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"Top Ten" Estate Planning and Estate Tax Developments of 2019

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In an annual tradition, Ron Aucutt, Senior Fiduciary Counsel, has identified the following as the top ten estate planning and estate tax developments of 2019. Ron is a past president of The American College of Trust and Estate Counsel; he has been an observer and frequent participant in the formation of tax policy and regulatory and interpretive guidance in Washington, D.C.; and he is the editor of the Recent Developments materials that are presented each year at the Heckerling Institute on Estate Planning.

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Number Ten: Qualified Opportunity Fund Inclusion Events (Reg. §1.1400Z2(b)-1)

Regulations implementing a prominent feature of the 2017 Tax Act may shed light on how the IRS might view more common estate planning techniques.

1. **Statutory Background.** One of the provisions of the 2017 Tax Act that had bipartisan support added a new Subchapter Z to the income tax chapter of the Internal Revenue Code, containing two new sections 1400Z-1 and 1400Z-2. These sections provide income tax incentives to invest in distressed low-income communities called "opportunity zones." A qualified opportunity fund (QOF) is a corporation or partnership that has at least 90% of its assets invested in qualified opportunity zone property.

   An investor who has sold appreciated property may defer recognition of the resulting capital gain, at least until December 31, 2026, by investing the amount of the gain in a qualified opportunity fund within 180 days. The investor's basis in the QOF is initially zero and increases by 10% of the original deferred gain after five years (in effect the forgiveness of 10% of the original gain) and by another 5% after seven years (in effect the forgiveness of another 5% 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.

   Of course, Congress might extend the December 31, 2026, recognition date, like it might extend some or all of the other provisions of the 2017 Tax Act that sunset at the beginning of 2026. It is already impossible to make an investment and hold it for seven years before December 31, 2026. In addition, section 1400Z-2(c) provides an opportunity to avoid recognition of all gain and obtain a fair market value basis by holding the investment for 10 years (necessarily beyond December 31, 2026).

2. **Regulations.** Regulations implementing these provisions were published as proposed regulations in May 2019 and finalized in December 2019. **T.D. 9889**, 84 FED. REG. __ (Jan. 13, 2020). As released by the Treasury Department and the IRS (not as published in the Federal Register), the final regulations are 190 pages, and the Preamble is 354 pages. The regulations discussed here generally will take effect for taxable years beginning after March 13, 2020 (that is, for calendar year taxpayers, January 1, 2021), with taxpayers permitted to elect to apply them earlier.

   a. **Gifts Are Inclusion Events.** Reg. §1.1400Z2(b)-1 provides rules for determining when deferred gain is accelerated by an "inclusion event" regarding an investor's interest in a QOF, which the regulations call a "qualifying investment" (defined in Reg. §1.1400Z2(a)-1(b)(34)). Of most interest from an estate planning perspective, Reg. §1.1400Z2(b)-1(c)(1)(i) provides that an event is an inclusion event if it "reduces an eligible taxpayer's direct equity interest for Federal income tax purposes in the qualifying investment." As suggested by that broad definition, Reg. §1.1400Z2(b)-1(c)(3)(i) provides in general that a transfer of a qualifying investment by gift is an inclusion event.

   b. **Transfers by Reason of Death Are Not Inclusion Events.** Reg. §1.1400Z2(b)-1(c)(4)(i) provides that a transfer of a qualifying investment by reason of the investor's death is not an inclusion event. It further provides:

Transfers by reason of death include, for example:

> (A) A transfer by reason of death to the deceased owner's estate;
>
> (B) A distribution of a qualifying investment by the deceased owner's estate;
>
> (C) A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death;
>
> (D) The passing of a jointly owned qualifying investment to the surviving co-owner by operation of law; and
>
> (E) Any other transfer of a qualifying investment at death by operation of law.

In contrast, Reg. §1.1400Z2(b)-1(c)(4)(ii) specifies that "a transfer by reason of the taxpayer's death" does not include any other sale, exchange, or disposition by the deceased investor's estate or trust, any disposition by the legatee, heir, beneficiary surviving joint owner, or other recipient who received the qualifying investment by reason of the taxpayer's death.

c. **Transactions with a Grantor Trust Are Not Inclusion Events.** Another exception from the treatment of gifts of qualifying investments as inclusion events is Reg. §1.1400Z2(b)-1(c)(5)(i), which exempts a contribution to a trust if "under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust)."

The reference to subpart E generally and the use of the term "deemed owner" rather than "grantor" suggest that the regulation applies to trusts deemed owned by a third party under section 678, not just trusts owned by the "grantor" under sections 673 through 677. And, in an addition not included in the May 2019 proposed regulations, Reg. §1.1400Z2(b)-1(c)(5)(i) goes on to provide:

> Similarly, a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event. For all purposes of the section 1400Z-2 regulations, references to the term grantor trust mean the portion of the trust that holds the qualifying investment in the QOF, and such a grantor trust, or portion of the trust, is a wholly grantor trust as to the deemed owner. Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust rules.

This addition helpfully clarifies that transfers from the trust to the deemed owner, not just transfers from the deemed owner to the trust, are exempt from treatment as inclusion events. It also clarifies that the term "contribution" includes not just gifts (as in funding the trust) but "any other type of transfer … that is a nonrecognition event as a result of the application of the grantor trust rules." As an example, a sale to a deemed owned trust comes to mind. The

Preamble, somewhat timidly, seems to affirm application to a sale in the following explanation:

> A commenter also requested clarification that non-gift transactions between a grantor trust and its deemed owner that are not recognition events for Federal income tax purposes are not inclusion events, and that such transactions do not start a new holding period for purposes of section 1400Z. In such transactions, the deemed owner of the trust continues, for Federal income tax purposes, to be the taxpayer liable for the Federal income tax on the qualifying investment. Thus, the Treasury Department and the IRS have determined that, like transfers by the deemed owner to the grantor trust, these transactions (including transfers from the grantor trust to its deemed owner) are not inclusion events.

Finally, Reg. §1.1400Z2(b)-1(c)(5)(ii) adds that "the termination of grantor trust status or the creation of grantor trust status … is an inclusion event," except that "termination of grantor trust status as the result of the death of the owner of a qualifying investment is not an inclusion event."

d. **Holding Period and Tacking.** Consistently with the exception of transfers by reason of death and transfers to a deemed owned trust from treatment as an inclusion event, Reg. §1.1400Z2(b)-1(d)(1)(iii) provides that the recipient in either of those scenarios does not begin a new holding period for the qualifying investment, but succeeds to or "tacks" the decedent's or other transferor's holding period. This is a clarifying rewording of the proposed regulation (Proposed Reg. §1.1400Z2(b)-1(d)(1)(iv)), which bore the possibly misleading heading "Tacking with donor or deceased owner" and identified one of its subjects as "a gift that was not an inclusion event." The final regulation drops the use of the word "gift" and elaborates as follows:

> This same rule [applicable to transfers by reason of death] also applies to allow a grantor trust to tack the holding period of the deemed owner if the grantor trust acquires the qualifying investment from the deemed owner in a transaction that is not an inclusion event.

This does not explicitly pick up the expansion of Reg. §1.1400Z2(b)-1(c)(5)(i) to include "a transfer of the investment **by** the grantor trust **to** the trust's deemed owner" (emphasis added) described above, but it is reasonable to hope that in context the tacking rule of Reg. §1.1400Z2(b)-1(d)(1)(iii) will be given the same scope as Reg. §1.1400Z2(b)-1(c)(5)(i).

3. **Comment.** Treatment of a gift as a recognition event is not the normal result estate planners are accustomed to, and it is especially surprising in light of section 1400Z-2(b)(1), which states that the otherwise deferred gain "shall be included in income in the taxable year which includes the earlier of (A) the date on which such investment is sold or exchanged, or (B) December 31, 2026." A gift obviously is not a sale or exchange. But the Preamble explains why that obvious interpretation wouldn't work (emphasis added):

> As indicated … in the Explanation of Provisions in the May 2019 proposed regulations, the termination of a direct interest in a qualifying investment that

> resulted in an inclusion event terminated the status of an investment in a QOF as a qualifying investment "[f]or purposes of sections 1400Z-2(b) and (c)." This is because the statutory text of each of section 1400Z-2(a), (b), (c), and (e)(1) focuses on one holding period of "the taxpayer" tested at various points during a period of at least 10 years. [The inclusion of subsection (e)(1) looks like a typo, possible meant to be subsection (d)(3).]
>
> …
>
> This degree of identity of taxpayer [between the transferor and transferee] is fundamentally different (and more demanding) than a mere "step in the shoes" concept based on whether the transferee of the interest can tack the holding period and basis of the transferor. Accordingly, the May 2019 proposed regulations treated, among other transactions, gifts and section 351 exchanges as inclusion events because, in each instance, (i) the initial eligible taxpayer had severed the direct investment interest in the QOF and (ii) the transferee taxpayer was not treated for Federal income tax purposes either as the same taxpayer as the initial eligible taxpayer or as a successor taxpayer.
>
> …
>
> As noted in the preamble to the May 2019 proposed regulations, section 1400Z-2(b)(1) does not directly address non-sale or exchange dispositions, such as gifts and bequests. However, the Conference Report provides that, under section 1400Z-2(b)(1), the "deferred gain is recognized on the earlier of the date on which the [qualifying] investment **is disposed of** or December 31, 2026." See Conference Report at 539 (indicating that continued gain recognition deferral requires the taxpayer to maintain directly the taxpayer's qualifying investment).
>
> … The Treasury Department and the IRS have concluded that (i) no authority exists to impose the donor's deferred capital gains tax liability on the donee of the qualifying investment, and therefore (ii) the Federal income tax on the deferred gain must be collected from the donor at the time of the gift of the qualifying investment. Accordingly, the final regulations continue to provide that a gift of the qualifying investment in a QOF is an inclusion event.

In other words, a qualifying investment in a qualified opportunity fund is simply not like other assets, because section 1400Z-2 requires the tax law, in effect, to follow the investment, but the general rules in the rest of the Code do not provide a way to do that. So the tax is collected from the investor-transferor when the transfer is made.

Applying that principle, the exception for transfers (in either direction) between a grantor trust and the deemed owner of the trust makes sense, because "the taxpayer" – that is, the deemed owner who bears the tax liability under the grantor trust rules – does not change. Indeed, although the regulations and Preamble do not cite Rev. Rul. 85-13, 1985-1 C.B. 184 (the acknowledged foundation of much grantor trust planning), they do mirror its analysis.

Similarly, the creation or termination of grantor trust status does not qualify for the exception and must be treated as an inclusion event, because "the taxpayer" does change. Finally, a transfer at death can be exempted, because the rest of the Code does

provide an enforcement tool in the rules of section 691 governing income in respect of a decedent, which are explicitly incorporated into section 1400Z-2(e)(3).

