same beneficiaries, see Item 7.(m)(7) below.

f. **Effective Date of Final Regulations**. The §199A regulations *apply* to taxable years ending after the date of publication in the Federal Register (February 8, 2019). However, the preamble to the final regulations provides that for taxable years ending in 2018 taxpayers have an option either to rely on the final regulations in their entirety or to rely on the proposed regulations that were proposed on August 16, 2018, in their entirety. Preamble to Final Regulations at 2, 117-118. Presumably this rather unusual option is allowed in light of the fact that some taxpayers may have relied on the proposed regulations in the course of their planning in 2018, and advisors may have already started preparing compliance reports based on the proposed regulations.

Various anti-abuse rules apply to taxable years ending after December 22, 2017, the date of enactment of the 2017 Tax Act (these are the regulations addressing UBIA property acquired at the end of a year, Reg. §1.199A-2(c)(1)(iv),certain REIT dividends, Reg. §1.199A-3(c)(2)(ii), anti-cracking and packing rule, Reg. §1.199A-5(c)(2), the presumption that former employees are still employees, Reg. §1.199A-5(d)(3), creation of a trust to avoid §199A, Reg. §1.199A-6(d)(3)(vii), and the multiple trust rule, Reg. §1.643-1). The preamble to the proposed regulations explains that §7805(b)(3) provides that any regulation may take effect or apply retroactively to prevent abuse.

g. **General Computation Formula for Deduction**.

(1) **Threshold Amount**. Special limitations on the amount of the §199A deduction (the "W-2 wages and capital limitation" and the limitation for SSTBs, both of which are discussed below) apply to taxpayers having taxable income above a specified

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)(12). (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, 2018-49 I.R.B. 827,§3.27. The 2020 threshold amounts are $163,300/$326,600.) 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). Tax-exempt income obviously is not included. Low income taxpayers (with taxable income below the threshold amount) are not subject to the "W-2 and UBIA limitation" or the SSTB 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.

Anything that drives down taxable income (other than the §199A deduction itself) helps in getting below the threshold amount. This could include strategies such as making additional charitable contributions or IRA contributions, or shifting the investment mix toward investments producing tax-exempt income.

(2) **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). 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). The final regulations add that net capital gain means net capital gain as defined in §1221(11) plus any qualified dividend income for the taxable year. Reg. §1.199A-1(b)(3).

(3) **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). Reg. §1.199A-1(d)(1).

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 UBIA 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

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

The QBI component is the sum of the formula amounts (i.e., the lesser of 20% of QBI or the "W-2 wages or capital limitation") for *each* separate trade or business. See Item 7.h.(6) below.

The formula is subject to a special rule for SSTBs, which is that QBI, W-2 wages, and UBIA of qualified property of a SSTB are not taken into account, Reg. §1.199A-1(d)(2)(i), (meaning that no deduction would be allowed with respect to SSTB QBI).

This W-2 wages or UBIA limitation is subject to a phase-in rule if taxable income is in the "phase-in range." Reg. §1.199A-1(d)(2)(iv)(B).

Even if a taxpayer has no QBI component, qualified REIT dividends or PTP income can still result in a §199A deduction, and the deduction attributable to REIT dividends or PTP income is not limited based on whether the taxpayer's taxable income exceeds the threshold amount.

A rule of thumb is that no cutback in the allowed QBI deduction will result from the W-2 wages limitation as long as the wages are at least 2/7ths of the entity's income.

Phase-In Range. For taxpayers with up to $50,000 ($100,000 for joint returns) over the threshold amount, the W-2 wages or UBIA limitation is applied proportionately by the amount that the excess bears to $50,000 (or $100,000, as appropriate). Reg. §1.199A-1(d)(iv)(B). As an example, if a married/joint return taxpayer has taxable income that is $30,000 over the threshold amount, the QBI deduction will be reduced by 30% of the difference between 20% of QBI and the amount of the "W-2 wages or capital limitation" amount. In this simple example, the "applicable percentage" as used in the calculations would be 70%. Reg. §1.199A-1(b)(2). The actual calculation process is rather tedious, and the final regulations made some modifications regarding the treatment of REIT dividends, PTP income, and PTP income generated by an SSTB in the phase-in range computations. Reg. §1.199A-1(d)(iv)(B)(3).

The REIT dividends and PTP income provisions in the first element of the basic deduction formula in effect mean that the W-2 wages and capital limitation and the limitation of SSTB income do not apply to those types of income.

h. **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]." Reg. §1.199A-1(b)(5). (Observe that credits attributable to trades or businesses are not considered.)

(1) **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).)

(a) **Real Estate**. The 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 typically would not qualify as a trade or business. (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). The example was revised to delete the reference to land, and the preamble to the final regulations made clear that the examples "were not intended to suggest that the lease of the land is or is not a trade or business for purposes of section 199A." Preamble to Final Regulations at 18. *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 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). For an excellent discussion of background information and various interesting issues raised by the final regulations regarding whether rental real estate is a trade or business, see Alan Gassman & Martin Shenkman, *When is Rental Real Estate a "Trade or Business" Under 199A*, LEIMBERG INCOME TAX PLANNING NEWSLETTER #175 (February 18, 2019).

(b) **"Self-Rental" Exception for Real Estate**. The regulations add a helpful special rule for purposes of §199A–the rental of property to a related trade or business that is "conducted by the individual or an RPE" (added in the final regulation that the related business cannot be a C corporation) is treated as a separate trade or business if the two separate businesses are commonly controlled, meaning the same persons directly or indirectly own 50% or more of each business (applying broad attribution rules attributing ownership from an individual's siblings, spouse, ancestors, and lineal descendants as well as trust/trust, trust/grantor, and trust/beneficiary attribution). Reg. §1.199A-1(b)(14), referring to §1.199A-4(b)(1)(i), which refers to §§ 267(b) or 707(b). 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.)

(c) **Rental Real Estate Safe Harbor, Revenue Procedure 2019-38 & Notice 2019-7**. Rental real estate that is not rented to a commonly controlled individual or RPE can nevertheless qualify for a safe harbor to be treated as a trade or business for purposes of §199A by meeting the requirements described in Notice 2019-7, which proposed a Revenue Procedure but that can be relied on currently for any taxable year ending after 2017. That Revenue Procedure, Rev. Proc. 2019-38, was released on September 24, 2019. The Revenue Procedure applies to taxable years ending after December 31, 2017. Alternatively, taxpayers and RPEs may rely on the safe harbor described in Notice 2019-07 for the 2018 taxable year.

The safe harbor applies to a "real estate enterprise" defined as an interest in rental real property owned by an individual or RPE directly or in a disregarded entity and may consist of a single property or multiple similar properties. Certain rental real estate arrangements are excluded, however, including property used as a residence for any part of the year, or real estate rented under a triple net lease.

A rental real estate enterprise qualifies for the safe harbor if (A) separate books and records are maintained to reflect income and expenses for each enterprise; (B) for enterprises in existence less than four years, 250 or more hours or rental services (specifically defined) are performed annually, and for enterprises in existence at least four years, 250 hours of service are performed in three of five consecutive taxable years ending with the taxable year in question; and (C) the taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services (but the contemporaneous records requirement does not apply to taxable years beginning before January 1, 2020).

For a summary of planning considerations for using this safe harbor, see Alan Gassman, John Beck, & Brandon Ketron, *One Particular Harbor, New Regulatory Guidance on If and When a Rental Real Estate Activity Can Qualify for the 20% Section 199A Deduction*, LEIMBERG INC. TAX PL. NEWSLETTER #170 (Jan. 21, 2019).

(2) **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. 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, and the final regulations add that this presumption continues for three years after ceasing to be treated as an employee. Reg. §1.199A-5(d)(3)(i). The presumption may be rebutted by showing that the individual is performing services in a capacity other than as an employee, *Id.*, which may be demonstrated by "providing records, such as contracts or partnership agreements that provide sufficient evidence to corroborate the individual's status as a non-employee." Reg. §1.199A-5(d)(3)(ii). The proposed regulations contained three rather detailed examples, and the final regulations add a fourth example of rebutting the presumption by an employee who became a partner, thus sharing the profits of the firm and materially modifying the relationship with the firm. This presumption provision is one of the anti-abuse provisions that applies to taxable years ending after December 22, 2017. 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.

(3) **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 that are treated as capital gains or losses under other Code sections such as under §1231, 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 in QBI), annuity income not received in connection with the business, net gain from foreign currency transactions and commodities transactions, and income from notional contracts. The final regulations are clarified and the preamble specifically summarizes that items treated as capital gain or loss under any Code section are not included in QBI but items not treated as capital gain or loss under other Code sections are included in QBI unless otherwise excluded by §199A or the regulations. For example, the preamble notes that net §1231 losses are characterized as ordinary so are included in QBI. Preamble to Final Regulations at 54-55. 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). Reg. §1.199A-3(b).

(4) **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 regulations do not require a partnership to pay reasonable compensation for purposes of §199A. Preamble to August 2018 Proposed Regulations at 39-40.

(5) **Disregarded Entities.** Trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of §199A. Reg. §1.199A-1(e)(2).

(6) **Multiple Businesses; Losses**. If a taxpayer has multiple businesses, the QBI must be determined for each separate business. The preamble to the final regulations noted that some commenters requested more guidance in determining when separate trades or businesses exist in an entity or when an entity's combined activities should be considered a single §162 trade or business. The IRS declined to provide additional guidance but observed that under Reg. §1.446-1(d) separate trades or businesses will not exist within an entity unless a complete and separable set of books and records is kept for each trade or business and accounting methods are not used to create or shift profits or losses between the businesses so that income of the taxpayer is not clearly reflected. Preamble to Final Regulations at 19-20. See Item 7.l.(4) below).

If any business has a negative QBI, that loss is netted against the QBI from businesses with positive 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 UBIA of qualified property. The net QBI of each business, after considering apportioned losses, is then compared with the W-2 wages and UBIA limitation for each business. The W-2 wages and UBIA 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. 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. Reg. §1.199A-1(d)(2)(iii)(B).

Previously disallowed losses that are allowed in the current taxable year are taken into account in computing QBI, and the final regulations add that such prior disallowed losses will be used, for §199A purposes, in order from oldest to the most recent on a FIFO basis. Reg. §1.199A-3(b)(1)(iv).

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. Reg. §1.199A-3(b)(1)(v).

i. **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 UBIA limitation.

(1) **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. 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 60th 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. Reg. §1.199A-2(b)(2)(iii)(B). One aspect of being able to show that W-2 wages are attributable to QBI is that the wages should have been deducted in calculating QBI. Reg. §1.199A-2(b)(4).

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

Three alternative methods were provided for calculating W-2 wages in Notice 2018-64, issued in conjunction with the proposed regulations, and are now included in Rev. Proc. 2019-11, issued in conjunction with the final 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 contributions (including elective deferrals), health insurance costs, and various other items of compensation.

(2) **Management Company Exception.** The 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. Reg. §1.199A-2(b)(2)(ii). 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*.

(3) **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. Reg. §1.199A-2(b)(3)-(4). (An RPE must identify and report associated wages to its partners or shareholders. Reg. §1.199A-6(b)(3)(i)(A).)

(4) **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 payments for services as 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.

The preamble to the final regulations (at p. 51-52) noted that the reasonable compensation requirement for S corporations could be advantageous for purposes of the W-2 limitation, and some commenters "suggested that the final regulations should strive for equity between taxpayers operating businesses in different entity structures," but the IRS responded the §199A(c)(4) clearly excludes reasonable compensation from QBI.

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. An alternative is for the partner not to receive any set payments as compensation for services, which would increase the profits of the business. But a partner may be reluctant to give up the economic security of a guaranteed payment. Another possible alternative is for the partner 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; to avoid that result have wages paid from an entity not owned by the employee.

(5) **Balancing.** The optimal amount of compensation for §199A purposes is a balancing act. Wages reduce QBI (and therefore reduce the 20% of QBI deduction), but for taxpayers with taxable income over the threshold amount, additional wages can help satisfy the wage or capital limitation.

j. **UBIA Limitation (Sometimes Referred to as the "Capital Limitation")**.

(1) **Code Description**. The wage limitation was relaxed in the Conference Agreement for the 2017 Tax Act 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.

(2) **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. Reg. §1.199A-2(c)(1)(i). Raw land and inventory are not depreciable, so do not count. The preamble to the final regulations (at p. 38) clarifies that if the individual taxpayer and the RPE have different taxable years, the qualified property must be held at the close of the RPE's tax year.

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.) 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. Reg. §1.199A-2(c)(1)(iv). This end-of-the-year provision is one of the anti-abuse rules that has an immediate effective date from the date of enactment of §199A, applying to taxable years ending after December 22, 2017. Reg. §1.199A-5(d)(2)(i).

(3) **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). Reg. §1.199A-2(c)(2). The business will need to keep track of this period as well as the period of actual depreciation.

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

Substantial UBIA may be needed to avoid a reduction of the 20% QBI deduction. For example, if a business has no wages, the UBIA would need to be eight times the amount of QBI in order to take advantage of the full 20% of QBI deduction. (Calculation: .20 x QBI = .025 x 8 x QBI.)

(5) **Like-Kind Exchanges**. For like-kind exchanges, the date of service of the relinquished property applies, but under the proposed regulations 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). That result was controversial leading 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 BNA DAILY TAX REPORT HIGHLIGHTS (Oct., 12, 2018). The issue was noted in various comments to the IRS, and the final regulations change the result.

The final regulations provide that the replacement property received in a like-kind exchange will have a UBIA based on the transferee's unadjusted basis in the relinquished property. (i.e., not reduced by depreciation or other adjustments to basis after the relinquished property was acquired and before it was exchanged), but "decreased by excess boot or increased by the amount of money paid or the fair market value of property not of a like kind to the relinquished property." Reg. §1.199A-2(c)(3)(ii). To the extent that the UBIA of the replacement property is greater than that of the relinquished property (reflecting increases in UBIA due to money paid or non like-kind qualified property received in the exchange), the excess is treated as separate qualified property that is placed into service on the date that the replacement property is placed into service.

The final regulations have helpful examples illustrating these rules. One of the examples provides that A purchased Real Property X for $1 million and placed it into service on January 5, 2012. Real Property X appreciated to $1.3 million by January 15, 2019 and had an adjusted basis on that date of $820,482. A exchanged Real Property X plus $200,000 cash for Real Property Y, valued at $1.5 million, on January 15, 2019. The result for purposes of §199A is as follows:

> A's UBIA in Real Property Y is $1.2 million as determined under paragraph (c)(3)(ii) of this section ($1 million in UBIA from Real Property X plus $200,000 cash paid by A to acquire Real Property Y). Because the UBIA of Real Property Y exceeds the UBIA of Real Property X, Real Property Y is treated as being two separate qualified properties for purposes of applying paragraph (c)(2)(iii)(A) of this section. One property has a UBIA of $1 million (the portion of A's UBIA of $1.2 million in Real Property Y that does not exceed A's UBIA of $1 million in Real Property X) and it is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A. The other property has a UBIA of $200,000 (the portion of A's UBIA of $1.2 million in Real Property Y that exceeds A's UBIA of $1 million in Real Property X) and it is first placed in service by A on January 15, 2019, which is the date on which Real Property Y was first placed in service by A. Reg. §1.199A-2(c)(4)(iv)(B).

(6) **Involuntary Conversions**. Similar rules apply for involuntary conversions. Reg. §§1.199A-2(c)(2)(iii) (depreciable period) & 1.199A-2(c)(3)(iii) (unadjusted basis immediately after acquisition).

(7) **Non-Recognition Contributions to an RPE**. Similar to the like-kind exchange rules, 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 applied under the proposed regulations–the original life continued but the adjusted basis at the time of the contribution (which may reflect prior depreciation deductions or other downward basis adjustments) became 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 recommended that the UBIA 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."

The final regulations change the result. For property contributed to a partnership or S corporation in nonrecognition transactions (under §§721 or 351, respectively), the transferor's UBIA will be the UBIA of the contributed property (i.e., not reduced by depreciation deductions or other downward adjustments before the date of the contribution), "decreased by the amount of money received by the transferee in the transaction or increased by the amount of money paid by the transferee to acquire the property in the transaction." Reg. §1.199A-2(c)(3)(iv). *See* Reg. §1.199A-2(c)(4)(viii)-(ix), Exs. 8-9.

(8) **Section 754 Election**. Basis adjustments under §§734(b) and 743(b) of property held in an RPE with a §754 election in effect were not counted in determining UBIA under the proposed regulations. Prop. Reg. §1.199A-2(c)(1)(iii). Many comments were submitted to the IRS about this provision and pointing out various alternatives. The final regulations change the result, explained in the preamble as follows:

> The Treasury Department and the IRS agree that section 743(b) basis adjustments should be treated as qualified property to extent the section 743(b) basis adjustment reflects an increase in the fair market value of the underlying qualified property. Accordingly, the final regulations define an "excess section 743(b) basis adjustment" as an amount determined with respect to each item of qualified property equal to the excess of the partner's section 743(b) basis adjustment with respect to each item over an amount that would represent the partner's section 743(b) basis adjustment with respect to the property, but calculated as if the adjusted basis of all of the partnership's property was equal to the UBIA of such property. The excess section 743(b) basis adjustment is treated as a separate item of qualified property placed in service when the transfer of the partnership interest occurs. This rule is limited solely to the determination of the depreciable period for purposes of section 199A and is not applicable to the determination of the placed in service date for depreciation or tax credit purposes. The recovery period for such property is determined under §1.7431(j)(4)(i)(B) with respect to positive basis adjustments and §1.743-1(j)(4)(ii)(B) with respect to negative basis adjustments. Preamble to Final Regulations at 36.

(9) **Allocation of UBIA Based on Depreciation Allocation**. UBIA is allocated among the owners of an RPE based on how depreciation is allocated. The final regulations make a technical change in the way that the allocation is made, as summarized by the preamble:

> The Treasury Department and the IRS agree with the commenters that relying on section 704(c) to allocate UBIA could lead to unintended shifts in the allocation of UBIA. Therefore, the final regulations provide that each partner's share of the UBIA of qualified property is determined in accordance with how depreciation would be allocated for section 704(b) book purposes under §1.704-1(b)(2)(iv)(g) on the last day of the taxable year. To the extent a partner has depreciation expense as an ordinary deduction and as a rental real estate deduction, the allocation of the UBIA should match the allocation of the expenses. The Treasury Department and the IRS request comments on whether a new regime is necessary in the case of a partnership with qualified property that does not produce tax depreciation during the taxable year. In the case of qualified property held by an S corporation, each shareholder's share of UBIA of qualified property is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the taxable year over the total issued and outstanding shares of the S corporation. Preamble to Final Regulations at 28-29.

(10) **Property Acquired From a Decedent.** The preamble to the proposed regulations stated that the UBIA of property acquired from a decedent will generally be the fair market value at the date of death, but that was not included in the actual regulations. The final regulations add a provision that for qualified property acquired from a decedent and immediately placed into service, the UBIA will generally be the fair market value at the date of the decedent's death under §1014. For purposes of §199A, a new depreciable period begins on the date of death. Reg. §1.199A-2(c)(3)(v).

k. **Aggregation**.

(1) **Significance**. The preamble to the final regulations summarizes that that the aggregation rules "are optional and are intended to assist taxpayers in applying the W-2 wage and UBIA of qualified property limitations in situations in which a unified business is conducted across multiple entities." Preamble to Final Regulations at 22. The regulations adopt an approach of allowing taxpayers (and, added in the final regulations, sometimes 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 (except in situations in which an RPE makes the aggregation election).

Under the proposed regulations, aggregation is allowed at the individual owner level. Commentators have strongly encouraged the IRS to allow aggregation at the entity level to simplify compliance, and the final regulations add that flexibility.

(2) **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 (and the final regulations add that the ownership requirement must be satisfied on the last day 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, property, or 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

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

The regulations provide an additional example satisfying the (C) category of a movie theater business and food service business that operate in coordination and in reliance on each other. Reg. §1.199A-4(d)(15), Ex. 15.

(3) **Election to Aggregate at Entity Level**. Multiple commenters recommended that RPEs be permitted to aggregate at the entity level to reduce reporting requirements, to avoid the necessity for non-majority owners to know ownership information, and for simplification purposes. The final regulations permit an RPE to aggregate separate businesses that it operates directly or through lower-tier RPEs. If the election is made, the aggregation must be reported by the RPE and all owners of the RPE, and if an election is not made at the entity level, the individual owners may (or may not) elect to aggregate businesses of the RPE and do not have to make the same election. An upper-tier RPE must maintain aggregation made at the lower-tier level (i.e., it cannot subtract from the businesses aggregated at the lower-tier level), but an upper-tier RPE may aggregate additional businesses with the lower-tier RPE's aggregation if the aggregation requirements are otherwise satisfied. Reg. §1.199A-4(b)(2)(ii).

(4) **Common Ownership Test**. Common ownership is determined after applying an attribution rule attributing ownership under §§267(b) or 707(b) (applying broad attribution rules attributing ownership from an individual's siblings, spouse, ancestors, and lineal descendants as well as trust/trust, trust/grantor, and trust/beneficiary attribution). Reg. §1.199A-4(b)(1)(i). The proposed regulations had a much more limited attribution rule, including only family attribution by or for an individual's spouse, children, grandchildren, or parents. Prop. Reg. §1.199A-4(b)(3). Under the proposed regulations there was 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 created 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, and the IRS adopted that approach in the final regulations.

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.

(5) **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 significantly 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). Reg. §1.199A-4(c)(1).

The final regulations add that a failure to aggregate will not be considered to be an aggregation (meaning that the aggregation election could be made in later years). An aggregation election generally cannot be made for a prior year by filing an amended return, but initial aggregation elections may be made on amended returns for the 2018 taxable year because many taxpayers may have been unaware of the aggregation rules when filing their 2018 returns. *Id*. Similar consistency requirements apply to aggregation at the entity level by an RPE. Reg. §1.199A-4(c)(3).

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 UBIA of those other businesses).

(6) **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 (and the final regulations add that any such disaggregated businesses may not be aggregated again for the three subsequent taxable years). Reg. §1.199A-4(c)(2).

RPEs that elect to aggregate businesses must also submit similar annual disclosure statements on each owner's Schedule K-1, identifying each business that is aggregated by the RPE or by any other RPE in which the RPE owns an interest, and including "[s]uch other information as the Commissioner may require in forms, instructions, or other published guidance." Reg. §1.199A-4(c)(4)(i). If such statements are not attached to the Schedule K-1, the IRS may disaggregate the businesses, and they may not be re-aggregated in the subsequent three taxable years. Reg. §1.199A-4(c)(4)(ii).

If an entity-level aggregation election is not made, the aggregation requirements would seem to necessitate that an RPE 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 regulations do not require that information to be reported, however, which leads to the practical problem of how an individual owner will know if multiple businesses will satisfy the 50% common ownership requirement.

(7) **Examples**. The regulations contain 17 detailed examples illustrating the aggregation rules. Reg. §1.199A-4(d). The final regulations added three additional examples, two of which involve real estate businesses.

l. **Specified Service Trades or Businesses (SSTBs)**. The SSTBs rules are only relevant for taxpayers with taxable income over the threshold amount.

(1) **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); Reg. §1.199A-5(b)(2)(vii). 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 exist 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.

A few examples of the various service fields are summarized below.

- Health – "means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals performing services in their capacity as such" but the final regulations omitted the phrase "who provide medical services directly to a patient (service recipient)." Reg. §1.199A-5(b)(2)(ii).
- Law – "the performance of legal (that word was added in the final regulations) services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professional performing services in their capacity as such" but not for services not requiring skills unique to the field of law, such as services by printers, delivery services, or stenography services. Reg. §1.199A-5(b)(2)(iii).
- Accounting – "the provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professional performing services in their capacity as such." Reg. §1.199A-5(b)(2)(iv).
- 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. 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.

The SSTB rules are applied to each separate business; the presence of SSTB activity in one business will not cause the taxpayer's other businesses to be considered SSTBs (except as might be required by the "anti-packing and cracking" rule, described below). Preamble to Final Regulations, at 102.

(2) **Mixed Activities–De Minimis Rule if Little SSTB Income and Effect of Flunking This De Minimis Test.** 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)(1).

Examples added to the final regulations help clarify this de minimis rule. In Example 1, an LLC sells lawn care and landscaping equipment and also provides landscape design services (which are SSTB "consulting" services). The LLC keeps one set of books and treats the sales and the design services as a single trade or business for purposes of §§162 and 199A. The design services gross receipts of $250,000 represents more than 10% of the $2 million gross receipts of the LLC, so "the entirety of Landscape LLC's trade or business is considered an SSTB." Reg. §1.199A-5(c)(1)(iii)(A) Ex. 1.

Example 2 involves an LLC that provide veterinarian services (an SSTB activity in the health field) and sells its own line of organic dog food. The LLC separately invoices and keeps separate books and records for the veterinarian and sales activities, has separate employees unaffiliated with the veterinarian clinic that work on the dog food products and treats the veterinarian practice and dog food development and sales as separate trades or businesses for purposes of §§162 and 199A. Even though the gross receipts of the veterinarian activity is 1/3 of the total gross receipts, "the dog food development and sales business is not considered an SSTB because the veterinarian practice and dog food development and sales are separate trades or businesses under section 162." Reg. §1.199A-5(c)(1)(iii)(B) Ex. 2.

Comments from various groups recommended that the 10% (or 5%) tests not be applied as a cliff test, meaning that failing the test would cause *all* of the business to be an SSTB, but instead to allow the business to separate its SSTB and non-SSTB activities. The final regulations obviously do not adopt that recommendation, as evidenced by Example 1 above. As illustrated by Example 2, the key will be whether the SSTB and non-SSTB activities are conducted in separate *businesses*. If so, the SSTB activities of one business will not taint the non-SSTB activities of the other business—unless the businesses violate the "anti-cracking and packing" rule described below.

(3) **Mixed Businesses—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 13, 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.

(a) **50% Test; Deletion of 80% Test in Final Regulations**. 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 would be treated as part of the service entity, and the entire entity will be an SSTB.

Various comments to the IRS pointed out that the 80% test is unnecessary "as there are not abuse concerns regarding the portions of goods or services provided to a third party." Preamble to Final Regulations at 104. The IRS agreed with those comments and deleted the 80% test, so that only the portion of the trade or business providing property or services to the 50 percent or more commonly-owned SSTB will be treated as a separate SSTB with respect to related parties. Reg. §1.199A-5(c)(2)(i).

(b) **Common Ownership**. 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 lineal descendants. (The attribution rule applied for purposes of the aggregation rule discussed above was much narrower under the proposed regulations, but is the same as under this section under the final regulations.)

(c) **Effective Date**. The anti-cracking and packing rule is one of the anti-abuse rules that has an immediate effective date from the date of enactment of §199A, applying to taxable years ending after December 22, 2017. Reg. §1.199A-5(e)(2)(i).

(4) **Business Incidental to SSTB Test Deleted From Final Regulations; Separate SSTB and Non-SSTB Businesses**. Under the proposed regulations, if a non-SSTB business entity that would not otherwise be an SSTB (i) had 50% common ownership (applying attribution under §267(b) and §707(b)) with a separate SSTB entity, (ii) shared expenses with the SSTB, and (iii) accounted 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).

Comments to the IRS included that this rule is unnecessary, causes administrative difficulties for taxpayers who must determine whether a trade or business is incidental in order to apply the rule, and that much more detail would be needed if the rule were retained. The IRS agreed with the comments and deleted the rule. Preamble to Final Regulations at 104-105. Therefore, if the non-SSTB activities and the SSTB activities are in **separate trades or businesses**, the fact that the

businesses are commonly controlled and share expenses will not cause the non-SSTB business to be treated as part of the SSTB business. Of course, the separate businesses will need to properly allocate the shared expenses between the two businesses so that the SSTB business does not pay more than its reasonable portion of the shared expenses. (If the non-SSTB activities and the SSTB activities are part of the *same business*, the de minimis rule described above applies, and the entire business will be treated as an SSTB if the gross receipts from the SSTB activities are 10% or more of the total gross receipts (5% or more gross receipts exceed $25 million).

In order to qualify as separate businesses, some confusion exists over whether the businesses must maintain separate books and records. The preamble to the initial final regulations referred to having "a complete and **separate** set of books and records" but the revised final regulations as published in the Federal Register refers to "a complete and **separable** set of books and records." Examples in the regulations suggest that separate books and records would be needed. These examples are discussed in Item 7.l.(2) above. *See* Alan Gassman & Brandon Ketron, *Just Missed It by That Much!*, LEIMBERG INC. TAX PL. NEWSLETTER #174 (Feb. 12, 2019); Alan Gassman, Brandon Ketron & John Beck, *Handling Specified Service Trades or Businesses & Non-Specified Trades or Businesses Under One Entity – What Rules Apply and Are Separate Books and Records Required?*, LEIMBERG INC. TAX PL. NEWSLETTER #172 (Jan. 28, 2019).

Audrey Ellis, from Treasury's Office of Tax Policy, stated on an ABA Real Property Trust and Estate Law Section webinar on April 4, 2019, that the intent was merely to require that the books and records be separable.

(5) **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.

m. **Trusts.** The deduction is available to non-corporate taxpayers, including trusts and estates. (The Senate version of §199A would not have made the deduction available to trusts and estates.) References to trusts below also apply to estates.

(1) **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 in 2018. §199A(e)(2)(A); Reg. §1.199A-6(d)(3)(iv). (This indexed amount is increased under the indexing provision of Reg. §1.199A-1(b)(12), and is $160,700 in 2019, Rev. Proc. 2018-57, , 2018-49 I.R.B. 827, §3.27, and in 2020 will be $163,300.)

The proposed regulations took the position that in determining whether the trust's taxable income exceeds the threshold amount, the separate share rule is applied, but surprisingly, the distribution deduction was not considered. Prop. Reg. §1.199A-6(d)(3)(iii). Many comments were received about the unfairness of denying the

distribution deduction (in part because it results in double counting income both in the trust and for beneficiaries and because §199A references the "taxable income" of the taxpayer and the Code very objectively defines taxable income of a trust to take the distribution deduction into consideration), and the IRS agreed as to the distribution deduction. Under the final regulations, for purposes of determining whether the trust's taxable income exceeds the threshold amount, the taxable income is determined *after* taking into account the distribution deduction. Reg. §1.199A-6(d)(3)(iv).

Being able to take the distribution deduction into account for purposes of determining whether a trust exceeds the threshold amount opens the door to planning distributions to leave the trust with taxable income below the threshold amount, if appropriate based on the trust's distribution standards. Distributions made within 65 days of the end of the taxable year, which will be March 5, 2020 for the 2019 taxable year, can be considered under the 65-day rule. §663(b) (distributions by an estate or trust within 65 days of the tax year can be treated as having been made on the last day of the prior tax year, March 5 in leap years and March 6 in non-leap years).

(2) **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. Reg. §1.199A-6(d)(1).

The QBI (including any negative amounts at the trust level), W-2 wages, UBIA 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. Reg. §1.199A-6(d)(3)(ii).

(3) **Calculation at Trust Level.** The regulations provide detail about how the trust calculates its QBI, including how to allocate qualified items of deduction for determining QBI. Reg. §1.199A-6(d)(3)(i). A very detailed two-page example of the rather complicated calculation process is provided. Reg. §1.199A-6(d)(3)(viii). The example was revised in the final regulations to clarify the allocation of QBI and depreciation to the trust and the beneficiaries.

(4) **Grantor Trusts**. To the extent that the grantor (under §§671-677 & 679) or another person (under §678) is treated as 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. Reg. §1.199A-6(d)(2). 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, UBIA limitation, etc. This treatment suggests that the anti-abuse rules (described below), which are in a subparagraph (3) titled "Non-grantor trusts and estates," do not apply to grantor trusts. *See* Gassman, Shenkman, Ketron, Denicolo & Crotty, *Proposed Regulations for 199A – The Good, The Bad, the Taxpayer-Unfriendly*, LEIMBERG 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").

(5) **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 provided that ESBTs are entitled to the §199A deduction. Prop. Reg. §1.199A-6(d)(v). The final regulations continue that position but also address whether the S and non-S components of the ESBT (for example if the trust owns an S corporation with a business and owns other businesses in partnerships) are treated as two separate trusts for purposes of applying the threshold amount. The preamble to the final regulations acknowledges that the S and non-S components of an ESBT are treated as "separate trusts," §641(c)(1)(A) & Reg. §1.641(c)-1(a), but reasons that "[a]lthough an ESBT has separate portions, it is one trust." Preamble to Final Regulations at 112-113. The final regulations clarify that the S and non-S portions of an ESBT are treated as a single trust for purposes of determining the threshold amount. Reg. §1.199A-6(d)(3)(vi).

(6) **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 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 regulations to §643).

The proposed regulations included 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).

Comments pointed out the inconsistency of applying a "significant" purpose test under this provision vs. the "principal" purpose test in the §643 multiple trust rule. Comments also asked for clarification about what "not respecting" the trust means, and whether the rule applies only to multiple trusts or could also apply to a single trust.

The final regulations clarify all of those issues. This anti-abuse rule is changed from a significant purpose test to whether the trust is formed or funded with a "principal purpose of avoiding, or of using more than one, threshold amount," it can apply to a single trust, and the effect is that the trust is not respected "as a separate trust entity for purposes of determining the threshold amount." Reg. §1.199A-6(d)(3)(vii). The preamble adds that "[i]f any such trust violates the rule, the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the deduction under section 199A." Query how distributions from the trust that carry out DNI as taxable income to a beneficiary will be treated? Will that taxable income be counted as taxable income both of the grantor and of the beneficiary (which would be double counting the same taxable income) for purposes of determining the threshold amounts of each under §199A?

The anti-abuse rule saying a trust will not be respected if a principal 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 UBIA 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 UBIA limitation or the limitation on SSTBs. The IRS may argue in such a fact situation that a "principal" purpose of the trust is receiving a §199A deduction, so the 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 $160,700 (the threshold amount for the trust is $160,700 in 2019) times a 20% §199A deduction times a 37% rate, or $11,892. (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 $11,892, or $59,460 in 2019.

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

From a planning perspective, this anti-avoidance rule should not apply to a trust that was funded before the enactment of §199A (such a trust obviously was not formed or funded to obtain a deduction under a Code section that was not even in existence). If such a trust has taxable income below the threshold amount, consider having the trust purchase business interests that have "insufficient" W-2 wages or

UBIA as long as the trust would still have taxable income under the threshold amount. The §199A anti-abuse rule should not apply even though a purpose for the purchase is to obtain a §199A deduction. *See* Alan Gassman & Brandon Ketron, *What the Final 199A Regulations Say Regarding Trust Planning*, LEIMBERG INC. TAX PL. NEWSLETTER #169 (Jan. 21, 2019)("When subsequent Section 199A opportunities arise or become apparent, and the trust can purchase interests in a business or entity by making a capital contribution or buying an interest therein, the anti-abuse rule would not seem to apply").

(7) **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, even though the statute was passed in 1984 – 34 years ago. 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? Final regulations have now been issued.

Paragraph (a) of the proposed regulations reiterated 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 addressed the principal purpose requirement and provided 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 proposed regulation also had two examples illustrating this "significant income tax benefit" test. While the two examples are based on examples in the legislative history, they create confusion with respect to what having the "same primary beneficiary" means. The two examples, and the ambiguity created by them, are discussed in Item 2.f.(11)(g) of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

The proposed regulation's conversion of the "principal" purpose test into a "significant" purpose test unless the taxpayer could prove the existence of a "significant non-tax (or non-income tax) purpose" achievable *only* with the separate trusts was roundly criticized as being inconsistent with the statutory language.

The final regulations made substantial changes to these §643 regulations. Subparagraph (b), which stated this special rule for applying the principal purpose test that is in the statute and the two examples were omitted from the final regulations. The §643 final regulation is left with just a general rule that restates the statute, adding the following underlined phrase to what was in the proposed regulation – "if a principal purpose for establishing one or more of such trusts...." However, the preamble to the final regulations says that the IRS and Treasury "are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as 'principal purpose' and 'substantially identical grantors and beneficiaries' should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms." Preamble to Final Regulations at 116.

The §643(f) multiple trust regulation applies to taxable years ending after the date that the proposed regulation was published in the Federal Register (August 16, 2018). Reg. §1.643(f)-1(b). Applying the regulation retroactively to taxable years ending after August 18, 2018, at this point is rather meaningless in light of the fact that the final regulation merely restates the statute.

For multiple trusts entered into or modified before the effective date of the regulations, the preamble to the final regulations states that "the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f)." Preamble to Final Regulations at 116-117.

The preamble to the proposed regulation had added that the Treasury and the Service contend that "the rule in proposed §1.643(f)-1 generally reflects the intent of Congress regarding the arrangements involving multiple trusts that are appropriately subject to treatment under section 643(f)," Preamble to August 2018 Proposed Regulation at 78. The net effect might have been interpreted to apply the reasoning of the proposed regulation (with its greatly expanded definition of the principal purpose test and the two examples) to multiple trusts existing before August 16, 2018. That additional clause was deleted from the preamble to the final regulations, but the deletion of the principal purpose definition and the two examples from the final regulation makes that possible interpretation rather meaningless.

Section 643(f) determinations have been added to the 2019 list of issues on which the IRS will not issue private rulings. Rev. Proc. 2019-3, §3.01(85)("Section 643(f).—Treatment of multiple trusts.—Whether two or more trusts shall be treated as one trust for purposes of subchapter J of chapter 1.").

n. **Fiscal Year Entities**. Planners have wondered how income from a fiscal year entity with a fiscal year that ended in 2018 would be treated for QBI purposes. Section 199A applies to taxable years beginning after 2017 and before 2026. The regulations generally apply for fiscal years ending after the date they are published in the Federal Register (sometime in 2019). *E.g.,* Reg. §1.199A-6(e)(1)(similar to effective date general rule provisions of the end of each of the six sections of the §199A final

regulations). The regulations take the very taxpayer friendly position that "[f]or purposes of determining QBI, W-2 wages, and UBIA 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." 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.

> 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 UBIA 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).

o. **Reporting Requirements for Passthrough Entities**.