The Preamble provides confirmation of this analysis:

> The Treasury Department and the IRS have determined that [rules similar to those for certain other passthrough entities] for a grantor trust are not necessary because the grantor is treated as the owner of the grantor trust's property for Federal income tax purposes. Therefore, the final regulations set forth different rules applicable to the grantor.
>
> …
>
> The Treasury Department and the IRS have received several comments requesting clarification that qualifying investments include interests received in a transfer by reason of death that is not an inclusion event. In the case of a decedent, section 1400Z-2(e)(3) provides a special rule requiring amounts recognized under section 1400Z-2, if not properly includible in the gross income of the decedent, to be includible in gross income as provided by section 691. In that specific case, the beneficiary that receives the qualifying investment has the obligation to include the deferred gain in gross income in the event of any subsequent inclusion event, including for example, any further disposition by that recipient. … In other words, unlike an inclusion event contemplated by the general rules of section 1400Z-2(b), the obligation to include the original taxpayer investor's deferred gain in income travels with that taxpayer's qualifying investment to the beneficiary. Accordingly, the May 2019 proposed regulations excepted transfers of a qualifying investment to the deceased owner's estate, as well as distributions by the estate, from the definition of "inclusion event."

4. **Implications for Estate Planning in General.** Because of the unique origin and nature of QOFs, care is required in generalizing the rules of these regulations beyond the QOF context. But a few observations may be safe.

   As noted above, the notion that a gift is a recognition event while death is not a recognition event is inconsistent with general rules, but is explained by the unique requirements of the QOF rules to follow the investment. Thus, the distinction between gifts and transfers by reason of death in the QOF regulations should have no general implications outside of that context.

   Similarly, when contrasted with general rules, it is ironic that a qualifying investment in effect gets a stepped-up basis upon a gift (because of the donor-investor's recognition) but a carryover basis at death (subject to the holding period that the recipient succeeds to or "tacks"). But that also is just the result of the unique requirements of the QOF rules, as well as the income in respect of a decedent rules that always produce a carryover basis at death.

   The most interesting implications arise from the treatment of grantor trusts. Recognition of gain upon the loss of grantor trust status during life has generally come to be expected, under authorities such as Reg. §1.1001-2(c), Example 5; *Madorin v.*

Commissioner, 84 T.C. 667 (1985); and Rev. Rul. 77-402, 1977-2 C.B. 222. On the other hand, avoiding recognition of gain when grantor trust status is unavoidably lost at the death of the grantor is not always as clear and has sometimes been debated. Chief Counsel Advice 200923024 (issued Dec. 31, 2008; released June 5, 2009) has often been cited as an indication that the IRS acknowledges that there is no recognition at death. After discussing Reg. §1.1001-2(c), Example 5, *Madorin*, and Rev. Rul. 77-402, the CCA stated (emphasis added):

> 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**.

Now a regulation has added significantly more weight to that proposition.

Number Nine: Estate Tax Charitable Deduction Affected by Subsequent Actions (*Dieringer*)

1. **Factual Background.** In *Estate of Dieringer v. Commissioner*, 917 F.3d 1135 (9th Cir. March 12, 2019), *aff'g* 146 T.C. 117 (2016), the decedent, a widow in Oregon with 12 children, died in 2009. Her son Eugene was her executor, the trustee of her trust, the director of the family foundation, and the president of a family real estate business. Her trust left some personal effects to her children, $600,000 to various charitable organizations, and the residue of her estate to the family foundation, including a solid majority interest in the family business (425 out of 525 voting shares and 7,736.5 out of 9,220.5 nonvoting shares). The estate tax values, determined on a controlling basis, were $1,824 per share of voting stock and $1,733 per share of non-voting stock (reflecting a 5% discount for lack of voting rights), for a total estate tax value of $14,182,471 for the decedent's interest. Because of the charitable deduction, the return showed no estate tax due.

   After the decedent's death, the family corporation elected S corporation status and, to avoid making annual distributions of income to fund the foundation's 5% minimum distributions and creating excess business holdings problems, the company decided to redeem the trust's interests in the company. Ultimately, by April 2010, the company had reduced the redemption to what was thought to be more affordable and had redeemed, for promissory notes, all of the trust's 425 shares of voting stock and 5,600.5 (out of 7,736.5) shares of its nonvoting stock. The stock values used in the redemption were determined by an appraiser whom Eugene's lawyer instructed to value the stock as if it were a minority interest. Those values were $916 per voting share and $870 per non-voting share, reflecting a 15% lack of control discount, a 35% lack of marketability discount, and, for the nonvoting stock, a 5% lack of voting power discount.

   The trust reported a capital loss on the redemption for 2009. The Foundation reported receipt of the promissory notes and the remaining nonvoting stock from the trust on January 1, 2011. In November and December 2011, to satisfy the private foundation self-dealing requirements, Eugene sought and obtained the retroactive approval of the appropriate Oregon court.

2. **Tax Deficiency and Court Proceedings.** In September 2013, the IRS reduced the estate tax charitable deduction to reflect the value of the property actually distributed to the foundation. On that basis, the IRS assessed a deficiency of $4,124,717 and an

accuracy-related penalty of $824,943. The Tax Court upheld both the deficiency and the penalty, and the estate appealed, arguing that the Tax Court erred in taking into account post-death events in determining the value of the charitable deduction.

The Court of Appeals for the Ninth Circuit also upheld both the deficiency and the penalty. Quoting its opinion in *Ahmanson Foundation v. United States*, 674 F.2d 761, 772 (9th Cir. 1981), it found that "[t]he proper administration of the charitable deduction cannot ignore such differences in the value actually received by the charity." The estate had argued that any consideration of post-death events also required finding that the decline in the value of the stock was due, at least in part, to market forces. The Tax Court, however, had found that "[t]he evidence does not support a significant decline in the economy that resulted in a large decrease in value in only seven months," and that "[t]he reported decline in per share value was primarily due to the specific instruction to value decedent's majority interest as a minority interest with a 50% discount." The court of appeals concluded that "[w]e find nothing in the record—nor does the Estate point to anything in the record—that suggests the Tax Court's findings were clearly erroneous."

3. **Comment.** This case presents extremely bad and, it is hoped, uncommon facts. But it also offers a lesson: It normally doesn't matter what people do that reduces the value of their own property. But where a charitable deduction is involved and the executor has made representations on an estate tax return about what charity is going to get, it is dangerous business to effectively change the estate plan after the return is filed. Letting value be affected by post-valuation-date events is serious stuff, but the IRS and courts are willing to go that route on facts like these.

   The Tax Court and Ninth Circuit opinions do not reveal what Eugene told the Oregon court that approved the redemption. But this case also offers the lesson that approval of a state court alone is not a guarantee of immunity from the IRS in a context like this.

Number Eight: Follow-Up of State Taxation of QTIP Trusts at the Surviving Spouse's Death (*Seiden* (NY), *Taylor* (MD))

The facts in these cases are simple; the consequences could be complex.

1. **Introduction.** In 1981, when Congress added section 2056(b)(7) to the Code to permit what have become known as QTIP trusts, it seemed like such a perfect idea. Even though the trust for the surviving spouse (or donee spouse under section 2523(f)) did not need any of the traditional features that by their terms would include the value of the trust assets in the surviving spouse's gross estate – such as a general power of appointment under sections 2056(b)(5) and 2523(e) or payment to the spouse's estate under Reg. §20.2056(c)-2(b)(1)(iii) – that inclusion in the surviving spouse's gross estate was assured by the contemporaneous enactment of section 2044, providing for inclusion whenever a marital deduction had been allowed under section 2056(b)(7) or 2523(f), backstopped by section 2519 in the case of the surviving spouse's actions during life. Thus was maintained the fundamental character of the marital deduction as a deferral only – the asset escapes tax at the first death but is taxed at the second death. Even if the surviving spouse, who generally must be a U.S. citizen under section 2056(d), moves out of the country, section 2001(a) continues to apply, and if such a surviving spouse with sufficient income or assets also renounces that U.S. citizenship, sections 877 and

2107 ensure continued taxation for 10 years. Meanwhile, the 1981 objective of making the marital deduction unlimited without having to give the surviving spouse control over the disposition of the remainder is fulfilled in the QTIP trust.

Since the phase-out of the credit for state death taxes under the 2001 Tax Act, and especially with state legislatures setting their estate tax exemptions lower than the federal basic exclusion amount, some states that still have an estate tax have provided for a state-only QTIP election, available when the estate is under the federal exclusion amount but not under the state exemption, or applicable to the extent the state exemption is less than the federal exclusion amount. But symmetry is lost to the fact that a state is powerless when the surviving spouse moves out of the state. "Worldwide," or nationwide, taxation is not allowed, and, under Section 1 of the Fourteenth Amendment to the U.S. Constitution, a citizen of a state loses that citizenship merely by moving to another state. That dissymmetry is the backdrop for these cases that were Number Six in the 2018 Top Ten, and the follow-up of which is now Number Eight in the 2019 Top Ten.

2. ***Seiden* (New York).** In *In re Estate of Seiden*, NYLJ 10/12/18 p. 23, col. 5 (N.Y. County Surr. Ct.), the predeceased spouse died domiciled in New York in 2010, when there was no federal estate tax. But New York still had its estate tax, and a New York-only QTIP election was made. The surviving spouse died domiciled in New York in 2014.

   The New York court held that New York cannot tax the QTIP trust because New York totally piggybacks on the federal gross estate, and there was no QTIP trust for federal estate tax purposes to include in the federal gross estate. The New York court relied on New York Tax Law §954(a), which stated that the New York gross estate of a deceased resident "means his or her federal gross estate." Because there was no federal QTIP election, the value of the trust assets was not included in the federal gross estate and hence was not included in the New York gross estate either.

   The court added that "the legislature could still amend the Tax Law to apply to future estates." Sure enough, effective April 1, 2019, the New York Executive Budget (signed into law by the Governor April 12, 2019) applied the New York estate tax at the surviving spouse's death to a trust for which a QTIP election was made for New York estate tax purposes even if a federal QTIP election was not made.

3. ***Taylor* (Maryland).** In contrast, in *Comptroller of the Treasury v. Taylor*, 189 A.3d 799 (Md. Ct. Spec. App. July 25, 2018), the predeceased spouse died domiciled in Michigan in 1989 and created a trust. Both federal and Michigan QTIP elections were made. The surviving spouse moved to Maryland in 1993 and died domiciled in Maryland in 2013.

   The Maryland court of special appeals held that Maryland cannot tax the QTIP trust because no **Maryland** QTIP election had been made. The court cited Code of Maryland-Tax-General (TG) §7-309(b)(6)(i) (emphasis added):

   > For purposes of calculating Maryland estate tax, a decedent shall be deemed to have had a qualifying income interest for life under §2044(a) of the Internal Revenue Code with regard to any property for which a marital deduction qualified terminable interest property election was made for the decedent's predeceased spouse **on a timely filed Maryland estate tax return**.

Then, in *Comptroller of the Treasury v. Taylor*, 213 A.3d 629 (Md. July 29, 2019), the Court of Appeals (Maryland's supreme court) **reversed**, on the odd ground that the decedent "had a property interest in the full value of the marital trust" because of the "fictional transfer" created by federal tax law.

A more understandable concurring opinion noted that TG §7-301(b) states, like the New York statute applied in *Seiden*, that "'Estate' means the federal gross estate." and that TG §7-309(b)(6)(i) **includes** a Maryland QTIP trust even if it is not subject to federal estate tax, but does "not state or imply that that is the **only** circumstance under which the Maryland estate tax can apply to a Maryland resident's interest in a QTIP trust."

One judge dissented, noting that "[t]he QTIP deduction is premised on an exchange of benefits between the surviving spouse and the government granting a tax deferral," and that Maryland had granted no benefit because the predeceased spouse had resided in Michigan. He also pointed out that even if the surviving spouse had stayed in Michigan, Michigan would not have taxed the QTIP trust upon her death in 2013, because its estate tax was tied to the federal credit for state death taxes, which was phased out by the 2001 Tax Act.

Number Seven: Final "Anti-Clawback" Regulations (Reg. §20.2010-1(c))

1. **Background**. Number Four in the **2018 Top Ten** was the proposal of regulations on November 20, 2018, pursuant to section 2001(g)(2), to ensure that the a large gift made before the doubling of the gift and estate tax basic exclusion amount (BEA) sunsets in 2026 would not in effect be "clawed back" into the calculation of the estate tax if the donor dies after 2025. The November 2018 proposed regulations, accompanied by only one simplified example, were reassuring on the basic issue, but they left some doubt about secondary issues, including the application of inflation adjustments and the effects of a portability election made during the 2018-2025 doubling period.

2. **Final Regulations.** The **final regulations** issued on November 12, 2019, respond to those concerns. The Preamble notes that inflation adjustments were omitted from the example just for the sake of simplicity. That example, now Example 1 in Reg. §20.2010-1(c)(2), has been changed to include hypothetical inflation-adjusted numbers. Example 2 has been added to illustrate what the Preamble acknowledges is the "use or lose" nature of the doubled BEA when a donor uses some BEA, but not the entire BEA, available from 2018 through 2025. And new Examples 3 and 4 illustrate scenarios where a deceased spousal unused exclusion (DSUE) amount from a predeceased spouse who dies before 2026 is applied to the surviving spouse's gifts before 2026 and to the calculation of the estate tax when the surviving spouse dies after 2025.

3. **Portability History.** Referring to the 2015 portability regulations (T.D. 9725), the Preamble to the final anti-clawback regulations states:

   > The regulations in §§ 20.2010-1(d)(4) and 20.2010-2(c)(1) confirm that the reference to BEA is to the BEA in effect at the time of the deceased spouse's death, rather than the BEA in effect at the death of the surviving spouse.

   The reason for that result is very logically and helpfully explained in the Preamble to the 2012 temporary regulations (T.D. 9593):

> The 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. Generally, only the basic exclusion amount of the decedent, as in effect in the year of the decedent's death, will be known at the time the DSUE amount must be computed and reported on the decedent's estate tax return. Because section 2010(c)(5)(A) requires the executor of an estate electing portability to compute and report the DSUE amount on a timely-filed estate tax return, and because the basic exclusion amount is integral to this computation, the term "basic exclusion amount" in section 2010(c)(4)(A) necessarily refers to such decedent's basic exclusion amount.

4. **Portability Problem.** The problem was that the 2015 regulations were arguably addressed to the calculation of the DSUE amount by the predeceased spouse's executor. The title to Reg. §20.2010-2 is "Portability provisions applicable to estate of a decedent survived by a spouse" – that is, the predeceased spouse, not the surviving spouse. In contrast, section 2010(c)(4) itself states (emphasis added):

   > For purposes of this subsection, **with respect to a surviving spouse** of a deceased spouse dying after December 31, 2010, the term "deceased spousal unused exclusion amount" means the **lesser** of—
   >
   > (A) **the basic exclusion amount**, or
   >
   > (B) the excess of—
   >
   > (i) the applicable exclusion amount **of the last such deceased spouse** of such surviving spouse, over
   >
   > (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate **of such deceased spouse**.

   The use of the term "basic exclusion amount" in subparagraph (A) under the introduction "with respect to a surviving spouse," with the explicit focus on "the last such deceased spouse" not occurring until the following subparagraph (B), could imply that the term "basic exclusion amount" in subparagraph (A) is indeed the BEA in effect when the surviving spouse dies and therefore applicable to the surviving spouse's estate. In other words, regardless of the DSUE amount calculated at the predeceased spouse's death and reported on the predeceased spouse's estate tax return, that DSUE amount might be recalibrated at the death of the surviving spouse to take into account the BEA in effect at that time.

   That interpretation would give effect to the general notion held by congressional drafters that in order to prevent tax avoidance by successive acquisition of DSUE amounts from multiple successive marriages (perhaps even tax-motivated "deathbed marriages"), portability should in effect be allowed to no more than double what would otherwise be the survivor's exemption. For example, a statement submitted on behalf of The

American College of Trust and Estate Counsel to the Senate Finance Committee when it was considering portability addressed that problem with doubling as the presumed solution:

> One of the technical challenges to implementing portability was the tracing problem. Tracing refers to tracking assets from the deceased spouse to the surviving spouse in order to determine how much unused exemption should be transferred to the surviving spouse's estate. H.R. 5970 [the "Estate Tax and Extension of Tax Relief Act of 2006," passed by the House of Representatives on July 29, 2006] solved this problem by transferring the entire unused exemption of the deceased spouse to the estate of the surviving spouse but capping the amount of unused exemption the survivor's estate can use to the same amount as the survivor's exemption. Therefore, the total exemption in the surviving spouse's estate would never exceed twice the amount of a single exemption.

OUTSIDE THE BOX OF ESTATE TAX REFORM: REVIEWING IDEAS TO SIMPLIFY PLANNING, **SENATE HEARING 110-1019**, 110TH CONG., 2D SESS. 124 (Statement of Shirley L. Kovar, Chair of ACTEC's Transfer Tax Study Committee (now renamed as the Tax Policy Study Committee), April 3, 2008).

H.R. 5970 predated the development of the limitation of portability to the "last" deceased spouse now included in section 2010(c)(4)(B)(i) as a way to address the "tracing problem." While H.R. 5970 would have allowed portability of a DSUE amount from more than one predeceased spouse, it would have added the following limitation as section 2010(c)(4):

> For purposes of this subsection, the term "aggregate deceased spousal unused exclusion amount" means the lesser of—
>
> (A) the basic exclusion amount, or
>
> (B) the sum of the deceased spousal unused exclusion amounts of the surviving spouse.

In that case, "the basic exclusion amount" in subparagraph (A) evidently is the BEA of the surviving spouse, because no single deceased spouse is identified at all. The current limitation of portability to the "last" deceased spouse in the version that ultimately became law in 2011 arguably makes the doubling limitation unnecessary. Nevertheless, the similarity of current section 2010(c)(4) to H.R. 5970, and the fact that the portability regulations were not written in a climate when a "sunset" or a "clawback" issue would necessarily have been in view, justified the concerns about the durability of the DSUE amount under the 2017 Tax Act. And certainly preserving the DSUE amount when portability has been elected with that expectation is the right result.

5. **Conclusion.** Although the statement in the Preamble alone might not have allayed all concerns (any more than the Preamble to the 2012 temporary portability regulations), the incorporation of DSUE amounts into new Examples 3 and 4 should suffice. The anti-

clawback regulations are final and portability is preserved. This is a welcome affirmation of the significance of public comments in the regulation process.

Number Six: Deductibility of Trust and Estate Administration Expenses (Sections 67(e)(1) and 642(h)(2))

1. **Background: Section 67(e) and (g).** Section 67 was added to the Code by the Tax Reform Act of 1986. Section 67(a) limits an individual's income tax deduction of "miscellaneous itemized deductions" to the amount that such deductions exceed 2% of the individual's adjusted gross income. Section 67(e)(1), as amended in 1988, allows an estate or trust a deduction in computing adjusted gross income – that is, an "above the line" deduction not subject to the 2% floor of section 67(a) – "for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." But Reg. §1.67-4(b)(4) and (c)(2) (proposed in 2011 to reflect the Supreme Court's decision in *Knight v. Commissioner*, 552 U.S. 181 (2008) and finalized in 2014) controversially – and, in the view of many, including this author, wrongly – provided that fees for investment advice, including the portion of a "bundled" fiduciary fee attributable to investment advice, are generally not covered by section 67(e)(1) and are therefore subject to the 2% floor.

   Then the 2017 Tax Act (often called the "Tax Cuts and Jobs Act") added section 67(g), providing: "Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026." But the Act did not alter or limit section 67(e).

   In the 2018-2019 Treasury-IRS Priority Guidance Plan, Part 1 was titled "Implementation of Tax Cuts and Jobs Act (TCJA)." Item 3 of Part 1 was described as "Guidance clarifying the deductibility of certain expenses described in §67(b) and (e) that are incurred by estates and non-grantor trusts." This was carried over as Item 6 in Part 1 of the **2019-2020 Priority Guidance Plan**, issued October 8, 2019, to cover the plan year from July 1, 2019, through June 30, 2020; the only change was to replace the word "Guidance" with "Regulations."

   Meanwhile, Notice 2018-61, **2018-31 I.R.B. 278**, was released on July 13, 2018, and published in the Internal Revenue Bulletin on July 30, 2018. Because the 2017 Tax Act did not alter or limit section 67(e), Notice 2018-61 stated that "[t]he Treasury Department 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)" despite the eight-year "suspension" of section 67(a) by section 67(g).

   It appears, however, that deductibility will continue to be limited by the harsh treatment in Reg. §1.67-4(b)(4) and (c)(2) of fiduciary investment advisory fees, which now will mean total disallowance, not just the application of a 2% floor. Notice 2018-61 stated flatly that "nothing in section 67(g) impacts the determination of what expenses are described in section 67(e)(1)."

2. **Application to Section 642(f)(2).** Notice 2018-61 also stated that Treasury and the IRS intend to issue regulations to address the availability of "excess deductions" to individual beneficiaries under section 642(h)(2) and Reg. §1.642(h)-2(a) on termination of a trust or estate – in other words, the pass-through to beneficiaries the amount of otherwise

deductible expenses in the final taxable year of the trust or estate that exceed the gross income of the trust or estate – and the Notice asked for comments from the public on that issue.

a. **Reassurance from the Instructions.** The **instructions** for the 2018 Form 1041, dated February 5, 2019, appeared to assume a favorable resolution of that issue, and the **draft instructions** for the 2019 Form 1041, dated November 4, 2019, make no change in that reassuring impression. The specific instructions for line 22 of the 2018 Form and line 23 of the draft 2019 Form, Taxable Income, on page 26, state:

    > If the estate or trust has for its final year deductions (excluding the charitable deduction and exemption) in excess of its gross income, the excess is allowed as an itemized deduction to the beneficiaries succeeding to the property of the estate or trust.