(1) **Reporting Requirements**. 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. Each RPE must determine and separately report QBI, W-2 wages, UBIA of qualified property, and whether the trade or business is an SSTB for each of the RPE's trades or businesses (or report combined QBI, W-2 wages, and UBIA of qualified property for businesses that the RPE elects to aggregate). The RPE must report that information on the Schedule K-1 issued to each of its owners, Reg. §1.199A-6(b)(3)(i), and report on a statement attached to Schedule K-1 those items reported to it by another RPE in which the RPE owns an interest. Reg. §1.199A-6(b)(3)(ii).

(2) **Effect of Failure to Report**. 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 UBIA of qualified property was presumed to be zero under the proposed regulations, Prop. Reg. §1.199A-6(b)(3)(iii), but final regulations relaxed this harsh rule to provide that only "each unreported item" is presumed to be zero. Reg. §1.199A-6(b)(3)(iii).

(3) **Reporting on Amended or Late Return**. The final regulations also add a somewhat relaxed rule allowing items to be reported on "an amended or late filed return to the extent that the period of limitations remains open." The preamble states that rule generally with respect to all of the information that an RPE is required to

report: "The final regulations also provide that such information can be reported on an amended or late filed return for any open tax year." Preamble to Final Regulations at 109-110. Nothing else in the paragraph containing that sentence refers to flow-through information that an RPE must report from another RPE that it owns. The actual substantive regulation, however, includes the ability to report information on an amended or late filed return only in subparagraph (ii) of Reg. §1.199A-6(b)(3) titled "Other items" and referring to reporting flow-through from another RPE in which the reporting RPE owns a direct or indirect interest. It is not also included in subparagraph (i) titled "Trade or business directly engaged in" regarding information that an RPE must report with respect to its directly owned businesses.

(4) **IRS Forms**. The draft instructions to Schedule K-1 for Forms 1065, 1041, and 1120A for 2018 provide that the §199A related information will be reported under various Codes. For example to Schedule K to Form 1065 has the §199A information reported on Box 20 code Z, section 199A income; code AA, section 199A W-2 wages; code AB, section 199A unadjusted basis; code AC, section 199A qualified REIT dividends; code AD, section 199A qualified PTP income. The instructions have detailed information about each of those, with particular reference to various schedules of the Publication 535 Worksheet if the business is an SSTB or if the RPE is electing to aggregate separate businesses.

The Schedule K-1 for Form 1120S reports the §199A information in Codes V-Z for Box 17, and the Schedule K-1 for Form 1041 reports the information in a statements attached in conjunction with Code I for Box 14.

(5) **Substantial Reporting Obligations**. In summary, 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. These additional reporting requirements at the entity level will likely result in K-1s being received later in the year than usual.

p. **Impact of §199A on Tax Calculation and Other Taxes; IRS Forms.**

(1) **No Reduction of AGI; Deduction Available to Non-Itemizers; Form 1040 and Relevant Worksheets**. 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 on Line 9 of Form 1040 after Line 7 for adjusted gross income and after Line 8 for the standard deduction or itemized deductions. It is neither an "above the line" deduction in arriving at adjusted gross income nor an itemized deduction. The amount to enter on Line 9 can be determined from the "Qualified Business Income Deduction—Simplified Worksheet" in the Instructions to Form 1040 for individual taxpayers below the taxable income threshold and for taxpayers with taxable income over the threshold, using Worksheet 12-A "Qualified Business Income Deduction Worksheet" and accompanying Schedules A-C as appropriate in Publication 535, Business Expenses. For further information, the instructions to Form 1040 refer to Publication 535, which was published in final form on January 25, 2019.

The IRS announced on January 29, 2019, that the instructions for 2018 Form 1040, Form 1065 Schedule K-1, Form 1120S Schedule K-1, Form 1041 and Form 1041 Schedule K-1 will soon be updated to reflect changes as a result of the §199A final regulations. New Form 8995, Qualified Business Income Deduction Simplified Computation, was released February 13, 2019. It applies for taxpayers under the taxable income threshold.

(2) **Effect of Deduction for Partners or S Corporation Shareholders**. The §199A deduction is applied in the calculation of 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. Reg. §1.199A-1(e)(1).

(3) **Disregarded Entities**. Trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of §199A. Reg. §1.199A-1(e)(2).

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

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

(6) **Alternative Minimum Tax**. The QBI deduction is the same for both regular tax and AMT purposes. Reg. §1.199A-1(e)(5).

q. **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 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).

8. 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.bessemertrust.com/for-professional-partners/advisor-insights** 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. 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 a family member 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, Minnesota, New Jersey, and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created. *E.g., 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) (discussed below); *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.bessemertrust.com/for-professional-partners/advisor-insights**.

Another relatively recent case contrary to this trend 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 had held that the 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) reported 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. Minnesota joined this trend in the *Fielding* case.

d. **U.S. Supreme Court Weighs In*, North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust***.

(1) **Case Synopsis**. In a 9-0 decision, the U.S. Supreme Court upheld lower court findings that the taxation of undistributed income from a trust by North Carolina based solely on the beneficiaries' residence in North Carolina violated the Due Process Clause, but the Court emphasized that its ruling was based on the specific facts of the case for the specific tax years in question.

The first paragraph of the opinion is an excellent synopsis of the case and the Court's holding.

> This case is about the limits of a State's power to tax a trust. North Carolina imposes a tax on any trust income that "is for the benefit of" a North Carolina resident. N. C. Gen. Stat. Ann. §105–160.2 (2017). The North Carolina courts interpret this law to mean that a trust owes income tax to North Carolina whenever the trust's beneficiaries live in the State, even if—as is the case here—those beneficiaries received no income from the trust in the relevant tax year, had no right to demand income from the trust in that year, and could not count on ever receiving income from the trust. The North Carolina courts held the tax to be unconstitutional when assessed in such a case because the State lacks the minimum connection with the object of its tax that the Constitution requires. We agree and affirm. As applied in these circumstances, the State's tax violates the Due Process Clause of the Fourteenth Amendment.

North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust, 588 U.S. __ (2019)(Justice Sotomayor), concurring opinion (Justice Alito, joined by Chief Justice Roberts and Justice Gorsuch), *aff'g Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 814 S.E.2d 43 (N.C. June 8, 2018), *aff'g* 789 S.E.2d 645 (N.C. App. 2016), *aff'g*, 12 CVS 8740 (N.C. 2015).

The decision is narrow in the sense that North Carolina may be unique in looking solely to the residency of a beneficiary, including a beneficiary whose interest is "contingent," but the opinion does respect the fundamental character of trusts and recognizes the distinct interests and functions of the settlor, trustee and beneficiaries. In addition the opinion implies that the Court's recent opinion in *South Dakota v. Wayfair, Inc*. 585 U.S. __ (2018), will not have a major impact on the analysis of the constitutionality of state taxation of trusts. While the trend of cases over the last four years has been to find state taxation of trusts on various grounds to be unconstitutional (with most of those cases addressing systems that tax trusts based on the residency of the settlor of the trust), the Court goes out of its way to make clear that it is not addressing any of the other regimes for state taxation of trusts. The opinion provides minimal guidance as to the constitutionality of those various systems (or the North Carolina beneficiary-based system under other facts),

but reiterates and applies traditional concepts that due process concerns the "fundamental fairness" of government activity and requires "minimum contacts" under a flexible inquiry focusing on the reasonableness of the government's action.

For a more detailed analysis of the *Kaestner* opinion and planning alternatives in light of the opinion, see Kaestner Trust – Supreme Court Guidance for State Trust Income Taxation found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(2) **Basic Facts of *Kaestner***. The trust was originally created by a New York resident in 1992 for his three children. No party to the trust was in North Carolina until one of the daughters, Kimberly, moved to North Carolina in 1997 at age 28. The original trustee was a New York resident, and a Connecticut resident later became trustee. The trust was governed by the laws of New York. The financial assets were held by custodians in Boston. The financial books and records were kept in New York, and the tax returns and accountings were prepared in New York for administrative convenience. The trust eventually was separated into three subtrusts for the three children in 2002 and the separate shares became separate trusts in 2006. Kimberly's trust was formed for the benefit of Kimberly and her three children.

North Carolina taxed Kimberly's trust more than $1.3 million in 2005-2008 based on N.C.G.S. §105-160.2, which provides that the state can tax a trust "that is for the benefit of a resident of this State." The trust paid the tax and filed a claim for refund on the basis that the North Carolina tax provision was unconstitutional.

The beneficiaries were merely discretionary beneficiaries; the trustee had "absolute discretion" to distribute assets to the beneficiaries "in such amount and proportions" as the trustee might "from time to time" decide. No distributions were made to the beneficiaries during the tax years in question. A loan was made to Kimberly, which she repaid the following year.

The trustee provided Kimberly with accountings of trust assets, and she received legal advice about the trust from the trustee and his law firm in New York. She and her husband met with the trustee in New York to discuss investment opportunities for the trust and whether she wanted to receive income distributions.

The trust agreement provided that the trust would terminate in 2009 (on Kimberly's 40th birthday), but after the tax years in question and before the termination date, the trustee consulted with Kimberly and in accordance with her wishes the trustee decanted the trust into a new trust under the New York decanting statute (N.Y. Est., Powers & Trusts Law Ann. §10-6.6(b)).

(3) **Overview of Court Analysis**.

(a) General Due Process Principles Regarding State Taxation. The Due Process Clause of the Fourteenth Amendment provides that "[n]o State shall… deprive any person of life, liberty, or property, without due process of law." The Due Process Clause centrally concerns the "fundamental fairness of governmental activity" [citing *Quill Corp. v. North Dakota*]. The clause limits states to imposing only taxes that "bea[r] fiscal relation to protection, opportunities and benefits given by the state." *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444 (1940). The Court applies a two-step process to make this determination.

> First, and most relevant here, there must be some "'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'" Quill, 504 U.S. at 306. Second, "the 'income attributed to the State for tax purposes must be rationally related to "values connected with the taxing State."'" *Ibid.*

Footnote 5 clarifies that because the Kaestner Trust does not meet the first test, the Court does not address the second.

In the context of state taxation, the state must have "certain minimum contacts" such that the tax "does not offend 'traditional notions of fair play and substantial justice.'" [quoting *International Shoe Co.*, 326 U.S., at 316]. The "minimum connection" inquiry is "flexible" and focuses on the reasonableness of the government's action [citing *Quill*, 504 U.S. at 307].

(b) **General Application of Due Process Principles to State Taxation of Trusts**. "One can imagine" various contacts "with a trust or its constituents" that might provide the "minimum connection" to justify taxation of the trust assets. The Court in the past has looked at "the relationship between the relevant trust constituent (settlor, trustee, or beneficiary) and the trust assets." Prior cases have recognized that basing state taxation on income distributed to an in-state **beneficiary** or on a **trustee's** in-state residence satisfies the Due Process Clause. Other cases "suggest" that a tax based on the site of **trust administration** is constitutional.

As to **beneficiary** contacts, specifically, "the Court has focused on the in-state beneficiary's right to control, possess, enjoy, or receive trust assets." A common governing principle for a State basing trust taxation on the residence of a trust beneficiary is that "the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State's tax."

The court analogizes this analysis for **beneficiary** contacts to **settlor** or **trustee** contacts with a state. A state can tax a trust based on an in-state settlor who retained the "power to dispose of" the trust property or to the in-state residence of a **trustee**. (The Court in footnote 7 makes clear that it is not addressing whether a lesser degree of control by a settlor could also sustain a tax by the settlor's domicile state.)

The Court briefly summarizes the Due Process Clause analysis for the various types of trust constituents (beneficiary, settlor, and trustee), and particularly for beneficiaries. That summary is quoted in Item 8 of the Observations, below.

(c) **Application of Principles to Kaestner Trust Facts**. The Court makes very clear that its conclusion that the Due Process Clause is not satisfied as to North Carolina's taxation of the trust is based on the specific facts in these years. The Court concludes that the Kaestner Trust beneficiaries do not have the requisite relationship with the trust property to justify the state's tax, but footnote 7 makes clear that the Court does "not decide what degree of possession, control, or enjoyment would be sufficient to support taxation."

The Court points to various reasons that the mere residence of the beneficiaries in North Carolina does not supply the required "minimum connection" necessary to support state taxation of the trust.

First, the beneficiaries did not actually receive any income during the years in question.

Second, "the beneficiaries had no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue." The trustee had "absolute discretion" in deciding when, whether, and to whom distributions would be made. The Court emphasizes that "Critically, this meant that the trustee had exclusive control over the allocation and timing of trust distributions." Distributions could be made to one beneficiary to the exclusion of others, "with the effect of cutting one or more beneficiaries out of the Trust." The trustee and not beneficiaries made investment decisions. A spendthrift clause prevented beneficiaries from assigning their interests in trust property to anyone. (Footnote 9 makes clear that the Court does not address whether the absence of a spendthrift clause would mean that the minimum contacts requirements for due process is satisfied.) While the trust agreement directs the trustee to be liberal in exercising its distribution discretion and the trustee could not act in bad faith or some improper motive, the beneficiaries still could not demand distributions or direct that Trust assets be used for their benefit.

Third, the beneficiaries "could not count on necessarily receiving a specific amount of income from the Trust in the future." While the trust was scheduled to terminate in 2009, the New York decanting statute allowed the trust to distribute to a new trust with a later termination date, which the trustee in fact did. As a result of these facts, one might view the interests of the beneficiaries as "contingent" on the exercise of the trustee's discretion. The Court in footnote 10 says that it specifically is not addressing "whether a different result would follow if the beneficiaries were certain to receive funds in the future."

In light of these three reasons, Kimberly and her children "had no right to 'control or posses[s]' the trust assets 'or to receive income therefrom.'" "Given these features of the Trust, the beneficiaries' residence cannot, consistent with due process, serve as the sole basis for North Carolina's tax on trust income."

(d) **Rejection of State's Counterarguments**. First, the State argued a prior case stands "for the broad proposition that that 'a trust and its constituents' are always 'inextricably intertwined,' and that because trustee residence support trust taxation, so too must beneficiary residence. This argument "fails to grapple with the wide variation in beneficiaries'' interests." The relationship between beneficiaries and trust assets maybe very close in some situations, but not in others.

Second, the State argued that a ruling a favor of the Trust will undermine numerous state taxation regimes. The Court rejects that argument because few states rely on beneficiary residency as the sole basis for state taxation. Footnote 12 points out that five states (Alabama, Connecticut, Missouri, Ohio, and Rhode Island) look at a beneficiary's residence in combination with other factors. Furthermore, three states (Georgia, Montana, North Dakota), that purportedly look at beneficiary residency apply flexible tests and may not rely on beneficiary residency alone. Tennessee uses beneficiary residency but will phase out its income tax by 2021. California applies beneficiary residency as a factor, but only where the beneficiary is not contingent. No other state has a regime that is clearly like that in North Carolina.

Third, the State argued that adopting the Trust's position will lead to "opportunistic gaming of state tax systems," by delaying taking distributions until the beneficiary moves to a state with a lower level of taxation. The Court responds that such gaming is by no means certain to occur because the trustee, not the beneficiary, has the power to make or delay distributions, and because the holding addresses only circumstances in which a beneficiary receives no income, has no right to demand income, and is uncertain necessarily to receive income. "In any event, mere speculation about negative consequences cannot conjure the 'minimum connection' missing between North Carolina and the object of its tax."

(e) **Concurring Opinion**. A separate brief concurring opinion by Justice Alito, joined by Chief Justice Roberts and Justice Gorsuch, states that its purpose is to make clear that the opinion of the Court is based on the "unusually tenuous" connection between the Kaestner beneficiaries and the trust income, and that "the opinion of the Court merely applies our existing precedent and that its decision not to answer questions not presented by the facts of this case does not open for reconsideration any points resolved by our prior decisions."

(4) **Significance (and Insignificance) of *Kaestner***. The Due Process and Commerce Clauses of the U.S. Constitution both place limits on the ability of a state to tax income when the income is not directly produced within the state. In particular, courts over the last century have grappled with when a state can tax the undistributed income of trusts based on some connection to the state and still satisfy the Due Process Clause's requirement of fundamental fairness. A number of state court cases have addressed this issue (increasingly over the last decade), but *Kaestner* is the U.S. Supreme Court's first effort to address this important issue regarding state taxation of trust income in many decades, and the case reiterates established guidance regarding the Due Process Clause's limits on the ability of states to tax income and the general principles for when a state can tax trust income under the Due Process Clause. For that reason, the case is highly significant.

The opinion is very limited, however, in establishing guidelines for what specific connections that a state has with a trust income *will satisfy* the due process requirements. Professor Sam Donaldson's view is that this was an extremely easy case because of the almost complete absence of contacts with North Carolina as, he says, is indicated by the "deeply divided 9-0 opinion."

(5) **Open Questions Even for a Beneficiary-Based State**. A handful of states use a beneficiary's residence as at least one factor in determining whether the trust is a resident trust. The opinion leaves open whether the presence of certain factors might justify state trust taxation based on beneficiary contacts, such as if the beneficiary—

- received some income during the year in question (or possibly even in a prior year),
- had the right to demand income from the trust during that year (for example under a "health, education, maintenance, and support" standard),
- had a vested interest in ultimately receiving that trust income (for example, one of the factors that California uses in taxing the undistributed income of trusts is whether any "non-contingent" beneficiaries reside in California),

- had some control over trust decisions short of being a trustee (for example if the beneficiary was an investment advisor), or
- had the ability to remove and replace trustees.

(6) **Guidance as to Factors That Would Justify State Taxation of Trust Income**. Page 6 of the *Kaestner* opinion addresses three taxing regimes that do pass the Due Process Clause's "minimum contacts" requirement—

(1) taxation of actual trust distributions to a state resident (*Maguire v. Trefry*),

(2) taxation based on the residence of the trustee (*Greenough v. Tax Assessors of Newport*), and

(3) possibly taxation based on the place of administration (cases *suggesting* that is constitutional are *Hanson v. Denckla* (involving personal jurisdiction, not trust taxation, issues), and *Curry v. McCanless*).

In addition, cases are clear that states can (and do!) tax trust income that comes from sources within the state (sometime referred to as "source income").

Although states may tax trusts based on the presence of the trustee in the state, some states do not use that as a factor for fear of discouraging banks from locating in the state (a prime example is North Carolina, which is home to several large national banks).

(7) **Minimal Guidance as to Settlor-Based Regimes**. The most prevalent factor that is used by states for taxing undistributed trust income is whether the trust was originally created by a resident of the state. The opinion provides little guidance regarding whether those systems will satisfy the due process requirements unless the settlor had the "power to dispose of" the trust property (*Curry v. McCanless*), or the "right to revoke" the trust (*Graves v. Elliott*). Beyond those cases, in which the settlor retains the clear power to control or possess the trust property, the opinion gives no guidance regarding the constitutionality of settlor-based taxing regimes.

Although a few exceptions exist, a wide variety of state cases have found that systems based solely on the existence of a resident-settlor do not satisfy due process requirements. See Item 20.d of the 2012 Heckerling Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)** for a history of such cases and 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.bessemertrust.com/for-professional-partners/advisor-insights** for a discussion of the trend of more recent cases finding such systems unconstitutional.

In many situations, the fact that a settlor lived in the state years earlier when the trust was created may result in even less contacts with a trust currently than the beneficiary situation addressed in *Kaestner*.

Even among settlor-based regimes, the constitutionality analysis may vary. Taxation of testamentary trusts by the state of the decedent's residence may have a somewhat greater possibility of withstanding constitutional challenge than inter vivos trusts because of the utilization of the state's probate courts in the establishment of

the testamentary trusts. The courts have generally focused their constitutional analysis of state taxation of trusts under the Due Process Clause (and the involvement of the local courts in creating the trust is an additional contact with the state that may help support the existence of the required "**minimum contacts**" required for due process), but the state taxation must also be permitted under the Commerce Clause, which requires a **substantial nexus** between the activity being taxed and the taxing state, and the local court involvement might help in establishing that the required substantial nexus exists.

Another variance is that some settlor-based state regimes also add a "nonresident resident trust" exception (such as New Jersey and New York); the state cannot tax the income of a "resident trust" created by a resident-settlor if no trustees, assets or source income are present in that state.

(8) **Planning Opportunities**. Settlor-based state systems can sometimes create planning opportunities for trusts created by residents in other states. For example, New York resident-settlors may create trusts with New Jersey trustees and assets that are not subject to New York taxation (because of the absence of a New York trustee or New York assets) or New Jersey taxation (because the trust was not created by a New Jersey testator or settlor).

Selecting a trustee (or trust protector or trust advisor) that is located in a state that does not tax trusts will be determinative for many situations. If a bank is chosen, consider selecting a bank that is incorporated or administered in a state that does not tax trusts or that would require some fact in addition to the mere presence of a trustee in the state.

(9) **Impact of Decanting Statute**. One of the reasons the Court gave for concluding that the beneficiaries did not have the requisite "minimum connection" with the income being taxed was that they were not assured of ever receiving the income. The tax years in question were 2006-2008, and the trust agreement said that the trust would terminate in 2009. To reason that the beneficiaries were not assured of receiving the income when the trust would terminate in the *following* year (as to the 2008-year tax) may seem somewhat of a stretch. Apparently, as of 2008, the Court would have been relying on the fact that the trustee had the authority to distribute the assets to a longer-term trust under the New York decanting statute, so the beneficiaries were not assured of receiving the income. Indeed, the trustee consulted with the beneficiary and in accordance with her wishes the trustee decanted the trust into a new trust under the New York decanting statute (N.Y. Est., Powers & Trusts Law Ann. §10-6.6(b)).

(10) **Massive Refund Actions in North Carolina**. The result of *Kaestner* is that at least 400 protective claims for refund have been filed. The North Carolina Department of Revenue has published a notice that persons who filed a "Notice of Contingent Event" based on the contingency of the pending *Kaestner* case must file an amended return within six months after the contingent event concluded, which would be six months after the date of the June 21, 2019 *Kaestner* opinion, or by December 21, 2019. Taxpayers who had not previously filed a Notice of Contingent Event relating to the *Kaestner* opinion must file an amended return or a refund claim within the statute of limitations for obtaining a refund.

e. **Minnesota Courts Find Application of Founder Statute Unconstitutional, Supreme Court Refuses Appeal, *Fielding***. 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 Minnesota 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 contacts with Minnesota would be considered, the court concluded that the only factor that was relevant for consideration was the statute's description of 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 (916 N.W.2d 323), largely following the reasoning of the Minnesota Tax Court. The state filed a certiorari petition with the United States Supreme Court. The Court did not address that petition while the *Kaestner* case was pending, but it denied the petition on June 28, 2019.

f. **A Year Earlier – Supreme Court Overruling of *Quill* in *Wayfair***. *South Dakota v. Wayfair*, 138 S. Ct. 2080 (U.S. 2018), holds that states may require a seller to collect and remit sales tax on internet purchases even where the seller does not have a physical presence in the purchaser's state. *Wayfair* does not involve trust income taxation, but some of the recent trend of trust state income tax cases have cited *Quill Corp v. North Dakota*, and *Wayfair* overrules the physical presence test in *Quill* for applying the Commerce Clause.

Quill v. North Dakota, 504 U.S. 298 (1992), held that a state could require a mail order house located in another state to collect a sales tax for the customer's state without violating the Due Process Clause (which merely requires minimum contacts with the state sufficient to justify the fundamental fairness of the State's exercise of power—i.e., mailing a "deluge of catalogs" into the state to solicit customers in the state) but not without violating the Commerce Clause which requires a physical presence in the state to establish a "substantial nexus" with the activity being taxed.

In considering the impact of *Wayfair* in other situations, the distinction between the Due Process Clause and Commerce Clause will be important. *Quill* discussed distinctions between the purposes of the **Due Process** clause (fundamental fairness of government activity and "minimum contacts" substantial enough to legitimate the State's exercise of power over an individual) and the **Commerce Clause** (not about fairness but structural concerns about effects of state regulation on the national economy). *Quill*'s analysis of these separate clauses:

- **Due Process Clause**: Soliciting orders by mail, "a deluge of catalogs," etc. can be sufficient to satisfy the Due Process Clause; it does not require a physical presence in a State for the imposition of a use tax.
- **Commerce Clause**: A physical presence test is applied, based on the notion that a state must have a "substantial nexus" with activity being taxed.

Wayfair overruled the physical presence test of *Quill,* which was based on satisfying the Commerce Clause. Without a physical presence test, the issue is still whether the substantial nexus with the taxing state can be established to satisfy the Commerce Clause. The South Dakota Act requiring an online retailer to collect sales tax for South Dakota customers applies only to sellers who engage in a significant quantity of business in the state ($100,000 of goods or services or engaging in 200 or more separate transactions). "This quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota. And respondents are large, national companies that undoubtedly maintain an extensive virtual presence. Thus, the substantial nexus requirement … is satisfied in this case."

g. **Minimal Apparent Impact of *Wayfair* on State Taxation of Trusts**. While *Wayfair* overrules the physical presence test in *Quill* for applying the Commerce Clause, the state trust taxation cases have quoted *Quill* primarily for its discussion of the Due Process Clause, not the Commerce Clause. The fact that the Court in *Wayfair* overruled the *Quill* case in one respect (albeit not related to the Due Process Clause) has raised some question as to whether the Court might change its analysis of the constitutionality of states' taxation of trust income.

   That question has been answered; *Wayfair* appears to have no impact on the constitutionality of state taxation of trusts (at least under a Due Process Clause analysis). The *Wayfair* case was not even mentioned in the *Kaestner* opinion, other than including it in the citation of the *Quill* case to point out that *Wayfair* overruled *Quill* "in part on other grounds" – that is, as to an issue other than *Quill*'s discussion of the Due Process Clause.

   Some of the state trust income tax cases have addressed both the Commerce and Due Process Clauses. Taxing states must satisfy both the Due Process Clause, which requires **minimum contacts**, and the Commerce Clause, which requires a **substantial nexus** between the activity being taxed and the taxing state. *Wayfair*'s overruling of the physical presence test in *Quill*'s analysis of the Commerce Clause could conceivably have an impact on any future cases that test state taxation of trust income under the Commerce Clause. *Wayfair* says that an essential 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."

h. **Approach While Awaiting Determination of Constitutionality**. If a state attempts to tax the accumulated income of a trust based solely on the settlor's residence when the trust was created or a beneficiary's residence under facts different than the *Kaestner* facts, what should the trust do? The most conservative approach would be to pay the tax and request a refund based on the unconstitutionality of the tax.

9. Estate Planning For Moderately Wealthy Clients

a. **Small Percentage of Population Subject to Transfer Taxes; Paradigm Shift for Planners**. The Joint Committee staff has estimated that only about 1,800 of 2018 decedents will have to pay estate tax (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). 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.

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

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

b. **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.

   One nationally respected GST expert practitioner reported recently dealing with a trust that had to pay a 40% GST tax – and the trust only had several million dollars.

   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. The Bluebook for the 2017 Tax Act (published in December 2018 about a year after the Act was passed) has a detailed footnote saying that is permitted. See Item 3.a above.

c. **Review Formula Clauses.** Review formula clauses in existing documents; otherwise the will may leave the first spouse's entire estate to a credit shelter trust even though that now provides no estate tax savings.

d. **Testamentary Planning**. Many moderately wealthy clients will want to rely on portability and leave assets at the first spouse's death either outright to the surviving spouse (and rely on disclaimers if a trust is desirable) or to a QTIP trust with a Clayton provision (which allows the most flexibility). See Item 3.g of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

   Alternatively, using a credit shelter trust may be advantageous for various reasons including 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.bessemertrust.com/for-professional-partners/advisor-insights**.

e. **State Estate Tax Planning Issues**. About one-third of the states have a state estate or inheritance tax, and in those states, state estate tax issues must be considered.

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. The last two of those three results in effectively having a federal bypass trust for an amount up to the full federal exclusion amount. The planner should run numbers to see how much savings is generated by using the state-only QTIP election, to determine whether the complexity of having that additional trust is worthwhile. See Item 26.d below.

f. **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.

Four basic approaches can be used:

(1) making 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));

(2) having someone grant a general power of appointment to the beneficiary (but consider including the broadest possible exculpatory clause for that person, and providing that the person has no authority to exercise the power until requested to consider exercising the discretion to grant the power by some designated persons or class of persons);

(3) using a formula general power of appointment (perhaps adding that a non-adverse party could modify the power of appointment to add flexibility; structure the formula based on the lesser of the individual's remaining GST exemption or applicable exclusion amount, and limit the formula to $10,000 less than that amount so that the existence of the general power of appointment will not require the powerholder's estate to file an estate tax return); or

(4) triggering 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.

To limit the possible "inappropriate" exercise of a power of appointment, (i) grant a testamentary power that some independent person has the ability to to remove before the powerholder dies or to revise the power (for example, to adjust a formula general power of appointment), (ii) specify that the power is exercisable only with the consent of some other non-adverse party (but not the grantor), *see* Reg. §20.2041-3(c)(2), Ex. 3, and (iii) limit the permissible appointees of the power (such as to persons related by blood, marriage, or adoption or to creditors).

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.

For a detailed discussion of various basis adjustment planning alternatives (including various form provisions), see Item 5 of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

g. **Upstream Gifts or Other Gifts to Moderate Wealth Individuals; §1014(e)**. Consider *upstream* basis adjustment planning by including an older generation client as a discretionary beneficiary and holder of a general power of appointment (as discussed in Item 9.f above, limited to the lesser of that person's GST exemption amount or $10,000 under the applicable exclusion amount after considering all other assets of that individual). At the client's death, a basis adjustment will be allowed under §1014. If the assets pass back to the donor within one year of the gift, §1014(e) will preclude a basis adjustment, but if the assets pass to someone else (or perhaps even if the assets pass into a trust with the donor included as a discretionary beneficiary), §1014(e) will not apply. See Item 19.c for further discussion.

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 sometimes harmful) 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;
- authorizing trust decanting (which may be available under state statutes); 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.bessemertrust.com/for-professional-partners/advisor-insights** and Item 3.j.(13) of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** for a more detailed discussion of powers and limitations that can be added for trust protectors to provide flexibility).

i. **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. His non-exclusive 22-item list is at Item 3.s of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

10. Transfer Planning for Clients Who Want to Make Use of the Increased Exclusion Amounts But Do Not Want to Make Large Gifts (At Least Don't Want to Lose Access)

a. **Significance**. 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 (perhaps only if the exclusion amount drops below its current high amount at some point in the future), (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.

b. **Window of Opportunity; Impact of Having DSUE Amount From Prior Deceased Spouse**. 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 seven years through 2025 (assuming Congress doesn't reduce the exclusion amount before 2026).

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), under the "anti-clawback" regulation.

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. 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. See Item 4.k 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. See Austin Bramwell & Katie Lynagh, *The Paradoxical New Gift Splitting Calculus*, LEIMBERG EST. PL NEWSLETTER #2713 (April 1, 2019).

If the client has DSUE from a predeceased spouse, the client must first apply the DSUE before utilizing his or her own gift exclusion amount. Reg. §25.2505-2(b). Therefore, in order for the client 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 client's own gift exclusion amount.

c. **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.

d. **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 observations about defined value clauses, see Item 11.m below, and for a more detailed discussion of defined value clauses, see Item 14 of the Current Developments and Hot Topics Summary (December 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

e. **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, see Item 8.f and Item 11 of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** for a more detailed discussion of sales to grantor trusts.;
- 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, of the Estate Planning Current Developments Summary (December 2018 found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights,** and for an outstanding detailed discussion of planning by a surviving spouse with QTIP trusts, see Read Moore, Neil Kawashima & Joy Miyasaki, Estate Planning for QTIP Trust Assets, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 ¶ 1202.3 (2010)); 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.bessemertrust.com/for-professional-partners/advisor-insights**.

f. **Factors Impacting Appropriateness of a Client Making Substantial Gifts**.

(1) Possibility of future appreciation.

(2) Current cost basis.

(3) Willingness to defend gift tax audit.

(4) Willingness to pay fees to implement gift transactions.

(5) Willingness to give up assets.

(6) Desire to protect assets from future creditors.

(7) Willingness to manage assets actively so that over time there will not be a significant disparity between fair market value and basis of the assets.

(8) Whether gift assets will be sold vs. retained long term.

(9) Knowing that the donor can keep the ability to reacquire the asset for equivalent value and possibly avoid losing a basis step-up at death.

(10) Willingness to pay income taxes on the grantor trust, with the understanding that this obligation can be ended when desired.

g. **Overview of Gifting Opportunity Approaches (in Order of Increasing Aggressiveness and/or Complexity), Particularly for Clients Who Want Some Type of Continued Access to Gift Assets**.

(1) Gifts up to the gift tax annual exclusion and the tuition and medical expense exclusion. Such gifts could be outright, to custodianships for minors, or to trusts (annual exclusion gift trusts would be to Crummey trusts.)

(2) More significant gifts to trusts with neither the donor nor donor's spouse as a present or future possible beneficiary, regardless of any reversal in financial position.

(3) Gifts to a trust with the donor's spouse (and possibly children) as discretionary beneficiaries; at death of the spouse, the assets would be held for descendants.

(4) Gifts to a trust with the donor's spouse (and possibly children) as discretionary beneficiaries; at death of the spouse, the spouse may decide to have all or some of the assets pass into a trust with the original donor as a discretionary beneficiary (depending on whether DAPT legislation or a statute reversing the "relation back doctrine" applies to the continuing trust for the donor).

(5) Gifts to a trust with the donor's spouse (and possibly children) as discretionary beneficiaries; at a predetermined future date, the assets will be distributed outright or in trust for descendants only if the donor's net worth is at least a specified value determined at the creation of the original trust.

(6) Gifts to a trust in which the donor (and others, if desired) are discretionary beneficiaries if DAPT legislation applies to the trust. (Estate inclusion may nevertheless result if the trustee makes frequent distributions to the donor or the IRS can otherwise establish the existence of a prearrangement that the donor would receive distributions.)

(7) Gifts to a trust in which others are discretionary beneficiaries, but a third party has the discretion to add the donor as a discretionary beneficiary after a specified period of time if DAPT legislation applies to the trust. *See* Abigail O'Connor, Mitchell Gans & Jonathan Blattmachr, *SPATs: A Flexible Asset Protection Alternative to DAPTs*, 46 ESTATE PLANNING 3 (Feb. 2019).

(8) If estate tax savings are not a concern, gift to an inter vivos QTIP trust for the donor's spouse, retaining the right to be a discretionary beneficiary if the spouse predeceases the donor.

(9) All of the above alternatives might be combined with the donor's spouse making a gift to a similar, but not identical, trust.

h. **Transfers with Possible Continued Benefit for Grantor or Grantor's Spouse**. Couples making gifts of a large portion of their $10 million (indexed) applicable exclusion amount 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") (discussed in more detail in Item 10.i below) and/or exercise by beneficiaries of nontaxable powers of appointment;
- "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 settlor under a non-fiduciary power of appointment rather than including the settlor as a discretionary beneficiary under fiduciary standards);
- Transferring a residence to a 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, Item 3(q) of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**;
- 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.

These alternatives are discussed in more detail in Items 14-25 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

i. **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 to 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 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 23.d 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.bessemertrust.com/for-professional-partners/advisor-insights**.

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

(1) **Enhanced Grantor Retained Income Trust**. For the client that is reluctant to relinquish substantial value, but wants to make a large gift to "lock in" use of the increased gift exclusion to take advantage of the window of opportunity, consider making a gift of an asset while retaining the income from or use of the asset (in a manner that does not satisfy §2702). The gift will be a completed gift of the full value of the transferred asset if §2702 is not satisfied and if the donor's creditors cannot reach the assets. The asset will be included at its date of death value in the gross estate under §2036(a)(1), but the date of gift value will not also be included in the estate tax calculation as an adjusted taxable gift. §2001(b) (last sentence). The effect is that the asset has been given to someone else, the date of death asset value is included in the gross estate but is offset by the estate tax unified credit, which is increased by the amount of exclusion applied against lifetime gifts if that amount exceeds the exclusion amount available at death (for example, due to a decrease in the basic exclusion amount in 2026). The post-gift appreciation in the asset is all that is effectively subject to estate tax. For a detailed discussion of this

approach, see R. Eric Viehman, *Using an Enhanced Grantor Retained Income Trust (E-GRAT) to Preserve the Basic Exclusion Amount*, STATE BAR OF TEXAS ADVANCED ESTATE PLANNING STRATEGIES COURSE, ch. 4.7 (April 2019).

(2) **Transaction That Does Not Satisfy §2701**. Another approach that has been suggested by Ellen K. Harrison (Washington, D.C.) is making a transfer that intentionally fails to satisfy §2701. A donor would make a gift of a common interest in a partnership/LLC while retaining a preferred interest that does not meet the requirements of §2701. The effect under §2701 is that the preferred interest is treated as having a zero value (for example, because it is noncumulative). The donor would be treated under §2701 as making a gift equal to the donor's entire interest in the entity. (The donor would need to have remaining gift exemption equal to the value of the entity to avoid having to pay gift tax.)
At the donor's death, the value of the preferred interest is includable in the gross estate. A put right would assure that the value will be at least equal to the liquidation preference if the preferred payment right is noncumulative. Thus, a basis step up should be permitted equal to that value. There is no transfer tax on the income and appreciation to the extent it exceeds whatever the donor receives (if anything) in preferred payments. The mitigation rule in Reg. §25.2701-5(a)(3) makes the zero value rule less significant since the donor's estate will be reduced by the same amount by which the gift value was increased due to the zero value rule.

The following example describes how this strategy would work.

- The gift of the common interest is valued as if the preferred interest retained by the donor had a zero value if the preference is noncumulative. Assume the preference is $5MM and the value of the common would be zero if §2701 did not apply (because the assets owned by the entity are only $5MM) but because §2701 does apply the gift is assumed to be $5MM.
- All dividends and appreciation in excess of the preferred return belong to the common shareholders, partners or members because that is what the document says. That is, upon liquidation the preferred gets its preference and any additional value goes to the common. Assume that no dividend is declared during the donor's lifetime (although this doesn't matter, presumably dividends would be declared only if the donor needs the funds, but no dividends could be paid to the common shareholders until the preference was paid for a particular year) so earnings accumulate.
- Donor dies and the value of the preferred is included in the estate of the donor and the preferred gets a basis adjustment equal to its then fair market value. The value cannot exceed the liquidation preference (presumably no value would be attributed to the right to dividends because they are noncumulative); §2701 should not apply a second time since there is no transfer occurring at death.