    On page 36 of the 2018 instructions and page 38 of the draft 2019 instructions, at the beginning of the specific instructions for Schedule K-1, Beneficiary's Share of Income, Deductions, Credits, etc., there is this warning:

    > **Note.** Section 67(g) suspends miscellaneous itemized deductions subject to the 2% floor for tax years 2018 through 2025. See Notice 2018-61 for information about allowable beneficiary deductions under section 67(e) and 642(h).

    Nevertheless, on page 39 of the 2018 instructions and page 40 of the draft 2019 instructions, the instructions confirm:

    > If this is the final return of the estate or trust, and there are excess deductions on termination (see the instructions for line 22), enter the beneficiary's share of the excess deductions in box 11 [Final year deductions], using code A. Figure the deductions on a separate sheet and attach it to the return.

    In contrast, the **instructions** for line 16 of the 2018 Form 1040, Schedule A ("Other Itemized Deductions"), dated December 10, 2018 (page A-12), and the **instructions** for line 16 of the 2019 Form 1040, Schedule A, dated December 10, 2019 (page A-12), state that "Only the expenses listed next can be deducted on line 16" and then provide a list that does not include excess deductions on termination of a trust or estate. In this respect, however, those instructions are identical to the **instructions** for line 28 of the 2017 Schedule A, dated February 15, 2018 (page A-13), before the 2017 Tax Act when there was no doubt that excess deductions on termination could be deducted.

b. **Comment.** It is common for an estate or trust to actually have extra expenses related to its wind-up and final distributions in its final taxable year, at the same time its gross income is declining because it is distributing its income-producing assets. The ability of a fiduciary to pass through those final-year excess deductions provides very important relief from what would otherwise be

pressure to artificially time the payment of expenses, the distribution of trust assets, and the termination of the trust or estate to preserve this tax benefit, which could be unfair and frustrating to beneficiaries.

Addressing this concern in light of section 67(g) is more difficult than addressing the year-to-year deductibility of administration expenses by the trust or estate because individual beneficiaries are not given the explicit workaround of an above-the-line deduction that fiduciaries are given by section 67(e)(1). Indeed, Reg. §1.642(h)-2(a) bluntly states that the deduction "is not allowed in computing adjusted gross income." That is probably why Notice 2018-61 speaks more decisively about the fiduciary's deduction ("intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct expenses") than about the passthrough to beneficiaries ("intend to issue regulations in this area"). And the blunt prohibition currently in Reg. §1.642(h)-2(a) is probably at least one reason why the 2019-2020 Priority Guidance Plan changes the description of the project from "guidance" to "regulations."

The 2019 developments are only instructions, and the new development is only a draft of instructions. Obviously, regulations supersede instructions. But it is very significant that, even after the opportunity to think about this issue for eight months since the publication of the 2018 instructions, eight months during which this issue has been widely discussed in professional circles, the draft of the 2019 instructions does not back down. Reassuring proposed (and perhaps temporary) regulations on this vexing topic should be seen in 2020. Although they apparently will not undo the now total disallowance of fiduciary expenses for investment advice under the unfortunate choice made in the 2014 regulations, their sensitivity to the challenges of terminating a trust or estate will be most welcome.

Number Five: Uniform Electronic Wills Act

1. **Overview.** At its annual meeting in Anchorage, Alaska, in July 2019, the Uniform Law Commission (ULC) approved the new "**Uniform Electronic Wills Act**," (or "E-Wills Act"), thereby recommending it for enactment in all of the states to allow for the electronic execution and enforcement of wills. The first paragraph of the Act's Prefatory Note sets the stage:

   > People increasingly turn to electronic tools to accomplish life's tasks, including legal tasks. They use computers, tablets, or smartphones to execute electronically a variety of estate planning documents, including pay-on-death and transfer-on-death beneficiary designations and powers of attorney. Some people assume that they will be able to execute all their estate planning documents electronically, and they prefer to do so for efficiency, cost savings, or other reasons. Indeed, a few cases involving wills executed on electronic devices have already arisen.

   The Prefatory Note continues by noting cases that have approved wills for which a testator typed his signature in a cursive font at the end of the electronic text (*Taylor v. Holt*, 134 S.W.3d 830 (Tenn. 2003)); a testator dictated a will to his brother, who wrote the will with a stylus on an electronic tablet, and the testator and two witnesses signed the will on the tablet with the stylus (*In re Estate of Javier Castro*, Case No.

2013ES00140, Court of Common Pleas Probate Division, Lorain County, Ohio (June 19, 2013)); and a 21-year-old testator, shortly before committing suicide, handwrote a journal entry with instructions for accessing a "Last Note" on his phone, which included directions relating to his property as well as apologies and personal comments about his suicide, with his name typed at the end of the document (*In re Estate of Horton*, 925 N.W.2d 207 (Mich. 2018)). And the Prefatory Note observes that as of 2019 four states (Arizona, Florida, Indiana, and Nevada) had adopted electronic wills legislation and five jurisdictions (California, the District of Columbia, New Hampshire, Texas, and Virginia) had considered such legislation.

2. **Approach of the E-Wills Act.** The E-Wills Act seeks to reduce uncertainty (as illustrated by the above cases that required litigation) and promote uniformity that is especially important in a mobile population. It also recognizes and seeks to preserve the four functions served by will formalities, as described in Langbein, *Substantial Compliance with the Wills Act*, 88 HARV. L. REV. 489 (1975):

    - Evidentiary – the will provides permanent and reliable evidence of the testator's intent.
    - Channeling – the testator's intent is expressed in a way that is understood by those who will interpret it so that the courts and personal representatives can process the will efficiently and without litigation.
    - Ritual (cautionary) – the testator has a serious intent to dispose of property in the way indicated and the instrument is in final form and not a draft.
    - Protective – the testator has capacity and is protected from undue influence, fraud, delusion and coercion. The instrument is not the product of forgery or perjury.

    Section 5 of the E-Wills Act retains the traditional requirement of a writing (called "a record"), but permits the writing to be electronic. It also provides the option of the testator and each of the two witnesses being in different locations, so long as they are in real-time communication. If another person signs for the testator at the testator's direction, however, the testator and the person who signs must be in the same location. A person who notarizes may or may not be required to be in the same location, depending on state law regarding online notarization.

    Under Section 7 of the Act, a will may be revoked by a superseding will, or (as with a paper writing) it may be revoked by a physical act. Recognizing, for example, that there may be multiple copies of an electronic writing with no clear "original," the Act permits the intent to revoke by any physical act to be "established by a preponderance of the evidence." But (like tearing up a written will) the physical act must be performed to or on the will itself. The Comment to Section 7 offers the examples of "deleting a file with the click of a mouse or smashing a flash drive with a hammer," but notes that "[s]ending an email that says, 'I revoke my will,' is not a physical act performed on the will itself" and therefore is not a revocation.

3. **Comment.** By changing the way wills may be executed, the E-Wills Act may change the custom for executing other documents too, because the formality of "signing a will" will

no longer be the occasion for bringing clients to the drafter's office. While some people of modest wealth might be more encouraged to use online services and thereby avoid intestacy, busy people, regardless of their wealth, might also welcome the convenience. For them, eliminating the face-to-face discussion with their advisor about subtleties of their estate plan may alter the way advice is given and received in general, perhaps for the better and perhaps for the worse. Lawyers and other advisors themselves are likely to have a range of reactions, from welcoming the efficiency to regretting what seems like a sacrifice of formality and dignity. Thus, predictably, reactions may range from "How can we possibly live with this?" to "How did we ever live without it?"

For more commentary on the E-Will Act, see *Ready or Not, Here They Come: Electronic Wills Are Coming to a Probate Court Near You*, 33 PROB. & PROP. No. 5 (Sept./Oct. 2019); Glazier, *Electronic Wills: Revolution, Evolution, or Devolution*, 44 BLOOMBERG BNA TAX MANAGEMENT ESTATES, GIFTS & TRUSTS J. 34 (Jan. 10, 2019); and Stone, *Technology and Estate Planning – The Machines Are Coming, Will You Be Ready?,* LEIMBERG ESTATE PLANNING NEWSLETTER #2625 (Feb. 6, 2018).

Number Four: Senator Sanders' "For the 99.8 Percent Act"

1. **Background and Significance.** On January 31, 2019, following the Democratic victories in the 2018 House of Representatives elections, Senator Bernie Sanders (I-Vermont) introduced **S. 309**, titled "For the 99.8 Percent Act," an updated compilation of legislative proposals he and Democrats have been offering regarding the estate, gift, and GST taxes and related grantor trust income tax issues. It includes adaptations of proposals in the Treasury Department's "General Explanations" (popularly called "Greenbooks") of revenue provisions in the budget proposals of the Obama Administration and even the Clinton Administration.

   Senator Sanders of course is running for President, but if Democrats retain control of the House of Representative and gain control of either the Senate or the White House or both in the 2020 elections, his proposals could be important whether or not he himself happens to be the President or even the Democratic nominee. That is true simply because his proposals have been written – that is, reduced to statutory wording – and are "out there" or "on the shelf" for lawmakers to incorporate into whatever other legislation happens to be popular at the time. These proposals are distinguished in that respect from some other more fundamental ideas that have been offered from time to time during the campaign, such as a "wealth tax" that would have to be written and refined and would probably still face years of uncertainty about its constitutionality. (For those reasons in general, although the introduction of S. 309 is Number Four in this list, the Democratic presidential candidates' respective campaign proposals as such are not included as "developments" in this Top Ten.)

   And Senator Sanders' bill is important for another reason. In any scenario following the 2020 elections, even a Republican sweep, drafted legislation like this can be the source for fillers in the legislation of the day, particularly a revenue-raiser that has just the right revenue estimate to "pay for" other legislation. That is exactly what happened when "Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent" was added to the Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41) by a Republican-controlled Congress in July 2015. It raised just the right amount of money to fund a desired extension of the Highway

Trust Fund that was scheduled to expire on the day President Obama signed the Act into law. Consistent basis has become the occasion for controversial proposed regulations in March 2016, the finalizing of which is likely to make 2020's Top Ten. Significantly, the first introduced statutory wording for the consistent basis provision had been section 6 of the "Responsible Estate Tax Act" (S. 3533), introduced on June 24, 2010, by Senator Sanders.

2. **Modifications to Rates and Exemptions.** Section 2 of the "For the 99.8 Percent Act" would raise gift and estate tax rates to 45% (from $3.5 million to $10 million), 50% (from $10 million to $50 million), 55% (from $50 million to $1 billion), and 77% (over $1 billion). While these rates are high (higher than even Senator Sanders' previous bills) and should not be expected to be approved by Republicans, even as a pay-for filler, all these marginal rates have actually been the top rate within the memories of some of us (including this author) – 45% in 2007-2009, 50% in 2002, 55% in 1984-2001, and even 77% in 1941-1976. But the overall taxes of those years actually exceeded the taxes that the "For the 99.8 Percent Act" would impose, because the brackets in those years were much lower.

   The "For the 99.8 Percent Act" would make the basic exclusion amount $3.5 million for estate tax purposes (as in 2009) and $1 million for gift tax purposes (as in 2002-2010), not indexed but including an "anti-clawback" rule. The bill says nothing about the GST tax, which apparently would make the GST tax rate 77% and the GST exemption $3.5 million.

3. **Quadrupling of the Special Use Valuation Benefit.** Section 3 of the "For the 99.8 Percent Act," like section 4 of the 2010 "Responsible Estate Tax Act," would **quadruple** the cap on the reduction in value under the special use valuation rules of section 2032A from $750,000 ($1.16 million in 2019) to $3 million, still indexed for inflation from 1997 (so the number in 2020 would be about $4.7 million). Lawmakers who favor the repeal of the estate tax often cite the effect of the estate tax on family businesses as a reason. Those who oppose repeal of the estate tax, like Senator Sanders, often argue that family businesses could be helped just as effectively by more targeted relief, like this proposal to quadruple the benefits of section 2032A.

4. **Quadrupling of the Conservation Easement Exclusion.** Similarly, section 4 of the "For the 99.8 Percent Act," like section 5 of the 2010 "Responsible Estate Tax Act," would increase the maximum exclusion from the gross estate under section 2031(c) by reason of a conservation easement from the lesser of $500,000 or 40 percent of the net value of the land to the lesser of $2 million or 60 percent of the net value of the land.

5. **Consistent Basis Reporting Extended to Gifts.** Section 5 of the "For the 99.8 Percent Act" would extend the "consistent basis" rules of section 1014(f) and the accompanying reporting rules of section 6035(a) to **property received by gift**, in new sections 1015(f) and 6035(b). This is one of the revenue-raisers that conceivably could be picked up regardless of the outcome of the 2020 elections, as its estate counterpart was in 2015.

6. **Valuation of Nonbusiness Assets.** It is with regard to the valuation of **nonbusiness** assets that the "For the 99.8 Percent Act" gets tough. Section 6 is titled "Valuation Rules for Certain Transfers of Nonbusiness Assets; Limitation on Minority Discounts." It

would provide that in the case of a transfer of an interest in an entity other than an interest that is actively traded, for estate and gift tax purposes (a) the value of any nonbusiness assets held by the entity must be determined as if the transferor had transferred such assets directly to the transferee, with no valuation discount, and (b) no discount shall be allowed by reason of the fact that the transferee does not have control of such entity if the transferor, the transferee, and members of the family of either the transferor and transferee control the entity or own a majority of the ownership interests (by value) in the entity.

Section 6 is virtually identical to section 7 of Senator Sanders' 2010 "Responsible Estate Tax Act" and similar to section 276 of H.R. 3874, introduced in March 2000 by Rep. Charles Rangel of New York, the Ranking Democrat on the House Ways and Means Committee, to implement a legislative proposal in the 1998 Clinton Administration's "Greenbook." It is also virtually identical to section 303 of H.R. 1264, introduced by Rep. Rangel in March 2001 as an alternative to the Republican proposals that became the 2001 Tax Act, and to three bills subsequently introduced by Rep. Earl Pomeroy (D-North Dakota): H.R. 5008 in June 2002, H.R. 1577 in April 2005, and H.R. 4242 in November 2007.

It is not very likely that this revenue-raiser would be picked up in the absence of a Democratic sweep in the 2020 elections.

7. **Grantor Retained Annuity Trusts.** Section 7 of the "For the 99.8 Percent Act" revives the proposals of the Obama Administration's Greenbooks regarding GRATs, generally in the form in which those proposals solidified in the 2015 and 2016 Greenbooks. It would require any GRAT to

    - have a term no shorter than 10 years (the proposal in the original 2009 Obama Administration Greenbook),
    - prohibit any decrease in the annuity during the GRAT term (a proposal added in the 2010 Greenbook),
    - have a term no longer than the life expectancy of the grantor plus 10 years (a proposal added in the 2012 Greenbook), and
    - have a remainder interest with a value for gift tax purposes when the GRAT is created equal to at least 25 percent of the value of the assets contributed to the GRAT or $500,000, whichever is greater (but not greater than the value of the assets contributed) (a proposal added in the 2015 Greenbook).

    Section 8 of Senator Sanders' 2010 "Responsible Estate Tax Act" had included only the minimum 10-year term and the prohibition on decreases in the annuity, reflecting only the 2009 and 2010 Greenbooks that had been published before then.

    This is also one of the revenue-raisers that conceivably could be picked up regardless of the outcome of the 2020 elections, although it is unlikely (but not impossible) that the fourth point regarding a minimum 25% value would be included.

8. **Grantor Trusts in General**. Similarly, section 8 of the "For the 99.8 Percent Act" revives the proposals of the Obama Administration's Greenbooks regarding grantor trusts and provides proposed statutory language for those proposals, generally following the 2013 and 2014 Greenbooks. Under section 8, a new chapter 16 of the Code,

containing a single section 2901, would basically conform the income tax and transfer tax treatment of certain deemed-owned trusts, by

- subjecting to gift tax any distribution from such portion to one or more beneficiaries during the deemed owner's life,
- treating as a gift subject to gift tax the assets of such portion at any time during the deemed owner's life that the deemed owner ceases to be treated as an owner of such portion for income tax purposes, and
- including the value of the assets of such portion in the gross estate of the deemed owner for estate tax purposes.

Effective on the date of enactment, section 2901 would apply to any portion of a trust if

- the grantor is the deemed owner of that portion under subchapter J, or
- a person other that the grantor is the deemed owner of that portion under subchapter J, if that person "engages in a sale, exchange, or comparable transaction with the trust that is disregarded for purposes of subtitle A [the federal income tax subtitle]," to the extent of "the portion of the trust attributable to the property received by the trust in such transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction." (This second category appears to target the techniques known as "BDITs" and "BDOTs," whether as a matter of tax policy or simply to crack down on techniques known to be in use.)

While conformity of the income and transfer tax rules may be superficially appealing (and may have been a sensible way to design these rules in the first place), this revenue-raiser is not likely to be picked up regardless of the outcome of the 2020 elections, because of the negative attention it would attract and the transitional disruption it could create.

9. **Elimination of GST Exemption for Certain Long-Term Trusts.** Section 9 of the "For the 99.8 Percent Act" would mandate an inclusion ratio of one for any trust that is not a "qualifying trust." A "qualifying trust" is "a trust for which the date of termination of such trust is not greater than 50 years after the date on which such trust is created."

   This recalls a similar proposal in the Obama Administration's Greenbooks, but would be significantly more aggressive. It would use a period of 50 years (rather than 90 years in the Greenbooks) and would mandate an inclusion ratio of one from the beginning of a trust (rather than resetting the inclusion ratio to one on the 90th anniversary), apparently without any "wait and see" relief.

   A trust created before the date of enactment with an inclusion ratio less than one would be allowed to keep that inclusion ratio for 50 years, and then the inclusion ratio would be reset to one.

These restrictions seem unlikely to be picked up as revenue-raisers apart from a change in the control of the Senate and White House. But anything is possible, as shown by the inclusion of the consistent basis rules in the 2015 highway legislation.

10. **"Simplifying" Gift Tax Exclusion for Annual Gifts.** Section 10 of the "For the 99.8 Percent Act" would significantly limit the availability of the gift tax annual exclusion. It would implement a similar proposal in the Obama Administration Greenbooks, from which it borrows the euphemistic characterization of "simplifying."

    Like the Greenbooks, section 10 would introduce a **per-donor** limit on the annual exclusion, as a further limitation on the $10,000 per-donee exclusion of current law (indexed for inflation since 1998). While the per-donor limit in the Greenbooks would have been $50,000 (indexed for inflation), the "For the 99.8 Percent Act" proposes a per-donor limit of twice the per-donee limit, currently $30,000 (also indexed for inflation). Section 10 would impose this new limitation on transfers in trust (but without an exception for trusts described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee. It would leave in place the per-donee annual exclusion (currently $15,000) for outright gifts of cash or marketable securities, for example.

    Section 10 would repeal section 2503(c), which provides a special way that a trust for a minor can qualify as a present interest. As in the Greenbook proposals, the new $30,000 per-donor limit would apply to all transfers in trust.

    The "For the 99.8 Percent Act" would not change the unlimited exclusion in section 2503(e) for tuition and medical expenses paid directly to the provider or the gift-splitting rules in section 2513. It is also a possible, but unlikely, prospect in the absence of a change in the control of the Senate and the White House.

Number Three: Possible Breakthrough in the Judicial Acceptance of "Tax-Affecting" (*Kress, Jones*)

Two court decisions, one in a Federal District Court and one in the Tax Court, represent a significant affirmation of the appraisal community's insistence on tax-affecting in the valuation of an interest in a business conducted in a passthrough entity.

1. **Background of Tax-Affecting.** "Tax-affecting" refers to the step in the valuation of interests in a closely-held business that seeks to adjust for certain differences between passthrough entities and C corporations.

    a. **Justification for Tax-Affecting.** While many discussions of tax-affecting are quite technical, the core justifications for tax-affecting are generally that (1) a hypothetical willing buyer in the willing-buyer-willing-seller construct of fair market value is looking for a return on investment and necessarily will enjoy and therefore evaluate that return only on an *after-tax* basis, and (2) 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.

b. **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.

2. **Tax-Affecting in the Courts Before 2019.** For two decades the IRS was successful in defending its rejection of tax-affecting.

a. ***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, G&J Pepsi-Cola Bottlers, Inc. (G&J), 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 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." He refused to allow tax-affecting.

Regarding the IRS internal guide and handbook quoted above, Judge Halpern wrote:

> 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. *Gross v. Commissioner*, 272 F.3d 333 (6th Cir, 2001). 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 G&J 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 G&J 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 G&J 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.

The IRS jumped on the decision in *Gross*, viewed it in effect as a Tax Court ban on tax-affecting, rewrote its internal guidance, and took very strong stands against tax-affecting in subsequent cases.

b. ***Estate of Gallagher v. Commissioner*.** The Tax Court largely went along with the IRS. For example, in ***Estate of Gallagher v. Commissioner***, T.C. Memo. 2011-148 (corrected, T.C. Memo. 2011-244), Judge Halpern again, faced with an expert's tax-affecting assuming a 39-percent corporate income tax rate, 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.

c. ***Estate of Giustina v. Commissioner*.** In ***Estate of Giustina v. Commissioner***, T.C. Memo. 2011-141, *rev'd on other grounds*, 586 F. App'x 417 (9th Cir. 2014), Judge Morrison briefly mentioned what appeared to be tax-affecting using a 25-percent corporate income tax rate and rejected it with the following explanation:

> One problem with [the estate's expert]'s computations is that he reduced each year's predicted cashflows by 25 percent to account for the income taxes that would be owed by the owner of the partnership interest on that owner's share of the partnership's income. The 25-percent reduction is inappropriate because the rate at which [the expert] discounted the cashflows to present value was a pretax rate of return, not a posttax rate of return. An appraiser should not reduce cashflows by income tax while simultaneously using a pretax rate of return to discount the cashflows to present value.