Under Reg. §25.2701-5(a)(3), "the amount on which the decedent's tentative tax is computed under section 2001(b)" is reduced by the amount by which the gift was increased because of the zero value rule. Thus, the value in the gross estate is not impacted, but merely for purposes of calculating the estate tax, a reduction is

allowed for the amount by which the taxable gift was increased because of §2701. If the value of the preferred at the time of the gift was reduced from $5MM to zero and if the value of the preferred at the time of death is still $5MM, the estate tax base on which tax is calculated is reduced by $5MM (and in our example nets to zero). This adjustment would not affect the income tax basis because this adjustment does not change the amount included in the gross estate; it is merely a factor considered in calculating the estate tax.

(3) **Section 2519 Deemed Transfer**. Another planning possibility is to make a §2519 deemed transfer (if a large QTIP exists for the client's benefit), which is discussed in Item 3.j.(8) of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(4) **Retained Income Trust**. A retained income trust alternative is discussed in Item 25 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(5) **New York State Tax Section Recommendation to IRS**. See Item 4.m above for a discussion of the New York State Bar Association Tax Section comments to the IRS recommending revisions to the anti-clawback proposed regulations to eliminate this planning approach. Planners should be cautious in using these approaches as a way of making use of the increased gift exclusion amount until final anti-clawback regulations have been issued, and we know whether the IRS adopts the recommendation not to extend the anti-clawback adjustment to gifts that are included in the gross estate.

k. **Lifetime Gifts of Low Basis Assets; "Appreciation Hurdle."** The estate tax savings of gifts are offset by the loss of a basis step-up if the client dies no longer owning the donated property. For example, assuming a 40% estate tax rate and a 25% rate on capital gains (20% + 3.8% NIT + assumed 1.2% state rate) a gift of a $1 million asset with a zero basis would need combined net income/appreciation of 166.667%, and grow to $2,666,667 (to a value that is 267% of the current value) in order for the estate tax savings on the *future* growth ($1,666,667 x 40%) to start to offset the loss of basis step-up ($2,666,667 x 25%).

David Handler refers to the "appreciation hurdle" as the aggregate (not annual) combined net growth required between the date of a lifetime asset transfer and the date of the transferor's death for the estate tax savings to equal the capital gains tax cost. It is derived using the following formula:

> Capital Gains Tax Rate x (1 - Basis as % of Asset Value) / (Estate Tax Rate - Capital Gains Tax Rate).

David has produced the following chart to reflect the appreciation required, depending on the asset's bases, as a percentage of the asset value, at the date of the gift.

If basis is this % of value	Appreciation required (%)	$100 would grow to this amount
0%	166.667%	$266.67
10%	150.000%	$250.00
20%	133.333%	$233.33
30%	116.667%	$216.67
40%	100.000%	$200.00
50%	83.333%	$183.33
60%	66.667%	$166.67
70%	50.000%	$150.00
80%	33.333%	$133.33
90%	16.667%	$116.67
100%	0.000%	$100.00

The average annual return required depends on how long the donor lives after the gift. For example, if the donor lives 10 years after the gift and if the gifted asset has a basis of zero, annual growth of 10.31% would produce the aggregate required growth of 166.67%. David Handler, *Income Tax Basis: No Longer the Stepchild of Wealth Transfers*, ACTEC 2019 ANNUAL MEETING, at 13-14.

l. **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). See Item 11.a below for a summary of auditing statistics of gift tax returns.

In order to start the statute of limitations, the return must meet the adequate disclosure requirements of Reg. §301.6501(c)-1(f). Guidance from the IRS over the last several years has been strict in applying those requirements. *See e.g.*, LAFA (Legal Advice Issued by Field Attorneys) 20172801F (requirements not satisfied); Field Attorney Advice 20152201F (no adequate disclosure); 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 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. See Item 11.d below for a discussion of the IRS process of "flagging" gift tax returns with possible adequate disclosure problems for later review after the donor's death.

For a detailed discussion of the background and planning issues around the adequate disclosure rules see Item 20.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

11. Insights from the Trenches of Transfer Tax Audits and Controversies in an Era of Higher Exclusions, Including Defined Value Clauses and *True* Settlement

The following comments in paragraphs (a)-(m) below are by John Porter (Houston, Texas) and John Prokey (San Jose, California), who both handle a significant amount of audit controversy and litigation involving transfer tax matters.

a. **Statistics of Gift Tax Returns and Revenue**. In 2005, 260,000 gift tax returns were filed, and in 2017 about 240,000 returns were filed (staying fairly consistent). 370,000 returns were filed in 2013 reporting gifts made in the infamous 2012 year.

The number of **taxable** gift tax returns has dropped dramatically, from about 7,600 in 2005 to 2,804 in 2017.

About $1.7 billion of gift tax **revenue** was collected in both 2005 and 2017, staying constant.

Total gifts have doubled, from $37 billion in 2005 to $75 billion in 2017. In 2013 (reporting 2012 gifts), $421 billion of gifts were reported, with about $4.7 billion of gift tax collected.

In summary, the total number of gift tax returns and the gift tax revenue is staying about the same, but the number of taxable gift tax returns is dropping.

In 2016, the IRS **closed** about 1,800 gift tax returns, with about $300 million of proposed upward adjustments. In 2017, the goal was for 1,700 returns to be closed. Accordingly, the IRS is closing about 1,700 of the 2,800 taxable gift tax returns that are filed, reflecting about a two-thirds audit capacity of the taxable returns. Therefore, about 60% of *taxable* gift tax returns are audited, but only about 1% of total gift tax returns are audited.

b. **Statistics of Estate Tax Returns and Revenue**. The number of estate tax returns **filed** has dropped dramatically from 109,000 returns in 2001 to about 11,000 returns in 2016 and 2017. For deaths occurring in 2018, estimates are that 4,000 returns will be filed, with only 1,900 taxable returns. Presumably, a lot of the estate tax returns are portability returns.

Of the 12,711 estate tax returns filed in 2017, 5,185 were taxable returns, and 7,526 were nontaxable returns. Interestingly, only 603 of the nontaxable returns had gross estates under $5 million, suggesting a relatively few returns being filed merely to elect portability.

In 2017, the target was for the IRS to close about 2,400 estate tax returns. If this same experience continues in the future, at current staffing levels, the IRS will have **capacity to audit almost all** taxable gift and estate tax returns.

Estate tax **revenue** is dropping significantly: $24 billion in $2011; $20 billion in 2017; and an expected $15 billion is expected for deaths in 2017.

c. **Whether to Report Sale to Grantor Trust Transactions**. The gift tax audit statistics would seem to favor reporting sale to grantor trust transactions on a gift tax return in order to get the statute of limitations running that the sale price was adequate to avoid gift treatment. That return could be used to bolster an argument that the full and adequate consideration exception to §2036 was satisfied if the IRS should argue that §2036 applies to the sale transaction in an estate tax audit at the seller's death. (Ultimately, that is a client decision. Many clients may conclude "that is my children's problem," and do not want to risk a gift tax audit during their lives.)

   Another factor for current consideration is whether gift tax returns filed under the current Administration may see less scrutiny than under future Administrations.

d. **"Flagging" of Gift Tax Returns for Adequate Disclosure Problems**. IRS officials have indicated informally that when gift tax returns are reviewed, if potential adequate disclosure problems are observed the returns are "flagged" so that the issue will be revisited in connection with the estate tax return when the donor dies. If the gift tax return did not satisfy the adequate disclosure requirements, the statute of limitations would not have run on the gift, and substantial additional adjusted taxable gifts may be added to the estate tax calculation, and if gift taxes are due, penalties and interest may be added to those amounts for the intervening years. As an example, the *Estate of Redstone* estate tax case revisited gifts that occurred in 1972 and the ongoing *Marshall* case involves a 1995 transaction. Furthermore, donees may have personal liability for added gift taxes under the transferee liability rules. Awareness of this "flagging" system heightens the importance of making adequate disclosure on gift tax returns.

   Keep in mind that if a planner discovers that a prior gift has not been reported properly by a prior planner, an amended gift tax return can be filed that would satisfy the adequate disclosure requirements. Rev. Proc. 2000-34, 2000-2 C.B. 186, §4 states: "The top of the first page of the amended return must have the words 'Amended Form 709 for gift(s) made in [insert the calendar year that the gift was made] — In accordance with Rev. Proc. 2000-34, 2000-2 C.B. 186.'"

   Similarly, the DSUE reported on portability returns will be revisited at the surviving spouse's subsequent death (the *Sower* case confirms that the statute of limitations does not run on the DSUE amount until it is applied in some manner), emphasizing the importance of having adequate documentation for the value of assets passing in a way that does not qualify for the marital or charitable deduction at the first spouse's death.

e. **Changes in Planning Under 2017 Tax Act**.

   - Even very wealthy donors have expressed hesitancy about making $22 million of gifts, partly over concerns that such large gifts may have a bad influence on their children, even for amounts given in trust.
   - Silicon Valley planners are seeing significant increased interest in "qualified small business stock" with the possibility of 100% gain exclusion under §1202.

- Some planners are seeing a significant interest in upstream planning, using the exclusion amounts of parents for basis adjustment purposes and for using the parents' GST exemptions.
- For some clients, significant interest in causing estate inclusion to achieve basis adjustments is important, such as trying to use §2036 to cause estate inclusion for QPRTs.

f. **Focus on what is Actually Transferred for Valuation Purposes; Lessons from *Cavallaro*.** The *Cavallaro* case (T.C. Memo. 2014-189) involves a merger of companies owned separately by parents and children, and whether proper values were used in determining shares of the new company that each received. Gift tax returns were not filed at the time of the merger transaction. When shares of the merged company were later sold, the income tax examiner spotted the gift issue and referred it to gift tax representatives. The court discussed that important intellectual property was probably still owned by the parents' company, and that the parents' company contributed to the merger was substantially undervalued. The case raised questions about the ownership of the intellectual property rights, but that issue was not ultimately resolved. The court determined that the taxpayers' appraisal did not consider the additional intellectual property that appeared to be owned by the parents' company, so it was disregarded, and the court based its decisions on the IRS expert's appraisal. The Tax Court held that the parents made a gift equal to the difference between the value of the shares that they received in the merger and the value of the company they owned before it went into the merger.

The Court of Appeals determined that the parties should still have the ability to point out the defects in the IRS expert's appraisal. The case was remanded for that consideration, and on remand the Tax Court (Judge Gustafson) reduced the value of the gift from $29.7 million to $22.8 million, or by $6.9 million, because of a technical mistake in the IRS's expert's report that used a method that was not statistically correct in determining the profit margin of the children's company before the merger. After correcting that mistake (which adjusted the profitably margin of the children's company from 7.5% to 9.66%, thus increasing the value of the children's company), the parties agreed that the effect was to reduce the gift amount by about $6.9 million. T.C. Memo. 2019-144 (October 24, 2019).

This case highlights the importance of focusing on what is actually transferred. First, a resolution of what intellectual property rights were actually owned by the parents' company and what was owned by the children's company was never determined. The court merely raised questions. Second, the gift amount determined by the Tax Court was the total diminution of the parents' value in the merger, but that is not what was actually transferred for gift tax valuation purposes. The court should have valued the gifts that were made to *each* of the three children, which would have been minority interests in the company entitled to significant lack of control discounts. . Apparently, the taxpayers never made that argument. In response to the taxpayers' argument on remand that lack of control and lack of marketability discounts should apply, the court observed that it would not consider arguments the taxpayers raised for the first time on remand and pointed out that neither of the taxpayers' own experts had applied a discount for lack of control or lack of marketability.

The case also raises the issue of whether to have multiple appraisals, taking into account alternative ownership scenarios. Expert testimony regarding the nature of underlying assets (for example, who legally owns intellectual property rights) may also be needed.

g. **IRS In-House and Outside Appraisals**. IRS examining agents routinely refer valuation matters to in-house appraisers. That process often takes 6 to 8 months, and the quality of the reports varies dramatically. Some are good detailed reports, and others are just several pages, sometimes merely canned reports from prior cases.

In litigation, the IRS typically gets outside appraisals. The IRS also sometimes gets outside appraisals in audits, but this seems to depend not on the complexity or amount involved, but upon whether the IRS still has money in its budget for outside appraisals in the current fiscal year. (Toward the end of each summer, it is likely that no funds will be available.)

One speaker said he has offered to pay for the IRS to get an outside appraisal, but the Service would not agree to that.

h. **Unaccepted Offers**. Unaccepted offers should not be ignored by the appraiser. If no better evidence of value exists, they may be given heightened significance. But a good appraisal methodology supported by truly comparable public companies is a better indicator of value.

i. **Post-Transfer Sales; Anticipated Sales or Mergers**.

(1) **Post-Transfer Sales**. Sales after the date of a gift or the date of death must be considered by the appraiser. Some appraisers indicate that they are not able to consider post-event sales under standard valuation principles, but the IRS and courts will require it.

Post-event sales may not be determinative if market conditions have changed. For real estate sales, real estate contracts are often just a way of locking up the property, but the purchaser may have 1-3 years to walk away from the contract with little risk. That is not an "as is" sale that is an indicator of value for transfer tax purposes.

The Tax Court is consistently looking at post-event sales up to **three years** after the valuation date. The trend of the cases, in the absence of other good valuation evidence, is merely to discount the subsequent sales price to present value at the valuation date.

(2) **Anticipated Sales**. If a pending sale is contemplated, report that to the appraiser. John Prokey: "There's no hiding from this. Your appraiser needs to address it and deal with it. If they don't, the cases show that the report will be disregarded by the Tax Court. That has happened to both taxpayers and the IRS in valuation cases."

(3) **Anticipated Merger**. The appraiser should also be notified of pending mergers. CCA 201939002 concluded that stock on a listed exchange had to be valued for gift tax purposes by taking into consideration an anticipated merger of the underlying company that was expected to increase the value of the stock. See Item 35 below

for a discussion of this CCA and an unaddressed issue of whether hypothetical sellers and buyers should be presumed to have knowledge of merger negotiations in the case of secrecy imposed by law or agreement.

j. **Tax-Affecting**. Cases generally have 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 "preshareholder-tax discount rate," so there was no necessity of "tax affecting" the earnings). Various cases have followed the *Gross* reasoning. *E.g., Giustina, Gallagher* (LLC taxed as S corporation; "we will not impose an unjustified fictitious corporate rate burden on PMG's future earnings"), *Dallas, Adams, Heck.*

(1) **Appraisers Typically Tax Affect**. Valuation experts are critical of the refusal to allow any adjustment to reflect that an S corporation's income is subject to shareholder-level taxes and most appraisers do tax affect the earnings of S corporations.

(2) **Court Reaction**. When a taxpayer's expert's report tax affects, the court's reaction is that the expert did not demonstrate that shareholder taxes affected the value of the shares (a corporate level tax is traded for an increased shareholder level tax). Appraisal reports should focus on the total tax burden on C corporations (on which public company comparables are based) vs. flow-through entities.

(3) **Empirical Research Resource**. A lot of empirical research supports using an after-shareholder tax discount rate, taking into account shareholder tax rates. An excellent resource is a book by Nancy Fannon and Keith Sellers, *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle*.

(4) **IRS Valuation Aid Report**. In 2014 the IRS published *A Job Aid for IRS Valuation Analysts – Valuation of Non-Controlling Interests in Business Entities Electing to be Treated as S Corporations for Federal Tax Purposes*. Its position is that absent a compelling showing that unrelated parties dealing at arms-length would reduce the projected cash flows by a hypothetical entity level tax, no entity level tax should be applied in determining the cash flows of an S corporation.

(5) **Actual Buyers and Sellers DO Tax Affect**. Clients have told John Porter that they buy and sell S corporations as their business, and they clearly tax affect the cash flows of S corporations in determining the purchase price.

(6) **Appraisal Report Approach**. If the appraiser tax affects the cash flows, the appraisal should address the reasons for doing so in detail. Otherwise, the court will ask why the appraiser adjusted for entity-level taxes when the entity pays no taxes. In addition, the report should take into consideration and balance any benefits that exist associated with flow-through status. (For high cash-flowing businesses, the flow-through treatment is typically better, but entities that retain all of their cash flows may fare better under C corporation treatment.)

(7) **Settlements**. John Porter has settled a number of these cases, sometimes in a backdoor way. Some examining agents and appeals officers take the position that until *Gross* is overturned, they are not allowing tax affecting. John's approach is that

if the agent is assuming S corporation status in perpetuity (i.e., not considering an entity-level tax), the pool of hypothetical buyers has shrunk substantially because the hypothetical buyer must be a qualified S corporation shareholder. Therefore, the lack of marketability discount should be substantially greater. John has settled a number of cases on that basis. His experience is that the ability to settle these cases depends upon how creative the examining agent or appeals officer is willing to be.

(8) **Impact of Lower Corporate Rates**. The lower C corporation tax rate may have some effect on this issue, but substantial discounts from tax affecting will still exist. John Porter reports that failing to tax affect S corporations results in a 60 to 70% greater value in some cases, and that does not make any economic sense.

(9) ***Estate of Cecil v. Commissioner***. 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. The Tax Court may have a hard time rejecting tax affecting as a matter of law when both experts agree in its application. (Tax affecting is not the only issue in the case.)

(10) ***Kress v. U.S***. Both the taxpayer and government experts tax-affected the earnings of an S corporation, and the court followed that approach in valuing the S corporation stock in *Kress v. U.S.* (E.D. Wis. March 26, 2019). See Item 33 below.

(11) ***Estate of Jones v. Commissioner***. Judge Pugh allowed tax-affecting the earnings of a partnership and of an S corporation. *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101 (August 19, 2019). This may represent a "crack in the 20-year old dam" of the Tax Court's reluctance to recognize tax-affecting. See Item 34 below.

(12) **Law is Evolving on Tax Affecting**. John Porter: "The final chapter in this story has yet to be written." John Pokey: "We may need a Fifth Circuit or Eleventh Circuit case to get the final answer – as with the built-in gains discount cases." Perhaps *Estate of Jones v. Commissioner* will signal that evolution.

k. **Client Must Review Appraisal**. Too many times, preparers of gift or estate tax returns simply report the value that is in an appraisal report on a gift or estate tax return without further review. Not only should planners review appraisals in detail, clients also have an obligation to review appraisals. If something is in the report that the taxpayer knows is wrong, the taxpayer will not be entitled to penalty protection for relying on the report.

The defense to a valuation penalty is that the client has in good faith and reasonably relied on professional advice. An appraisal by a quality appraiser that does not have missing pieces will qualify for the exception from penalties even if the value is ultimately determined to be too low. In addition, the late Judge Laro added in a case that to avoid penalties, the taxpayer must provide necessary and accurate information to the appraiser.

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

(1) **Bona Fide Sale for Full Consideration Defense**. This defense is the key for defending both §2036(a)(1) and §2036(a)(2) cases. Almost every one of these cases that the taxpayer has won was based on the bona fide sale for full consideration exception to §2036. (The three exceptions are *Kelly, Mirowski,* and *Kimbell* (at least as to some assets). See Item 12.e below.)

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

Also, make sure that other planning is consistent with the purposes of the partnership. For example, if the same person is in charge of the partnership, is the agent on the power of attorney, and is the trustee of trust owning other assets, is the partnership really necessary? If one of the reasons for creating the partnership is to involve next-generation family members in the management, don't make them solely limited partners.

Consider documenting the non-tax reasons. Contemporaneous evidence really helps satisfy the court. John Porter has tried seven §2036 cases that have gone to decision and in every one the estate planning lawyer testified and in some the CPA testified as well. If the estate planning attorney testifies, the client will have to waive the attorney-client privilege. The taxpayer is willing to do that because the taxpayer has the burden of proof to establish a legitimate and significant nontax reason. The estate planning attorney's files can significantly help (or hurt) at trial.

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

(2) **Section 2036(a)(1)**. The IRS typically argues that assets should be included under §2036(a)(1) as a transfer to the FLP/LLC with an implied agreement of retained enjoyment. The government wins about 2/3 of those cases. (In some of those cases, the FLP/LLC assets have been included in the estate under §2036 even though the decedent had transferred the partnership interests during life (*Harper, Korby*).)

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

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

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

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

(b) ***Powell* and *Cahill*.** *Powell* (discussed in Item 12.d below) and *Cahill* (discussed in Item 13 below) add a significant additional risk under §2036(a)(2), focusing on whether the decedent could act with third parties to undo whatever is causing a discount. These seem to be the ability to join with others to cause a liquidation of an entity (or termination of an agreement, as in *Cahill*), and would seem to extend to the ability to join with others in amending documents to permit liquidation or termination. (The ability to amend the partnership agreement without consent of limited partners was one of the factors that the court mentioned in *Turner I* for applying §2036(a)(2)). One possible response is to provide in the underlying agreements that the decedent owns a class of interest that does not permit joining with others to liquidate the entity or amend the agreement. Query whether the absence of a right to vote on liquidation or amendment would be a §2703 restriction that is ignored under the *Cahill* reasoning?

Other cases have limited the broad application of the "in conjunction with" argument relied on in *Powell* and *Cahill*. (See Item 12.d.(5) below for a discussion of the *Helmholz*, *Tully*, and *Bowgren* cases.) The taxpayer in *Morrissette* made these arguments (so far, unsuccessfully) in that pending Tax Court case (set for trial October 7, 2019), as discussed in Item 13.c.(6) below.

(c) **IRS Agents Are Making the *Powell* Argument**. John Porter tried *Estate of Wittingham v. Commissioner* in February 2018. The case was ultimately settled, but the IRS made the *Powell* argument with respect to an LLC created by the decedent,

in which the decedent and her two sons were the managing members and held the Class A units with voting rights. The case involved the sale of units in return for a private annuity even though the decedent had just found out that she had pancreatic cancer. The case ultimately settled with the taxpayer conceding that some prior purported loans were gifts and conceding about 20% of the private annuity issue because of uncertainty about some medical issues.

m. **Defined Value Clauses**.

(1) **Overview**. Defined value clauses use a formula to allocate assets that are transferred, with a certain value passing for family members and the excess that was transferred passing to another (non-taxable) person or entity (*see McCord*, *Hendrix*, *Christiansen*, *Petter*). Alternatively, a specified dollar amount of units of an asset may be all that is transferred (*see Wandry*). Another alternative is a price adjustment clause, which would revise the note given to the transferor if the value is later re-determined for transfer tax purposes (*see King*). 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.bessemertrust.com/for-professional-partners/advisor-insights**.

(2) **Strongly Recommended.** John Porter strongly recommends using defined value clauses when doing planning with hard-to-value assets. "It truly does serve as a poison pill to an IRS audit and an attempt to assess gift taxes."

(3) **Caution Using *Wandry* Clause with Partnership**. If values are re-determined for transfer tax purposes with a *Wandry* clause, certain units will end up not being transferred and remain with the transferor. If partnership units are being transferred, the IRS might conceivably argue that the retained right (i.e., of certain units not being transferred) is a §2036 issue. Arguably, using a *Wandry* clause with a family partnership leaves additional §2036 exposure.

(4) **Operations**. (1) Determine the appropriate type of defined value clause. (2) Gift tax return reporting should be consistent, reflecting the transfer of a formula amount rather than a particular number of shares, although the return could recite that "based on the appraisal attached to this return, __ units have initially been allocated to the transfer." (3) Other outside documentation should also be consistent, including transfer documents, amendments to partnership or LLC agreements and acknowledgments of other partners/members to the transfer. Because the IRS has lost these defined value cases in court, IRS examiners look for ways to get around the case law, and one of their approaches is to show that the taxpayer did not respect the integrity of the entity or the operation of the clause.

(5) **Income Tax**. Consider filing protective claims for refund of income taxes. If a transfer is made using a *Wandry* clause to a grantor trust, this is not critical, because all of the income is reported to the grantor in any event. However, if a *Petter* type clause is used, the protective claim for refund of income taxes is very important.

(6) **Settlement Effects**. John Porter says "We've been able to settle a lot of cases with the Service where the clauses are respected – *Wandry* clauses, price adjustment clauses, certainly *Petter*-type clauses. A lot depends on who the examining agent is and how willing they are to resolve the case creatively. Some examining agents will say that the government is still challenging *Wandry* and I'm not

going to respect it. But even if the examining agent refuses to respect the clause, it gives you something else to argue for a greater valuation discount or concession of other issues. We have certainly seen that in practice. In many many cases they are respected by the Service when you are settling valuation issues."

n. **Defined Value Clauses; Settlement of *True* Case**.

(1) **Case Synopsis**. Mr. True made gifts of interests in a family business to one of his daughters and made sales of the business interests to all of his children and a trust. The transfers were made based on an appraisal from a recognized reputable national appraisal firm. The transfers to his children were subject to a "transfer agreement" with a defined value/price adjustment provision. The spouses made the split gift election, so any gift was made one-half by each spouse; hence separate Tax Court petitions for Mr. and Mrs. True.

A gift of units in the family business was made to one daughter (Barbara True), and the transfer agreement provided that if the transfer of those interests is determined for federal gift tax purposes to be worth more than the anticipated $34,044,838 amount of the gift, "(i) the ownership interest gifted would be adjusted so that the value of the gift remained at $34,044,838, and (ii) Barbara True would be treated as having purchased the ownership interests that were removed from her gift."

Sales of business interests were made to that daughter, the other two children, and a trust. According to the petition, the transfer agreement for the sales to his children "provided that if it is determined for federal gift tax purposes that the interests sold were undervalued by FMV Opinions, the purchase price would be increased to reflect the finally-determined fair market values."

The IRS alleged a gift tax deficiency of $16,591,418 by each of Mr. and Mrs. True. The taxpayers contended that the valuations were correct, but if the transferred interests were determined to have a higher value, no gift should result because of the price adjustment provisions in the transfer agreement. *Karen S. True v. Commissioner,* Tax Court Docket No. 21896-16, and *H.A. True III v. Commissioner*, Tax Court Docket No. 21897-16 (petitions filed October 11, 2016).

(2) **Settlement**. The IRS alleged additional gift tax from each parent of about $16.6 million. Stipulated decisions were filed in both cases in July 2018 reflecting a gift tax efficiency for each parent in the amount of $2,004,322.00.

This would seem to represent a very favorable settlement from the taxpayer's perspective. The real impact cannot be discerned from the extremely short stipulated decision filed in the docket in each of these cases. While the gift tax deficiency is much less than alleged by the IRS, other accommodating adjustments may also have been made, for example documenting that some of the gift shares to Barbara under the *Wandry* clause may not have actually been transferred and the notes may have been adjusted significantly, both of which would mean that more value is in the parents' estates subject to future transfer taxation.

That more value may be included in the parents' estates because of note adjustments is merely a valuation issue, however. The point of the defined value clauses is to cap the amount of current gift taxes due with respect to intended

transfers, and except for the relatively small settlement amounts, that was accomplished. To understand how big of an accomplishment that is, reflect back on the overall picture of what was transferred and the potential gift tax risks involved.

(3) **Significance of Settlement in Capping Current Gift Tax Outlay (Almost) on Well Over $160 Million of Transfers**. The case involved a gift from Mr. True to a daughter of about $34 million with a *Wandry*-like clause (with provisions for a note to be given representing any excess value of the units transferred), and Mr. True sold assets having an appraised value of $128 million (plus additional assets were sold to another trust, the value of which is not stated in the petition). Because of the split gift election, any resulting gift was made one-half by each of the spouses. Thus, the total transfers were $162 million ($128 million + $34 million) plus an additional amount sold to a trust. The gifts were made in 2012 when the gift tax rate was 35%.

The IRS determined that the transfers resulted in additional gifts by the parents collectively of $94,808,104 resulting in additional combined gift taxes of 35% of that amount, or $33,182,836. That is precisely the horror show that the parents wanted to avoid by using the defined value clauses. And indeed, the clauses did work to a very large extent, because they ended up paying only an additional $4,008,642 (combined) of gift tax. The taxpayers no doubt viewed an additional current outlay of about **$4 million rather than $33 million** as a **huge victory**!!

How much of that was simply the result of valuation compromises or reductions under the defined value clauses is unknown, but making transfers of hard-to-value assets worth well over $160 million and limiting the additional gift tax outlay to just $4 million must have been viewed as a huge victory.

12. Family Limited Partnership and LLC Planning Developments; Powell v. Commissioner; Estate of Streightoff v. Commissioner; Estate of Turner v. Commissioner (Turner III)

a. **Section 2036 Issues**. The application of §2036 to assets contributed to an FLP/LLC is a frequently litigated issue (with over 30 reported cases, listed in Item 12.e below). Various §2036 issues are discussed in Item 11.l above.

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

b. **Other Issues – §2703 and Indirect Gift.** Other issues that the IRS sometimes raises in audits regarding FLP/LLCs are (1) whether specific restrictions in partnership agreements should be ignored for tax purposes under §2703 (*see Holman* and *Fisher II*) and (2) whether contributions to an FLP/LLC immediately followed by gifts of interests in the entity should be treated as indirect gifts of the underlying assets of the entity (*see Holman, Gross, Linton,* and *Heckerman*).

c. **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 12.h below (updated with the result from the recent *Streightoff* case).

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

(1) **Synopsis.** *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 were surprising (but whether a majority of the judges would apply the double inclusion analysis is not clear).

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. The court held that any such fiduciary duty here 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 limited partner "in conjunction with" all of the other partners could dissolve the partnership at any time.

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.

For an excellent discussion of the *Powell* case, see Todd Angkatavanich, James Dougherty & Eric Fisher, Estate of Powell: *Stranger Than* Strangi *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 and planning implications of *Powell*, see Item 15.g of the Current Developments and Hot Topics Summary (December 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(2) **Significant Extension of Application of §2036(a)(2) to Retained Limited Partnership Interests.** As noted above, *Powell* is the first case to apply §2036(a)(2) when the decedent merely owned a limited partnership interest.

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 a contribution 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) **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 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.

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 discounted 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).

(4) **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 "double inclusion" 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 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 63RD 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 in 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 keeps 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.)

(5) **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 in a trust agreement to terminate the trust with the consent of all beneficiaries was not a power to revoke, alter, or amend the trust in conjunction with others because state law conferred the right to terminate a trust with the consent of all beneficiaries, and the trust provision "added nothing to the rights which the law conferred." *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.

Another example is *Estate of Bowgren v. Commissioner*, T.C. Memo. 1995-447, *rev'd and remanded on other grounds*, 105 F.3d 1156 (7th Cir. 1997). In *Bowgren*, the decedent transferred real estate to a land trust and later gave beneficial interests in the trust to her children. The court held that when

> the only method by which the decedent could have terminated or modified the beneficial interests of the children was to act not by herself … but as a beneficiary with the unanimous consent of the children, i.e., all the other beneficiaries … [s]uch a power is not a retained power under section 2036(a)(2), see Stephens, Maxfield, Lind & Calfee, Federal Estate and Gift Taxation 4-148 n.52 (6 th ed. 1991), and is a power to which section 2038(a) does not apply, see sec 20.2038-1(a)(2).

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.

e. **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);

(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 *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 Mille*r *v. Commissioner*, T.C. Memo 2009-119 (as to transfers made 13 days before death but not as to prior transfers), *Estate of Malkin v. Commissioner*, T.C. Memo 2009-212, *Estate of Holliday v. Commissioner*, T.C. Memo 2016-51, *Estate of Beyer v. Commissioner*, T.C. Memo 2016-183, 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.***

(1) **Synopsis**. *Turner I* held that assets in a limited partnership were includible 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 expressed an intent that the marital deduction should not be reduced by estate tax liabilities.

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).

For a summary of the basic facts of the case and the court findings and reasoning in Turner I and Turner II, see Item 6.f of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(2) ***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 lifetime gifts of partnership interests 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 includible 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 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 I* 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).***

(1) **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).

(2) **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 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.

(3) **Analysis**.

(a) **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.

(b) **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 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.

(c) **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.

(d) **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.

(4) Observations.

(a) **Assignee Valuation by Merely Transferring to Revocable Trust?** 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.

(b) **Substantial Marketability Discount on These Facts.** 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.

h. **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 FLP/LLC cases as follows (the *Streightoff* and *Estate of Jones* case results have been added to the table):

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Strangi I	securities	Tax	31%
Knight	securities/real estate	Tax	15%
Jones	real estate	Tax	8%; 44%
Dailey	securities	Tax	40%
Adams	securities/real estate/minerals	Fed.Dist.	54%
Church	securities/real estate	Fed. Dist.	63%
McCord	securities/real estate	Tax	32%
Lappo	securities/real estate	Tax	35.4%
Peracchio	securities	Tax	29.5%
Deputy	boat company	Tax	30%
Green	bank stock	Tax	46%
Thompson	publishing company	Tax	40.5%
Kelley	cash	Tax	32%
Temple	Marketable securities	Fed. Dist.	21.25%
Temple	ranch	Fed. Dist.	38%
Temple	winery	Fed. Dist.	60%

Astleford	real estate	Tax	30% (GP); 36% (LP)
Holman	dell stock	Tax	22.5%
Keller	securities	Fed. Dist.	47.5%
Murphy	securities/real estate	Fed. Dist.	41%
Pierre II	securities	Tax	35.6%
Levy	undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Giustina	timberland; forestry	Tax	25% with respect to cash flow valuation (75% weighting to cash flow factor and 25% weighting to asset method); BUT reversed by 9th Circuit and remanded to reconsider without giving 25% weight to asset value
Koons	securities	Tax	7.5%; Estate owned 70.42% of vote and could remove limitation on distributions
Gallagher	publishing company	Tax	47%
Streightoff	securities	Tax	0% lack of control discount because the 88.99% LP interest could remove the general partner and terminate the partnership; 18% lack of marketability discount
Jones	Sawmill & timber	Tax	35% lack of marketability discount from noncontrolling interest value

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

13. 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* and *Estate of Morrissette v. Commissioner*

a. ***Cahill*** **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), and 2703(a) did 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 conceded as to the value of certain notes from family members unrelated to the split dollar transaction.

b. **Basic Facts and Court Analysis**. For a summary of the basic facts and the court's analysis, see Item 7 of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

In addition, also see Item 7 of that summary for a brief background about intergenerational split dollar agreements, other equitable tax doctrine issues that the IRS might raise, reasons that loan regime intergenerational split dollar agreements might be preferable but still risky, and the income tax effects of discounting notes.

c. **Observations**.

(1) **"Hogs Get Slaughtered**." The case exemplifies the "pigs get fat, hogs get slaughtered" mantra. For various reasons, the *Cahill* case does not present a sympathetic fact situation.

(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 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 transfers 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 In Item 12.d above. 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. *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 Item 12.d.(5) above for a discussion of the *Helmholz*, *Tully*, and *Bowgren* cases that limited the application of the "in conjunction with" clause.

The court may not view the *Helmholz*, *Tully*, and *Bowgren* 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. Even so, the authority to terminate the contract "added nothing to the rights which the law conferred" on all of the parties to terminate a contract, and the "in conjunction with" clause would seem not to be applicable under the Supreme Court's reasoning in the *Helmholz* case.

(4) **Ramifications of the §2703(a) Analysis**. Section 2703(a) describes the *general rule* that if any "property" is (1) subject to an agreement or restriction allowing someone to acquire or use the property for less than fair market value, or (2) subject to a restriction on 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 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.

The court rejected the estate's analogies to loans and partnership interests, as discussed in Paragraph (5) of Observations in Item 7 of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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).

(5) **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) 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.

(6) **Similar Arguments Regarding §§2036, 2038, and 2703 and Motions for Partial Summary Judgment in *Estate of Morrissette v. Commissioner*.** The initial case in *Estate of 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 denying the taxpayer's motion for summary judgment that §2703(a) was inapplicable, observing that "the termination restriction prevented the decedent from terminating the split-dollar arrangements unilaterally and receiving repayment of the premium or, if greater, the policy's cash surrender value," and concluding that "[t]he restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2)." Order in Docket No. 4415-14 (June 21, 2018 (Judge Goeke). The Order observed that the IRS had also raised §§2036 and 2038 as alternative arguments. The *Morrissette* case was scheduled for trial on May 6, 2019, but the trial has been postponed until October 7, 2019 (in Washington, D.C.) while the court is resolving disputes about discovery requests. The IRS filed a motion for partial summary judgment on November 21, 2018, and the estate on January 15, 2019 filed its response in opposition to the IRS motion and its own cross motion for partial summary judgment that §2036(a)(2), 2038(a)(1), and 2703(a) do not apply.

The taxpayer's Memorandum in support of its motion emphasizes the prior cases that have limited the broad application of the "in conjunction with" clause to rights already provided by state law. The Memorandum makes strong arguments, and portions of the memorandum are quoted at length.