3. ***Kress v. United States*.** In 2019, the march of taxpayer losses in the courts was stalled. The first case was *Kress v. United States*, 382 F. Supp. 3d 820, 123 AFTR 2d 2019-1224 (E.D. Wis. March 26, 2019), addressing 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).

   a. **Facts.** 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. In 2007, 2008, and 2009, James Kress (the son of George Kress, the founder of GBP) and Julie Kress (James Kress's wife) gave minority-interest stock in GBP to their children and grandchildren. The IRS disputed the donors' valuations and assessed gift tax deficiencies of $1.8 million. The donors paid those deficiencies and then filed claims for refund and ultimately sued for refunds in the Federal District Court in Milwaukee, Wisconsin.

   b. **Surprising Consensus on Tax-Affecting.** Both the taxpayers' expert, who had been preparing valuation reports for GBP since 1999, and the Government's expert 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, [the Government's expert] … 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."

   c. **The Court's Opinion.** Overall, the court found that the taxpayers' expert had "provided reliable valuations of the GBP minority-owned shares of stock" and accepted most of his conclusions, including his conclusions regarding tax-affecting.

4. ***Estate of Jones v. Commissioner*.** Five months later (but without citing *Kress*), the Tax Court broke from its 20 years of reluctance to embrace tax-affecting, in ***Estate of Jones v. Commissioner***, T.C. Memo. 2019-191 (August 19, 2019), involving Seneca Sawmill Co. (SSC), an S corporation, and Seneca Jones Timber Co. (SJTC), a limited partnership, both headquartered in Eugene, Oregon.

    a. **Facts.** Mr. Jones founded SSC in 1954 as a lumber manufacturing business. 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 SJTC to hold timberlands intended to be SSC's inventory and to obtain debt financing secured by the timberlands. SSC is 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.

       Also in 1996, Mr. Jones began a process of succession planning, which culminated on May 28, 2009, when he 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. After the gifts, Mr. Jones and his daughters (or trusts for them and their families) each owned an equal number of shares (counting voting and nonvoting) of SSC and an equal number of limited partner units in SJTC.

       Mr. Jones's 2009 gift tax return reported total gifts of about $21 million. The IRS viewed the correct values as about $120 million and asserted a gift tax deficiency (including other much smaller items that were not disputed in the Tax Court) of almost $45 million. 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. A four-day trial was held in Portland, Oregon, in November 2017 before Judge Pugh.

    b. **Positions in the Tax Court.** The estate engaged an appraiser who determined values of the gifts somewhat higher than the values reported on the gift tax return but far smaller than the values claimed by the IRS. An appraiser engaged by the IRS, using a net asset value (NAV) approach, determined the value of the SJTC limited partner units to be slightly higher than what the IRS had claimed in the notice of deficiency. (The court explained that "Respondent did not submit a valuation of SSC and largely accepted the valuation methods and inputs [the estate's appraiser] used in his valuation of SSC.")

       The estate's appraiser "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 *Gross*, *Gallagher*, and *Giustina*.

c. **The Tax Court's Opinion.** Judge Pugh appeared to believe that the IRS had inappropriately allowed tax-affecting to become more of a legal issue than a factual inquiry informed by experts, and that the experts needed to be listened to. She bluntly wrote:

> While respondent objects vociferously in his brief to petitioner's tax-affecting, his experts are notably silent… Thus, we do not have a fight between valuation experts but a fight between lawyers.

In that light, Judge Pugh's opinion, supported by references to the reasoning in *Gross*, *Gallagher*, and *Giustina* and even quotations from *Gross* and *Giustina*, explains that those cases did not prohibit tax-affecting the earnings of a flowthrough entity *per se*, but instead had viewed the issue as fact-based. Noting that in those cases the court had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases, Judge Pugh concluded that in contrast the Jones Estate's appraiser's detailed tax-affecting analysis was appropriate:

We find on the record before us that [the estate's appraiser] 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… [The estate's appraiser]'s tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate.

Typically, the passthrough entity to which tax-affecting is applied is an S corporation, but tax-affecting can be applied in the partnership context too, and *Jones* involved tax-affecting for both an S corporation (SSC) and a partnership (SJTC). Judge Pugh's discussion of tax-affecting is addressed to the partnership, SJTC, which comes first in its opinion. 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:

> [The estate's appraiser] 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 [the estate's appraiser]'s method of tax-affecting the valuation of SSC for the same reasons we accepted it for the valuation of SJTC.

Judge Pugh concluded simply that "we therefore adopt the valuations in [the estate's appraiser]'s report."
A taxpayer victory, a decade after the gifts and two decades after *Gross*.

5. **Reflections on the Significance of These Cases.** *Kress* and especially *Jones* (because it is a decision of the Tax Court where other taxpayers can and probably will go) are very important cases, particularly for the appraisal community.

a. **IRS Reaction.** It might be thought that the IRS would be embarrassed by a case in which it was caught ignoring the consensus of the appraisal community and keeping its "experts … notably silent," and would take pains to avoid such a risk in the future. But it cannot be so easily assumed that the IRS will now give up its hostility to tax-affecting. One Tax Court loss (making the IRS's Tax Court record, in effect, 3-1) may encourage some in the IRS to work even harder to uphold its position in the next case, perhaps by choosing to litigate a case in which the facts provide less justification for tax-affecting or where (as apparently in *Gross*) the taxpayer's appraiser has taken a less thorough and balanced approach than the appraiser in *Jones*.

   Moreover, the hostile view toward tax-affecting is not necessarily shared, or apparently even known and understood, uniformly within the IRS. There is informal anecdotal evidence of both the historical unevenness of resisting tax-affecting within the IRS and the survival of that resistance after *Jones*.

b. **At Least One More Case.** Meanwhile, almost four years ago, the Tax Court tried a case that includes the issue of tax-affecting in valuing S corporation stock. *Estate of William A. V. Cecil, Sr. v. Commissioner*, Docket No. 14639-14, and *Estate of Mary R. Cecil v. Commissioner*, Docket No. 14640-14 (trial held February 2016). As of December 31, 2019, 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 on April 12, 2019 (probably *Kress*) and August 20, 2019 (undoubtedly *Jones*), with IRS answers three days later in each case. In *Cecil*, as in *Kress*, both the taxpayers' expert and the IRS's expert used tax-affecting in their analysis. This may be an example of the lack of uniformity or discipline within the IRS on this issue. Or it may mean simply that facts vary and facts matter and the presentation of facts matters. Also, tax-affecting is not the only issue in *Cecil*. But at a minimum the Tax Court, post-*Jones*, may have a hard time rejecting tax-affecting as a matter of law in *Cecil* when both experts agree on its application, but it still depends both on the facts and on the presentation of the facts, as illustrated in *Jones*.

c. **The Importance of the Role of the Appraiser.** That leads to what might be the most important take-away from the *Kress* and *Jones* cases. If facts matter and the presentation of facts matters, then the selection, thoroughness, and effectiveness of the appraiser are crucial. All indications are that the successes of the taxpayers in *Kress* and *Jones* were attributable, at least in part, to the thorough and balanced job the taxpayers' appraisers had done to appraise the gifts and to the effectiveness of those appraisers in explaining their methods to the courts. For example, the taxpayers' appraisers in both cases were careful to balance the tax-affecting discount with a "premium" to reflect the benefits of the S corporation of partnership structure. Indeed, so was the Government's appraiser in *Kress*, while to some extent the IRS's appraisers in *Jones* were, in Judge Pugh's words, "notably silent." The taxpayers' investment in expert advice paid off.

6. **Other Features of These Cases.** Aside from the important issue of tax-affecting, other elements of the *Kress* and *Jones* opinions are worthy of note.

   a. **Good Facts.** These cases presented some "good facts," and the absence of "bad facts," that may have contributed to the outcomes and, in turn, may limit the reach of the cases as precedents:

      - There were of course legitimate 74-year-old and 55-year-old family-owned operating businesses.
      - There is no indication that the donors' actions were taken for them under a power of attorney or any other agency arrangement.
      - Mr. Jones's 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 invite scrutiny. There is no indication that the Kresses' gifts, spread over three years, involved that kind of division either.
      - These were not "deathbed" gifts. Mr. Jones survived his gifts by more than five years, Mr. Kress survived his gifts by about 10 years, and Mrs. Kress is still alive. 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.)
      - The donors actually paid some gift tax with their returns.

   b. **The 2008 Economic Downturn.** Both courts took note of the 2008 downturn in the United States economy, which had the effect of depressing the value of the interests given in 2008 and 2009 in *Kress* and in 2008 in *Jones*. In *Jones* especially, Judge Pugh noted that the downturn had had a particularly large effect on housing starts, on which SSC's "lumber sales were almost completely dependent."

   c. **Income or Asset-Based Approach for SJTC.** In *Jones*, although tax-affecting may be the most interesting issue to appraisers and advisors, the biggest issue in dollar terms for the taxpayers was whether an income or asset-based approach should be used for valuing the timberland held by SJTC. (That is why, as noted above, the valuation of SJTC is discussed first in the Tax Court's opinion.) The taxpayer's appraiser 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, the taxpayer's appraiser calculated the weighted enterprise value of SJTC to be $107 million – barely one-fourth the asset value.

      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 [the taxpayer's expert]'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.

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 appraiser were all the same as in the *Jones* case. Rejecting that appraiser'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 had bluntly 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.

On remand, Judge Morrison went along with the Ninth Circuit. **T.C. Memo. 2016-114.**

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*.

The alignment and interdependence of the two entities in *Jones* were also the grounds for the Tax Court to accept the taxpayer's valuation of intercompany debt (owed by SJTC to SSC) as operating income and expense, not as an investment asset, and to accept the taxpayer's valuation of SSC's 10 percent general partner interest in SJTC on the basis of expected distributions, not as simply 10 percent of the value of SJTC.

d. **Interesting Section 2703 Dicta About a Family Transfer Restriction in *Kress*.** The GBP Bylaws contained the following limitation on the transfer of Kress family shares:

> Transfer of shares of the Corporation by shareholders who are members of the Kress Family … is hereby restricted to transfers by gift, bequest or private sale to a member or members of the Kress family, provided, however, that the children of George and Marguerite Kress may transfer shares of the Corporation by gift to such child's spouse or trust therefor and further provided that in the event of any such transfer as above provided to issue and descendants or spouse of a child or trust therefor of George and Marguerite Kress, that all of the restrictions set forth herein shall continue to be applicable to the shares of common stock then held by such issue and descendants or spouse or trust therefor as transferee.

The Government argued that the restriction should be disregarded under section 2703(a). The taxpayers argued that section 2703(b) applied, which exempts from section 2703(a)

> any option, agreement, right, or restriction which meets each of the following requirements:
>
> > (1) It is a bona fide business arrangement.
> >
> > (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
> >
> > (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

The court determined, however that the requirement of section 2703(b)(3) had not been met because:

> Though Plaintiffs contend restrictions like the Kress Family Restriction are common in the commercial world, they have not produced any evidence that unrelated parties dealing at arms' length would agree to such an arrangement.

But the court reduced the lack-of-marketability discounts in question only by 3 percent – from 30, 30, and 28 percent for the three respective years to 27, 27, and 25 percent. (In contrast, the Government's expert had determined lack-of-marketability discounts of only 10.8, 11.0, and 11.2 percent.)

Meanwhile, despite the fact that all three requirements of section 2703(b) had to be met to qualify for the exception, the court opined that the requirements of

section 2703(b)(1) and (2) would otherwise apply. The court in effect found the "bona fide business arrangement" requirement of section 2703(b)(1) to be obvious in the context of GBP, which the court described as "unmistakably an operating business."

And as to the requirement of section 2703(b)(2), the court reasoned simply that the restriction could not be "a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth" because the gifts were *inter vivos* and the Kresses were not "decedents." The court acknowledged that Reg. §25.2703-1(b)(1)(ii) substitutes "the natural objects of the transferor's bounty" for the statutory term "members of the decedent's family," which the Government argued resolves the ambiguity of "decedent" in the statutory context of chapter 14. Reviving a debate that seemed to have been dormant since the early 1990s, the District Court found the word "decedent" to be unambiguous and in effect declared the regulation invalid – all, however, totally dicta!

In *Jones*, regarding similar transfer restrictions in an SSC Buy-Sell Agreement and SJTC's partnership agreement, the Tax Court noted that only 5 percent separated the taxpayer's appraiser (35 percent) and the IRS's appraiser (30 percent) and again accepted the determination of the taxpayer's appraiser. Section 2703 was not mentioned, and the IRS evidently did not raise it.

e. **Litigation Strategy.** Finally, it is instructive to reflect on the fact that the company involved in *Kress* was named Green Bay Packaging. When the donors paid the disputed gift tax deficiencies the IRS had assessed and then filed claims for refund and ultimately sued for refunds in the Federal District Court in Milwaukee, Wisconsin, they ensured themselves a measure of "home field advantage" before a local judge. They added to that advantage by engaging two experts, each with two degrees from the University of Wisconsin. The outcome might have been the same on the facts of *Kress* in any court, but the importance of litigation strategy, especially in close cases, should not be overlooked.

Number Two: Not Much Help, but at Least No Harm, Regarding the State Income Taxation of Trusts (*Kaestner*)

In a 9-0 decision, the U.S. Supreme Court upheld the decisions of North Carolina courts that it was unconstitutional for North Carolina to tax the undistributed income of a trust solely because beneficiaries resided in North Carolina, but the Court emphasized that its ruling was narrowly confined to the specific facts of the case for the specific tax years in question. ***North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust***, 588 U.S. __, 139 S. Ct. 2213 (June 21, 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*, 371 N.C. 133, 814 S.E.2d 43 (2018), *aff'g* 789 S.E.2d 645 (N.C. App. 2016), *aff'g*, 12 CVS 8740 (N.C. 2015).

The first paragraph of the Court's opinion sums up its 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.

1. **Facts.** The Kaestner 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 the grantor's daughter, Kimberley, moved to North Carolina in 1997 at the age of 28. A New York resident was the original trustee, 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. Kimberley's Trust was formed for the benefit of Kimberley and her three children.

   North Carolina taxed Kimberley'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 Kimberley, which she repaid the following year.

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

2. **North Carolina Court Opinions**. The North Carolina trial court held that taxing the Trust was unconstitutional under both the Due Process Clause and the Commerce Clause. The Court of Appeals affirmed, addressing only the Due Process Clause.

For its constitutional analysis, the North Carolina Supreme Court quoted rather extensively from the Due Process analysis (not the Commerce Clause analysis) in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), overruled as to physical presence test in Commerce Clause analysis*, South Dakota v. Wayfair, Inc.*, 585 U.S. __ (2018). Quoting *Quill* ("[t]he Due Process Clause requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax"), the North Carolina Supreme Court reasoned that "[t]his 'minimum connection,' which is more commonly referred to as 'minimum contacts,'… exists when the tax entity 'purposefully avails itself of the benefits of an economic market' in the taxing state 'even if it has no physical presence in the state.'"

The North Carolina Supreme Court emphasized that the Trust and the North Carolina beneficiaries have separate legal taxable existences and, citing several U.S. Supreme Court cases, it noted that "a taxed entity's minimum contacts with the taxing state cannot be established by a third party's minimum contacts." The court concisely concluded that the Trust, "as a separate legal entity in the context of taxation, would have needed to purposefully avail *itself* of the benefits and protections offered by the State [citing *Quill*]. Mere contact with a North Carolina beneficiary does not suffice." The court held that the statute authorizing taxation of the undistributed income of a trust based on the beneficiary's residence is unconstitutional under the Due Process Clauses of the U.S. and North Carolina Constitutions as applied to the facts of this case.

3. **U.S. Supreme Court's Approach.** The United States Supreme Court concluded that the Due Process Clause was not satisfied as to North Carolina's taxation of the Trust, but its opinion makes it very clear that its conclusion was based on the specific facts relating to this Trust in the years in question. The Court concluded that the Kaestner Trust beneficiaries did not have the requisite relationship with the trust property to justify the state's tax, but footnote 7 makes clear that the Court did "not decide what degree of possession, control, or enjoyment would be sufficient to support taxation."

   a. **Distinctive Features of the Kaestner Trust.** 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 emphasized that "[c]ritically, 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 it clear that the Court did not address whether the absence of a spendthrift clause would mean that the minimum contacts requirements for due

process were 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 from 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 longer 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.

In light of these three reasons, Kimberley 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."

Significantly, the Court did not indicate how the outcome might change if a beneficiary had received, or had the right to demand, some, but not all, of the Trust's distributable net income, or could count on receiving a specific amount of Trust income in the future. Indeed, in footnotes the Court repeatedly disavowed any intention to address such questions.

b. **Rejection of North Carolina's Counterarguments**. North Carolina had argued that *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947) stood "for the broad proposition that that 'a trust and its constituents' are always 'inextricably intertwined,' and that because the trustee's residence supports trust taxation, so too must a beneficiary's residence. The Court found that this argument "fails to grapple with the wide variation in beneficiaries' interests." The relationship between beneficiaries and trust assets may be very close in some situations, but not in others.

Second, North Carolina had argued that a ruling a favor of the Trust would undermine numerous state taxation regimes. The Court rejected 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. Three other states (Georgia, Montana, and 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, North Carolina had argued that adopting the Trust's position would 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 responded 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."

c. **Avoidance of a Key Rationale of the North Carolina Supreme Court.** The North Carolina Supreme Court had reasoned that the Trust and the beneficiaries have separate legal taxable existences, and that the Trust itself must have sufficient "minimum contacts" with the State and mere contact by a beneficiary will not suffice. Footnote 11 of the U.S. Supreme Court's opinion observes that the Court does not address the Trust's "broader argument that the trustee's contacts alone determine the State's power over the Trust."

d. **Concurring Opinion.** A separate brief concurring opinion by Justice Alito, joined by Chief Justice Roberts and Justice Gorsuch, states that their 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. **Reflections on the Significance of the Supreme Court's Opinion.** *Kaestner* probably deserves a high ranking in the Top Ten simply because it comes from the Supreme Court of the United States. Much has been written and said, and will be written and said, about what the case does and doesn't do. Here are the lessons that are clearest at this time:

   a. **Survival of Supreme Court Precedents.** It is hard to tell if the three concurring Justices intended their opinion to emphasize that the Court's decision is very narrow because they wished it had gone farther or because they were relieved it was so narrow and wanted no one to miss that point. Either way, it is clear that the Court left intact all relevant precedents that might inform the evaluation of the estate and trust income tax approaches of any state, which may be the most important lesson of *Kaestner*. Specifically, the Court cited the following precedents with approval:

      - *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), for the propositions that the Due Process Clause "centrally concerns the fundamental fairness of governmental activity" (*id.* at 312) and requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax" (*id.* at 306).
      - *Maguire* v. *Trefry*, 253 U.S. 12, 16-17 (1920) ("The Court has already held that a tax on trust income distributed to an in-state resident passes muster under the Due Process Clause").
      - *Greenough v. Tax Assessors of Newport*, 331 U.S. 486, 498 (1947) ("So does a tax based on a trustee's in-state residence").

- *Hanson* v. *Denckla*, 357 U.S. 235, 251 (1958), and *Curry* v. *McCanless*, 307 U.S. 357, 370 (1939) ("The Court's cases also suggest that a tax based on the site of trust administration is constitutional").
- *Graves v. Elliott*, 307 U.S. 383, 387 (1939) ("a settlor's 'right to revoke [a] trust and to demand the transmission to her of the intangibles … was a potential source of wealth' subject to tax by her State of residence").
- *Safe Deposit & Trust Co. of Baltimore* v. *Virginia*, 280 U.S. 83 (1929), and *Brooke* v. *Norfolk*, 277 U.S. 27 (1928), for the proposition that "[i]n the past, the Court has analyzed state trust taxes for consistency with the Due Process Clause by looking to the relationship between the relevant trust constituent (settlor, trustee, or beneficiary) and the trust assets that the State seeks to tax."

Regarding *Safe Deposit* and *Brooke* in particular, the Court elaborated:

> In the context of beneficiary contacts specifically, the Court has focused on the extent of the in-state beneficiary's right to control, possess, enjoy, or receive trust assets.
>
> The Court's emphasis on these factors emerged in two early cases, [*Safe Deposit* and *Brooke*], both of which invalidated state taxes premised on the in-state residency of beneficiaries. In each case the challenged tax fell on the entirety of a trust's property, rather than on only the share of trust assets to which the beneficiaries were entitled. *Safe Deposit*, 280 U.S. at 90, 92; *Brooke*, 277 U.S. at 28. In *Safe Deposit*, the Court rejected Virginia's attempt to tax a trustee on the "whole corpus of the trust estate," 280 U.S. at 90; see *id.* at 93, explaining that "nobody within Virginia ha[d] present right to [the trust property's] control or possession, or to receive income therefrom," *id.* at 91. In *Brooke*, the Court rejected a tax on the entirety of a trust fund assessed against a resident beneficiary because the trust property "[wa]s not within the State, d[id] not belong to the [beneficiary] and [wa]s not within her possession or control." 277 U.S. at 29.