> [T]he Supreme Court examined whether section 302(c) of the 26 Act (i.e., predecessor to section 2038) applied as a result of the existence of a termination provision in a trust agreement in Helvering v. Helmholz, 296 U.S. 93 (1935). In 1918, Mrs. Helmholz and members of her family agreed to convey to a trustee all of their shares of stock in their family business. Id. at 94. The dividends from the shares Mrs. Helmholz contributed were payable "to Mrs. Helmholtz for life, remainder to her appointee by will and remainder to her issue." Id. The trust agreement contained a termination provision whereby "upon delivery to the said trustee of a written instrument signed by all of the then beneficiaries, other than testamentary appointees, declaring said trust term at an end," "[t]he term of the primary trust … shall end." Id.
>
> The Service determined that, in light of the right Mrs. Helmholz retained to terminate the trust in conjunction with all the other beneficiaries, section 302(d) of the 26 Act requires that Mrs. Helmholz's gross estate include the value of the transferred shares. …
>
> …
>
> The Supreme Court disagreed, holding that the "argument overlooks the essential difference between a power to revoke, alter, or amend, and a condition which the law imposes." Id. As a general rule, all the parties in interest may agree to terminate a trust. Thus, "[t]he clause in question added nothing to the rights which the law conferred." Id. Accordingly, "Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust." Id. …
>
> Helmholz specifically provides that if a right to terminate a contract or an arrangement is provided by law, then the incorporation of such right into an agreement grants the parties thereto nothing more than that which the law confers. [Citing Leo W. Leary, *Termination of Inter-Vivos Trusts Under State Law and the Internal Revenue Code Section 2038*, 47 MARQ. L. REV. 323 (1964).] Respondent cannot rely upon such right as the basis to pull back transferred property into the transferor's estate, notwithstanding the fact that the statute authorizes such pull-back if the right is exercised by the transferor either "alone or in conjunction with any person."
>
> In this case, the Split Dollar Agreements provide both parties to the Arrangement the right to agree to terminate the Arrangement. Under common law, a contract may be formed only with the mutual assent of the parties. Similarly, a contract may be terminated with the mutual assent of the parties. Accordingly, the ability of all the parties to a Split-Dollar Agreement to terminate the arrangement is a right conferred by law. Under Helmholz, such right cannot be the basis for pulling the property transferred by the CMM Trust back into Mrs. Morrissette's estate.
>
> While Helmholz addressed the predecessor to section 2038, its rationale is equally applicable to section 2036(a)(2), because both provisions (i) were part of section 302 of the 26 Act, (ii) contain the same phrase "alone or in conjunction with any person," and (iii) addressed the same subject matter (i.e., pullback of inter vivos transfers). In Estate of Bowgren v. Commissioner, [T.C. Memo. 1995-447, *rev'd and remanded on other grounds*, 105 F.3d 1156 (7th Cir. 1997)] the decedent transferred real estate to a land trust and then gifted beneficial interests in the trust to her children. The court held that when "the only method by which the decedent could have terminated or modified the beneficial interests of the children was to act not by herself … but as a beneficiary with the unanimous consent of the children, i.e., all the other beneficiaries… ***[s]uch a power is not a retained power under section 2036(a)(2)***, see Stevens, Maxfield, Lind & Calfee, Federal Estate and Gift Taxation 4-148 n.52 (6th ed. 1991), and ***is a power to which section 2038(a) does not apply***, see sec. 20.2038-1(a)(2)." Bowgren, T.C. Memo. 1995-447 (emphasis added). Petitioners' Memorandum of Law in Support of Petitioners' Response in Opposition to Respondent's Motion for Partial Summary Judgment and Petitioners' Cross Motion for Partial Summary Judgment and Petitioners' Cross-Motion for Partial Summary Judgment, Docket 4415-14, at 29-31(filed January 15, 2019).

Similarly, the taxpayer's Memorandum in support of its cross motion for partial summary judgment argued that the restriction on the trust's right unilaterally to terminate the split dollar agreements is provided under common law and is not a basis for applying §2703.

> Petitioners disagree with the finding that the CMM Trust had a "right" to terminate the Split-Dollar Agreement that was being restricted by the Termination Provision. As discussed supra in connection with sections 2036(a)(2) and 2038, all the parties to a contract must agree in order for there to be a valid and binding contract. Similarly, a contract may be terminated if all the parties to such contract agree. Accordingly, the Termination Provision merely incorporates the parties' existing common-law rights, namely, all the parties to a contract may jointly terminate such contract. According to the rationale of Helmholz, a restriction imposed by law cannot be the type of restriction that is disregarded under section 2703. This rationale is supported by Church v. United States, [85 A.F.T.R.2d 804 (W.D. Tex. 2000), *aff'd without pub. Opinion*, 268 F.3d 1063 (5th Cir. 2001)] where the District Court, in rejecting the Government's contention that section 2703(a) would disregard the term restriction in the partnership agreement, stated:
>
> > No case supports the Government's position, and nothing in the legislative history, or the regulations adopted by the IRS itself, convince this Court to read into Section 2703 something that is not there….**Term restrictions**, or those on the sale or assignment of a partnership interest that preclude partnership status for a buyer, **are** part and parcel of the property interest **created by state law**. **These are not the agreements or restrictions Congress intended to reach in passing I.R.C. [section] 2703**. Reviewing the legislative history, and construing I.R.C. [section] 2703 with its companion statute, I.R.C. [section] 2704, **it is clear that the former was intended to deal with below-market buy-sell agreements and options that artificially depress the fair market value of property subject to tax, and are not inherent components of the property interest itself.** [Id. at 811 (emphasis added)]
>
> Cahill attempted to distinguish a split-dollar arrangement, such as the one in this case, from Church and Strangi, which involved partnerships, based on the existence of a state law entity. However, a careful reading of both cases revealed that their holding is not conditioned upon the existence of a state law entity. In addition, the implication of Cahill is that every contract that has any effect on the value of property in which the decedent had any direct or indirect interest must either (i) provide a unilateral termination right (which would make the contract practically worthless), or (ii) satisfy the exceptions set forth in section 2703(b). If Congress intended to test every contract under section 2703(b), it would have made section 2703(b) the general rule rather than the exception. Finally, Cahill directly contradicts the legislative intent found in Church—that section 2703 was only intended to deal with below-market buy-sell agreements and options (rather than every contract without a unilateral termination right).
>
> The restriction on CMM Trust's ability to unilaterally terminate the Split-Dollar Agreements is provided under common law; therefore, the provision in the Split-Dollar Agreements to the same effect cannot be the basis for applying section 2703(a). Petitioners' Memorandum of Law in Support of Petitioners' Response in Opposition to Respondent's Motion for Partial Summary Judgment and Petitioners' Cross Motion for Partial Summary Judgment, Docket 4415-14, at 42-43 (filed January 15, 2019).

The court entered an Order dated February 19, 2019 denying the taxpayer's motions for summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) do not apply. The court merely reasoned that *Estate of Cahill* "is directly on point" as to §§ 2036(a)(2) and 2038(a)(1) but denied the IRS's motion for summary judgment because a material factual dispute exists concerning the issue of full and adequate consideration. The Order made no mention whatsoever of the taxpayer's analysis of cases that placed outer limits on the application of the "in conjunction with" provisions in §§2036(a)(2) and 2038. Similarly, the Order denied the taxpayer's motion for summary judgment that §2703(a) did not apply based on *Estate of Cahill* and denied the IRS's motion for summary judgment that §2703 applied because a

genuine dispute of material fact exists as to whether the transfers were a device to transfer property to members of decedent's family for less than full and adequate consideration.

*T*he IRS has made a discovery request in *Morrissette,* for copies of all communications related to the split-dollar arrangements and all documents regarding the purposes for which the decedent and her family entered into the split-dollar arrangements. The taxpayers responded by sending a 96 page privilege log identifying 1,642 documents that were being withheld pursuant to the attorney-client privilege and the attorney work product doctrine. The IRS on February 26, 2019, filed a Motion to Compel Production of Documents in which it maintains that the taxpayer "has waived the attorney-client privilege and attorney work product protection by placing at issue (1) whether the Split-Dollar Arrangements were bona fide sales for adequate and full consideration [for purposes of §§2036(a)(2) and 2038], (2) whether the Split-Dollar Arrangements were bona fide business arrangements [for purposes of §2703(b)(1)], and (3) whether the Split-Dollar Arrangements are devices that transfer property to members of the Decedent's family for less than full and adequate consideration [for purposes of §2703(b)(2)]." The IRS position is that the waiver would similarly be implied if the taxpayer were to argue that penalties should not apply because of reasonable reliance on tax professionals. In support of its implied waiver of attorney-client privilege argument, the IRS cites *Johnston v. Commissioner*, 119 T.C. 27, 36, *supplemented sub nom. Johnston v. C.I.R.*, 122 T.C. 124 (2004), *aff'd*, 461 F.3d 1162 (9th Cir. 2006), and *Ad Investment 2000 Fund LLC v. C.I.R.*, 142 T.C. 248, 254 (2014). In support of waiver of the attorney work product doctrine claim, the IRS cites *Eaton Corporation & Subsidiaries v. Commissioner*, Docket No. 5576-12, Order dated May 11, 2015. The court heard oral arguments about the discovery request issues on May 8, 2019, and Tax Court Judge Joseph Robert Goeke ordered the attorneys to "narrow their arguments for a later time." Carolina Vargas, *IRS, Morrissette Estate Must Trim Arguments in Document Row*, BNA BLOOMBERG DAILY TAX REPORT (May 8, 2019). The parties filed additional memoranda, the court addressed some of the discovery issues in an order of July 8, 2019, and a hearing was held on discovery issues on August 13, 2019. The court denied respondent's motions to compel production of documents and to compel responses to interrogatories on September 24, 2019.

The trial was held October 8-11, 2019. Apparently the primary issues for the trial were (1) whether the bona fide sale for full and adequate consideration exception under §§2036(a)(2) and 2038(a)(1) applies, (2) whether the transfers were a device to transfer property to members of decedent's family for less than full and adequate consideration under §2703(b), and (3) whether the 20% accuracy related penalty under §6662 applies. Following the trial, the trial judge (Judge Goeke) purportedly said "I look forward to your briefs because for me this is going to be a hard case."

The taxpayers argued that the life insurance purchase arrangement was a bona fide sale or business transaction that provided funding for a buy sell agreement (each of decedent's three sons' trusts owns life insurance on the lives of the other two sons, and the life insurance would be used to fund a buy sell agreement requiring the surviving sons to purchase a deceased son's interest in family businesses (which included Interstate Van Lines)). The IRS responded that the primary motivation for the split-dollar arrangements was saving millions of dollars of taxes. One of the sons

testified that the purpose of the arrangement was to help the surviving sons buy a deceased son's interest in the family company and that the policies paid a better return than the family was obtaining by having the $30 million premium amount sit in investment accounts.

The trials also included evidence about whether the transfers from the decedent were for full and adequate consideration.

For a brief summary of the arguments and evidence from the four-day trial, see Aysha Bagchi, *$30 Million Estate Tax Case Going to be 'Hard,' Judge Says*, BLOOMBERG DAILY TAX REPORT (October 15, 2019).

(7) **Major Blow to Intergenerational Split Dollar Plans**. The *Cahill* decision (and the capitulation of the taxpayer in the settlement of the case) is a major blow to the desired extremely advantageous tax treatment of intergenerational split dollar plans. 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).

Ron Aucutt's Top Ten List of 2018 Estate Planning Developments (his report is available **here** (from the ACTEC "Capital Letters" webpage)) concludes that this is "Crunch Time for Intergenerational Split-Dollar Arrangements."

(8) **Other Pending Intergenerational Split Dollar Cases; Potential Attacks**. 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 in which the decedent was merely entitled to reimbursement of the fixed amount of the advanced premiums (or the cash surrender value if greater) without interest. 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.

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.* Arguments made in the taxpayer's motion for summary judgment in *Morrissette* are discussed above in Item 13.c.(6) above.

The Tax Court trial in *Levine* was held in November, 2017, and the post-trial briefs have been filed. *Levine* thus may 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 situations 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.

For a discussion of the IRS attacks under various other equitable tax doctrine general arguments, see Item 27.f.(2) of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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).

(9) **Loan Regime Intergenerational Split Dollar Arrangements**. The IRS so far generally has not been emphasizing audits of loan regime arrangements, and taxpayers may have stronger arguments than for equity split dollar arrangements. Discounts on the reimbursement right may be less but still significant. 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 Sections 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.").

14. Evolutionary Planning – Practice Ideas (Non-Tax) to Increase Client Happiness and Planners' Happiness

Lou Harrison (Chicago, Illinois) and Nancy Hughes (Birmingham, Alabama) discussed a presentation titled "Evolutionary Planning: 20 or So Ways to Increase Client Happiness and Value to Your Practice with Planning Techniques (Non-Tax) and Strategic Practice Techniques."

Estate planning practices must constantly evolve to bring added value to clients and address what is really important to them.

a. **Focus on What the Client Cares About**. Lou said that an old Gary Larson "Far Side" comic illustrates the point. In the first frame, the owner says to his dog, Ginger: "I have a new bowl for you with really good dog food. Ginger, I want you to eat that dog food then go outside and do your business." The next frame is what the dog hears: "Blah blah blah, Ginger, blah blah blah blah." When lawyers are going through the estate tax discussion with clients, the clients may often be are thinking "blah blah blah John blah blah blah." But Lou says that when planners talk about trusts for client's children and that we are going to protect those assets from the children's spouses in the case of a divorce, now the clients look at the attorney and think "Lou, not only are you an old and wise practitioner, but you need to charge me way more, because that's exactly what I want."

b. **What Clients Really Care About**. Every client who comes to see a planner for estate planning has micro objectives, but the macro objective of every client is to make sure that the assets go to the beneficiaries and are used to enhance their beneficiaries' lives and purposes.

   And that the assets not go to predators – like taxing authorities (we're good at that), and even more important, the other predators such as children's spouses, people who sue your children, evil PI attorneys, mean-spirited lending institutions that default children's debts, and fraudsters.

   And avoid the improper use of funds that destroy the children's purposes and motivation.

   That's what clients really want. And we know how to do that.

c. **Creative Structuring of Trusts.** Do not leave assets outright to children but use trusts creatively to achieve spousal protection, creditor protection, and enhanced purpose in the lives of beneficiaries, while providing flexibility to accommodate changing situations. "That's what we need to be focused on as estate planners."

d. **Simplified Sophistication Versus Complicated Unintelligibility.** Estate planners are incredible draftsman because every word translates into dollars for some and no dollars for others. Our trust documents are incredible complicated masterpieces. So is Ulysses by James Joyce – but no one has ever read that. And unfortunately, to be honest, our documents are not read or understood by our clients. Simplify wherever possible.

   Since 2012, a way to have simplified sophisticated tax planning in our documents is to use a single QTIP trust approach in wills and revocable trusts. The document itself is simple, and leaves open the flexibility to have sophisticated tax planning after the first spouse has died.

e. **Family Meetings**. Family meetings are a way to bring great value to clients, and increasingly, estate planners are leading those meetings. They can become a significant part of planners' practices. See Item 15 below.

f. **Avoid (or Fire) Bad Clients; Lou's 90/10 Rule**. We are all familiar with the 80/20 rule that 80% of revenue comes from 20% of clients. Lou's 90/10 rule is that 90% of our aggravation in our practice life comes from 10% of our clients, that is, bad

clients or bad projects. Avoiding those 10% of clients can increase the planner's happiness "but this means we have to be strong and not select those 10% clients or matters."

> Usually, listening carefully during the initial telephone call, or sending out a questionnaire and reviewing that carefully, will provide clues as to client matters for which a "no" should be immediate.
>
> Examples are common place, such as being the prospective client's third attorney in a representation: "I didn't love them, but in 5 minutes, Lou, I know you are my guy." Hmmm. This was usually the kind of statement heard on a date when I would excuse myself to go to the bathroom, detour and exit through the kitchen, and begin changing my phone number.
>
> Other clues are a bit more subtle, but if we pay attention to the clues, we can do well to avoid certain representations. At the initial meeting, listen carefully to the buzz words and concepts that will make you want to dismiss a potential client. These include the ones on the list below:
>
> i. The prospect has had too many lawyers before you, and may even refuse to name them. Or, worse, wants to consult with you about how and why he should not pay his prior attorney.
>
> ii. The prospect thinks all previous lawyers were "idiots," or makes otherwise derogatory statements about lawyers in general.
>
> iii. The prospect cannot demonstrate he/she can pay for the cost of your services, balks at paying a retainer, and/or asks for a special reduced rate or payment terms up front.
>
> iv. WANTS TO BE NOT JUST A PRIORITY, WHICH ALL CLIENTS ARE, BUT THE SOLE AND PRIMARY PRIORITY. WITH THESE CAPS, DOES IT SOUND LIKE I AM SCREAMING AT YOU? SORT OF LIKE HOW THIS CLIENT MAY SOUND.
>
> v. You do not agree with the prospect's legal position.
>
> vi. You do not believe the prospect is being truthful.
>
> vii. The prospect is VAV (vindictive, angry and vengeful).
>
> viii. The prospect is a family member.
>
> ix. The prospect indicates they know the law and what they want to do, and just wants the attorney to do the front end work for them.

Bad clients can be fired, but follow ethical requirements in doing so. ABA Model Rule 1.16(b) is the ethical rule governing the voluntary termination of the attorney/client relationship. The engagement letter can build in provisions about being able to withdraw from representation for non-payment of invoices or for any reason. (Example: "*If at any time we desire to withdraw from this engagement, we may do so with written notice to you.*") A notice to withdraw from representation should provide the client with adequate time to engage a new lawyer, include a refund of any advance fees, identify filing deadlines, recommend that a new lawyer be engaged, and include delivery of the client's file (with the attorney retaining an electronic copy). Special procedures are required for withdrawing from representation in the litigation context.

> We are not indentured servants. Put another way, we do NOT have to continue representing clients if we do not want to do so. We can fire clients who complain about our bills, clients who complain about our timetable, and clients who are rude to our staff. *In a nutshell, we can fire clients we just don't like (bless their hearts).*

g. **Happiness Axioms**. Lou and Nancy presented "Happiness Axioms" as ways to bring added value to clients and also to improve the planner's professional practice and happiness. This summary quotes them verbatim (with added subtitles for each), with Lou's and Nancy's consent.

(1) **Axiom 1 – Build Flexibility for Modifying Trusts**. "When clients hear the words 'irrevocable and unamendable' they will nevertheless ask you in about T years to change their irrevocable trust. Coupled with exponential changes in technology, expected changes in tax laws, cultural changes, investment, wealth, and attitudes towards charities and money-with-children, documents should build in safety valves to change irrevocable trusts."

(2) **Axiom 2 – Focus on Discretionary Provisions For Bolstering Spendthrift Protection. "**Focus on the discretionary provisions in a trust in determining creditor protection, rather than relying solely on the spendthrift provision for any great creditor protection. For example, as a rule of thumb, a purely discretionary trust, with no mandatory income interest, has in effect more relevant creditor protection than a mandatory income trust coupled with the typical spendthrift provision."

(3) **Axiom 3 – Dealing With Beneficiaries' Creditors**. "Using the spendthrift provision, in the event that there are creditors, the trustee can undertake two approaches. First, discuss a compromise on the debt with the creditor since the creditor may be waiting a long time for a distribution to the beneficiary; that compromise could be twenty or thirty cents on the dollar. And second, without a compromise, consider making all distributions 'for the benefit of' (to third parties) the beneficiary while, at the same time, allowing the beneficiary to enroll in the FBI witness protection program for relocation."

(4) **Axiom 4 – Protecting Trust Assets From Being Treated as Marital Property**. "Third-party created trusts are intended to preserve separate property as separate property. Those trusts should be effective for those purposes, even under evolving (unfortunately and incorrectly) statutes eroding a certain amount of protection. Judges may look at these trusts in providing equitable reasons for giving the non-moneyed spouse, the other spouse, a greater share of marital property, or increased maintenance amounts. And these trusts may be accessible to pay for unpaid maintenance obligations. To increase protection of these trusts, consider moving the situs and trusteeship of the trust to a jurisdiction that is more protective of these trusts, say Alaska, Delaware or Nevada; and avoid California or Minnesota, for example."

(5) **Axiom 5 – Eliminate Withdrawal Powers to Shield Trusts From Creditors**. "Because powers of withdrawal or general powers of appointment (express) will under case law allow creditors to access that power, see, e.g., *Frisch*, eliminate lifetime powers in these trusts for a beneficiary."

(6) **Axiom 6 – Use "May" vs. "Shall."** "In drafting the discretionary standard for distribution, make sure to use the word 'may' after trustee, versus 'shall.' Also, given the Illinois *McCoy* case, I am not as focused on ascertainable standards as I am on who is the trustee. Therefore, revert to an unascertainable standard in most of these trusts. In various Illinois cases, including *McCoy v. McCoy*, 274 B.R. 751 (2002), and *Hawley v. Simpson*, (Bankruptcy Court, CD Ill. No. 02-83674-2004), the courts have focused on the fact that the beneficiary was trustee with access to trust funds and the ability to control the timing or manner of distributions."

(7) **Axiom 7 – Use Completely Discretionary Trusts**. "Consider an evolution to a completely discretionary trust. The world of thoughtful trust standards has paradoxically tipped in a toxic direction. In those cases in which the grantors wanted a HEMS standard, a rather limited one related to health, education, support and maintenance, somehow courts have focused on the 'support' aspect of this to achieve rather unintended consequences from the grantor's perspective, especially in the creditor world. Accompany unlimited grantor discretion with careful trustee selection (committee of trustees) and precatory letters of intent."

(8) **Axiom 8 – Avoid Beneficiary as Sole Trustee**. "Going forward, try to have the creditor protection trust for a G2 have both the G2 plus another as co-trustees. If not achievable, live with the G2 as sole trustee and recognize that there may not always be complete creditor protection."

(9) **Axiom 9 – Portability Reduces Need for Spousal Asset Transfers**. "With portability, the absolute funding requirement for each spouse to have $11 million is reduced. Now the practitioner can focus a bit more on the effects of divorce on a change of titling, and perhaps not shift title as often as we used to have to. We suspect that changing title to assets for future testamentary funding will be occurring less frequently in the future."

(10) **Axiom 10 – Pay Attention to 90/10 Rule**. "Life is short and should be accompanied by smiles, not frowns. We are in control of this emotion and adherence to the 90/10 rule will have a strong influence on getting us to the happy face**.**"

(11) **Axiom 11 – Use Billing Best Practices**. Best billing practices are summarized.

1. Discuss fees during the initial meeting
2. Time that discussion for the tail end of the meeting
3. Determine a fee quote at the first meeting
4. Deliver fee quote in a thought out manner and make sure you believe in and deliver the quote in a way conveying fairness
5. Have client provide down payment or retainer before engagement begins
6. Understand that Fairness matters to clients – clients want to pay for services that they perceive as Fair
7. Many estate planning projects will be perceived as Fair if quoted as a Flat Fee
8. To demonstrate Fairness, make sure that all the component parts, and accomplishments, with the estate planning project are demonstrated throughout the project; also, deliver excellent service; also, de-cliché clichés
9. Divide estate planning BIG PROJECT into sub projects so that value and accomplishments can be more easily understood
10. Value added billing can be considered but must be addressed in the engagement letter (see below)
11. Send bills frequently and timely
12. On a bill, do not exceed a quoted fee unless explained and discussed with the client during the project
13. Connote value in the bill itself and descriptions; spend time with each individual bill
14. Make sure to consider the format of the bill that will most easily connote value and which will avoid the Client's Loss Aversion function
15. Decouple services and bill, when possible
16. Discounting is appreciated by clients, in many situations
17. Demonstrate client care throughout the process by prompt service, attention, and non work communications
18. Know when you are proposing unique solutions to an estate planning or transfer tax issue that justifies a bonus or premium arrangement
19. Consider for unique solutions to difficult projects structuring the engagement as a combination hourly, accompanied with a bonus payment because of the uniqueness of the solution
20. Make sure the bonus avoids Circular 230 prohibitions
21. Determine how to properly discuss and market the bonus structure to a client

(12) **Axiom 12 – Delayed Delivery of Email**. "Learn and use the Delay Delivery option. Use the Delay Delivery option on email. For example, do not respond to a client question minutes after receiving the question, to create an expectation of immediate response. Delay messages for associates prepared over the weekend for Monday delivery. If you plan to work on an email in 3 days, send it to yourself with 3-day Delay Delivery."

(13) **Axiom 13 – Include Change of Situs and Trustee Succession Provisions**. "Have both change of situs and trustee designation provisions in the documents, and discuss the BENEFITS to clients, at a follow up estate planning meeting. Changing the situs and trustees may be important to avoid state income taxation of trusts and for more favorable administration protection."

(14) **Axiom 14 – Contemplate Beneficiaries Wanting to Move Abroad**. "Trustee guidance could consider distribution of funds to allow beneficiaries to move to jurisdictions outside of the United States, to allow distributions for security measures for beneficiaries, and also to consider distributions needed to modify food/food production. Can we think of any other? I suspect yes. The world is becoming a much smaller place and clients' descendants may choose to move abroad."

(15) **Axiom 15 – Authorize Distributions for Security Measures for Beneficiaries**. "Consider including in the definition of 'support' expenses necessary to provide physical security measures, as well as allowing one to domicile outside of the United States." (Providing physical security measures can be important as well for domestic beneficiaries.)

(16) **Axiom 16 – Simplify, Simplify**. "Recognize the status quo bias, but begin introducing the concept of simplification into your drafting thought process. A place to begin is to replace complicated marital deduction formula with a single fund marital trust, drafted to be QTIP eligible."

(17) **Axiom 17 – Manage Client Expectations**. "Clients want to know what they can expect. If you intentionally or unintentionally create unreasonable expectations, they will be unhappy when you fail to measure up. Do the client and yourself a favor by creating a *reasonable* framework for your interaction with the client and your generation of the work for the client."

(18) **Axiom 18 – Family Meetings**. "The toughest decision a client faces in estate planning is who to name as guardian to raise the children if both parents die while the children are minors. Family meetings are the lifetime corollary to the guardian appointment – this is the way the client can 'raise' the children in the adult world. **As a result, facilitating family meetings can be one of the most important things you can do for the client. And, if successful, you can pick up another generation of clients**."

(19) **Axiom 19 – Work With Focus**. "Finishing projects requires focus. Finishing projects allows you to feel a sense of accomplishment (and avoids feeling negatively about yourself when you do not finish). Finishing projects allows you to bill the client and get paid. Working with focus is a technique that will help you finish!"

(20) **Axiom 20 – Bill Early and Often**. "Billing is like exercise. It must be done and leads to good results."

(21) **Axiom 21 – Fire Bad Clients**. "Life is short. What we do is hard. Let's enjoy it more by working only with the clients with whom we choose to work."

(22) **Axiom 22 – Use Swap Power for Near Death Planning**. "We create irrevocable trusts as a way to shift appreciation down to lower generations and to provide an extra gift to the lower generation – the payment of income tax by the grantor. However, we sacrifice the step-up in basis by doing so. Using the swap power as the 'defect' gives flexibility to do near death planning for cost basis."

(23) **Axiom 23 – Include Charities as Permissible Appointees**. "Effective planning incorporates as many techniques as possible to provide flexibility. By including charities as permissible appointees in limited powers of appointment, the client has the opportunity to say to future generations that transferring wealth to charity instead of family might be the best decision."

15. Family Meetings

a. **Significance**. In 2019 the reality is that knowledge is power. The family meeting may not have been important about 10 years ago, but it has morphed into an extremely valuable and important tool, and absolutely should be considered going forward.

Nancy Hughes (Birmingham, Alabama) expressed that in the past, she thought "there is no way the clients would pay me at my hourly rate to facilitate a meeting. And yet, they really want them; they do pay me. I view them as how to bring along the client's children in a world of wealth, how to raise them not to be trust fund babies, how to pass along family values, how to get the children and grandchildren to understand where the family wealth came from and what it's for."

"The family meeting is about teaching the next generation to be grown-ups in a world of wealth."

Lou Harrison (Chicago, Illinois) observes that when he leads family meetings, "it is absolutely the hardest thing that I'm doing that day. And I can say unequivocally it is the most important thing if done right, in terms of value added for my client."

b. **Estate Planner's Role**. Nancy is doing more and more family meetings in her practice. "If I bring it up they tend to resist; if they bring it up then we go forward." She tends to lead the meetings. Part of the family meeting is typically going over estate planning documents, tax considerations, and asset protection issues. The estate planning attorney is well suited to lead that. If unusual family dynamics exist, a life coach or psychologist might be included in the meeting.

c. **Purposes of Meeting from Client Perspective**. The family meeting must be customized according to the specific client's goals for the meeting. The following are some purposes that the family meeting can serve from the client's perspective.

- To communicate family values.
- To teach stewardship.
- To introduce the topic of prenuptial agreements.
- To educate on the use of trusts. ("It's not that your parents don't trust you. Trusts are very valuable. If you grow up to be a doctor, lawyer, or accountant or whatever that is fraught with malpractice, you will be glad that your inheritance is held in trust.")
- To instruct on various tax considerations in estate planning.
- To encourage estate planning as soon as a child reaches adulthood.
- To disclose the senior generation's estate plan to avoid "surprises" when Mom and Dad die.
- To promote philanthropy.

d. **Purposes of Meeting from Planner's Perspective**. The following are some purposes that the meeting can serve from the planner's perspective.

- To meet the next generation and if no conflict, to become their lawyer.
- To become the client's "consigliere."
- To assist the client in "raising" his/her children not to be trust fund babies.

e. **Planning and Structuring the Meeting**. The following are some pointers for planning the meeting.

- Have pre-meetings with the client to review the proposed agenda and to get buy-in on what will be discussed/disclosed.
- Decide, with client, if the estate planner should lead or if you should bring in an outside expert.
- Decide whether the meeting should be at your office, the client's office or offsite. Your office may be intimidating. The client's office likely will chill open discussion and will not be "warm and fuzzy." Offsite could be the best option. The investment advisor's office is a possibility.
- Decide if in-laws (some might call them out-laws) are in or out of meeting. (Do not pick and choose. Include them all, or exclude them all. Over time, with longer marriages, they are likely to be included.)
- Decide if other advisors (CPA, investment advisor, etc.) should be included in the meeting or in part of the meeting. For example, you might combine an investment review with part of the family meeting.

16. Selection of Fiduciaries

a. **Significance of Assisting Clients in Selecting Fiduciaries**. Stuart Bear (Minneapolis, Minnesota) observes: "Fiduciary selection should not be as straightforward as asking the client who he or she wants to nominate as his or her fiduciaries. Inevitably a client will select his or her spouse, followed by his or her children. The selection should be made only after a thoughtful discussion that addresses the complexity of the client's estate and his or her family's dynamics and explores the possibility of naming an independent third-party (such as a family friend, or business partner) or corporate trustee."

Bernard Krooks (New York) analogizes that the fiduciary in an estate plan is like the driver in a race car. There would be no chance of winning without a good driver. Bernie's approach: "Planners should be more involved in assisting clients in selecting the appropriate fiduciary. Too often, the selection of the fiduciary is an afterthought, even to seasoned practitioners. The planner talks about estate taxes, GRATs, family partnerships, note sales, and then ends with 'who do you want to be the executor and trustee?' It should be the other way around; more focus should be placed on who the fiduciary will be so that when we get into the race, we can actually drive and win."

Bernie recommends asking the person who the client has selected to be the trustee – How many times have you served as trustee? How many times have you read the state trust code? How many Form 1041's have you filed?"

Lou Harrison (Chicago, Illinois) says that when a client (as happens many times) says to name the client's spouse as trustee, and then to name each child as sole trustee of his or her trust upon reaching age 30 or so, "the easy lethargic answer" for the estate planner is to go along. "The harder answer is to talk with your client about the value of having an independent co-trustee with your surviving spouse and kids, and to have that conversation regardless who the client is or how much experience the client has."

b. **Important Factors in Fiduciary Selection**. These are the important factors that Bernie suggests in deciding who should be the trustee.

"– How long do you expect the trust to be in existence? The longer it is, the more appropriate it is to have somebody who is not going to die.

– What is the value of the assets going into the trust? The more you have, the more it cries out for a professional trustee.

– What types of assets are going into the trust – marketable securities or other difficult assets such as real estate, closely-held businesses, artwork, etc. that require active management, which clearly cries out for a corporate trustee?

– Who are the beneficiaries of the trust? Are some beneficiaries spendthrifts? If so, a trustee is needed who has the backbone not to make inappropriate distributions. --- For beneficiaries with special needs, the trustee takes on even more work. The trustee must become familiar with the beneficiary and get involved with schooling and education issues, and housing, and public benefits.

– Discretionary distribution provisions are more complicated to administer and lend themselves more to a professional trustee to carry out the wishes and intent of the settlor."

17. Planning Issues for Minors

a. **Financial Considerations**. The most recent estimates from the U.S. Department of Agriculture are that middle income married couples will spend $233,610 to raise a child to age 18, increasing to $494,000 in the urban Northeast. For a child born today, approximately $500,000 will be needed to pay for college tuition, room and board at a private institution. A rule of thumb for clients of newborn children is that they should have liquid assets and/or life insurance of at least $1 million per child.

b. **Trusts that Provide for Minors and Guardian**.

(1) **Visitation**. Consider including a provision for travel to see relatives and to pay for less wealthy relatives to visit the child. Sarah Johnson (Washington, D.C.) suggests the following form provision.

> **Visitation**. It is my intent and conviction that my child spend time with both sets of grandparents and all aunts, uncles and cousins, at least once a year. The Guardian should make any arrangements necessary to accomplish my intent, and the Trustee is authorized to pay any expenses that may be incurred, including the cost of any domestic and/or international travel, for the child to visit a relative, or even for the relative to visit the child.

(2) **Provisions Benefiting Guardian**. In addition to, or in lieu of compensation, Sarah Johnson (Washington, D.C.) suggests adding to the trust agreement that the trust could provide that the guardian can receive distributions for things such as:

- Allow the guardian to reside in the client's residence without any obligation to pay rent or carrying costs;
- Loan money or pay for an addition to the guardian's residence or purchase a new residence to accommodate the guardian's larger "family";

– Purchase additional furniture or use the clients' furniture;

– Subsidize a change of career or employment to facilitate that person's serving as guardian;

– Employ childcare providers, a housekeeper, driver or other support to enable the guardian to balance a career and the responsibilities of parenting;

– Offset any expenses of the guardian that he or she would not otherwise incur but for the fact that the person is serving as the guardian; and

– Allow distributions to be used for the social, educational or travel experiences of both the clients' children and the guardian's own children, so that the Guardian's children have the same privileges and opportunities.

The trust should clarify that those types of distributions will be treated as distributions for the benefit of the clients' children:

> **Distributions for Benefit of My Children**. It is my intention that distributions made for the reasons described in [this section] will provide my children with the style and comforts of life that I would have provided if living. Therefore, any such distributions are intended to be distributions to or for the benefit of my children, even if the Guardian of any minor child of mine, members of such Guardian's family or a relative of my children may also benefit.

c. **UTMA Accounts**.

(1) **Creation of UTMA Account**. Magic words must be used to create a UTMA account. The Act must be referenced in the transfer documents, and the designated custodian and the minor must be named: "as custodian for [Name of Minor] under the [Enacting State] Uniform Transfers to Minors Act."

(2) **Authorize Transfer to UTMA Account in "Facility of Payment" Clause**. Most trusts contain a "facility of payment" provision that allows transfers to a custodian under the Uniform Transfers to Minors Act. If the trust does not contain that provision, the Act authorizes a fiduciary to make a transfer to a UTMA account, but only if several requirements are satisfied, one of which is that the transfer must be authorized by court if it exceeds the amount that would otherwise require the appointment of a conservator ($10,000 in UPC states).

(3) **One Custodian at a Time; Successors**. The Act does not allow joint custodians. A custodian may designate a successor custodian. A custodian may resign by delivering written notice to the minor (if at least 14 years of age) and to the successor custodian. If no appointed custodian is available, the minor who is age 14 or older may select a successor.

(4) **Compensation**. A custodian (other than the transferor) may be paid reasonable compensation.

(5) **Management Duties**. A custodian is subject only to the "prudent person" rule, but is expressly permitted to retain any custodial property without a duty to diversify.

(6) **Use of Property for Minor**. The custodian is authorized "to deliver or pay to the minor or expend for the minor's benefit so much of the custodial property as the

custodian considers advisable for the *use and benefit* of the minor" without regard to the ability of the custodian to support the minor and without regard to the other assets of the minor. This very broad standard is an extension of the more limited distribution standard under the prior Uniform Gifts to Minors Act.

(7) **Creditor Issues**. The account assets are not exempt from the minor's creditors, but should be protected from creditors of the transferor or the custodian.

(8) **Age of Termination**. Some states require the account to terminate at age 18. Numerous states terminate the account at age 18 unless a later age, usually 21, is expressly specified in the transfer. A growing number of states allow the custodianship to continue to age 25, but that could present gift tax consequences because the transfer would not satisfy § 2503(c) to qualify for the gift tax annual exclusion.

(9) **Tax Consequences**.

(a) **Gift Tax Consequences**. Transfers to the account qualify for the annual exclusion (perhaps unless the account continues to age 25).

(b) **Estate Tax Consequences**. The assets will be included in the transferor's gross estate under §2036 and §2038 if the transferor is the custodian (and the three-year rule of §2035 will apply if the transferor resigns as custodian).

If the non-transferor parent is the custodian, the IRS might argue that the assets are included in the parent's gross estate under §2041 if the parent could have used the UTMA property to discharge the parent's legal obligation to support the child.

(c) **GST Tax Consequences**. If the transfer is for the donor's grandchild or more remote recipient, the transfer is a direct skip, but it qualifies for the annual exclusion exception from GST tax.

(d) **Income Tax Consequences**. Income of the account is reportable to the minor, whether or not actually distributed to the minor. The Kiddie Tax generally will apply if the minor is under age 18 (sometimes up to age 24). The IRS has taken the position that the account income is included in the gross income of any person (such as the parent) who is legally obligated to support the minor, but under Regulation § 1.662(a)-4, the account income should not be taxable to the parent when the child's resources are adequate to cover the child's support.

(10) **Options for Distribution Prior to Account Termination**. If a donor wishes to delay or restrict the minor's access to the account at termination, possibilities include (i) transferring assets to an LLC, (ii) transferring assets to a Qualified Minor's Trust satisfying the requirements of § 2503(c) (as expressly authorized in several states including Colorado, Florida, Illinois, Maryland, New Hampshire, South Dakota, Tennessee, Texas, Virginia, and Wisconsin), or (iii) transferring assets to a 529 Plan for the minor.

(14) **Options for Distribution after Account Termination**. After the minor has reached the age for the termination of the account, few viable options exist for restricting or delaying the beneficiary's access. These could include (i) transferring assets to a special needs trust or ABLE Account if the beneficiary is disabled or has

special needs, (ii) have the child sign a power of attorney authorizing the parent or custodian to continue to manage the account, (iii) create a revocable trust and name someone other than the child as trustee, or name the child as one of three or more co-trustees), or (iv) with the beneficiary's informed consent, transfer assets to a domestic asset protection trust to protect the assets from creditors, including divorcing spouses.

(15) **Interplay between 529 Plans, UTMA Accounts and Financial Aid**. The "Free Application for Federal Student Aid ("FAFSA") form for requesting federal student aid requires disclosure of assets and income of the parent and student as a part of determining the amount of aid that might be available. A 529 Plan is treated as an asset of the parent (regardless of whether it is owned by the parent, student, or UTMA), which is advantageous because only 5.64% of parental assets are counted in calculating the student's Expected Family Contribution, whereas 20% of the student's assets (including UTMA accounts) are counted.

Tax-free distributions from a 529 Plan to pay current year college expenses are not part of the base-year income that reduces future years' financial aid eligibility, so long as the 529 Plan is owned by the student or a parent. Distributions from a 529 Plan owned by anyone else is counted as student income, which would reduce eligibility for future aid by 50% of that amount. Therefore, a 529 Plan owned by the student or parent may be most advantageous for a student who will be otherwise relying on financial aid.

18. Charitable Planning Observations

a. **Impact of 2017 Tax Act on Charitable Giving**. Charitable giving tax planning paradigms will change in light of the 2017 Tax Act. The number of taxpayers expected to itemize deductions is expected to decrease from about 37 million to about 16 million (because of the limits on deducting miscellaneous itemized deductions, the $10,000 limit on the deduction for state and local taxes, and the increased standard deduction). The preamble to final regulations addressing limitations of deductions of charitable contributions that result in credits against state and local taxes indicate that only about 10% of taxpayers will itemize deductions. TD 9864, Contributions in Exchange for State or Local Tax Credits Final Regulations, Preamble at 64. Many taxpayers will receive no federal income tax benefit from making charitable contributions (or from home mortgage interest payments or state and local tax payments). 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 loss of itemized deductions for most taxpayers on the huge amount of "small" charitable gifts on which many charities rely heavily. 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.

b. **Bunching Deductions**.

The combination of the increased standard deduction ($24,000 for married individuals filing joint returns in 2018, $24,400 in 2019) and the elimination of most itemized deductions means that many taxpayers will receive no tax benefit for making

charitable contributions. Taxpayers may consider "bunching" deductions into a particular year. For example, if a taxpayer wishes to give $10,000 per year to charity, consider giving $40,000 in one year to a donor advised fund, which can distribute $10,000 per year to the desired charity over the next four years. Indeed, a donor could give closely held stock to a donor advised fund and the donor's child could buy the stock back from the fund. The taxpayer could itemize deductions in the year in which the large payments are made, and use the increased standard deduction in other years.

c. **A Few Comments about Donor Advised Funds.**

(1) **Deduction for Contributions to Fund**. Donors to donor advised funds are entitled to a charitable income tax deduction under the same limitations that apply for gifts to public charities.

(2) **Contemporaneous Written Acknowledgment**. In order to take a charitable income tax deduction for contribution to a donor advised fund, the donor must receive a contemporaneous written acknowledgment that is similar to that required for donations to public charities, except it must also state that the sponsoring organization "has exclusive legal control over the assets contributed." A sponsoring organization that has different types of funds can easily inadvertently send the wrong notice, and donors to donor advised funds should make sure that the acknowledgment contains those magic words.

(3) **Growing Popularity**. In 2017, $29 billion was donated to donor advised funds, and by the end of 2017, donor advised funds had $110 billion. One report indicated that **10% of all charitable contributions in 2017** were to donor advised funds.

463,000 donor advised funds existed in 2017. Of all of the donor advised funds in existence in the United States today, **one-third were established in one year – 2017**. Donor advised funds have 20% percent more assets than in 2016. 2018 and 2019 will probably prove to be boom years for donor advised funds as well, as taxpayers realize the impact of the 2017 Act on their charitable giving.

(4) **Permissible Grants**. Donor advised funds can make contributions in various ways including to any public charity or private operating foundation (except type III supporting organizations), the sponsoring public charity, another donor advised fund, and any foreign charity or civic organization if the fund exercises expenditure responsibility. A donor advised fund absolutely cannot make any grant to a human being or for a non-charitable purpose.

(5) **Penalties**. Various onerous penalties can apply to mistaken transactions.

- An impermissible grant from a donor advised fund triggers a 20% penalty to the charity that administers the fund and a 5% penalty to an employee who knew about the impermissible payment, §4966(a)(1).
- If an impermissible grant or other impermissible payment is made to the donor or a family member, an additional 25% penalty is imposed on that individual, plus a potential 200% penalty if the payment is not returned to the charity, §4958(c)(2).

- The private foundation excess business holding restrictions apply to donor advised funds, §4943(e).
- The entire amount of any loan or compensation to a donor or disqualified person is an "excess benefit," subject to a 25% penalty on the individual (200% if the payment is not returned), a 10% penalty on the sponsoring charity, and a 5% penalty on an employee who knew about the impermissible payment, §4958.
- A 125% penalty applies to a donor for advising a distribution that provides the donor with "a more than incidental benefit" (and a 10% tax applies to the fund manager who knew of the benefit), §4967.

(6) **Notice 2017-34**. Notice 2017-34, 2017-51 I.R.B. 562, explains that the IRS is considering regulations (1) restricting payments from a donor advised fund to purchase a ticket so that a donor, advisor, or related person can attend a charity-sponsored event even if the individual pays the non-charitable portion of the ticket price, and (2) allowing distributions that the recipient charity treats as fulfilling a pledge by the donor, advisor or related person 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). For further discussion of Notice 2017-73, see item 10.f of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

d. **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 will avoid recognizing income on the required distributions from the IRA.

(1) **Who Can Benefit?** Taxpayers who can benefit from using the charitable IRA rollover arrangement include (a) taxpayers who do not itemize deductions, (b) taxpayers who pay more taxes as their adjusted gross income increases, such as taxpayers who (i) pay the 3.8% net investment income tax, (ii) pay income tax on Social Security payments, and (iii) pay Medicare B premiums (because rates increase for taxpayers with income over certain amounts), (c) donors who live in states with a state income tax but no charitable deduction, (d) donors subject to the 60% annual charitable deduction limitation, and (e) donors who can retain appreciated stock by making charitable contributions from IRAs (so that the donor can obtain a basis step up on the stock at death).

(2) **Reporting**. Box 1 of Form 1099-R from the IRA custodian will show the total amount of distributions from the IRA. The Form 1099-R does not reflect which of the distributions are"qualified charitable distributions." The taxpayer reports the full distribution amount on line 4a of Form 1040, and reports the taxable distributions (for example, the amount that is not a qualified charitable distribution) on line 4b of Form 1040, and should enter "QCD" next to line 4b. The qualified charitable distribution amount cannot be deducted and will not be entered on Lines 11 or 12, Schedule A of Form 1040.

(3) **Cannot Use Donor Advised Fund**. An IRA qualified charitable rollover cannot be made to a donor advised fund (or to a supporting organization or private foundation).

(4) **Inherited IRAs, Pledges**. The charitable IRA exclusion can be used for inherited IRAs (as long as the beneficiary is over age 70 ½) and can be used to satisfy a pledge (even if it is a legally binding pledge).

(5) **Analogous to Gifts of Appreciated Property**. 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.

If an individual holds highly appreciated stock that the individual thinks will appreciate further, the individual could give the stock to charity and immediately replace it by buying the same stock, which the taxpayer would then hold with a cost basis equal to the amount paid for it. ("Wash sale" rules limit the ability to take losses if the asset is replaced within 30 days, but no similar rule exists if no losses are incurred.)

e. **Non-Grantor Trust for Family Charitable Giving**. For a client that is taking the standard deduction and cannot benefit from charitable deductions, consider 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.

f. **Revised Charitable Bequest Paradigms**. Almost all decedents have no estate tax concerns (at least before sunsetting occurs in 2026) and do not need an estate tax charitable deduction. Accordingly, make use of income tax benefits with charitable transfers following the death of an individual.

(1) **Gifts to Individuals Who Make Charitable Contributions**. 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.

(2) **Gifts to Trusts with Income Paid to Charity**. To assure that the charitable contribution is actually made, 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. For example, an individual who wants to make a $50,000 bequest to charity could provide that the first $50,000 of income from the family trust would be paid to the charity.

After the mandatory income amount has been paid to the charity, the trust could leave the trustee with the discretion to make income distributions to charity in case the family wanted to make the charitable contributions from that trust (allowing the individuals to take the increased standard deduction rather than directly making charitable contributions for which they may receive little income tax benefit.

(3) **Funding Charitable Pecuniary Bequests with Appreciated Property.** Funding any pecuniary bequest (including to charity) with appreciated (or depreciated) property generates taxable gain (or loss), Reg. §1.661(a)-2(f). Include boilerplate language for wills making a pecuniary charitable bequest providing that the bequest would be satisfied with any gross income generated by making the charitable bequest (if any).

(4) **Funding Charitable Bequests with IRD**. IRD will be taxable income to recipients when received, so funding charitable bequests with IRD is preferable (because the charity is an exempt entity and will pay no income tax on the IRD).

Drafting Tip: Professor Chris Hoyt suggests using the following as boilerplate for wills with charitable distributions:

> *Except as otherwise provided in this governing instrument, I instruct my fiduciary than all of my charitable bequests (if any) shall be paid first with taxable income in respect of a decedent (if any) included in gross income, and second with any gross income generated by making the charitable bequest (if any), so that this trust [or estate] shall be entitled to claim a charitable income tax deduction for such transfer under Section 642(c) of the Internal Revenue Code of 1986, as amended, or under any corresponding section of future income tax laws.*

Professor Hoyt cautions that IRD sometimes should not be payable to charity, for example as beneficiaries of a "stretch IRA," or if the distribution is being made from an amount that would otherwise qualify for the estate tax marital deduction as an amount passing to a QTIP trust, and the clause should be revised for any such appropriate exceptions.

(5) **Satisfying "Qualified" Charitable Trust Requirements May Not Be Necessary; Income Trust or Mere Authority to Pay Income to Charity May be Sufficient**. Charitable bequests to trusts may no longer have to be in the form of a qualified interest in order to obtain an estate tax charitable deduction if such deduction is not relevant. 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. *See* Reg. §1.662(b)-2, Ex. 1(e) ("In determining the amount to be included in the gross income of B under section 662 for the taxable year, however, the entire charitable contributions deduction is taken into account, with the result that there is no distributable net income and therefore no amount to be included in gross income.").

g. **Contributions for Priority Seating**. One of the changes in the 2017 Tax Act is to eliminate the 80% deduction for contributions to colleges or universities in order to obtain priority for seating or parking at college or university events. Creative alternatives to avoid that rule still have not surfaced.

h. **Substantiation Requirements**. The 2017 Tax Act repealed the exception from the substantiation requirement if the donee organization files a return that contains the same required information, effective for contributions made in taxable years beginning after 2016.

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 clarifies that they apply only for income tax deduction purposes under §170, and not to estate or gift tax charitable deductions.

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, and making sure that every "i" is dotted and every "t" is crossed. 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.

i. **Transfer to Private Foundation Having Donor as a Director**. If the donor to a private foundation is also a director of the foundation, the date of death value of the transferred assets will be included in the donor's gross estate, but will be offset by the estate tax charitable deduction. Even though that appears to be a net offset, several disadvantages could apply: First, the foundation's assets (at least to the extent represented by the donor's contributions) may be subject to a lien for unpaid estate taxes; and negative effects could result from certain sections of the Code that operate based on the size of the adjusted gross estate (such as §303 relating to distributions in redemption of stock and §6166 relating to extension of time for payment of estate taxes for a closely-held business).

j. **Charitable Remainder Trust with Flexibility to Sprinkle Some of the Lead Interest to Charity, PLR 201845014.** In PLR 201845014, the charitable remainder unitrust provided that only a portion of the unitrust amount had to be paid annually to the donor (an amount determined to be more than de minimis), and that the balance of the annual unitrust amount could be paid in an independent trustee's discretion either to the donor or to qualified charities, and the donor retained the right to select and change members of the charitable sprinkling class. Thus, the donor had the flexibility, to discuss with the independent trustee about diverting some of the unitrust amount directly to charities, rather than paying it to the donor who might then make desired payments to charities. This kind of flexibility seems to be contemplated in the Code, which does not require that all of the unitrust amount must be paid to non-charitable beneficiaries. §664(d)(2) ("to one or more persons (at least one of which is not an organization described in section 170(c)"). Other rulings have similarly approved sprinkling CRTs. *See e.g.*, Rev. Rul. 77-73, 1977-1 C.B. 175, (sprinkling among three individuals); PLR 200813023 (50% of unitrust amount paid to donor and 50% sprinkled among qualified charities in special trustee's discretion).

The ability of the donor to select and change the members of the charitable sprinkling class is important to avoid a current gift issue when the CRT was created because any amounts that *could* be diverted to charity would have constituted a gift that did not qualify for the gift tax charitable deduction (because the amount was not ascertainable at the outset). The donor's retained ability to change the potential charitable donees, however, prevented the gift from being a completed gift until a payment was actually made to charity, at which time the amount transferred would be ascertainable and qualify for the gift tax charitable deduction. *See* Larry Katzenstein, *PLR 201845014 – Internal Revenue Service Issues Interesting Ruling on Sprinkling Charitable Remainder Trust*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #279 (February 7, 2019).

k **Camp Proposals in the Wings.** 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 included major changes regarding charitable deductions. The proposal included 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 would simplify 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.

19. Basis Adjustment Planning

Basis adjustment planning takes on added significance in light of the greatly enhanced $10 million (indexed) exclusion amount under the 2017 Tax Act. It is now a central part of tax planning considerations in preparing estate plans.

a. **Resources**. The outline by Lester Law and Howard Zaritsky titled "Basis After the 2017 Tax Act – Important Before, Crucial Now" from the 53rd Annual Heckerling Institute is an ***outstanding*** technical resource of a very wide variety of issues about basis.

For background information about basis considerations, including (1) basis adjustments for property acquired from a decedent or for gifts, (2) GST tax effects, (3) holding period, (4) uniform basis rules, (5) proving basis, (6) part gift/part sale transactions, (7) sales to grantor trusts, (8) private annuities, (9) self-cancelling installment notes, (10) special use valuation, and (11) life insurance, see Item 9 of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

For a discussion of general planning issues to maximize flexibility for basis adjustments, either for the settlor or for trust beneficiaries (which are very briefly summarized in Item 9.f above), including various form provisions, see Item 5 of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **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.bessemertrust.com/for-professional-partners/advisor-insights**. Highlights of planning ideas are summarized briefly below.

(1) **Community Property.** Spouses in community property states get a basis step-up on all community property assets (both halves) 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.bessemertrust.com/for-professional-partners/advisor-insights**.

Whether such property will be treated "as community property" for purposes of §1014(b)(6) is not clear. The Alaska statute is similar to the Uniform Marital Property Act (except that Alaska is an opt-in rather than a default system), which addresses the wide range of effects of community property, including management, control, rights during lifetime, and disposition at death or divorce. It allows opting in to a community property regime even without a trust. The South Dakota and Tennessee statutes permit opting in to a system in which trust assets are community property, but the statutes do not address management and control issues and overall treatment of rights during lifetime. The assets are treated as community property under state law, but the IRS could argue that the assets do not have all the indicia of community property (especially under the more limited South Dakota and Tennessee statutes). Maximizing the contacts with the trust and the situs states (for example, the trustee having possession of trust assets in the state) may mitigate the risk of the full community property nature of the assets not being recognized under conflict of laws principles.

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

The Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA") provides that if a couple moves from a community property to a common law state,

the rights of a spouse at the spouse's death in property that was community property prior to the change of domicile will be preserved. It has no effect on the rights of creditors or the rights of the spouses or other persons prior to the death of a spouse. Sixteen non-community property states have adopted this Act. Will property subject to the Act be treated as community property for purposes of getting a basis adjustment at the first spouse's death under §1014(b)(6)? The answer is not clear, but §1014(b)(6) requires that the property be "community property … under the laws of any State…." UDCPRDA does not purport to say that the property is community, but just that at the death of a spouse, the spouse will have "community property rights" at death. If the state does not categorize the property as community property, no basis adjustment should result under §1014(b)(6). There is no law on the §1014(b)(6) issue in this context.

The IRS is not known to be actively pursuing whether property is entitled to the basis adjustment as community property under §1014(b)(6).

(2) **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 or the donor's spouse.

(3) **Joint Revocable 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, by giving the first decedent spouse a general power of appointment over all of the trust assets. *E.g.* PLR 200101021(denying basis increase because of §1014(e)).

(4) **Joint Exempt Step-Up Trust ("JEST")**. The strategy has been refined with an alternative that has been termed the Joint Exempt Step-Up Trust ("JEST"), an arrangement in which assets contributed by the surviving spouse do not pass into a trust of which the surviving spouse is a discretionary beneficiary (to minimize the risk of §1014(e) applying). *See* Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1,* 40 EST. PLAN. 3 (Oct. 2013); Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 2,* 40 EST. PLAN. _ (Nov. 2013). Such a trust might add flexibility by giving an independent trust protector the power to add the surviving spouse as a discretionary beneficiary, or might add restrictions on being able to make distributions to the spouse or require the consent of an adverse party to bolster an argument that §1014(e) should not apply even if the surviving spouse later becomes a discretionary beneficiary.

One approach may be to sell the asset soon after if it is acquired from the first-decedent spouse (which should generate very little gain) and later repurchase similar (or even identical) assets (there are no wash sale rules for recognition of gain purposes). That would start the 3-year statute of limitations on assessment of additional income tax.

(5) **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 gift to the trust is complete, even though H retains the right to terminate the trust early, because the mere power to affect the time of enjoyment does not make a gift incomplete. The gift qualifies for the gift tax marital deduction because it is not a non-deductible terminable interest (the asset does not pass to another person when the spouse's interest terminates – the interest will pass either outright to the spouse or to the spouse's estate).

The assets would be includible in H's estate under §2038 if he dies first (because of his power to terminate the trust early) (furthermore, a basis adjustment would be allowed under §1014(b)(3) even if the assets are not included in H's estate under §2038), 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.bessemertrust.com/for-professional-partners/advisor-insights**.

One of the nationally respected speakers at the Heckerling Institute indicated that the speaker has used this alternative various times and thinks that it clearly works.

(6) **Step-Up Personal Residence Trust ("SUPRT")**. An article from several years ago describes a series of ingenious trusts that seek to adjust the traditional QPRT and GRAT to assure that a basis adjustment applies for the trust assets when the first spouse dies, regardless of which spouse dies first or which spouse contributed the assets to the trust. Austin W. Bramwell, Brad Dillon, & Leah Socash, *The New Estate Planning Lexicon: Sugrits and Other Grantor-Retained Interest Step-Up Trusts,* 123 J. TAX'N 196 (Nov. 2015).

The SUPRT is a QPRT created by one spouse who reserves the right to use the residence for life, but the trust terminates at the death of the first to die of the spouses. If the donor-spouse dies first, the assets pass to the surviving spouse, and if the donee-spouse dies first, the assets pass to his or her estate (and the donee-spouse's will may leave the assets back to the original donor-spouse). If the donor spouse dies first, the assets are included in his or her estate under §2036(a)(1), and if the donee-spouse dies first, the assets are included in his or her estate under §2033. Therefore, a basis adjustment applies at the first spouse's death, regardless which spouse dies first, although §1014(e) may preclude a basis adjustment if the donee-spouse dies within one year of when the trust is created (and when the gift of the remainder interest is complete).

The original transfer to the trust is a gift to the donee-spouse equal to the value of the remainder interest (the value of the donor-spouse's retained use of the residence is deducted from the value of the completed transfer under §2702). The gift of the remainder interest qualifies for the gift tax marital deduction, so no taxable gift occurs on the creation of the trust.

(7) **Step-Up Grantor Retained Income Trust ("SUGRIT")**. The article also describes a Step-Up Grantor Retained Income Trust ("SUGRIT") which acts similarly, but §2702 applies to value the retained income interest at zero so that a completed gift is made of the entire value transferred to the trust. A marital deduction would be allowed only for the value of the remainder interest, not the donor's retained income interest until the trust termination. Therefore, a taxable gift of the income interest is made with this approach (for assets other than a residence), but if the donor-spouse dies first, the gift amount is not included in the estate tax calculation as an adjusted taxable gift (because it is included in the gross estate, *see* §2001(b)), so the gift amount is effectively recovered in the estate tax calculation. The recovery *might* also happen if the donee-spouse dies first, but that is not clear.

(8) **Tangibles SUGRIT**. This approach is similar to the SUGRIT, but with tangible personal property so that the retained use of the tangible personal property can be given a value under §2702, to reduce the taxable gift that is made when the trust is created.

c. **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.bessemertrust.com/for-professional-partners/advisor-insights**.

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* 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. 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,* 50TH 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 9026036). 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.bessemertrust.com/for-professional-partners/advisor-insights**.

20. Judicial Modifications

Just because the parties involved want to modify a trust, do not assume that a court will necessarily approve the modification. The detailed requirements of trust modification statutes must be satisfied. Several interesting appellate cases in 2018 refused to allow a court-ordered modification.

a. ***Horgan v. Cosden* (Florida)**. In *Horgan v. Cosden* (Fla. Dist. Ct. May 25, 2018), a mother died with a revocable that left $3.0 million in trust with income to son for life; remainder to three educational institutions. The co-trustees were the son and Horgan, a personal assistant and friend of the mother. The son and educational institutions agreed to terminate the trust early and divide it actuarially, with the son getting about $2 million outright. The co-trustee (Horgan) disagreed.

An action was brought under the Florida trust modification statutes that allow modification in the case of unanticipated circumstances, if a material purpose no longer exists, or if it is for the best interests of beneficiaries. The existence of a spendthrift clause is a factor but does not preclude modification. Reasons cited in this case for early termination were (1) to avoid unnecessary expenses and trustee fees and to (2) avoid the risk of market fluctuation.

The district court allowed the termination, but the appellate court refused, and granted summary judgment denying early termination. The court's language is a strong rebuke of allowing early termination merely because the beneficiaries "want their money."

> The undisputed facts do not reflect that there has been any waste of Trust assets, that the purposes of the Trust have been fulfilled, or that termination is in the best interest of the beneficiaries when considered in light of the Settlor's intent. The trustees' fees are customary, there is no indication that the administration expenses are unusual, and there has been no invasion of principal. Further, the record does not establish that market fluctuations created a real risk that the Settlor's intent would be thwarted. In essence, the beneficiaries simply prefer a different course of action than that chosen by the Settlor: they want their money now. But on this record, the desire to have the money now would be in

direct contravention of the Settlor's intent, including her intent that the income beneficiary would only receive incremental distributions of income rather than a lump sum distribution of principal.

The fact that the Trust does not contain an express provision prohibiting early termination does not mean that the Settlor did not express her intent. She expressly stated that she wanted her son to have income payments over the course of his life. Many settlors choose to not provide a beneficiary with a lump sum distribution and may not want to spell out the reasons in a trust document. If we were to affirm the trial court's ruling, beneficiaries could have trusts terminated simply by stating that they did not want to pay trustees' fees, administrative expenses, or be concerned with market fluctuations. Nothing in the record indicates that the Settlor was unaware that markets fluctuate. And the Settlor purposefully chose two trustees and was aware of trustees' fees and administration expenses because she provided for them in the Trust.

b. ***Shire v. Unknown/Undiscovered Heirs*** **(Nebraska)**. This case is one in which the court modification likely would have been consistent with the settlor's intent, but the modification did not fit squarely within the requirements of any of the relevant state trust modification statutes. *In re Trust of Shire*, 907 N.W.3d 263 (Neb. 2018). The will was signed in 1947, and Shire died in 1948 (70 YEARS AGO). The will created a trust providing $500/month to Shire's daughter for her life, then to Shire's granddaughter for her life.

The granddaughter born in 1945, is now age 73. The will says she is to receive $500/month ($6,000/year) from the trust. Her total income is $14,000/ year (including the $6,000 from the trust).

Trust assets are worth about $1 million, producing income of about $65,000-80,000/year (compared to the $6,000 paid to the only beneficiary – the pauper-granddaughter).

This situation seems to cry out for modification based on changed circumstances. Evidence was produced that based on the rate of inflation, $500 in 1948 would be about $5,000 today (60,000 per year – the same as the approximate income of the trust).

Twelve remainder beneficiaries were identified, including charities represented by the state attorney general. Six filed a brief affirmatively consenting, and the other six did not object. The court appointed an attorney to represent "Unknown/Undiscovered Heirs." That attorney did file an obligatory objection.

The court refused modification based on specific analysis of modification statutes (which were based on UTC provisions):

-UTC 411(a) counterpart – requires consent of settlor and all beneficiaries (**but the t**e**stator was dead**);

-UTC 411(b) counterpart – requires consent of all beneficiaries (**but the attorney for "Unknown/Undiscovered Heirs" objected and six beneficiaries did not file express consents**); and

-UTC 411(e) counterpart – requires that if not all beneficiaries consent, (1) the court could have modified had all beneficiaries consented, AND (2) the interests of a non-consenting beneficiary will be "adequately protected" (**but the modification would prejudice interests of non-consenting beneficiaries**).

The UTC 412(a) counterpart, allowing modification based on unanticipated circumstances and that the modification will further the purposes of the trust, seems to apply, the Nebraska version of this statute applied only to trusts that became irrevocable on or after Jan. 1, 2005.

The parties argued that the common law doctrine of deviation applied, but the Nebraska Supreme Court said that had not been raised at trial court, so it could not hear that issue on appeal.

Drafting Pointer: An obvious drafting pointer from this case is not to draft distribution provisions using specific monetary amounts for long-term trusts without including an inflation adjustment clause.

21. Tax Effects of Settlements and Modifications; GST Rulings Regarding Trust 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.bessemertrust.com/for-professional-partners/advisor-insights**. This Item includes several brief miscellaneous comments.

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

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

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

b. **Revenue Ruling 73-142—Pre-Transaction Actions Can Avoid *Bosch* Analysis**. In Rev. Rul. 73-142, a Settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The Settlor obtained a local court construction that the Settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the Settlor removed the trustee and appointed another, so the Settlor no longer had the removal power. In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred *before the taxing event*, which would have been the Settlor's death. The IRS agreed that it was bound by the court's ruling as well, **"regardless of how erroneous the court's application of the state law may have been."**

Get the construction proceeding final order before the taxing event, and the IRS will be bound under Revenue Ruling 73-142. But the court order must be obtained *prior to* the event that would otherwise have been a taxable event.

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." See Item 21.d immediately below discussing several 2018 PLRs.

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 Giving Retroactive Effect to Modifications to Correct Scrivener's Error**. Several private rulings in 2018 gave retroactive effect to reformation actions. PLR 201837005 involved a Crummey trust in which a subsequent attorney discovered two mistakes: (1) the withdrawal power was not limited just to the gift tax annual exclusion amount, and (2) the withdrawal power lapsed entirely each year (which created a gift and estate tax problem to the extent of lapses greater than a "5 or 5" power). The state had a statute similar to §415 of the Uniform Trust Code, Modification to Correct Mistakes, authorizing reformation to conform the terms to the settlor's intention established by clear and convincing evidence where the terms were affected by a mistake of fact or law. The court reformation was "to eliminate the scrivener's error, retroactive to the date of the trust's creation," and the ruling observed that "[t]he purpose of the reformation is to correct the scrivener's error, not to alter or modify the trust instrument." The IRS ruled that (1) the powerholders did not have a general power of appointment except to the extent of the withdrawal powers as modified, (2) the reformation does not result in a gift (an issue that comes up in almost every ruling about a trust modification), (3) the lapse of withdrawal rights did not result in a gift (this is a clear retroactive effect of the ruling), (4) each beneficiary's portion of the trust would not be includible in the beneficiary's gross

estate under §2041, and (5) a purported GST exemption allocation made improperly on the Form 709 (on the schedule for indirect skips rather than on the correct schedule for direct skips) would be deemed valid because the information on the return was sufficient to indicate that the donor intended to make the allocation.

In PLR 201807001 a donor intended a trust to be a grantor trust, which it was at the time of creation, but §672(f)(1) retroactively caused the trust not to qualify as a grantor trust. A reformation was given retroactive effect in light of a retroactive law change to §672(f)(1) to carry out the settlor's intent. See Item 22.d of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

e. **Recent Rulings Regarding Availability of Trust Charitable Deduction Under §642(c) Following Court Modification**. 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 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 subsequent Chief Counsel Advice involving the same case 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. The case involved with that CCA was subsequently settled.

22. Effect of Modifying Trusts That Are GST Exempt by Exemption Allocations

a. **Effect of Modification Unclear**. Regulation §1.2601-1(b)(4) provides safe harbors for modifications that will not affect the grandfathered status of trusts created before September 26, 1985. Rulings involving trusts that are GST exempt by way of GST exemption allocation (rather than by being a grandfathered trust) typically contain the following (or similar) provision:

> No guidance has been issued concerning the modification of a trust that may affect the status of a trust that is exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

However, the IRS has never actually said that modification of a zero inclusion ratio trust by way of exemption allocation would cause a loss of the trust's zero inclusion ratio. No authority exists for the IRS to strip a trust of validly allocated GST exemption. (For grandfathered trusts, the issue is whether it is the SAME TRUST that was created before Sept. 26, 1985. That is not an issue for zero inclusion ratio trusts.)

Informally, IRS representatives say that if the modification does not meet the grandfathered trust safe harbors, the trust will lose "some benefit," but the IRS will not tell what the result is or precisely what benefit is lost.

b. **Argument That Modifications Resulting from Unqualified Severance Should Result in Trusts with Same Inclusion Ratio.** A creative argument (that seems technically correct) is based on the qualified severance regulations (initially finalized August 2, 2007). The regulations were amended effective for severances occurring on or after September 2, 2008 to add a new paragraph (h) and new examples in paragraph (j) regarding non-qualified severances. If a trust is modified by severing it in a way that is not a qualified severance (for example, the severed trusts do not have the same succession of interests of the beneficiaries), the resulting trusts "will be treated, after the date of severance, as separate trusts for purposes of the GST tax, provided that the trusts resulting from such severance are recognized as separate trusts under applicable state law." Reg. §26.2642-6(h). Furthermore, the regulation goes on to say: "Each trust resulting from a severance described in this paragraph (h) [i.e., non-qualified severance], however, will have the same inclusion ratio immediately after the severance as that of the original trust immediately before the severance."

   Example (12) describes a trust to which sufficient GST exemption has been allocated to give the trust an inclusion ratio of 0.30. The trust is divided "as permitted by state law" [some of the other examples specifically refer to severing trusts by court order] into two trusts in a non-qualified severance (because they do not provide for the same succession of interests). Because the two trusts are recognized as separate trusts under state law, the example says that they are recognized as separate trusts for GST purposes. "However, Trust 1 and Trust 2 each have an inclusion ratio of 0.30 immediately after the severance, the same as the inclusion ratio of Trust prior to severance." Reg. §26.2642-6(j), Ex. 12.

   As long as a trust is judicially modified by dividing it into two trusts and the beneficiaries' interests are modified as a result of the severance so that the severance is not a qualified severance, the severed trusts will have the same inclusion ratio as the original trust. In Example (12), the original and severed trusts have an inclusion ratio of 0.30, but nothing in the regulation suggests that the answer would change if the inclusion ratio were originally zero (i.e., the severed modified trusts would also have an inclusion ratio of zero).

   Despite the clear language of the regulation and Example (12), however, the IRS national office will not recognize that the authority to sever a trust to which GST exemption has been allocated into modified trusts will result in the modified trusts having the same inclusion ratio.

c. **Recent Rulings.**

   Various rulings in 2018 recognized that modifications of a grandfathered trust (created before September 26, 1985) would meet one of the safe harbors in Reg. §26.2601-1(b)(4)(i) so that the modified trust will not lose its grandfathered status. *E.g.*, PLRs 201803003, 201818005 (straightforward partition of trust into multiple trusts, representative of many similar rulings), 201825007.

Other rulings concluded that trusts that had a zero inclusion ratio by way of GST exemption allocation were modified in ways that would have satisfied the safe harbor rules had the trusts been grandfathered trusts, so the zero inclusion ratio was not affected by the modifications. *E.g.*, PLRs 201820007-008 (mandatory income trust modified to be a unitrust with an ordering rule for the character of trust distributions), 201845006 (trust modified to add a trustee who had the authority under the instrument to limit or eliminate a testamentary general power of appointment).

PLR 201814005 involved a creative modification that made substantial modifications (converting a mandatory income to a discretionary income distribution, eliminating a right of withdrawal at certain ages, eliminating a termination of the trust at age 30, and changing a trust for one beneficiary into a special needs trust), but all of the modifications were accompanied by revisions so no increase would result in assets that might possibly pass to younger generations (by leaving the affected portion to the beneficiary's estate or by giving the beneficiary a general power of appointment over the affected portion). The ruling concluded that the modification would have qualified for the "(D)" safe harbor, Reg. §26.2601-1(b)(4)(i)(D), if the trust had been a grandfathered trust, so the zero inclusion ratio did not change.

23. Non-Grantor Trusts for Income Tax Savings; Multiple Trusts

a. **Significance**. Because of the increased standard deduction and the fact that many deductions for individuals are eliminated or limited (as discussed above), some have estimated that the percentage of taxpayers that will itemize is expected by decline from about 30% to about 5%. The preamble to final regulations addressing limitations of deductions of charitable contributions that result in credits against state and local taxes indicate that only about 10% of taxpayers will itemize deductions. TD 9864, Contributions in Exchange for State or Local Tax Credits Final Regulations, Preamble at 64.

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.

b. **Potential Income Tax Savings**. 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 (indexed) 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, and (v) for state income tax savings purposes.

c. **Multiple Trust Rule**. These various reasons may create some incentive for creating multiple trusts, subject to the anti-abuse provisions for multiple trusts under §643(f). 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 to address the multiple trust rule include a definition of "principal" purpose that would have imposed a "significant non-tax purpose" test. 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). Those examples were deleted, however, in the final regulations, and the IRS is still studying the issues raised by the examples and the meaning of "principal purpose" under §643(f). See Item 7.m.(7) above for a discussion of the §643 regulation.

d. **"ING" Provisions if Donor is Potential Beneficiary**. To the extent that the grantor wishes 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 if the grantor's spouse will be a discretionary beneficiary 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).

e. **Potential for Immediate Savings**. The separate non-grantor trusts may result in substantial income tax savings in some situations. See Item 7.m.(6) 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.

f. **Disadvantage – Loss of Basis Adjustment**. A disadvantage of placing property in 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 the trust assets to be included in the client's estate for estate tax purposes in order to achieve a basis adjustment under §1014).

24. Deathbed Planning

If you get a call from a client that Aunt Mary is on her death bed, what do we need to do, what do you suggest?

Several quick ideas are as follows.

- **Exercise swap power**. If the individual has a grantor trust with a swap power, the person should purchase appreciated assets from the trust (to enjoy the basis step-up at death) and should swap loss assets into the trust (to avoid a basis step-down at death). This can be facilitated quickly if a line of credit has been prearranged at a bank in contemplation of this possible situation.

- **Take IRA distribution**. If the family will not be able to enjoy a long stretch-out of the IRA, have the decedent withdraw the funds and pay the income tax (thus reducing the estate tax value of the estate if it is a taxable estate), rather than having the beneficiary be stuck with paying the income tax as distributions are made.
- **Convert to Roth IRA**. 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.
- **Upstream planning if not a taxable estate**. If the individual has assets worth far less than the current estate exclusion amount, consider creating a grantor trust with the individual having a testamentary general power of appointment. If the assets come back to the donor within a year, §1014(e) precludes a basis adjustment at the individual's death, but if the assets remain in a trust with the donor as a mere discretionary beneficiary §1014(e) may not apply, and if the assets pass to family members other than the donor, a basis adjustment is allowed – and the individual's GST exemption could be allocated to the trust. See Item 19.c above.

25. Tax Consequences of Divorce in Light of 2017 Tax Act

a. **Overview of Provisions of 2017 Tax Act Having an Effect on Divorced Spouses.** The 2017 Tax Act continues the marriage penalty for spouses using the brackets for two married individuals versus two individuals using the single brackets.

Personal exemptions have been eliminated for the years 2018-2025. The standard deduction for all individual taxpayers has been increased, but the determination of which parent has custody of children will no longer result in a tax advantage to the spouse in the form of a dependent personal exemption (which was $4,050 per person). This is not a big dollar amount, but negotiations over which spouse gets the dependent personal exemption is often a hotly disputed matter (with lots of emotions involved). Divorcing spouses will now merely need to negotiate over which spouse gets the dependency exemption after 2025.

Most importantly, for divorces or legal separation agreements after 2018, the alimony deduction and §682 have been repealed.

b. **Repeal of Alimony Deduction**. Alimony payments will not be deductible and will not be income to the recipient.

(1) **Effective Date**. The alimony and repeal of §682 provisions (discussed below) are effective for any divorce or separation instruments executed after December 31, 2018 and any divorce or separation instruments executed before that date but later modified, if the modification expressly states that the amendments made by this section of the Act apply to such modification. The existence of a pre-nuptial agreement or marital agreement entered into before 2019 that references making alimony payments, and even mandating that such payments will be required, does not change the fact that no deduction is allowed if the divorce occurs after 2018.

(2) **Permanent Provision**. The elimination of the alimony deduction and the repeal of §682 are permanent and do not sunset after 2025.

(3) **Impact on Divorce Negotiations**. 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. 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.

c. **Economic Impact of Loss of Alimony Deduction**. The alimony deduction resulted in tax savings of up to about $36,000 annually, a level reached by a taxpayer with at least $1.0 million of income who pays $500,000 alimony to a spouse with no income. Any alimony above $500,000 would be taxed at the highest rate regardless of which spouse paid tax on the income. For less wealthy spouses, the dollar cost is not as great, but the economic impact is likely greater. For example, if one spouse earns $150,000 per year, the other spouse has no income, and the couple have two children, their joint tax liability is $15,600 but following divorce the tax liability increases to $23,410, a 40% increase. If the alimony deduction were still allowed and if the earning spouse pays $50,000 per year of alimony, the tax liability would not increase.

d. **Repeal of Section 682 Regarding Grantor Trusts**.

(1) **Repeal of §682**. Section 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 (the spousal unity rule), so the ex-spouse's interest as a beneficiary will likely be sufficient to trigger grantor trust status under §677 even following the divorce.

(2) **Effective Date**. As with the alimony deduction, the repeal of §682 is 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.

(3) **Permanent Provision**. As with elimination of the alimony deduction, the repeal of §682 is permanent and does not sunset after 2025.

e. **Repeal of Section 682; No Grandfathering of Existing Irrevocable Trusts**. 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 creates an extreme unfairness for grantors who created irrevocable grantor trusts with the understanding that the grantor would not 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."

ACTEC submitted a letter to Congressional leaders (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).

f. **Application of Spousal Unity Rule, and Status of Continued Grantor Trust Treatment after Divorce**. Notice 2018-37 also 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 as holding any power or 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 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.

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); 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.

Even if the IRS issues a regulation eliminating the spousal unity rule as a problem for grantor trusts following a divorce based on the ex-spouse's continued right to receive trust income distributions, the trust would clearly continue as a grantor trust if other trigger powers are present, such as a nonfiduciary substitution power. Well-designed grantor trusts leave someone with the ability to "turn off" grantor trust status by eliminating such powers.

g. **Impact of Section 682 Repeal on SLATs**. If the ex-spouse is a continuing beneficiary of the SLAT, it likely will continue as a grantor trust under §677, and the grantor will have to pay income tax with respect to the trust income, even as to the amount of income that is distributed to the ex-spouse. Divorce negotiations going forward will take this factor into consideration to the extent that either spouse has created a grantor trust of which the other spouse is a potential beneficiary.

(1) **Drafting Grantor Trusts**. In drafting grantor trusts, to avoid grantor trust status after the divorce, consider removing the grantor's spouse as a beneficiary after the divorce. This would avoid grantor trust status after the divorce if the trust is a grantor trust solely because of interests or powers that the grantor's spouse has in the trust. Even if the trust continues as a grantor trust if the ex-spouse is not a beneficiary, the grantor will not be faced with paying income tax on income that is actually passing to the ex-spouse. Consider including a tax reimbursement clause (which could even be limited to the divorce situation).

(2) **Pre-Existing Trusts**. For pre-existing trusts, removing the spouse as a beneficiary could be accomplished by an amendment power in the trust agreement, by decanting permitted under state law or under the agreement, or by a judicial or nonjudicial modification allowed under state law. Alternatively, the spouse might remain as a beneficiary but agree in the property settlement agreement to reimburse the grantor for income taxes paid by the grantor with respect to trust income paid to the spouse.

h. **Review of Existing Marital Agreements**. Existing pre-marital and post-marital agreements that provide for alimony payments, or that involve (or may involve) a grantor trust created by one spouse for the benefit of the other spouse should be reviewed. Such agreements often contain a severability clause similar to the following:

> *Each provision of this Agreement shall be considered severable and if for any reason any provision or provisions herein are determined to be invalid, unenforceable or illegal under any existing or future law, such invalidity, unenforceability or illegality shall not impair the operation of or affect those portions of this Agreement which are valid, enforceable and legal. Upon any determination that any term or other provision of this Agreement is invalid, illegal or incapable of being enforced, the parties to this Agreement shall negotiate in good faith to modify this Agreement so as to effect the original intent of the parties as closely as possible in an acceptable manner to the end that the transactions contemplated by this Agreement are fulfilled to the greatest extent possible.*

Changes as a result of the 2017 Tax Act provide the payor-spouse a basis for arguing that the payments or other provisions of the agreement in light of the grantor trust must be re-negotiated because of the significant tax law change.

i. **Trust Planning in Connection With Divorce**. The spouses may want to use trusts as a way of replicating the alimony deduction, or the spouses may want to utilize trusts to incorporate estate planning goals as part of the divorce process. For a summary of trust planning considerations suggested by Carlyn McCaffrey, see Items 30-35 of the ACTEC 2018 Fall Meeting Musings, found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

26. State Estate Tax Planning Issues; QTIP Trusts for State Estate Tax Purposes

a. **Multi-State Problems**. Thirteen states have state estate taxes, but not all of them allow state-only QTIP elections. This creates a significant problem for clients who own property in multiple states, or for a surviving spouse who moves after a QTIP trust has been created for his or her benefit.

For example, New Hampshire is surrounded by three states with state estate taxes. New Hampshire itself does not have a state estate tax. Massachusetts has a $1.0 million exemption and allows a state-only QTIP. Vermont has a $2.75 million exemption and does not allow a state-only QTIP election. Maine has a $5.6 million-dollar exemption and does allow a state-only QTIP election. If a New Hampshire resident owns property in two or more of these surrounding states, planning their estates in a way that defers all of the estate tax until the second spouse's death is extremely challenging.

b. ***Taylor* (Maryland).** In *Comptroller of the Treasury v. Taylor*, 189 A.3d 799 (Md. Ct. Special App. 2018), the husband died in Michigan in 1989, (before the federal credit was changed to a deduction). A QTIP trust was created for his surviving spouse, and a federal and Michigan QTIP election was made for the trust. The surviving wife

subsequently moved from Michigan to Maryland. Following her death in 2013 in Maryland, the state maintained that the QTIP property was included in her estate for Maryland estate tax purposes. The Maryland court disagreed, because no Maryland QTIP election had been made for that trust, and the Maryland taxing statute provides that a Maryland QTIP election is required before property will be included in the estate for Maryland state estate tax purposes.

c. ***Seiden* (New York)**. In *In re Estate of Seiden* (N.Y. County Surr. Ct.), the husband died in 2010 in New York when there was no federal estate tax, but New York does have a separate state estate tax. A marital trust was created for his wife and a New York QTIP election was made. His estate was not required to file a federal estate tax return, so no federal QTIP election was made. The surviving wife died in 2014 as a resident of New York. Under New York law, a resident's gross estate for New York state estate tax purposes is the federal gross estate, as defined in the Internal Revenue Code. The marital trust was not included in the federal gross estate because no federal QTIP election was made, so it was not included in her New York gross estate either. A proposed legislative change in the 2019-2020 New York Executive Budget would require that QTIP property be included in the surviving spouse's New York gross estate if New York previously allowed a marital deduction. The proposal would apply to estates of decedents who die on or after April 1, 2019.

d. **Observation**. These types of cases are very state specific. These cases were successful for the taxpayer, but that will not always be the case. Planning is particularly complicated for clients owning assets in multiple states that have state estate taxes. Multiple QTIP trusts may be needed to avoid paying state estate taxes at the first spouse's death. At times though, simply paying state estate tax at the first spouse's death may be worthwhile to avoid substantial complexity and costs in administering the separate QTIP trusts.

27. State Law Cases Involving Grantor Trusts

Several state court cases have involved attempts to exercise the right of the grantor in a nonfiduciary capacity to substitute assets of equivalent value with a grantor trust (i.e., a swap power). A 2018 case involved an attempted exercise of a swap power, and another 2018 case involved an attempted trust modification to eliminate a grantor trust trigger power.

a. ***Condiotti, Schinazi,* and *Benson* Cases**. These three cases involved attempts to exercise a swap power in return for a note.

Condiotti held the attempted swap was invalid, reasoning that the proffer of a note was effectively an attempt to borrow from the trust, not to substitute assets. *In re The Mark Vance Condiotti Irrevocable GST Trust*, No. 14CA0969 (unpublished opinion Col. App. 2015).

Schinazi rejected the attempted swap because the note was not equivalent value. A partnership interest held by the trust increased in value days after the purported swap because of a sale of an asset that the settlor knew was going to happen and because the formal steps to complete the assignment from the trust were not followed. *Schinazi v. Eden*, 729 S.E. 2d 94 (Ga. Ct. App. 2016).

Benson refused to grant summary judgment denying the effectiveness of the swap. *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).

For a further discussion of these 2015-2016 cases, see Item 25 of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. ***Manatt v. Manatt* (South Dakota)**. The *Manatt* case concluded that the trustee had no power to preclude an exchange under the exercise of a swap power, notwithstanding a caveat in the trust agreement that "the trustee shall satisfy himself or herself that the properties acquired and substituted … are … of equivalent value." The court reasoned that the grantor "had the unilateral right of substituting asets," and the trustee's "fiduciary duty to determine whether the substitution of assets was of equivalent value did not abridge, delay, or block [the grantor's] right of substitution." The court did not discuss the trustee's remedy if the substitution was not of equivalent value, just that the trustee could not initally prevent the exchange. *Manatt v. Manatt*, 2018 WL 3154461 (S.D. Iowa).

The case is an example of lack of understanding by state courts of the effect of swap powers in grantor trusts. The court stated "the result of a … substitution … not of equivalent value … could cause the … Trust to lose its grantor trust status, resulting in the trust corpus being includable in the grantor's gross estate for estate tax purposes." Both parts of that statement are incorrect.

c. **Failed Attempt to Modify Trust to Turn Off Grantor Trust Status, *Millstein* (Ohio)**. After tiring of paying $6 million annually for income taxes on the grantor trust's income, the grantor filed a petition to modify the trusts, to eliminate the defect that caused grantor trust status. Both the trustee and the beneficiaries, however, objected. The authority under the Ohio statute to modify trusts for tax related reasons did not apply. Furthermore, the court concluded that the grantor had no standing, but only a trustee or beneficiary may seek a modification. The court was unsympathetic because "appellant voluntarily created the situation that he now claims is inequitable." *Millstein v. Millstein*, 2018 WL 3005347 (Ohio Ct. App.), and 2018 WL 1567801 (Ohio Ct. App.).

This case highlights the importance of drafting grantor trusts to leave the flexibility of the grantor to turn off the grantor trust status of the trust.

28. Domestic Asset Protection Trusts; Alaska's Exclusive Jurisdiction Statute Unconstitutional, *Toni I Trust v. Wacker*

a. **Domestic Asset Protection Trust (DAPT) Statutes – Overview**. Alaska was the first state to adopt DAPT legislation 22 years ago, providing that a settlor's creditors would not be able to reach trust assets merely because the settlor was a discretionary beneficiary of the trust, if the trust met certain requirements. Some form of DAPT legislation now exists in 17 states: Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming. Those

17 states cover approximately 20% of the United States population. Nine additional states have recognized some limited version of self-settled trust creditor protections, such as for inter vivos spousal QTIP trusts that may remain in trust for the benefit of the original settlor after the spouse's death.

A significant uncertainty about DAPTs is the extent to which a resident in a state that does not have DAPT legislation can create a trust under the laws of a DAPT state and still enjoy protection of the spendthrift clause. To date, no case has recognized protection against the non-resident settlor's creditors. Various cases have not recognized protection, but they have generally involved egregious fraudulent transfers that would not be allowed protection under the state DAPT statute in any event. (Comment 8 to §4 of the UVTA suggests that transferring assets from a non-DAPT jurisdiction to a self-settled trust in a DAPT jurisdiction would be a voidable transaction and would not be entitled to spendthrift protection.)

b. **Alaska's Exclusive Jurisdiction Statute Unconstitutional, *Toni I Trust v. Wacker***. The facts of *Toni I Trust v. Wacker*, 413 P.3d 1199 (Alaska 2018), are outrageously egregious. After a series of judgments had been entered against a Montana debtor by Montana courts, the debtor transferred Montana real estate to an Alaska self-settled discretionary trust under the Alaska DAPT statute. A Montana court (and the Alaska Federal Bankruptcy Court) ruled that the transfers were fraudulent transfers and were not valid. Several years later, the trustee of the Alaska trust brought an action in Alaska, requesting the court to determine that Montana courts had no jurisdiction over the trust. Montana's contacts with the case were that it was the home of the debtor and the creditor, where the real property was located, and where the first judgments were issued. An Alaska statute says that Alaska courts have exclusive jurisdiction over any action based on any transfer of property located anywhere to an Alaska self-settled spendthrift trust. In a 5-0 decision, the Alaska Supreme Court the court observed that an Alaska statute can bar an Alaska creditor from bringing an action under Alaska law against an Alaska debtor for assets located in Alaska that are in an Alaska trust. But an Alaska statute cannot bar a Montana creditor from bringing a claim under Montana law against a Montana debtor over property located in Montana, just because the property had been assigned to an Alaska trust. The court held that the exclusive jurisdiction provision in the Alaska DAPT statute is unconstitutional.

   The court did not address choice-of-law issues or full faith and credit issues. These are the major issues that arise in determining whether a judgment rendered against a debtor in a non-DAPT statute can be enforced against the self-settled trust in the DAPT state.

c. **Conflict of Laws Issues**. A primary issue that has arisen in cases addressing DAPTs are the conflict of laws issues as to whether the law of the DAPT state where the trust is sitused or the laws of the debtor's state will apply. For example, *Waldron v. Huber (In re Huber)*, was a bankruptcy case concluding that Washington (the debtor's state) had a strong public policy against asset protection for self-settled trusts and applied the law of Washington rather than Alaska. *In re Huber*, 2013 WL 2154218 (Bankr. W.D. Wash. 2013)(Washington real estate developer created Alaska asset

protection trust in 2008 when he was aware of collapsing housing market and that his prospects for repaying loans was fragile at best; trust found to be a fraudulent transfer voidable under both §544(b)(1) [state law fraudulent transfers] and §548(e) [transfer made within 10 years of filing petition for bankruptcy to a self-settled trust or similar device if made with actual intent to defraud creditors]; trust also held invalid under conflict of laws analysis because trust had its most significant relationship with Washington, citing §270 of Restatement (Second) of Conflict of Laws and Washington had strong public policy against "asset protection trusts").

Section 270 of the Restatement (Second) of Conflict of Laws states: "An inter vivos trust in movables is valid if valid under the law of the state designated by the settlor to govern the validity of the trust, provided that the application of its law does not violate a strong public policy of the state with which the trust has its most significant relationship." In *Huber*, the court determined that Washington, not Alaska, had the most substantial relationship to the trust by looking at various factors.

d. **Transfer Tax Consequences of DAPTs**.

(1) **Completed Gift**. The IRS has acknowledged that a transfer to a DAPT can be a completed gift even though the asset may be distributed back to the settlor in the trustee's discretion. Rev. Rul. 76-103 ("If and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rule set forth in §25.2511-2").

(2) **Estate Inclusion**. If a grantor makes a transfer and retains the right to the income from the property or the property itself, §2036 may cause estate inclusion of the transferred asset. Several cases have held that the ability of a settlor's creditors to reach the assets will be deemed to be retained use and enjoyment of the transferred assets for purposes of §2036. (*Paxton v Commissioner, German Estate v. U.S., Outwin Estate v. Commissioner, Paolozzi v. Commissioner*).

Will §2036 apply if the trustee has the discretion to make distributions to the settlor but state law does not permit the settlor's creditors to reach the trust assets under a DAPT statute? In Letter Ruling 98337007 the IRS concluded that whether assets in an Alaska DAPT would be excluded from the settlor's estate depended upon the facts and circumstances existing at the settlor's death. Letter Ruling 200944002 similarly refused to rule as to whether the trustee's discretion to distribute trust assets to the settlor, when combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement), may cause inclusion in the settlor's gross estate under §2036.

29. Qualified Opportunity Funds

Estate planners need to understand the basic nuts and bolts of qualified opportunity funds and give some thought to some of the estate planning implications.

a. **2017 Tax Act**. The qualified opportunity zone investment regime was enacted as part of the 2017 Tax Act, but was actually based on an earlier bipartisan bill. This provision was included as a way to help get Senate approval of the Act.

b. **General Description of Income Tax Benefits**. Two new Code sections, §1400 Z-1 and §1400 Z-2, provide federal income tax benefits for investing in businesses that are located in "opportunity zones." Opportunity zones are distressed low-income communities that have already been identified; 8,700 of these distressed communities have been identified by census tract in all 50 states plus the District of Columbia plus 5 territories (all of Puerto Rico is considered to be a distressed community). Investors have pointed out that some of the "distressed low-income communities" are in areas of prime economic development. Potentially three income tax benefits arise from investing in a qualified opportunity fund that has invested in qualified opportunity zone property in any of these communities.

(1) **Tax Benefit 1: Deferral of Existing Gain**. An investor who has sold property and realized gains may defer until December 31, 2026 (or when the qualified opportunity fund investment is sold) capital gains that are invested in a qualified opportunity fund within 180 days of when the gain was realized. (The full sale proceeds do not need to be invested in the opportunity fund; just the amount of the capital gains.)

(2) **Tax Benefit 2: Exclusion of a Portion of Existing Gain**. Furthermore, 10% of the gain can be excluded if the opportunity fund investment is held at least 5 years, and 15% can be excluded if it is held at least 7 years by 2026. Exclusion of 10% or 15% of the gain is accomplished by increasing the basis by that much. The taxpayer's basis in the opportunity fund is initially zero, increasing by 10% of the original deferred gain after five years (resulting in forgiveness of 10% of the original gain), and increasing by another 5% after 7 years (resulting in forgiveness of a cumulative 15% of the original gain). On December 31, 2026, the gain is recognized and the investor's basis in the fund is stepped up to the amount of the original gain that was invested in the fund.

Example: If original gain of $10,000 was invested in the opportunity fund in 2018 within 180 days of when the gain was realized, the initial basis in the opportunity fund is zero, is increased by 10% of the original gain ($1,000) after 5 years, and is increased by another 5% of the original gain ($500) after 7 years. On December 31, 2026, the taxpayer realizes $8,500 of gain, and the taxpayer's basis in the fund is $10,000. A subsequent sale of the fund will generate capital gains, using $10,000 as the basis in the fund (but that gain can be eliminated after 10 years, as described in Tax Benefit 3 immediately below).

(3) **Tax Benefit 3: Possible Nonrecognition of Gains in Opportunity Fund Investment**. If the qualified opportunity fund is held for at least 10 years, all of the gain that is accrued after the investment in the opportunity fund is excluded.

(4) **Example**. For example, if an individual sells securities realizing a $1 million gain, in order to avoid paying $230,000 of income taxes the individual could within 180 days invest $1 million in a qualified opportunity fund. Recognition of the $1 million gain can be deferred until December 31, 2026.

Even better, if the investor retains the qualified opportunity fund for at least five years, only 90% of the gain is reported, and if he holds onto the investment for seven or more years only 85% of the gain is excluded when it must be reported at the end of 2026.

Assume the opportunity fund investment grows in value from $1 million to $1.5 million. If the opportunity fund investment has been held for at least 10 years (therefore beyond the 2026 deferral recognition date), none of the appreciation in the qualified opportunity fund investment must be recognized.

The combination of the deferral (coupled with the possible 15% exclusion) of the existing capital gain plus being able to exclude any subsequent gain to the extent the opportunity fund grows in value provides a powerful income tax incentive for investing in qualified opportunity funds.

c. **Qualified Opportunity Fund**. A qualified opportunity fund is a corporation or partnership that has at least 90% of its assets invested in qualified opportunity zone property on two measuring dates each year, June 30 and December 31.

Qualified opportunity zone property can be any of four alternatives: (1) tangible property that is used in a trade or business that is acquired by purchase in 2018 or later if the original use commences with that corporation or partnership (pre-existing investments do not count); (2) substantial improvements to existing property can be qualified opportunity property if the improvement at least doubles the basis in the property (for example, if a house in the distressed community is purchased for $50,000, improvements of at least another $50,000 would be required for the improvements to constitute qualified opportunity zone property); (3) an investment in stock of a corporation that has qualified opportunity zone property; or (4) an investment in a partnership that has qualified opportunity zone property.

d. **Proposed Regulations; Gifts as "Inclusion Event"; Tacking**. A first set of proposed regulations was issued on October 19, 2018, and Rev. Rul. 2018-29 was issued contemporaneously. The IRS held a hearing regarding those proposed regulations on February 14, 2019. A second set of proposed regulations was issued on April 17, 2019, which made some changes to the 2018 proposed regulations and addressed a number of additional issues. *See generally* Lisa Starczewski, *The Second Set of Proposed Opportunity Zone Regulations: Where Are We Now?*, BNA BLOOMBERG TAX MGMNT. MEMO. (April 22, 2019).

The second set of proposed regulations, among other things, addressed what transactions, referred to as "inclusion events," would trigger recognition of gains that were previously deferred. The statute provides that the deferred gain that is invested in opportunity zone property is recognized in the taxable year that includes the earlier of "(A) the date on which such investment is sold or exchanged, or (B) December 31, 2026." §1400Z-2(b)(1).

Among various transactions treated as inclusion events are gifts of interests in an opportunity zone fund (with an exception for gifts to grantor trusts, as discussed below).

> A taxpayer's transfer of a qualifying investment by gift, whether outright or in trust, is an inclusion event, regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift. Prop. Reg. §1.1400Z-2(c)(3).

This is quite surprising because the statute merely refers to a "sale or exchange" as triggering acceleration of the deferred gain, and traditionally accepted principles do not treat gifts as sales or exchanges. The preamble to the proposed regulations

makes no effort to explain this discrepancy other than to misstate the statute as applying to any "disposition" of the owner's qualifying investment. Preamble at 55. The donee of a gift of an interest in an opportunity fund may tack the donor's or decedent's holding period, respectively, for purposes of excluding 5% or 10% of the deferred gain if the interest in the fund is held for 5 or 7 years, respectively, (as discussed in Item 29.b.(2) above) and for purposes of excluding gain after the time of the investment in the opportunity fund if the interest in the fund is held at least 10 years (as discussed in Item 29.b.(3) above). Prop. Reg. §1.1400Z2(b)-1(d)(1)(iv).

e. **Estate Planning Issues**

(1) **Death before 12-31-2026 Deferral Recognition Date**. What if the investor dies before the December 31, 2026 deferral recognition date? The interest is treated as income in respect of a decedent (so no step up in basis occurs). The 2019 proposed regulations clarify that the death of the investor does not accelerate recognition of the deferred gain, but when the deferred gain is recognized, what if the beneficiary is taxed on the original investor's deferred gain, but the qualified opportunity fund has not performed well and the fund is no longer worth the amount of the deferred gain? In the example described above, what if the gain to be reported is $850,000, $900,000, or $1.0 million dollars (depending on how long the qualified opportunity fund investment was held), but the fund at that time is only worth $200,000? Where does the beneficiary come up with funds to pay the tax on the deferred gain? ACTEC comments to the IRS have requested guidance, and suggest a rule that would give the beneficiary a break in that circumstance.

(2) **Gift of Qualified Opportunity Fund Investments**. ACTEC comments to the IRS stated that as with other gifts that receive a carryover basis, the donee likely would "stand in the shoes" of the original investor for the deferral of the gain until the end of 2026 and the holding periods would presumably tack. However, the 2019 proposed regulations surprisingly take the position that gifts are treated as inclusion events that trigger the deferred gain, even though the statute merely refers to "sales or exchanges" as triggering the deferred gains prior to the December 31, 2026 final recognition date.

(3) **Application to Trusts**. After a gain is recognized on investment property, the investor generally has up to 180 days to invest that amount in a qualified opportunity fund. If a trust realizes an investment gain which eventually will be reported to a beneficiary when a distribution is made carrying out the gain as part of DNI, does the 180-day period begin from the date that the trust sells the property recognizing the gain, or the date that the distribution is deemed to be made to the beneficiary on the last day of the trust's taxable year, which would give the beneficiary a longer time to make the investment in a qualified opportunity fund? If the 180 days runs from when the trust sells the property, the 180 days could be completed before the beneficiary ever receives a K-1 advising the beneficiary of the gain.

(4) **Gifts to Grantor Trusts**. Even though gifts are generally treated as inclusion events, the 2019 proposed regulations make an exception for gifts to grantor trusts. The rationale for this exception is explained by the preamble to the proposed regulations:

> The rationale for this exception is that, for Federal income tax purposes, the owner of the grantor trust is treated as the owner of the property in the trust until such time that the owner releases certain powers that cause the trust to be treated as a grantor trust. Accordingly, the owner's qualifying investment is not reduced or eliminated for Federal income tax purposes upon the transfer to such a grantor trust. However, any change in the grantor trust status of the trust (except by reason of the grantor's death) is an inclusion event because the owner of the trust property for Federal income tax purposes is changing. Preamble at 55-56.

If the trust loses its status as a grantor trust, that will constitute an inclusion event. The proposed regulations state that "a change in the status of a grantor trust, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event." Prop. Reg. §1.1400Z2(b)-1(c)(5)(ii). Perhaps the "creation of grantor trust status" reference is to a non-grantor trust that has invested in an opportunity fund and that later becomes a grantor trust as to a deemed owner or to a grantor trust that becomes a grantor trust as to a different deemed owner under §678.

As a corollary to the following discussion that death is not a triggering event, "the termination of grantor trust status as a result of the death of the owner of a qualifying investment is not an inclusion event." Prop. Reg. §1.1400Z2(b)-1 (c)(5)(ii).

The literal wording of the proposed regulations seems to apply this grantor trust exception to trusts that are grantor trusts as to a "deemed owner" under §678 as well as to traditional grantor trusts. The proposed regulations state that the exception applies if the owner of the qualifying investment is the "deemed owner of the trust." The preamble similarly refers multiple times to the "owner" of the trust (but does in one place refer to the "grantor" rather than the "owner" in referring to the "grantor's death"). Applying the exception to transfers by an owner of a qualifying investment to a trust of which that person is the deemed owner of the trust seems to be applying the exception to trusts that are grantor trusts as to a third person deemed owner under §678, which indirectly suggests that the IRS would apply the rationale of Rev. Rul. 85-13, 1985-1 C.B. 184, to transfers by third party deemed owners to §678 trusts.

(5) **Death Not an Inclusion Event**. The 2019 proposed regulations provide that a transfer of an investment in an opportunity fund "by reason of the taxpayer's death" is not an inclusion event. This exception includes the death of the investor, the transfer of the investment to the deceased owner's estate, the distribution by the estate to legatees or heirs, a distribution by the deceased owner's trust that is made by reason of the deceased owner's death, or the passing of a jointly owned qualifying investment to the surviving co-owner by operation of law. Prop. Reg. §1.1400Z2(b)-1 (c)(4)(i). Not included in the exception is a "sale, exchange, or other disposition" (other than a distribution as described above), or any disposition by the legatee, heir, beneficiary, or surviving joint owner. Prop. Reg. §1.1400Z2(b)-1 (c)(4)(ii). The rationale stated in the preamble for not treating transfers by reason of the death of the investor as an inclusion event is "in part" that the recipient of the interest will have the obligation under §691 to include the deferred gain in gross income in the case of an inclusion event by that recipient.

(6) **Extension of Concepts in 2019 Proposed Regulations to Sales to Grantor Trust Transactions**. The 2019 proposed regulation refers to "contributions to grantor trusts" as not being an inclusion event. Prop. Reg. §1.1400Z2(b)-1 (c)(5)(i). This would seem to refer to **gifts** to grantor trusts and the proposed regulation does not specifically refer to **sales** to grantor trusts. However, the rationale for the exception as described in the preamble (and as quoted immediately above) would apply as aptly to sales as well as to gifts to grantor trusts.

The treatment of grantor trusts in the proposed regulations supports what has come to be thought as the general rule that losing grantor trust status during life may be a realization event (oft cited are *Madorin* and Rev. Rul. 77-402 about the effect of losing grantor trust status during life for partnership tax purposes), but that the death of the grantor does not result in a realization event. Chief Counsel Advice 200923024 is cited as evidence of the government's support of this position. That CCA concluded:

> 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)

Now something more authoritative than a CCA states the government's position—a proposed regulation takes the position that the death of a grantor is not a realization event with respect to "deferred recognition assets" in a grantor trust.

When note payments are made by a grantor trust after the grantor's death, is gain realized by the estate with respect to those subsequent payments? The analogy to the proposed regulations might suggest that gain realization applies as payments are received (if the grantor trust after the death of the grantor or if distributees of the grantor trust sell their interests in an opportunity fund, that triggers the deferred gain at that time). A big distinction applies for sales to grantor trusts. If a grantor sells an asset and invests the proceeds representing the appreciation in an opportunity fund within 180 days, the gain recognition is deferred. For the opportunity fund investment, an inclusion event causes the acceleration of the recognition of gain that has been realized but the recognition of which has just been deferred. On the other hand, if a grantor sells an asset to a grantor trust, no gain recognition occurs (under Rev. Rul. 85-13)—the issue is not merely deferring recognition of gain that has already occurred. At the grantor's death, the issue is whether the grantor's note from the trust gets a basis step-up wiping out the gain that might be realized when payments are received after the grantor's death. A rather commonly held belief is that the note is not IRD to the grantor so it would get a basis adjustment at death. It is not IRD because the existence, amount and character of IRD are determined as if "the decedent had lived and received such amount." §691(a)(3). The decedent would not have recognized income if the note were paid during life (under Rev. Rul. 85-13) so the note should not be IRD.

30. 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.bessemertrust.com/for-professional-partners/advisor-insights**.

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.bessemertrust.com/for-professional-partners/advisor-insights**.

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.bessemertrust.com/for-professional-partners/advisor-insights**.

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.bessemertrust.com/for-professional-partners/advisor-insights**.

d. **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.)

e. **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.bessemertrust.com/for-professional-partners/advisor-insights**.

31. Estate Planning and Trust Management for a Brave New World of Changing Demographics and Family Dynamics

Hugh Magill (Chicago, Illinois) discussed wide ranging impacts on estate planning of changing family structures and demographics. While estate planning issues will be evolving in light of those changes (and to accommodate those changes), we must keep in mind the overarching goals of assisting families with their planning. In Hugh's words: "While the composition of the families that we serve today is undergoing dramatic change, whatever the composition, of course, each family is a group of individuals – individual human beings drawn together by love and by financial wealth, addressing the issues we all face during our mortality."

For a summary of Hugh's excellent forward thinking about ways that estate planning must evolve to accommodate these changes, see Items 3-13 of the ACTEC 2018 Annual Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

32. Electronic Wills and Uniform 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). Electronic will statutes now exist in Nevada, Indiana, and Arizona. In 2017, legislation was passed by the Florida legislature 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, and it will be considered in Florida again this year. Legislation allowing electronic wills is being considered in other states as well. A growing trend of interest is appearing in this topic.

The Uniform Law Commission approved the Uniform Electronic Wills Act in July 2019. The Act recognizes the validity of electronic wills. The testator's electronic signature must be witnessed contemporaneously (or notarized contemporaneously in states that allow notarized wills), and the document must be stored in a tamper-evident file. An optional provision that may be adopted by states allows remote witnessing. The Act specifically addresses the recognition of electronic wills executed under another state's law.

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).

A handful of cases in the U.S. have approved electronic wills, and have all involved situations in which elements of authenticity backed by clear and convincing evidence of intent were present. *Taylor v. Holt*, 134 S.W.3d 830 (Tenn. Ct. App. 2004); *Litevich v. Probate Court, District of West Haven*, 2013 Ct. Supp. 1362 2013 WL 2945055; *In re: Estate of Javier Castro*, Deceased, 2013-ES-00140 (Ct. Comm. Pl. Lorain County, Prob. Div., Ohio, June 19, 2013); *In re Estate of Duane Francis Horton, II*, 2018 WL 3443383 (Mich. Ct. App. July 17, 2018. These cases and the existing state statutes in Nevada,

Indiana, and Arizona are summarized in Sandra Glazier, *Electronic Wills: Revolution, Evolution, or Devolution*, 44 TAX MANAGEMENT ESTS., GIFTS & TRUSTS J. 34 (January 10, 2019).

33. Valuation of S Corporation Shares; Applicability of Section 2703(b) to Family Transfer Restriction, *Kress v. U.S.* (E.D. Wis, March 26, 2019)

Kress v. U.S., 123 AFTR 2d 2019-1224 (E.D. Wisconsin March 26, 2019), is a very interesting case with respect to various valuation issues. It is a gift tax refund case, with the sole issue being the value of minority interests in S corporation stock. The S corporation (Green Bay Packaging, Inc., referred to in the opinion as "GBP") owned an operating business and non-operating assets. For an excellent detailed analysis of the case, see James Dougherty & Todd Povlich, *The Latest Development in Business Valuation: Burdens of Proof, Tax Affecting S Corporations, and Chapter 14 in* Kress, 44 BLOOMBERG TAX MNGT ESTATES, GIFTS AND TRUSTS J. 179 (July 11, 2019).

a. **Gift Tax Returns; Deficiency Assessment; Payment of Tax; Refund Action**. The gift tax returns (presumably making the split gift election) valued the gifted shares at $28.00 in 2007, $25.90 in 2008, and $21.60 in 2009, and the total gift tax paid for both spouses was $2,438,482. The IRS assessed gift tax based on "the price used for actual share transactions between GBP and its employees which was $45.97 on December 31, 2006, $47.63 on December 31, 2007, and $50.85 on December 31, 2008." (About 90% of the stock was owned by family members, and about 10% was owned by employees and directors. The purchase price for shares sold to or purchased from employees and directors was 120% of the book value of the shares. There was no established price for shares transferred to members of the Kress family.) The taxpayers paid the gift tax deficiencies and accrued interest of $2,218,465.80 and sued for a refund.

b. **Burden of Proof Shifted to Government**. The burden of proof was shifted to the government because the taxpayer produced credible evidence (though it is not clear that finding made a difference because the court found that the government failed to prove by a preponderance of the evidence that the government appraisal was correct).

c. **Appraiser's Prior Position Used to Criticize the Appraiser**. The government appraiser was Francis Burns; in criticizing Burns' appraisal, the court noted that Francis Burns allowed greater lack of marketability discounts in the *Holman* case (601 F.3d 763, 774 (8th Cir. 2010)) even though there was greater liquidity in that case than in the corporation being valued in *Kress* (GBP).

d. **Tax-Affecting**. Both the taxpayer and government experts tax-affected the earnings of the S corporation to apply a C corporation level tax to effectively compare the S corporation being valued to other C corporations that were used as comparables.

   For example, the government's appraiser (Burns) used a market approach (deriving multiples of enterprise value to earnings *before* interest, *tax*, depreciation, and amortization (EBITDA) and price to earnings of selected comparable companies and applying "the multiples to relevant GBP financial data") and also used an income

approach by completing a capitalized cash flow analysis in which "[h]e applied an **effective tax rate to GBP as if it were a C-corporation** and then applied an adjustment to reflect the value of GBP as an S-corporation."

Burns also applied an S corporation premium because of advantages associated with being an S corporation, but the court found the subchapter S status to be a neutral consideration because there were also disadvantages of S corporation status ("including the limited ability to reinvest in the company and the limited access to credit markets"), and it was "unclear if a minority shareholder enjoys those benefits."

See Item 11.j.(11) above for a discussion of the recent *Estate of Jones v. Commissioner* case (T.C. Memo. 2019-101) that allowed tax affecting of the earnings of a partnership and an S corporation as well as making appropriate adjustments to reflect the tax advantages of operating as flowthrough entities.

e. **Application of Section 2703(b) to Family Transfer Restriction**. A Family Transfer Restriction provided that family members could only transfer shares to other family members. The court addressed whether the transfer restriction satisfied the §2703(b) safe harbor.

(1) **Bona Fide Business Arrangement, §2703(b)(1)**. It satisfied the bona fide business arrangement test of 2703(b)(1) because it assured family control, minimized risks of a dissident shareholder, ensured confidentiality, and assured that sales were to qualified S shareholders. *Holman* had held that maintaining family control did not meet the bona fide business arrangement if there was not an operating business, but there was an operating business in *Kress*.

(2) **Device Test; "Natural Objects of the Bounty" Regulation Rejected, §2703(b)(2)**. The court held that the 2703(b)(2) "not a device" test was satisfied because this restriction was for inter vivos transfers, not just testamentary transfers, and the statute only applies to a device to transfer at less than fair market value to a DECEDENT's family. The court rejected the "natural objects of the bounty" regulation as not satisfying the *Chevron* test [467 U.S. 837 (1984)] because the statute was unambiguous.

(3) **Comparability Test, §2703(b)(3)**. The "comparable to arrangements in arms' length transactions" test of 2703(b)(3) was not satisfied. "Though Plaintiffs contend restrictions like the Kress Family Restriction are common in the commercial world, they have not produced any evidence that unrelated parties at arms' length would agree to such an arrangement."

(4) **Section 2703 Had Little Impact**. Even though §2703 prevented the court from considering the Family Transfer Restriction, the taxpayer's appraisers said that the restriction had little impact on the lack of marketability discount, and the court reduced the LOM discount by only 3% as a result of not taking into account the Family Transfer Restriction.

f. **Judicial Notice of 2008 Economic Recession**. One of the years in question was 2009, and the court took judicial notice of the economic downturn at the end of 2008 and criticized the Burns appraisal because it did not "adequately account for the 2008 recession." Also, the court concluded that Burns "relied on an outlier as a comparable company."

g. **Treatment of Non-Operating Assets**. The Burns appraisal added the value of non-operating assets "at almost their full value, with a slight discount … for minority shareholders." The John Emory appraisal (the taxpayer's appraisal that the court found most credible of the appraisals presented as evidence) "considered the non-operating assets to the extent that those assets contributed to GBP's overall earnings. He did not add their overall value back into the value of the minority shares, reasoning that a minority shareholder cannot realize the valuations."

   The court said the government appraiser's approach of adding the value of the non-operating assets at almost their full value was improper: "But a minority shareholder has no control over the use or dissipation of the assets and cannot realize the value of the assets until GBP is sold. Because there is no expectation of liquidation, Burns' treatment of the non-operating assets overstated the value of the stock for each year in question."

h. **Lack of Marketability Discounts**. The court applied lack of marketability discounts of 25% for 2007-2008 and 27% for 2009 (which numbers included a 3% downward adjustment because the Family Transfer Restriction was not being taken into account). There were two taxpayer opinions, and the court found one of them (by Emory) to be the "most sound." Emory had applied LOM discounts of 30% in 2007-2008 and 28% in 2009. Burns had used LOM discounts ranging from 10.8% to 11.2%.

i. **Overall Credibility of Emory Appraisal**. Perhaps key to the court's conclusion is the court's high opinion of the credibility of the Emory appraisal. The court's discussion of the reasons for its opinion of the Emory appraisal is instructive.

> Emory has prepared valuation reports for GBP since 1999 and prepared the valuation of the stock that was submitted with Plaintiffs' tax returns….
>
> … In applying the market approach, Emory reviewed his prior GBP valuation reports, GBP's audited consolidated financial statement for the previous five years, and GBP's financial estimates for the upcoming year. He also met with GBP management to discuss the company's state of affairs, its financial statements, and any unique circumstances GBP faced or expected to experience.
>
> …
>
> After reviewing the reports and testimony of these witnesses, the court finds the valuation methodology of Emory is the most sound. Emory is a certified appraiser who spent ample time with the company and management and truly understands GBP's business. As a result of this understanding, he used more accurate projections to value the business and more adequately accounted for the effects of the economic recession…. [Tt]he record shows that Emory derived base values through the exercise of interviewing GBP management, reviewing his prior year reports, and analyzing the guideline companies and the multiples they yielded. He further examined attributes that were specific to GBP, analyzed GBP's debt and management philosophy, and reviewed business metrics including price, book value, earnings, dividends, EBITDA, assets, and sales on a "holistic" basis to determine a value that best fit the guideline companies. His analysis recognizes the variability and non-quantifiable judgments by which various factors are taken into consideration and impact the price of a share of minority stock.

   The degree to which the court found Emory's appraisal credible is truly reflected in its summary of his appraisal:

Emory did not create his valuations with the benefit of hindsight, for the purpose of litigation, or for Plaintiffs' benefit in transferring their stock to their children and grandchildren. He provided credible and thorough valuations supporting the value of the stock Plaintiffs reported on their tax returns.

34. Valuation of Timberland Using Income Approach Rather Than Net Asset Value; Tax-Affecting Approved for Valuing S Corporation and Limited Partnership, *Estate of Jones v. Commissioner,* T.C. Memo. 2019-101 (August 19, 2019)

The following discussion of and commentary about *Estate of Jones v. Commissioner* is excerpted from a summary and analysis of *Jones* by Ronald D. Aucutt available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

a. **Synopsis**. In May 2009, Aaron Jones made gifts to his three daughters, and to trusts for their benefit, of voting and nonvoting interests in an S corporation and limited partnership that together operated a lumber and timber business that he had originally founded in 1954. He reported the gifts on his gift tax return with a total value of about $21 million, but the IRS notice of deficiency asserted a value of about $120 million and a gift tax deficiency of about $45 million. The Tax Court agreed with the taxpayer's appraiser that the value was about $24 million, and the resulting gift tax owed will apparently be less than $2 million.

The most significant issue from a monetary standpoint is that the timber is valued under the income method rather than the net asset value method in this situation where there is an ongoing business operation and the facts are clear that the timber will not be liquidated and the transferee would have no ability to force the liquidation. Another interesting issue is that the Tax Court concluded that "tax-affecting" the earnings of the S corporation and limited partnership was appropriate in determining the valuations of the entities under the income method. The Tax Court has been reluctant to accept tax-affecting following its decision twenty years ago in *Gross v. Commissioner*. That may be changing. *Estate of Aaron U. Jones v. Commissioner,* T.C. Memo. 2019-101 (August 19, 2019, Judge Pugh).

b. **Basic Facts**.

(1) **Background.** The core business involved in the 2009 gifts was Seneca Sawmill Co. (SSC) of Eugene, Oregon. Mr. Jones founded SSC in 1954 as a lumber manufacturing business; in 1986 it elected to be an S corporation. The Tax Court opinion describes the significant growth of the business since 1954 and includes considerable detail about the operation and business environment of the lumber business. At the time of the gifts in 2009, SJTC (introduced and described in the next paragraph) held approximately 1.45 billion board feet of timber over 165,000 acres in western Oregon.

Originally relying on timber from federal lands, SSC began purchasing its own land in 1989 when environmental regulations had reduced the access to federal lands. In 1992 Mr. Jones formed Seneca Jones Timber Co. (SJTC), an Oregon limited partnership, to hold timberlands intended to be SSC's inventory and to obtain debt financing secured by the timberlands. SSC was the 10 percent general partner of SJTC and contributed to SJTC the timberland it had recently acquired. SSC and SJTC share a management team and share their headquarters in Eugene, which was built in 1996.

SSC's shareholders could not sell, give away, or otherwise transfer their SSC stock, except in compliance with a Buy-Sell Agreement. Any sale of SSC stock that caused SSC to cease to be an S corporation would be null and void under the Buy-Sell Agreement, unless SSC and the holders of a majority of its outstanding shares consented. If an SSC shareholder intended to sell, give away, or otherwise transfer SSC stock to a person other than a family member, the shareholder had to notify SSC, which had a right of first refusal to purchase those shares. If SSC declined to purchase the shares, the other shareholders were given the option to purchase them. If either SSC or other shareholders exercised their option to purchase shares, the purchase price was the fair market value of the shares, which was to be mutually agreed upon or, if the parties could not agree, determined by an appraisal. Under the Buy-Sell Agreement, the reasonably anticipated cash distributions allocable to the shares had to be considered and discounts for lack of marketability, lack of control, and lack of voting rights had to be applied in determining the fair market value.

Under SJTC's partnership agreement, no transfer of SJTC partnership units was valid if it would terminate the partnership for federal or state tax purposes. The consent of all partners was required for the substitution of a transferee of SJTC partnership units as a limited partner. A transferee who was not substituted as a limited partner would be merely an assignee. Limited partners were also subject to a Buy-Sell Agreement, which mirrored SSC's Buy-Sell Agreement: Any transfers that would terminate SJTC's partnership status for tax purposes were void; SJTC and then the other limited partners were granted a right of first refusal before a limited partner could transfer units; and a determination of fair market value had to take into account lack of marketability, lack of control, lack of voting rights of an assignee, and the reasonably anticipated cash distributions allocable to the units.

(2) **2009 Gifts.** On May 28, 2009, pursuant to succession planning that began in 1996, Mr. Jones formed seven family trusts, made gifts to those trusts of SSC voting and nonvoting stock, and made gifts to his three daughters of SJTC limited partner interests.

(3) **Gift Tax Valuation Dispute.** Mr. Jones timely filed a 2009 gift tax return, reporting values based on accompanying appraisals that had determined values of $325 per share of SSC voting stock, $315 per share of SSC nonvoting stock, and $350 per SJTC limited partner unit, resulting in total gifts of about $20,895,000.

The IRS's notice of deficiency asserted that the corresponding values should have been $1,395 per share of SSC voting stock, $1,325 per share of SSC nonvoting stock, and $2,511 per SJTC limited partner unit, resulting in total gifts of about $119,987,000 and a gift tax deficiency (including other much smaller items which were not disputed in the Tax Court) of $44,986,416.

Mr. Jones filed a petition in the Tax Court in November 2013. He died on September 14, 2014, and was replaced in the Tax Court proceeding by his estate and his personal representatives. The estate engaged another appraiser, Robert Reilly of Willamette Management Associates, whose appraisal, employing a discounted cashflow (DCF) method, determined values of $390 per share of SSC voting stock, $380 per share of SSC nonvoting stock, and also $380 per SJTC limited partner unit, somewhat higher than the values reported on Mr. Jones's gift tax return but far smaller than the values asserted by the IRS.

An appraiser engaged by the IRS, using a net asset value (NAV) approach, determined the value of an SJTC limited partner unit to be $2,530, slightly higher than the notice of deficiency. (The court explained that "Respondent did not submit a valuation of SSC and largely accepted the valuation methods and inputs Mr. Reilly used in his valuation of SSC.")

The following table summarizes those per-share and per-unit values:

	Gift Tax Return	Notice of Deficiency	Estate's Expert	IRS's Expert	The Court
SSC voting	$325	$1,395	$390		$390
SSC nonvoting	$315	$1,325	$380		$380
SJTC limited	$350	$2,511	$380	$2,530	$380

c. **Opinion**. A four-day trial was held in Portland, Oregon, in November 2017, and Judge Pugh's opinion in *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101, was issued August 19, 2019, accepting all the values determined by Mr. Reilly.

In the view of the court:

> The primary dispute between the parties is whether SJTC should be valued using an income approach or an asset-based approach. The parties have several other points of dispute: (1) the reliability of the 2009 revised projections, (2) the propriety of "tax-affecting", (3) the proper treatment of intercompany loans from SSC to SJTC, (4) the proper treatment of SSC's 10% general partner interest in SJTC, and (5) the appropriate discount for lack of marketability.

(1) **Income or Asset-Based Approach for SJTC.** Whether an income or asset-based approach is used for valuing the timberland in SJTC makes an enormous dollar difference in this case. The court noted that the parties did not dispute that SJTC is a going concern, but also noted that "SJTC has aspects of both an operating company ("SJTC … plants trees and harvests and sells the logs") and an investment or holding company ("SJTC's timberlands are its primary asset, and they will retain and increase in value, even if SJTC is not profitable on a year-to-year basis")." The court stated:

> [T]he less likely SJTC is to sell its timberlands, the less weight we should assign to an asset-based approach. See Estate of Giustina v. Commissioner, 586 F. App'x 417, 418 (9th Cir. 2014) (holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record), rev'g and remanding T.C. Memo. 2011-141.

The court concluded that:

> SJTC and SSC were so closely aligned and interdependent that, in valuing SJTC, it is appropriate to take into account its relationship with SSC and vice versa …
>
> We, therefore, conclude that an income-based approach, like Mr. Reilly's DCF method, is more appropriate for SJTC than [the IRS's expert's] NAV method valuation. See Estate of Giustina v. Commissioner, 586 F. App'x at 418.

(2) **Reliability of 2009 Revised Projections.** Mr. Reilly's valuation relied on revised projections that SJTC's management made less than two months after SJTC's annual report, out of concern that SJTC might violate its loan covenants. The revised projections were made in April 2009, and the gifts were made in May 2009. The IRS and its expert thought the revised projections "may have represented the worst-case scenario and were overly pessimistic."

The court acknowledged the ground for such alleged pessimism in its description of the background and history of the business, where it noted:

> As of the valuation date SSC's dimension and stud lumber were used primarily to build houses and, therefore, its lumber sales were almost completely dependent on housing starts.
>
> …
>
> As of the valuation date the United States was experiencing severe economic turmoil amidst the subprime mortgage crisis, especially in the housing market. Housing starts, which measure new residential construction projects during a given period, declined in the United States from 2.3 million units in early 2006 to 490,000 units in early 2009. The crisis required SSC to reduce production. It also reduced the hours that its employees worked so that it could avoid layoffs.

Regarding the IRS's objection to the 2009 revised projections, the court turned the objection around and concluded:

> The only ground for challenging the reliability of the revised projections is that the volatile economic conditions meant that they were not reliable for long. This is precisely why management wanted the revised projections. As they were the most current as of the valuation date, Mr. Reilly's use was appropriate.

(3) **Tax-Affecting.** Mr. Reilly "tax-affected" the earnings of SJTC and SSC by using a proxy for the combined federal and state income tax rates they would bear if they were C corporations, albeit taxed at individual, not corporate rates, in order to adjust for the differences between passthrough entities and C corporations (like the public companies used for comparison in the valuation process). The IRS objected to tax-affecting, arguing that there was no evidence that SJTC or SSC would lose its passthrough status and insisting that the Tax Court had rejected tax-affecting in cases such as *Gross v. Commissioner*, T.C. Memo. 1999-254, *aff'd*, 272 F.3d 333 (6th Cir. 2001), *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, and *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141.

But the court explained that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax-affecting the earnings of a flowthrough entity per se. Instead, Judge Pugh viewed the issue as fact-based, and noted that the court in those cases had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases. The court viewed those cases as concluding that (1) assuming a zero income tax rate on the earnings properly reflected the overall tax savings of operating as an S corporation (*Gross v. Commissioner*), (2) the taxpayer's expert did not justify tax-affecting the earnings in balancing the burden of the individual level tax with the benefit of the reduced total tax burden (*Estate of Gallagher v. Commissioner*), and (3) tax-affecting the earnings resulted in a posttax cash flow but the expert applied a pretax discount rate (*Estate of Giustina v. Commissioner*). In *Jones*, on the contrary, Judge Pugh concluded that Mr. Reilly's detailed tax-affecting analysis was appropriate:

> We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flowthrough status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy. … Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate.

Footnote 5 emphasized that *Gross* was decided on the evidence before the court, which was far different than in the current case:

> In Gross the expert applied a hypothetical 40% corporate tax rate to earnings but did not apply any premium to reflect the benefit of avoided dividend tax. Thus the Court was presented with a choice between a 40% or a 0% corporate tax rate. Id. That is not the choice before us here.

As stated, *Jones* involves tax-affecting for both an S corporation (SSC) and a partnership (SJTC). The court's *discussion* of tax-affecting is addressed to the partnership, SJTC, which comes first in its opinion, probably so that the court could address first what it regarded as the "primary dispute" over the use of an income approach to value SJTC. But it should not be overlooked – and, it is hoped, won't be overlooked by the IRS and the judges in future valuation cases – that in the discussion specifically targeting SSC the court stated, without qualification:

> Mr. Reilly used the same methodology to tax-affect his valuation of SSC except that he used a different rate for the dividend tax avoided because his analysis of the implied benefit for SSC's shareholders in prior years yielded a different rate. We accept Mr. Reilly's method of tax-affecting the valuation of SSC for the same reasons we accepted it for the valuation of SJTC.

(4) **Intercompany Loans.** The IRS had argued that the intercompany debt (owed by SJTC to SSC) should be treated as a nonoperating investment asset and added to the value of SSC. Again emphasizing the interrelationship of the two companies, the court concluded:

> By eliminating SSC's receivable and SJTC's payable and treating their intercompany interest income and expense as operating income and expense, Mr. Reilly captured their relationship as interdependent parts of a single business enterprise. Because SJTC's intercompany interest income and expense were accounted for in the DCF method valuation, the intercompany debt need not be added in at the end as a nonoperating asset. See Estate of Heck v. Commissioner, T.C. Memo. 2002-34.

(5) **SSC's General Partner Interest in SJTC.** The IRS had argued that SSC's 10 percent general partner interest in SJTC should be valued as a *nonoperating* asset and a *controlling* interest by valuing it at simply 10 percent of the value of SJTC, rather than on the basis of expected distributions as in Mr. Reilly's DCF valuation. Consistently with its view of SSC and SJTC as a single business enterprise, the court rejected that argument.

(6) **Discount for Lack of Marketability.** The court noted that only 5 percent separated Mr. Reilly (35 percent) and the IRS's expert (30 percent) on the subject of lack-of-marketability discounts. The court adds that "Respondent contends that Mr. Reilly's 35% discount for lack of marketability was excessive and that he did not explain sufficiently how he arrived at the discount." There is no further elaboration of how the IRS found 35 percent to be excessive or how it defended its own expert's conclusion of 30 percent. If that is a true portrayal of the IRS's role on this issue, then the IRS must simply have been tired by this point.

To the allegation that Mr. Reilly had not sufficiently explained how he arrived at a 35 percent discount, the court replied "We disagree" and provided a whole paragraph summarizing what Mr. Reilly had done (quoted in subparagraph j below). It then pointed out:

> [The IRS's expert] did not consider the restrictions on transferability in the SJTC Buy-Sell Agreement, and he conceded at trial that it would likely increase the discount by "something like 1%, 2%". Because [the IRS's expert] was guessing at changes to his discount during the trial to account for considerations that he left out, we conclude that the proper discount for lack of marketability was 35%.

(7) **Conclusion.** The court concluded simply that "we therefore adopt the valuations in Mr. Reilly's report." A taxpayer victory, a decade after the gifts.

d. **Income or Asset-Based Approach.** The differences between an income approach and asset-based approach can be huge, particularly in a case involving standing timber that obviously is not harvested every year. In *Jones*, Mr. Reilly agreed with a valuation submitted by the IRS that SJTC's timberland had an estimated market value of $424 million. Yet, using an income approach and comparisons to guideline operating companies, Mr. Reilly calculated the weighted enterprise value of SJTC to be $107 million – barely one-fourth the asset value.

This is not the first time the Tax Court has chosen between an income and asset-based approach to the valuation of a Eugene, Oregon, timber business. *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141, also presented that issue, and the counsel for the estate, the counsel for the IRS, and the estate's expert were all the same as in the *Jones* case. Rejecting Mr. Reilly's view in *Giustina*, the Tax Court (Judge Morrison) gave a 25 percent weight to a $151 million value determined by an asset approach, compared to a value of $52 million determined by a cashflow method and given a 75 percent weight. As Judge Pugh's reference to *Giustina* (quoted above) acknowledges, that decision was reversed by the Court of Appeals for the Ninth Circuit's "holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record." In fact, quoting from a previous opinion, the Ninth Circuit stated in *Giustina*:

> As in *Estate of Simplot v. Commissioner*, 249 F.3d 1191, 1195 (9th Cir. 2001), the Tax Court engaged in "imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect" with the existing partners.

If the Tax Court in *Jones* had accepted an asset-based valuation, the estate could have appealed that decision to the Ninth Circuit. It is certainly plausible that the taxpayer's victory in *Jones*, at least on the issue of the asset-based approach, is attributable in part to the rebuke the Ninth Circuit had given the Tax Court in *Giustina*.

e. **The 2009 Revised Projections.** Neither is this the first time a court has been influenced in a gift tax valuation case by the gravity of the 2008 economic downturn. For example, judicial notice of that recession was a factor in *Kress v. United States* (discussed in subparagraph e.(7) below), which was also a taxpayer victory that involved tax-affecting and the credibility and thoroughness of the taxpayer's valuation expert.

f. **Tax-Affecting**. "Tax-affecting" refers to the step in the valuation of a closely-held business that seeks to adjust for certain differences between passthrough entities and C corporations. Typically, the passthrough entity in mind is an S corporation, but tax-affecting can be applied in the partnership context too. Significantly, *Jones* involved tax-affecting for both an S corporation (SSC) and a partnership (SJTC).

(1) **Core Justifications**. While many discussions of tax-affecting are quite technical, the core justifications for tax-affecting are generally (1) that a hypothetical willing buyer in the willing-buyer-willing-seller construct of fair market value is looking for a return on the investment and necessarily will enjoy and therefore evaluate that return only on an *after-tax* basis and (2) that comparable data to use in the valuation process typically comes from public sources and therefore largely comes from C corporations, for which earnings are, again, necessarily determined on an *after-tax* basis. Corollaries to those justifications are that passthrough status (3) confers a benefit of a single level of tax compared to a C corporation, but also (4) limits the universe of potential buyers and investors, who might not be able to buy or invest without forfeiting or jeopardizing (or at least complicating) the S corporation status or other passthrough status. Thus, tax-affecting sometimes includes adjustments to accommodate those corollaries, or sometimes is followed by the application of, for example, an "S corporation premium" as the next step following the tax-affecting. That approach is incorporated in a well-known model used by many appraisers in valuing S corporation stock, referred to sometimes as the S Corporation Economic Adjustment Model and sometimes as the S Corporation Equity Adjustment Model, or, in either case, "SEAM."

(2**) Prior Internal IRS Guidance**. Some 20 years ago, the IRS's internal valuation guide for income, estate, and gift taxes explained tax-affecting (without calling it that) this way:

> [S] corporations are treated similarly to partnerships for tax purposes. S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

The IRS's internal examination technique handbook for estate tax examiners added:

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

(3) ***Gross v. Commissioner***. While tax-affecting was not a new concept 20 years ago, it may have been overtly and directly raised and considered in a gift tax case for the first time in *Gross v. Commissioner*, T.C. Memo. 1999-254. In *Gross* the taxpayer's appraiser tax-affected the value of stock of an S corporation, by using an assumed undiscounted corporate income tax rate of 40 percent. Judge Halpern viewed that as "a fictitious tax burden, equal to an assumed corporate tax rate of 40 percent." He tied the idea of tax-affecting for an S corporation to the "*probability*"

that the corporation would lose its S status and concluded that "[w]e do not … think it is reasonable to tax affect an S corporation's projected earnings with an undiscounted corporate tax rate without facts or circumstances sufficient to establish the likelihood that the election would be lost." He acknowledged that the taxpayer's appraiser had discussed the disadvantage of S corporations in raising capital, due to the restrictions of ownership necessary to qualify for the S election, but concluded:

> This concern is more appropriately addressed in determining an appropriate cost of capital. In any event, it is not a justification for tax affecting an S corporation's projected earnings under a discounted cash-flow approach. [The taxpayer's appraiser] has failed to put forward any cognizable argument justifying the merits of tax affecting [the corporation's] projected earnings under a discounted cash-flow approach.

He also pointed out, although not in such words, that tax-affecting was counter-intuitive, noting (emphasis added) that "[w]e believe that the principal *benefit* that shareholders *expect* from an S corporation election is a *reduction* in the total tax burden imposed on the enterprise."

Regarding the IRS internal guide and handbook quoted above, Judge Halpern stated:

> Both statements lack analytical support, and we refuse to interpret them as establishing respondent's advocacy of tax-affecting as a necessary adjustment to be made in applying the discounted cash-flow analysis to establish the value of an S corporation.

In a confusing set of opinions, in which the lead opinion was not "the holding of the court," the Court of Appeals for the Sixth Circuit affirmed. The judge who wrote the lead opinion stated:

> I must recognize that we are merely determining those factors that hypothetical parties to a sale of [the corporation's] stock would have considered as of the gift date. In this regard, I believe that past practices, which the IRS had not deemed to create a deficiency, are demonstrative of the idea that such hypothetical actors would have considered tax affecting [the corporation's] stock. This fact in conjunction with the testimony of the experts informs my conclusion that the court's decision to use a 0% tax affect in deriving the value of [the corporation's] stock was implausible.

A judge who wrote an opinion "concurring in part, dissenting in part," but joined by another judge, viewed the issue essentially as an issue of fact, stating:

> Valuing closely held stock incorporates a number of alternative methods of valuation, and the appellate courts have afforded the tax court broad discretion in determining what method of valuation most fairly represents the fair market value of the stock in light of the facts presented at trial. See *Palmer v. Comm'r of Internal Rev.*, 523 F.2d 1308 (8th Cir. 1975). Moreover, "complex factual inquiries such as valuation require the trial judge to evaluate a number of facts: whether an expert appraiser's experience and testimony entitle his opinion to more or less weight; whether an alleged comparable sale fairly approximates the subject property's market value; and the overall cogency of each expert's analysis." *Ebben v. Comm'r of Internal Rev.*, 783 F.2d 906, 909 (9th Cir. 1986).
>
> …
>
> Valuation is a fact specific task exercise; tax affecting is but one tool in accomplishing that task. The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction. The Tax Court did that and determined that tax affecting was not appropriate in this case. I do not find its conclusions clearly erroneous.

(4) **IRS Response to *Gross***. The IRS jumped on the decision in *Gross*, viewed it as a Tax Court ban on tax-affecting, rewrote its internal guidance, and took very strong stands against tax-affecting in subsequent cases.

(5) ***Gallagher v. Commissioner***. The Tax Court largely went along with the IRS. For example, in *Gallagher v. Commissioner*, T.C. Memo. 2011-148, Judge Halpern, again, wrote (emphasis added):

> As we stated in *Gross v. Commissioner*, … the principal *benefit* enjoyed by S corporation shareholders is the *reduction* in their total tax burden, a *benefit* that should be considered when valuing an S corporation. [The estate's expert] has advanced no reason for ignoring such a benefit, and we will not impose an unjustified *fictitious* corporate tax rate burden on [the corporation's] future earnings.

(6***) Kress v. United States***. Then, this year, *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. March 26, 2019), addressed tax-affecting in determining the gift tax value of stock in a family owned and operated S corporation, Green Bay Packaging, Inc. (referred to in the court's opinion as "GBP"). GBP is a vertically integrated manufacturer of corrugated packaging, folding cartons, coated labels, and related products, founded in 1933 and headquartered in Green Bay, Wisconsin. Gifts of stock to younger family members in 2007, 2008, and 2006 resulted in gift tax deficiencies assessed by the IRS. The donors paid those gift tax deficiencies and then filed claims for refund and ultimately sued for refunds in the federal district court in Milwaukee. Both the taxpayers' expert (John Emory of Emory and Co. in Milwaukee, who had been preparing valuation reports for GBP since 1999) and the Government's expert (Francis Burns of Global Economics Group in Chicago) had tax-affected GBP's earnings to apply a C corporation level tax to compare the S corporation being valued to C corporations that were used as comparables. For example, the court noted that "[u]nder the income approach, Burns … applied an effective tax rate to GBP as if it were a C-corporation and then applied an adjustment to reflect the value of GBP as an S-corporation." Overall, the court found that "Emory provided reliable valuations of the GBP minority-owned shares of stock" and accepted most of Mr. Emory's conclusions, including his conclusions regarding tax-affecting.

(7) ***Jones,* Looking to Experts**. Now, in *Jones*, back in the Tax Court with attorneys from the IRS rather than the Justice Department, Judge Pugh appeared to agree that tax-affecting had inappropriately become more an issue with examiners and lawyers than a factual inquiry informed by experts and that the experts needed to be listened to. She said:

> While respondent objects vociferously in his brief to petitioner's tax-affecting, his experts are notably silent. The only mention comes in [the IRS's expert's] rebuttal report, in which he argues that Mr. Reilly's tax-affecting was improper, not because SJTC pays no entity level tax, but because SJTC is a natural resources holding company and therefore its "rate of return is closer to the property rates of return". They do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers.

(8) ***Cecil v. Commissioner***. Over three and a half years ago, the Tax Court tried a case, still awaiting decision, that includes tax affecting for valuing S corporation stock as one of its issues. *Estate of William Cecil v. Commissioner*, Cause Nos. 14639-14 and 14640-14 (trial held February 2016). The only entries on the Tax Court's dockets

since the filing of briefs in July 2016 have been papers in January 2018 to change the captions of the cases to reflect both William and Mary Cecil's deaths and Petitioner's Notices of Supplemental Authority this year on April 12 (probably *Kress*, discussed in the following paragraph) and August 20 (undoubtedly *Jones*), with IRS answers three days later in each case. In *Cecil*, both the taxpayer AND the IRS's expert used tax-affecting in their analysis. The Tax Court may have a hard time rejecting tax-affecting as a matter of law when both experts agree in its application. (Tax-affecting is not the only issue in the case.)

g. **No Mention of Section 2703.** Although there were relevant restrictions on transfer in the SSC and SJTC Buy-Sell Agreements, the IRS evidently did not raise the issue of section 2703. The *Jones* petition was filed in late 2013 and the IRS's answer in early 2014, the IRS successfully invoked §2703, at least for purposes of summary judgment, in *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018).

h. **The Importance of the Appraiser.** The outcome in *Jones* is additional confirmation of the importance of thorough and credible appraisals in Tax Court litigation. Willamette Management Associates had its beginning in Portland, Oregon, and Judge Pugh said of Robert Reilly (whom she called "Richard Reilly") that he "has performed approximately 100 business valuations of sawmills and timber product companies." In rather stark contrast, she said of the IRS's valuation expert only that he "has performed several privately held business valuations." As seen in the foregoing discussion, she found Mr. Reilly's work to be thorough and credible and adopted his judgment, for example, regarding his reliance on the rather atypical "revised projections" and his analysis of tax-affecting that brought her to conclude that "Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate."

   But Mr. Reilly, the appraiser whose opinion and work impressed Judge Pugh, apparently had not been engaged before the gift tax return was filed, but was engaged, like counsel was engaged, for the litigation. Nothing gets attention like a $45 million notice of deficiency! It may even have given Mr. Reilly greater credibility that his valuation report actually came in a bit *higher* than the values on the gift tax return. But the Jones family may have been lucky that the new appraiser's higher value was not any more higher, as it could have been awkward to disavow it.

i. **Good Facts.** There were some "good" facts in *Jones* that should not be overlooked in evaluating its precedential application.

   - There was of course a legitimate 55-year-old family-owned operating business.
   - There is no indication that Mr. Jones' actions were taken for him under a power of attorney or other agency arrangement.
   - Mr. Jones' gifts resulted in making his daughters and himself equal owners of the economic interests in both SSC and SJTC. There was no division like 99-1 to attract scrutiny.
   - These were not "deathbed" gifts. Mr. Jones survived the gifts by more than five years. When a deathbed scenario is encountered, it is not possible to go back. But the point remains that often the best estate planning is the earliest estate

planning. The counterpoint is that decisions irrevocably made can later become a source of regret and friction, and the desirability of flexibility should not be overlooked.

- Mr. Jones actually paid some gift tax with his return. The opinion tells us that in 1996 the Jones family built a new headquarters and began succession planning. The succession process was evidently deliberate and not hasty (and, as noted, not a "deathbed" scurry). Mr. Jones may have been advised to choose 2009 when business was down and a willing buyer would have paid less for the business, and there is nothing wrong with that. In 2010 the gift tax rate was scheduled to drop from 45 percent to 35 percent (with the exemption remaining $1 million), but there was uncertainty, especially after the 2008 election, about what the law in 2010 would be. Overall, Mr. Jones seems to have been very well served by his advisors.

j. **Detailed Appraisal Approach Regarding Tax-Affecting**. Valuation experts are critical of the refusal to allow any adjustment to reflect that an S corporation's income is subject to shareholder-level taxes and most appraisers do tax-affect the earnings of S corporations despite the Tax Court's reluctance to accept tax-affecting. If the appraiser tax- affects earnings to be consistent with data available for the capitalization rate used in the capitalization of earnings method or the discount rate used in the discounted cash flow method, the appraisal should address in detail the reasons for doing so. Otherwise, the court will ask why the appraiser adjusted for entity-level taxes when the entity pays no taxes. In addition, the report should take into consideration and balance any benefits that are associated with flow-through status.

   The estate's appraisal in *Jones* provides an excellent example of such a detailed approach that considered both the burden on net cashflow by the anticipated individual income taxes on the business income as well as the benefits of passthrough treatment. Mr. Reilly tax-affected the earnings of the partnership to reflect a 38 percent combined federal and state income tax that the owners would bear to calculate the net cashflow from the partnership as well as the cost of debt capital that was used to determine an appropriate post-tax discount rate. He also took into consideration the benefit of avoiding a dividend tax, including "by estimating the implied benefit for SJTC's partners in prior years and considering an empirical study analyzing S corporation acquisitions" and applying a 22 percent premium to the business enterprise value (that was determined both by a weighted discounted cashflow method and by a guideline publicly traded companies method) to reflect the benefit of avoiding the dividend tax.

   The court does not give a detailed description of the analysis used in tax-affecting the S corporation earnings, but said that Mr. Reilly used the same methodology except that "he used a different rate for the dividend tax avoided because his analysis of the implied benefit for SSC's shareholders in prior years yielded a different rate."

k. **Detailed Appraisal Approach Regarding Lack of Marketability Discount**. The *Jones* opinion also provides an excellent example of a detailed analysis of how an appraiser might arrive at an appropriate marketability discount:

> Mr. Reilly attached an appendix to his report in which he explained the reasoning behind the discount for lack of marketability. In doing so, he explained in detail the common empirical models--studies on the sales of restricted stock and on private, pre-IPO sales of stock--and the two theoretical models--the option pricing model and the DCF model--summarizing the methodology and results of individual studies. He then discussed the effect that restrictions on transferability have on a discount, as well as the other factors listed in Mandelbaum v. Commissioner, T.C. Memo. 1995-255, aff'd, 91 F.3d 124 (3d Cir. 1996). Mr. Reilly arrived at a 35% discount on the basis of the studies he previously discussed and on SJTC's unique characteristics, such as its Buy-Sell Agreement, its lack of historical transfers, a potentially indefinite holding period, its reported loss in the 12 months before to [sic] the valuation date, and the unpredictability of partner distributions.

35. Anticipated Merger Must be Considered in Valuing Stock, *CCA 201939002*.

a. **Synopsis**. IRS Chief Counsel Advice (CCA) 201939002, dated May 28, 2019, and released September 27, 2019, concluded that a stock on a listed exchange had to be valued for gift tax purposes by taking into consideration an anticipated merger of the underlying company that was expected to increase the value of the stock. The co-founder and Chairman of the Board of Corporation A, a publicly-traded corporation, transferred shares of stock of the corporation to a GRAT on "Date 1." Apparently extensive merger discussions had transpired before that date. The merger agreement apparently was based on a certain value being attributed to the shares of Corporation A, substantially greater than the value at which the shares were trading. Later, on "Date 2," the merger with Corporation B was announced, which resulted in the value of the Corporation A stock increasing substantially, though less than the agreed merger price.

Prior to Date 1, when the gift was made, "negotiations with multiple parties" had ensued and eventually "exclusive negotiations with Corporation B" occurred. Not stated in the CCA is whether the merger negotiations had proceeded to the point of having an agreed, or at least strongly anticipated, merger price being attributed to the shares of Corporation A on Date 1 when the gift was made.

The issue is whether the shares should be valued under Reg. § 25.2512-2(b)(1) at the mean between the highest and lowest quoted selling prices on the date of the gift, or by taking into consideration the anticipated merger. Reg. § 25.2512-2(e) states that if the value determined from the mean between the high and the low selling prices does not represent the fair market value of the shares, then some reasonable modification of the value shall be considered in determining fair market value.

Fair market value for transfer tax purposes is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Reg. § 25.2512-1. The CCA reasoned that the presumption of having "reasonable knowledge of relevant facts" applies even if the relevant facts were unknown to the actual owner of the property (citing *Estate of Kollsman v. Commissioner*, T.C. Memo. 2017-40, *aff'd*, 123 AFTR 2d 2019-2296 (9th Cir. June 21, 2019). Both parties are presumed to have made a reasonable investigation of the relevant facts, *id.*, and reasonable knowledge includes facts that a reasonable buyer or seller would uncover during the course of negotiations, even though not publicly available (the hypothetical willing buyer is presumed "to have asked the hypothetical willing seller for information that is not publicly available"). *Id.*

The CCA repeats the oft-stated general rule that post-transfer events may be considered only to the extent they are relevant to the value on the transfer date. *E.g. Estate of Noble v. Commissioner*, T.C. Memo. 2005-2.

The CCA cites two cases for authority that the value should be determined after taking into consideration the anticipated merger. *Silverman v. Commissione*r, T.C. Memo. 1974-285, *aff'd*, 538 F.2d 927 (2d Cir. 1976), *cert denied*, 431 U.S. 938 (1977) (gift of shares of preferred stock while in the process of reorganizing with the intent to go public; court rejected expert testimony that failed to consider the circumstances of the anticipated future public sale); *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), *aff'g,* 108 T.C. 244 (1997) (taxpayer was an officer and director of a corporation of which the board of directors had approved a merger agreement; after the merger was "practically certain to go through" but before the actual merger occurred, the taxpayer gave shares to charities; when the charities sold the shares, the taxpayer realized the gain under the assignment of income doctrine). While *Ferguson* was an anticipatory assignment of income case rather than a gift tax valuation case, the CCA pointed to the many factual similarities with *Ferguson* (a target search to find merger candidates, exclusive negotiations before the final agreement, generous terms of the merger, and an agreement that was "practically certain" to go through) in relying on it for the proposition that "the facts and circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through." The CCA concluded:

> Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger would undermine the basic tenets of fair market value and yield a baseless valuation.

b. **Important Questions Left Open**. The CCA fails to even mention one critical fact in its analysis. The donor was the Chairman of the Board of the publicly traded corporation, and federal securities laws may have prohibited the donor from disclosing confidential information regarding the merger to a purchaser. The CCA does repeat a statement from various cases that "[t]he willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the donor and the donee [citing *Estate of McCord* and *Estate of Newhouse*]," and that they are both "presumed to be dedicated to achieving the maximum economic advantage [citing *Estate of Newhouse*]." The CCA does not discuss this statement in light of the personal characteristics of the actual donor (as Chairman of the Board, subject to securities law limitations on disclosure of information about the publicly-held company), and the cited cases do not turn on any specific characteristics of the donor.

What if the merger discussions were highly secret and not even rumors of the discussions were available, so that no one who was not prohibited from disclosing the information knew about the discussions? The donor would know that the "mean between the high and the low" value was not appropriate, but no hypothetical third party could know that even with the exercise of reasonable diligence. A hypothetical purchaser who was dealing with a hypothetical seller who knew about the

information but could not disclose it would not be able to find out about the information even if the buyer made diligent and persistent inquiries. An answer to this theoretical dichotomy may be that a hypothetical **SELLER** with this knowledge would never sell at a price well below the anticipated merger price, even though that information could not be disclosed to a hypothetical buyer. Therefore, the donor's knowledge of the information, even though it could not be disclosed, would still have to be taken into account in determining the fair market value.

Nevertheless, the CCA concludes categorically that "as of Date 1 [the date the GRAT was funded], the hypothetical willing buyer of the stock could have reasonably foreseen the merger and anticipated that the price of Corporation A stock would trade at a premium" and that "the hypothetical willing buyer …, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger." Although that may have been true on the full facts the IRS was considering, such confidence is not explained in the CCA itself. Under applicable case law, the CCA correctly views the willing buyer and willing seller in the valuation standard of Reg. § 25.2512-1 as "hypothetical." The regulation deems those hypothetical parties to have "reasonable knowledge of relevant facts," and the anticipated merger certainly seems to be "relevant" to the value of the shares. The question under the regulation is whether knowledge of the merger would be "reasonable" in the case of secrecy imposed by law or agreement. The CCA assumes that such knowledge would be "reasonable" without discussion and without even acknowledging the question.

It should also be noted that under this analysis a donor might be able to make a gift KNOWING that the reported gift tax value will substantially understate the real value because of insider information known by the donor. (At the other end of the spectrum, in addition to asserting an anticipatory assignment of income as in *Ferguson*, the IRS might be able to argue for a much smaller charitable deduction than the realistic full value of the stock.) That may be another reason that the conclusion of the CCA is entirely appropriate, but, again, without explanation or acknowledgment.

Moreover, even if the anticipated merger were taken into consideration, that would not necessarily mean that the anticipated merger price would be the fair market value at the time the GRAT was funded. There may have been some possibility that the merger would fall through, and even if the merger were consummated, the extent to which the merger actually impacted the value of stock after the merger was announced would be uncertain. Indeed, the CCA acknowledges that "after the merger was announced, the value of the Corporation A stock increased substantially, though *less than the agreed merger price*" (emphasis added). But the anticipated merger would still be considered as a factor in determining the fair market value of the stock.

One lesson from CCA 201939002 is that every word of a regulation can matter. If advice is received from the National Office of the IRS during the audit of a valuation issue, care must be taken to confirm that every assumption underlying the advice –

whether explicit or implicit – is appropriate, and that a case against the taxpayer's position is not overstated, even inadvertently. As stated above, the conclusion of CCA 201939002 might be entirely appropriate on the full facts of the case, but vigilance and scrutiny would be needed to confirm that.

If the case for which this CCA was issued proceeds to trial, no doubt these facts will be fully explored by the court, and the court's discussion of the legal test of what is meant by "reasonable knowledge of relevant facts" in valuation cases may be quite interesting.

36. Late Filing Penalties Abated Where Full Estate Tax Payment Was Made Timely and Reasonable Cause Existed for Late Filing, *Estate of Skeba v. U.S.* (D.C. N.J. October 3, 2019)

a. **Basic Facts**. In *Estate of Skeba v. U.S.*, 124 AFTR 2d 2019-xxx, (D.C. N.J. October 3, 2019), the IRS assessed a penalty for filing an estate tax return late, which it calculated as 25% of the amount of the unpaid estate tax on the original due date of the estate tax return. This was despite the fact that all of the estate tax (and more) had been paid timely by the time the return was actually filed.

The fact chronology is summarized as follows:

- June 10, 2013 - the decedent died June 10, 2013;
- March 10, 2014 – original estate tax return due date;
- March 6, 2014 – estate filed for six-month extension of time to file and a 14-day extension of time pay tax, and paid estimated payment of $725,000 (all of the estate's liquid funds were used make a payment for federal and state estate taxes on that date); the extensions to file and pay tax were granted June 25, 2014 and July 8, 2014, respectively;
- March 18, 2014 – estate paid $2,745,000 to the IRS (within the extended payment period);
- September 10, 2014 – estate did not request further extension of time to file, in light of ongoing will contest litigation, which would have impacted the estate's ability to complete the filing and the executor's capacity to proceed, because an IRS representative purportedly told the estate's counsel "that so long as the payment was made in full, then the filing of the return beyond the extension deadline was permissible and would not subject the estate to any penalty," and an IRS representative purportedly told the estate's CPA (who ultimately filed the estate tax return) "you're paid in, you're fine," and the accountant understood that as long as the estate tax was paid, a penalty for failure to timely file would not be assessed;
- The will contest litigation was delayed initially due to health concerns of one of the parties and later because of serious health concerns of the plaintiff's attorney. In June 2015, the attorney's office advised that his health had deteriorated to the point that he could no longer handle the litigation and new counsel would be needed, at which time the estate decided to go ahead and file the estate tax return based on information that it had at that time;

- June 30, 2015 – estate filed the estate tax return, reporting a net estate tax of $2,528,838 and reporting the prior payments of $3,470,000 ($725,000 + $2,745,000), or an overpayment of $941,162;
- August 3, 2015 – IRS responded to the return, acknowledging an overpayment before adjustment of $941,162, and assessing a penalty due to the late filing in the amount of $450,959.50, which was 25% of the "unpaid amount" of $1,803,838, (the IRS reasoned that the unpaid amount due on the **original** March 10, 2014 due date was $2,528,838 minus the $750,000 estimated payment made by that date).

b. **Court's Analysis**. Section 6651(a)(1) imposes the failure to file penalty. It reads:

> (a) ADDITION TO THE TAX. In case of failure—
>
> (1) to file any *return* required under the authority of subchapter A of chapter [which includes §6018(a) (estate tax returns)]… on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate ....

Section 6651(b) clarifies calculation of the penalty:

> (b) PENALTY IMPOSED ON **NET AMOUNT DUE**. For purposes of—
>
> (1) subsection (a)(1), the amount of tax required to be shown on the return shall be reduced by the amount of any part of the tax which **is paid on or before the date prescribed for payment of the tax** and by the amount of any credit against the tax which may be claimed on the return[.] (emphasis added)

The estate maintained that the penalty is based on the "net amount due" on the "date prescribed for payment." Because all of the tax had been paid by the extended due date, there was no "net amount due" on the "date prescribed for payment" and the failure to file penalty should have been a specified percentage of **zero**, so no failure to file penalty should have been imposed. Furthermore, the estate maintained that it had reasonable cause for the failure to file the return timely.

The IRS argued that the requirements of §6651(a)(1) and 6651(b) must be construed in connection with a general statute about the time and place for paying federal taxes, §6161(a),which provides the general rule that federal taxes should be paid "at the time and place fixed for filing the return (determined without regard to any extension of time for filing the return)." Section 6151(c) describes the meaning of "date fixed for payment of tax" as meaning the "last day fixed for such payment (determined without regard to any extension of time for paying the tax.)" The term "date fixed for payment" of tax is used, for example, in §6161(b)(1)-(2) where it is clearly referring to the original date for payment of tax (e.g., §6161(b)(2) authorizes discretionary extensions of time for paying estate tax "for a reasonable period not to exceed 4 years from the date otherwise fixed for the payment").

The court observed that the IRS "cleverly reasons" that the last day for payment was March 10, 2014 and that the penalty should be based on the amount of tax unpaid on that date. "As such, the full payment of the estate tax on March 18, 2014 is of no avail because the 'last date fixed' was March 10, 2014."

The court rejected the IRS's "clever" argument because §6651(a)(1) is the statute that specifically addresses the late filing penalty and specifies that the "date prescribed" is to "be determined with regard to any extension of time for filing." The court reasoned that "the language of the state in dispute is the one which is given precedence over a more generic statute like §6151." The IRS had also pointed out that "there is an administrative need to complete and close tax matters … [and] the matter, in the government's view, lingered and the administrative objective to timely close the file was not met." In effect, the IRS argued that the estate had lingered too long in filing the return and that penalties should therefore apply. Indeed, the court remarked on "the seemingly lackadaisical approach taken by Plaintiff to file the return." Even so, the statute says that the late filing penalty is based on a percentage of the tax that is not paid "on or before the date prescribed for payment of the tax," and the court's reaction was that "[t]here may be a need for some other penalty for failure to timely file a return, but Congress must enact the same."

The analysis could have ended there. But the court pointed out that the estate had requested the IRS to abate the penalties because the estate had reasonable cause for the untimely filing. The IRS responded with a curt reply that "pending litigation is not a reasonable cause." The court's view was that

> [b]ased on the facts, this curt statement is insufficient. As such, the decision is arbitrary.
>
> … Hence the IRS denial without any further investigation of the facts is arbitrary.
>
> … [Observing that the estate also noted the difficulty in securing all of the necessary valuations and appraisals, the court concluded that the] IRS should have conducted an evidentiary hearing or undertaken some investigation before deciding the issue. At the end of the day, the curt one-line denial of the IRS is arbitrary and capricious.

c. **Prior Inconsistent Law**. Prior rulings and cases have adopted the analysis that §6151(c) applies, so that the penalty is based on a percentage of the tax due on the original payment due date without considering extensions. The IRS announced that conclusion 38 years ago in Rev. Rul. 81-237, 1981-2 C.B. 245.

> Neither section 6651 of the Code nor the regulations thereunder specifically define the phrase "date prescribed for payment of the tax" with respect to the limitation in section 6651(b). However, section 6151(c) provides that any reference in the Internal Revenue Code to the date fixed for payment of such tax shall be deemed a reference to the last day fixed for payment (determined without regard to any extension of time for paying the tax). Therefore, the date prescribed for payment of tax for purposes of section 6651(b) is determined without regard to any extension of time for paying the tax.

That reasoning was followed by the Ohio District Court in *Estate of Ridenour v. U.S.*, 468 F. Supp.2d 941 (D.C. Ohio 2006) (reasoning under §6151(a) rather than §6151(c)). In *Liftin v. U.S.*, 754 F.3d 975 (Fed. Cir. 2014), footnote 1 explains that the estate did not complain in the trial court or in the appeal about the IRS's use of the entire unpaid tax amount on the original payment due date in calculating the late filing penalty, and the court on its own motion asked about that issue at oral argument and requested

supplemental briefing about §6151(c). A dissent concluded that no penalty should have applied where the entire tax had been paid by the time of the extended payment date. The court observed that in its supplemental brief, the IRS argued that §6151(c) precluded consideration of payments made after the original due date in calculating the late filing penalty (and the estate's supplemental brief about the issue reportedly made no reference to §6151(c) even though the court specifically asked about the applicability of §6151(c)). The court declined to address the question, though, seeing no reason "to depart from the important rules requiring timely presentation and development of issues." For a discussion of *Lifton*, see Phil Jones, *Federal Circuit Imposes Penalty on No-Tax-Due Return*, 121 J. TAX'N 170 (Oct. 2014).

d. **Appeal Unlikely**. *Estate of Skeba* did not even cite, let alone attempt to distinguish, Rev. Rul. 81-237 or *Ridenour*. Even though the court's conclusion is directly contrary to those authorities, the likelihood that the IRS will appeal the case in an attempt to correct that court's analysis of §6151(c) is small because the court found that the estate had reasonable cause for the late filing in any event.

e. **Planning Pointers**.

- A late filing penalty may be due even if the tax is timely paid, and the late filing penalty can be very substantial. If the return is filed late (including extensions) without reasonable cause, the penalty is 5% per month of the amount of tax that is unpaid "on the date prescribed for payment" and that is interpreted to mean on the original payment date, without considering any later payments made within an extended time for payment of the tax. The maximum 25% penalty is reached after only five months has passed without timely filing the return.
- If an estate owes no estate tax, while a late filing penalty may not be due if the estate owes no tax (or if all of the tax is timely paid by the original due, at least under the IRS interpretation)),), keep in mind that some elections may only be made on a timely filed return. *E.g.*, §2010(c)(5)(A) (portability election); Reg. §1.645-1(c)(1)-(2) (time for making §645 election to treat "qualified revocable trust" as part of the estate for income tax purposes). On the other hand, some elections must be made on the first return filed if a return is not timely filed. Reg. §§20.2056(b)-7(b)(4) (QTIP election) and 20.2056A-3(a) (QDOT election). If the alternative valuation date election is not made on a timely filed estate tax return, it must be made on a return that is filed within one year of the due date (including extensions). Reg. §20.2032-1(a)(1). Some elections may be made on late-filed returns, without limit. *E.g.*, §2032A(d)(1) (special use valuation election for estates of decedents dying after 1981 does not have to be made on a timely filed return).
- Even if no penalty applies for filing a return late, the preparer nevertheless should strive to obtain filing extensions. As in *Estate of Skeba*, an agent may be perturbed to the point of pressing for litigation if the taxpayer is cavalier and lackadaisical about filing a return with any degree of timeliness. However, filing extensions may only be granted for up to six months (except for certain exceptions for taxpayers who are abroad), so the estate tax return cannot be extended beyond 15 months after the date of the decedent's death. §6081(a).

37. Savings Clause Rejected in Conservation Easement Case, *Coal Property Holdings, LLC v. Commissioner*

a. **Synopsis.** In a case reminiscent of the *Belk v. Commissioner* Fourth Circuit Court of Appeals case five years ago, the Tax Court has rejected a savings clause as an impermissible "condition subsequent" clause (citing *Commissioner v. Procter*) in a conservation easement case. *Coal Property Holdings LLC v. Commissioner*, 153 T.C. No. 7 (2019). The court concluded that the easement did not satisfy the "protected in perpetuity" requirement of §170(h)(5)(A) and granted summary judgment denying any charitable deduction for the easement.

The taxpayer donated a conservation easement, with the easement deed providing that if the property were sold following judicial extinguishment of the easement, the donee organization would receive a share of proceeds under a formula. The formula in the deed for several reasons did not comply with the payment formula requirements in Treasury regulations that must be satisfied in the case of a judicial extinguishment of the easement.

The deed also provided that the amount to be paid to the donee would be the amount required by the regulations "if different from" the formula in the deed, and the taxpayer argued that the "Treasury Regulation override" mandates that the payment provisions be interpreted to conform to the regulatory requirements as construed by the court. The Tax Court concluded "that the text to which petitioner refers constitutes a 'condition subsequent' saving clause, which we and other courts have consistently declined to enforce." The taxpayer urged that the text in the deed "does not constitute an impermissible saving clause but rather sets forth a 'permitted interpretation provision.'" The court disagreed.

> Rather than interpreting an ambiguous provision, the text to which petitioner refers purports to countermand the effect of an unambiguous provision, but only in the event of an adverse future occurrence. This is a classic "condition subsequent" saving clause, and we decline to give it effect.

The *Coal Property Holdings LLC* case does not involve a traditional defined value clause with a formula valuation, but it is the latest of various cases that have referred to the "condition subsequent saving clause" analysis in *Procter* following an adverse determination by the IRS or a court, and rejected an attempt to argue that the provision was merely an interpretive clause. *Coal Property Holdings LLC v. Commissioner*, 153 T.C. No. 7 (Oct. 28, 2019) (Judge Lauber).

b. **Brief Summary of Court Analysis**. The IRS requested summary judgment denying a charitable deduction for the grantor of a conservation easement for three reasons. The court granted summary judgment because the easement violated the "protected in perpetuity" requirement of §170(h)(5)(A) by not complying with the judicial extinguishment regulatory requirements, without addressing the other two reasons.

(1) **Failure to Meet Regulatory Requirements**. Regulations provide that if an easement is extinguished judicially and the property is sold, the charitable donee must be entitled to "the proportionate value that the perpetual conservation restriction at the time of the gift bears to the value of the property as a whole at that time." Reg. §170A-14(g)(6)(i)-(ii). The court restates that requirement in terms of a fractional formula, "the numerator of which is 'the fair market value of the

conservation easement on the date of the gift,' and the denominator of which is 'the fair market value of the property as a whole on the date of the gift.'"(citing and quoting from *Carroll v. Commissioner*, 146 T.C. 196 (2016)).

The easement deed stated the amount to be paid to the donee organization following a judicial extinguishment as follows: "The amount of the proceeds to which the Grantee shall be entitled, **after the satisfaction of prior claims**, … shall be the stipulated fair market value of this Easement … as determined in accordance with Section 9.2 or … Section 1.170A-14 [Income Tax Regulations,] if different from Section 9.2." (emphasis added). Section 9.2 stated that the fair market value to be paid to the charitable donee was

> determined by multiplying (a) the fair market value of the Property unencumbered by this Easement (**minus any increase in value after the date of this grant attributable to improvements**) by (b) a fraction, the numerator of which is the value of this Easement at the time of the grant and the denominator of which is the value of the Property without deduction of the value of this Easement at the time of this grant. (emphasis added).

The fraction stated in the deed complied with the proportion stated in the regulations, namely "a fraction, the numerator of which is the value of this Easement at the time of the grant and the denominator of which is the value of the Property without deduction of the value of this Easement at the time of this grant."

The problem is that the fraction was not multiplied by the full amount of the sale proceeds, but by the sales proceeds "minus any increase in value after the date of this grant attributable to improvements." Therefore, the deed called for the stated percentage (that complied with the regulations) to be multiplied by an amount that could be less than the full sales proceeds (which did not comply with the regulations).

A second problem is that the amount of the sales proceeds following a judicial extinguishment to be paid to the charitable donee was determined "after the satisfaction of prior claims." The easement was potentially subject to claims by lessees of oil and gas wells, operators of cell phone towers, or other persons holding claims against the donor as described in the easement deed. Again, the amount to be paid to the charitable donee might be less than the stated proportionate amount of the sales proceeds, as provided in the regulations.

Prior cases have "strictly construed" (*Carroll v. Commissioner*) this regulation implementing the "exceedingly narrow" (*Belk v. Commissioner*) judicial extinguishment exception, and the payment amount described in the deed did not comply with the regulation.

(2) **Court's Refusal to Recognize "Regulation Override."** The taxpayer seemed to recognize that one or both of those two problems existed in meeting the "judicial extinguishment" regulation, but contended "that the Easement Deed contains a 'Treasury Regulation override' mandating that these provisions be interpreted to conform to the regulatory requirements" as construed by the court. The court concluded that "the text to which petitioner refers constitutes a 'condition subsequent' saving clause, which we and other courts have consistently declined to enforce."

The court reasoned that the payment provision in the deed embodies a "condition subsequent" saving clause because the clear effect is "to cancel the literal requirements of section 9.2 in the event the latter are determined to be noncompliant."

The Fourth Circuit Court of Appeals in *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014) held that a provision allowing parties to an easement "to swap land in and out of the Easement" violated the "granted in perpetuity" requirement of §170(h)(2)(C). The contribution agreement included a "savings clause" providing that the charity (a land trust)

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

The taxpayer argued that even if the substitution provision caused the contribution not to satisfy the statutory requirements for a deductible easement, "the savings clause nonetheless renders the Easement eligible for a deduction." The court in *Coal Property Holdings* emphasized the Fourth Circuit's analysis in refusing to recognize the saving clause *Coal Property Holdings*.

> The Fourth Circuit refused to give effect to this provision. "When a savings clause provides that a future event alters the tax consequences of a conveyance," the court explained, "the savings clause imposes a condition subsequent and will not be enforced." Id. at 229 (citing Commissioner v. Procter, 142 F.2d 824, 827 (4th Cir. 1944)). The taxpayers attempted to distinguish Procter, noting that the saving clause in Procter altered the conveyance "following an adverse IRS determination or court judgment," whereas the saving clause in Belk "d[id] not expressly invoke the IRS or a court." Ibid. The Fourth Circuit found this "a distinction without a difference." Ibid. Because the saving clause purported to alter contract rights, it was triggered by "a determination that c[ould] only be made by either the IRS or a court." Id. at 229-230.
>
> The Fourth Circuit likewise rejected the taxpayers' argument that the saving clause was "simply `an interpretive clause' meant to ensure the `overriding intention' of the parties that the Easement qualify as a charitable deduction." Id. at 230. The court found that there existed "no open interpretive question for the savings clause to `help' clarify," since the reserved right to substitute property was "clear from the face of the Easement." Ibid. If the taxpayers' "overriding intent" had been that the easement qualify under section 170(h), the court suggested, "they would not have included a provision so clearly at odds with the language of § 170(h)(2)(C)." Id. at 230. The court refused to apply the saving clause as the taxpayers wished, ruling that to do so would be "sanctioning the very same `trifling with the judicial process" that the court had previously condemned. Ibid. (quoting Procter, 142 F.2d at 827).

The Tax Court reasoned similarly in a 2017 case involving an easement provision that also violated the judicial relinquishment regulatory requirement. *Palmolive Bldg. Inv'rs, LLC v. Commissioner*, 149 T.C. 380 (2017). The easement deed in that case had a provision stating that "[i]n the event that any of the provisions … conflict or are inconsistent with [the judicial extinguishment regulations], they shall be deemed to be amended to the extent necessary to eliminate such conflict or inconsistency and to bring them into full compliance with such regulations." The taxpayer argued in that case that the clause would retroactively reform the deed to comply with the regulations, but the court disagreed.

> When a savings clause provides that a future event alters the tax consequences of a conveyance, the savings clause imposes a condition subsequent and will not be enforced. (quoting *Belk*, 774 F.3d at 229).

The taxpayer in *Coal Property Holdings* urged that the text "does not constitute an impermissible saving clause but rather sets forth a "permitted interpretation provision'" because the regulation was ambiguous at the time the easement was granted in light of a private letter ruling that had permitted certain adjustments of post-judicial extinguishment proceeds. The court disagreed, observing that the Fifth Circuit had previously found the regulation to be unambiguous despite that private letter ruling in *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018). The court concluded that the regulation "plainly requires" that the charitable donee receive its full proportionate share of the sale proceeds" with no ambiguity.

> Contrary to petitioner's view, this text cannot be characterized as an "interpretation directive" or an "interpretational aid" because there is nothing that needs interpretation; the terms of section 9.2 are clear and unambiguous. As in Belk, there is "no open interpretive question for the savings clause to `help' clarify." Belk, 774 F.3d at 230. Rather than interpreting an ambiguous provision, the text to which petitioner refers purports to countermand the effect of an unambiguous provision, but only in the event of an adverse future occurrence. This is a classic "condition subsequent" saving clause, and we decline to give it effect. See Palmolive Bldg. Inv'rs, LLC, 149 T.C. at 405; cf. Estate of Cline v. Commissioner, T.C. Memo. 1982-90, 43 T.C.M. (CCH) 607, 609-610 (1982) (giving effect to a provision that clarified "ambiguous *** language in a poorly drafted prenuptial agreement," as opposed to being "a savings clause that would undertake to change the property interests otherwise created").

c. **Application to Defined Value Formula Valuation Clauses and Savings Clauses Generally**. Various courts have refused to treat certain defined value formula clauses as "condition subsequent" clauses that must be rejected under *Commissioner v. Proctor*. *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009) (formula disclaimer and "excess value" portion passed to a charity); *Estate of McCord*, 461 F.3d 614 (5th Cir. 2006); *Petter v. Commissioner*, T.C. Memo. 2009-280 (formula gifts and sales with "excess portion" passing to charity), *aff'd*, 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Commissioner*, T.C. Memo 2011-133. These cases have addressed, in varying degrees of detail, the three reasons cited in *Proctor* that the condition subsequent clause violates public policy: (1) the provision discouraged the collection of gift tax because any attempt to collect the tax would defeat the gift; (2) the condition obstructed the administration of justice by requiring a court to pass on a moot case; and (3) the provision would reduce a Federal court's final judgment to a declaratory judgment.

Cases like *Belk* and *Coal Property* are not directly relevant to formula valuation clauses, but are interesting in their discussion of saving clauses generally and their strict rejection of clauses that change results after the fact based on court or IRS determinations (in contrast to defining what is transferred in the first place based on values as finally determined for gift tax purposes). The following is an excellent summary of conclusions from *Belk* (and by extension, *Coal Property Holdings*) on savings clauses used in the estate planning context:

> *Procter* and its progeny are a subject of great interest to estate planners…. That interest has included intense curiosity about how the Fourth Circuit, which decided *Procter* in 1944, would view the issues today. *Belk* does not answer that question. In a case in which the holding of *Procter* appears not to have been challenged, the court simply found that the donors' effort to distinguish *Procter* did not work. And, notably, the issue in *Belk* was a substantive requirement of the conservation easement statute, not valuation.

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

Recent Developments – 2014, 49th ANNUAL HECKERLING INST. ON EST. PL. ¶105.4 (2015).

38. Interesting Quotations

a. **Lack of Respect**. Rodney Dangerfield could have said – "I left my body to science and now science is contesting the will." – Prof. Chris Hoyt (Rodney Dangerfield did say, "The shape I'm in, I could donate my body to science fiction.")

b. **Funerals**. Yogi Berra – "Always go to other people's funerals; otherwise they won't go to yours." – Prof. Chris Hoyt

c. **Riveting Information**. As an introduction to discussing the exoneration and abatement doctrines, "You paid tuition for the entire seat, but for this you only need the front edge because here folks, is perhaps some of the most exciting stuff you're going to hear all week. Perk up, pay attention out there in the other rooms, stop jogging on the treadmill. You can't do both of these at the same time." – Prof. Sam Donaldson

d. **Non-Grantor "DINGBAT Trust**." If this were a non-grantor trust, let's make it an incomplete non-grantor trust, let's make it a Delaware incomplete non-grantor trust, let's make it a Delaware incomplete non-grantor beneficiary advantaged trust. It's a DINGBAT. I need to trademark this before Jonathan does. Dibs, I've got this one. – Prof. Sam Donaldson

e. **Perception of Lawyers**. "Some have never had an attorney and view an attorney as someone with ethics just this side of a used car salesman, and who is overpaid and underworked." – Stuart Bear

f. **Executor Want Ad**. A want ad for an executor might read – "Seeking an individual to manage assets during incapacity and to administer assets upon death. Job Description: correspond with disgruntled beneficiaries; manage family drama; provide accountings to disgruntled beneficiaries; invest assets (that is don't lose money or you will hear from the disgruntled beneficiaries); and receive phone calls with kindness on the beneficiary's tongues inquiring as to when they will receive their inheritance, remembering of course 'it's never about the money;' Compensation is reasonable, but note that beneficiaries will question reasonableness." – Stuart Bear

g. **Family Cabin or Cottage**. "There's a corollary, something like one of Newton's laws of physics – The child who wants the cabin the most can afford it the least." – Stuart Bear

h. **The Gardner Gets Paid**. "I know how much work it is to pay all my bills each month and get things in order. If I had to do that for someone else, I'd want to get paid.

Family members typically will not get paid for serving as agent under a power of attorney, but if a third party serves as an agent they should be paid. When it comes to the lawn outside my house, if I don't pay the gardener I get weeds. If I send him a check, it looks nice." – Bernard Krooks

i. **Empty Threat**. "Under *Cohan v. Commissioner*, 39 F.2d 540 (2nd Cir. 1030), taxpayers can approximate basis in the absence of original documents that would establish absolute proof. However, a lot of agents will use the threat of a zero basis to intimidate. It is a completely empty threat. When they do it, smile and say that's very interesting but that's not how it works and here's our proof of basis. If you don't find that satisfactory, give me yours. … Agents have their own idea of what the law is. Sometimes you just have to smile, not be offended, and just explain to them how it actually works." – Howard Zaritsky

j. **When in Doubt Report**. In discussing reporting under the basis consistency rules Howard Zaritsky advises: "There are no penalties for over reporting – for reporting transactions that might arguably be exempt from reporting. There are penalties for failure to report. That's a no-brainer. When in doubt you report. Clients don't like the planner spending the extra time to report, but they don't like the penalties either if it turns out that you were wrong. You decide what's best to be done, and when in doubt report." – Howard Zaritsky

k. **Delaware Tax Trap Horrific Problem**. "There is one horrific problem with the Delaware tax trap – explaining it to a client. Those who have taught in an LLM program know how hard it is to explain the Delaware tax trap to tax lawyers. Explaining this to a layperson is hopeless. This means you'll have to have a clause in the document that you know the client doesn't understand and you are not even going to try to explain it, except that it enables somebody in some cases to increase the basis of assets." – Howard Zaritsky

l. **So it's Morbid**. "We're just waiting for mom to die under this scenario. It's morbid, but we are talking about tax planning. Let's keep the focus on that….The ideal person to give a general power of appointment for a basis increase is a terminal person in a coma." – Lester Law

m. **Precedent**. "I have often said that I am not a huge fan of planning based on analysis. I much prefer to plan based on precedent. It is infinitely safer, because until you go to court you never think of all the arguments. Once you go to court, they all come out." – Howard Zaritsky

n. **Trust Protectors and Prearrangement**. "Whenever you're worried about the IRS arguing prearrangement with respect to a trust advisor or trust protector, there is a good solution. The grantor doesn't name the trust protector; the trustee names the trust protector without consultation with the grantor. There can be no prearrangement between the grantor and somebody the grantor does not know will be the trust protector. The downside is that means the grantor may have a trust protector that may not have been their first choice, or second choice, or third choice." – Howard Zaritsky

o. **Stable Marriage**. In discussing the possibility of using an Alaska community property trust to achieve a basis increase at the first spouse's death, "the right client may be someone who is reasonably old and has a stable marriage. Well, that limits a

lot of them. Actually has a stable marriage, not just think they have a stable marriage, has highly appreciated assets, and assets may be sold after the first spouse's death. That's a lot of clients. Clients may not go along, but it ought to be on your list of proposals. – Howard Zaritsky

p. **"Deeming."** With respect to Revenue Ruling 85-13's "deeming" the assets in the grantor trust to be owned by the grantor for income tax purposes: "Any time you deem something in the tax law, several things can happen. One, the deeming can work perfectly – that doesn't happen often. Two, you can catch people you didn't mean to catch. Three, some smart lawyer can figure out how to turn it against you. That happens 100% of the time because lawyers, given enough time and enough inclination, which clients are happy to provide, will find ways to turn every "deem" against the government. – Howard Zaritsky

q. **Rev. Rul. 85-13 – A Deep Hole**. After Revenue Ruling 85-13 was published, Howard Zaritsky informally "warned some government officials that they really ought to undo it because it would come back to bite them. They sloughed it off. Not only did they slough it off, they have cited it as authority in seven more revenue rulings. They have dug this hole deep. They can't walk away from it. And it's funny that the entire point of the ruling was to say that Judge Friendly, one of the leading jurists in the country, was wrong in one case (*Rothstein*)." – Howard Zaritsky

r. **Politics**. "The word "politics" comes from ancient Greece. 'Poli' meaning many and 'ticks' meaning blood sucking parasites." – Prof. Chris Hoyt

s. **Customization**. In discussing how to customize planning for family meetings: "This is like driving through McDonald's. You can order it supersized, you can order it with or without fries, and whatever is on the client's mind is what goes on the agenda." – Nancy Hughes

t. **Pre-Nups**. Nancy Hughes started discussing pre-nuptial agreements with clients' children at age 18. She describes pre-nups this way: "Whatever you're going to inherit, you didn't make it. Therefore we should protect what you are going to inherit. Let me tell you that if we don't protect it, then I'll bet there'll be changes made in your parents wills. It's just the reality, but we can fix this." – Nancy Hughes

u. **Don't Be Rushed.** "A good lawyer is like a good restaurant. Do you want to eat at a restaurant that is not busy? Do you want to go to a lawyer who is not busy? It says something if a lawyer can get you in and do your work quickly, because the best lawyers are very busy." – Nancy Hughes

v. **No Med School**. "I don't want to be available 24/7. I did not go to med school, and I'm not on call. Make that clear to clients and train them to know we are not available 24/7." – Nancy Hughes

w. **Non-Performance; Set Expectations**. Benjamin Franklin said "Promises may fit the friends, but non-performance will turn them into enemies." – Nancy Hughes

x. **Mayhem**. "We may think that when mayhem shows up the litigator comes in. But probably most people think of litigators that they are the mayhem." – Meg Lodise

y. **Best Way to Learn**. "We learn lessons the best possible way – through the suffering of other people." – Dana Fitzsimons

z. **Not What It Seems**. "For those of you watching on the Jumbotron or simulcast, it is very important to keep in mind that the camera adds 10 pounds, and there are currently five cameras pointed at me. I'm actually a very slender man." – Dana Fitzsimons

aa. **Deferred Reaction**. In a case this year, a co-trustee took actions contrary to the terms of the trust funded in 1979, and starting in 2015, the bank co-trustee raised concerns, "as the old saying goes, better 39 years late than never." – Dana Fitzsimons

bb. **Minnesota**. "I don't know why so many fun cases come out of Minnesota, but they do. It could be the absence of sunlight." – Dana Fitzsimons

cc. **What's It Worth?** "Clients that are not comfortable paying fees for qualified professionals should not engage in complex planning. You get what you pay for, and that is a cost of doing this business." – Dana Fitzsimons

dd. **Greed**. "There is a Chinese proverb that says 'a man's greed is like a snake that wants to swallow an elephant.'" – Dana Fitzsimons

ee. **Location, Location**. "In a 2018 California case, a son sued a funeral home for $30 million for spreading his father's ashes in the wrong place – off the coast of Orange County rather than off the coast of Los Angeles County." – Dana Fitzsimons

ff. **The Life of a Trustee**. *Kliman v. Mutual Wealth Management Group* is an unpublished 2018 Indiana case making clear that "one cannot sue a trustee

- for denying discretionary distributions that were never requested,
- to reimburse expenses that were not incurred,
- for denying distributions that were actually paid,
- for failing to make distributions that are required after the stepmother dies while the stepmother is still alive, and
- for failing to pay for CPR training the beneficiary did not sign up for.

It took a Court of Appeals to add this gem to the esteemed common law of trusts (quoting the court of Appeals): 'You cannot make initial distribution requests by suing the trustee.'

As we say in the South, you can't fix stupid."

Dana says "this is every week for trust officers. Hug a trust officer."
– Dana Fitzsimons

gg. **Back to Trust Law Basics**. *In re Weitzel Trusts*, a 2018 unpublished Minnesota case, expounds on the basics. Dana begins, "Strap yourself in. The Indiana Court of Appeals held that (1) a trustee does not commit a RICO racketeering violation by administering a trust according to its terms, (2) a grantor's power to exclude a beneficiary from a Crummey withdrawal right does not invalidate a trust, (3) a trustee's duties do not include making sure that your parents are not mean to you, and (4) a trustee does not have a duty to compel the grantors to make additional gifts to the trust." – Dana Fitzsimons

hh. **1865 – Notable Events**. "A couple of highlights from 1865 –

- Robert E Lee surrendered to Ulysses S. Grant at Appomattox Courthouse ending the Civil War, or what Tom Word from Richmond, Virginia always referred to as The Recent Unpleasantness.
- Abraham Lincoln was assassinated and the Secret Service was founded.
- Wild Bill Hickok killed Davis Tutt in the first quick draw showdown.
- The 13th Amendment was ratified.
- The KKK was formed.
- John Deere got his first patent.
- The first train robbery happened in the United States.
- The Wagner opera *Tristan and Isolde* made its first debut.
- The Salvation Army was founded.
- Alice in Wonderland was published.
- Standard Oil was started.
- Florida passed its state constitution.
- Laura Ingalls' blind sister Mary was born, as was Rudyard Kipling."

– Dana Fitzsimons

ii. **The Dream Case**. "Litigation involving the Orkin pest control family has made its way to the Georgia Supreme Court four times. Based on the pleadings, it seems clear that at least six law firm partners have purchased Ferraris." – Dana Fitzsimons

jj. **Loss Aversion**. Dennis Belcher told me "'Heirs can accept a loss of a potential upside, it's the downside that they can't stomach." – Dana Fitzsimons

kk. **The Ungrateful**. "The *Erlich* case from New Jersey is the shocking decision proclaiming that you cannot sue your attorney for malpractice when he or she wins your case. It's a tough business out there, folks. Pay your carrier premiums." – Dana Fitzsimons

ll. **The Dumbest Criminal**. "Reader's Digest has a list of the dumbest criminals of all time. This includes a robber who had hidden from police at a nudist resort. He was easy to spot because he was the only person wearing clothes." – Dana Fitzsimons

mm. **The Dumbest Thief in Fiduciary Litigation**. *In re Estate of Field* is a 2018 Kansas case involving a forgery of a codicil. This is a failed attempt of a part-time bookkeeper to probate a forged will of Earl Field, which changed 30 years of prior wills that were professionally drafted by Earl's counsel that left a $20 million estate to a college.

Her original forged letters (that left half the estate to her) did not have witness signatures. After death when a lawyer pointed that out, she forged a new codicil that had witness signatures. She shredded the first forgeries but left the shredded forgeries in the shredder where they were recovered and reassembled. She claimed

to be surprised by the codicil, while at the same time claiming that the codicil was dictated to her by Earl, but Earl never gave dictation in his entire life. He used the other typewriter. Witnesses to the codicil died by a murder-suicide after the house was searched by the FBI and they were served with grand jury subpoenas in the case. She traced Earl's signature exactly from his 2010 will, which is impossible forensically for anybody to sign exactly the same way twice, let alone a 90-year-old man who went into hospice five days later. She crossed the "F" in the wrong direction, from left to right when Earl would always go from right to left. She failed to use Earl's punctuation, formatting and writing style. She left a handwritten draft in the shredder that was written in her own handwriting, and she had been fired from her bank job for writing forged checks from a client account." – Dana Fitzsimons

nn. **Marital Deduction**. "The marital deduction is like a dog. It's usually very friendly but if you poke it in the wrong spot, even the friendliest dog might bite you. And sometimes you don't know where the dog is particularly sensitive." – Amy Kanyuk

nn. **Personal Tax Shelter**. *Grainger v. Commissioner* involved a retired grandmother who came up with [in her own words to the Tax Court] her "personal tax shelter." She bought clothes at Talbot's or other stores using loyalty points and deep discounts from end-of-season sales and donated them to charity, taking a charitable deduction at the original full purchase price. "It is not a crime to appear pro se in front of the Tax Court. It is a crime if we are deprived of reading these opinions. The first year she claimed $18,000 of deductions, all supported by blank Goodwill receipts. The only problem was that she was not nearly aggressive enough, and the next several years she claimed deductions of $32,000, $34,000, $40,000, and $47,000. This is genius. But the Service discovered it. It's disappointing that the Grainger model is not available for you and me." –Prof. Sam Donaldson

oo. **Such a Romantic**. Gifts can be made of investments in qualified opportunity funds "Nothing says I love you like an investment in a distressed community." – Prof. Sam Donaldson

pp. **New Hampshire in the Middle**. "New Hampshire is located exactly halfway between the equator and the North Pole." – Amy Kanyuk

qq. **Use of PLRs**. "The theory is that we cannot rely on someone else's private letter ruling. But you sure can use it as a persuasive weapon in your dealing with a retirement plan provider and trying to persuade them to use a certain payout… I have used PLR 2016 33025 [which did not take into account certain "mere potential successor beneficiaries" in determining whether the plan had a designated beneficiary], even though we are not supposed to rely at the IRS level on someone else's PLR, but if you're dealing with a provider and you show them this ruling, it's persuasive. So use it. " – Bob Kirkland

rr. **Red Bike Syndrome**. Sibling rivalries, jealousies, or dysfunction often arise "from red bike syndrome – my sister got a red bike as a kid and I did not."
– Lauren Wolven

ss. **Parents' Fear about UTMAs**. "For parents, the biggest downside to an UTMA account seems to be that the custodianship comes to end. In the words of the Steve Miller band, the parents are afraid that their kids will 'Take the Money and Run.'"
– Sarah Johnson

tt. **Parents' Response to That Fear**. "Section 20 of the UTMA addresses termination of the custodianship by stating that 'the custodian shall transfer *in an appropriate manner* the custodial property to the minor' upon the minor's attainment of the applicable age. Many parents, my father included, decided that the 'appropriate manner' was to take no action at all – a 'don't ask don't tell policy.'" – Sarah Johnson

uu. **Rules of Thumb**. "The handy thing about Rules of Thumb is that they make you look smarter than you are." – Turney Berry

vv. **History**. "As you've heard, if you study history you will not repeat the mistakes of the past. If you study history like I do, you come up with completely new mistakes nobody has ever thought of before." – Prof. Chris Hoyt

ww. **Diversification Inconsistencies**. "The *Post* [*In re Trust of Ray D. Post*, 2018 N.J. Super. Unpub. LEXIS 1932 (2018)] and *Wellington* [*Matter of Wellington Trusts*, 2015 NY Slip Op 31294(U) (Nassau County Surrogate, 2015; 2018 N.Y. App. Div. LEXIS 6675 (2018)] cases are almost identical. The *Post* case was in New Jersey and *Wellington* in New York. In each there is a clear directive in the trust that inception assets should be retained. In *Post* the trustees started diversifying out of US large-cap securities and, lo and behold, the court said you shouldn't have done that. In *Wellington* the trustee started diversifying out of large-cap US securities and the court said it was fine. The difference – you've got two states; you've got two courts; there you are. Thus reminding you in a happy way that the quality of the lawyering and the quality of the witnesses can make a difference." – Turney Berry

xx. **Fundamental Legal Principle**. In the Ohio *Millstein* case, the appeals court dismissed the grantor's claim to be reimbursed for income taxes that the grantor paid on the grantor trust's income "on the well-established legal principle of "Too bad, so sad." – Amy Kanyuk

yy. **Income Tax Reporting**. Embezzled stolen funds must be reported as income on the Form 1040, even if they are subject to an obligation to repay the embezzled funds. "You need to report this on line 21 of Schedule 1 of the new 1040. Fortunately, that is captioned 'other income.' There is no specific line item for "stuff I stole." – Amy Kanyuk