More generally, the Court stated:

> All of the foregoing cases reflect a common governing principle: When a State seeks to base its tax on the in-state residence of a trust beneficiary, 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. See *Safe Deposit*, 280 U.S. at 91.

b. **No Interruption of Recent Trend.** State courts, with what seems to be a gradually increasing frequency, have expressed intolerance of taxation by their states of the income of out-of-state trusts. *See*, *e.g.*, *McNeil v. Commonwealth of Pennsylvania*, 67 A.3d 185 (Pa. Comm. Ct. 2013); *Linn v. Department of Revenue*, 2 N.E.3d 1203 (Ill. App. 2013); *Residuary Trust A u/w/o Kassner v. Director, Division of Taxation*, 28 N.J. Tax 541 (N.J. Sup'r Ct. App. Div. 2015); *Fielding v. Commissioner of Revenue*, 916 N.W.2d 323 (Minn. 2018), *cert. denied sub nom. Bauerly v. Fielding* (Docket No. 18-664, June 28, 2019). For more

distant background, see *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (N.Y. 1964); *In re Swift*, 727 S.W.2d 880 (Mo. 1987); *Blue v. Dep't of Treasury*, 462 N.W.2d 762 (Mich. Ct. App. 1990). *Kaestner* now joins that list. Nothing in the U.S. Supreme Court's opinion should impede that trend.

c. **Case-by-Case Situational Analysis Still Needed.** If there is in *Kaestner* any blueprint at all for future examination under the Due Process Clause of factors used by states for taxing trust income, it is this:

> In sum, when assessing a state tax premised on the in-state residency of a constituent of a trust—whether beneficiary, settlor, or trustee—the Due Process Clause demands attention to the particular relationship between the resident and the trust assets that the State seeks to tax. Because each individual fulfills different functions in the creation and continuation of the trust, the specific features of that relationship sufficient to sustain a tax may vary depending on whether the resident is a settlor, beneficiary, or trustee. When a tax is premised on the in-state residence of a beneficiary, the Constitution requires that the resident have some degree of possession, control, or enjoyment of the trust property or a right to receive that property before the State can tax the asset. Cf. *Safe Deposit*, 280 U. S., at 91-92. Otherwise, the State's relationship to the object of its tax is too attenuated to create the "minimum connection" that the Constitution requires. See *Quill*, 504 U.S. at 306.

And in a footnote, the Court added:

> As explained below, we hold that the Kaestner Trust beneficiaries do not have the requisite relationship with the Trust property to justify the State's tax. We do not decide what degree of possession, control, or enjoyment would be sufficient to support taxation.

d. **Minimized Relevance of *Wayfair*.** In ***South Dakota v. Wayfair, Inc.***, 585 U.S. ___, 138 S. Ct. 2080 (June 21, 2018), decided 13 days after the North Carolina Supreme Court decided *Kaestner*, the United States Supreme Court was called upon to reconsider the seller's physical presence in a state as a precondition to the constitutional imposition of the state's sales tax on the seller's shipment of goods to purchasers in the state. In *Wayfair*, as the inevitable successors to the catalog/mail-order sellers of the Twentieth Century, the merchants involved were leading online retailers of furniture, other home goods, clothing, jewelry, and consumer electronics. South Dakota initiated a declaratory judgment action in the South Dakota courts, seeking an injunction requiring the out-of-state merchants to collect South Dakota sales tax on their sales into South Dakota and to remit those taxes to the state.

While the South Dakota courts viewed themselves as without power to ignore the physical presence requirement of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the United States Supreme Court, with no such encumbrance, found that "*Quill* is flawed on its own terms" and "the physical presence rule of *Quill* is unsound and incorrect." Thus, the Court overruled *Quill* and ruled for South Dakota.

Notably, *Quill* and *Wayfair* are sales tax, not income tax, cases. They are not directed to trusts. In *Wayfair*, South Dakota hadn't even sought to impose a sales tax that wasn't unquestionably already owed; it merely sought to get the on-line retailer to collect **on South Dakota's behalf** the sales tax imposed on the purchaser, and then remit that tax **on the purchaser's behalf** to South Dakota. There was absolutely no question what was taxed; it was the sale that clearly had occurred. And there was absolutely no question who owed the tax; it was the purchaser in South Dakota who ended up with the merchandise. If there is any analogy at all between Wayfair and a trust, it is that a discrete unambiguous completed sale is analogous to a discrete unambiguous distribution of income. No one was questioning, for example, whether North Carolina could properly tax the trust income distributed to Kimberley Kaestner; the case was only about undistributed income. And other connections of the Trust to North Carolina that the State cited as justifications of its income taxation are little different from allowing South Dakota to tax its residents for looking at the Wayfair website.

Nevertheless, *Wayfair* fueled speculation that it would slow the expansion of the trend toward exempting out-of-state trusts from income tax seen in *Kaestner* and described in paragraph 4.b above. After all, in *Kaestner* the North Carolina Supreme Court began its application of constitutional analysis to taxation by quoting *Quill*, and it continued to refer to *Quill* several times.

That question has been answered; *Wayfair* appears to have no impact on the constitutionality of state income 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 first citation of the *Quill* case, where the Court pointedly noted that, in *Wayfair*, *Quill* had been "overruled on other grounds" – that is, as to an issue other than *Quill*'s discussion of the Due Process Clause.

e. **Low Profile for Decanting.** As noted in paragraph 3.a above, the Court's citation of the apparently material fact that the beneficiaries "could not count on necessarily receiving a specific amount of income from the Trust in the future" appears to rest, at least in part, on the trustee's ability to decant the Trust, which, in the absence of the decanting that actually occurred, in consultation with the beneficiary herself, would have terminated in 2009, the year after the taxable years (2005-2008) at issue in the case. But the Court did not mention decanting at all.

f. **Final Word.** In *Kaestner* the Supreme Court seems to have gone to a lot of trouble to say very little. The following is a possible explanation:

North Carolina's petition for certiorari was filed on October 9, 2018, less than four months after the Court decided *Wayfair*. The petition abundantly cited *Wayfair* for what it described as "a model for modernizing this Court's trust-taxation jurisprudence." Seeing the opportunity, or even a need, to build on its *Wayfair* jurisprudence, the Court granted certiorari on January 11, 2019, and heard counsel's argument on April 16, 2019.

Meanwhile, briefs were filed, including several *amicus* briefs, most of them in support of the Trust. The American College of Trust and Estate Counsel submitted an ***amicus* brief** in support of neither party, explaining the nature of

trusts and fiduciary income tax. The brief identified and analyzed some of the issues that the Justices raised at the oral argument (including the operation of a throwback tax) and was acknowledged by counsel at the oral argument.

Even the State of South Dakota, the prevailing party in *Wayfair*, joined by Alaska, Nevada, and Texas, filed an ***amicus* brief** drawing this stark contrast and conclusion:

> *Wayfair* sustained South Dakota's sales tax because South Dakota had created a market in which Wayfair could operate and profit; North Carolina's laws and markets contribute nothing to the Kaestner Trust's generation of income.… This Court's retreat from the simple formalism of physical presence in *Wayfair* certainly did not portend such a radical departure from larger constitutional norms [as North Carolina was seeking].

Thus informed, the Justices realized that *Kaestner* had little if anything to do with *Wayfair*, in the shadow of which they had granted certiorari, and they may have concluded that it therefore would not have been necessary to have granted certiorari at all. Although they could have simply dismissed the grant of certiorari as improvidently granted, they chose instead to write an opinion that was substantively equivalent. And one week later, they denied certiorari in the pending Minnesota *Fielding* case cited in paragraph 4.b above.

Number One: Enactment of the SECURE Act

On December 20, 2019, President Trump signed into law the **Further Consolidated Appropriations Act, 2020** (Public Law No. 116-94), which the Senate had approved (as H.R. 1865) by a vote of 71-23 only the day before. The immediate significance, of course, was that the federal government was funded through September 30, 2020. December 20 had been the deadline for avoiding a government shutdown. This shows two things: that Congress really can do what it absolutely must, when it absolutely must; but that Congress seems unable to do much else.

Division O of Public Law No. 116-94 is "Setting Every Community Up for Retirement Enhancement" (SECURE). It is generally effective January 1, 2020. As a standalone bill (H.R. 1994), SECURE had been approved unanimously by the House Ways and Means Committee on April 2, 2019, and, with a few modifications, passed by the House of Representatives, by a vote of 417-3, on May 23. That makes it look like one of the most noncontroversial, uncomplicated pieces of bipartisan legislation ever. But it isn't. Its enactment is Number One in this year's Top Ten because it is quite the opposite. It will demand the immediate careful attention of estate planning and retirement planning professionals, it will require prompt and thorough elucidation through Treasury and IRS guidance, and for many taxpayers and their advisors it will be disruptive and exasperating, particularly considering the 11-day window it provided for making significant changes to some estate plans.

1. **Assorted Expansions and Simplifications.** SECURE includes two dozen or so provisions intended to expand and simplify the access to various retirement benefits. For example—

a. **Repeal of Age Limit on Making Contributions.** Section 107(a) of SECURE repeals the prohibition on deductions for contributions to traditional IRAs in and after the year in which the individual attains age 70½. Section 107(b) adds a corresponding cut-back of the provision for qualified charitable distributions from an IRA to prevent a deductible contribution, in effect, to be made to a charity simply via an IRA.

b. **Postponement of Requirement for Minimum Distributions.** Section 114 changes the age that determines the beginning date for required minimum distributions from 70½ to 72. That seems simple, fair, and realistic in view of the ways people continue to work longer and defer retirement. But consider how this works by the use of a couple examples. Suppose a person was born in **January** 1950. That person will turn 70½ in July 2020 and 72 in January 2022. Under prior law, that person's first distribution calendar year under Reg §1.401(a)(9)-5(b) would have been 2020 and that person's required beginning date under Code section 401(a)(9)(C)(i) would have been April 1, 2021, but under SECURE the first distribution calendar year is 2022 and the required beginning date is April 1, 2023 – a **two-year** deferral. But suppose a person was born in **July** 1950. That person will turn 70½ in January 2021 and 72 in July 2022. Under prior law, that person's first distribution calendar year would have been 2021 and the required beginning date would have been April 1, 2022, but under SECURE the first distribution calendar year is 2022 and the required beginning date is April 1, 2023 – a **one-year** deferral.

   To be sure, these rules, tied to taxable years for administrative convenience, have always produced uneven results for persons with birthdays at different times of the year. And it will not likely be disputed that an even birthday like 72, rather than a "half-birthday" like 70½, will make it easier for a lot of people to keep track of their own status. Indeed, the use of ages like 70½ or 59½ for many purposes in the retirement rules may have been an awkward choice from the beginning. To pass a law, however, that confers a benefit on about half the affected population that is twice the benefit conferred on the other half is especially awkward. But awkwardness is often unavoidable when amending complex statutory structures.

c. **Expanded Uses of 529 Plans.** Effective January 1, 2019, section 302(a) of SECURE extends the use of 529 Plans to fees, books, supplies, and equipment required for the participation by a designated 529 Plan beneficiary in a registered and certified apprenticeship program. As approved by the Ways and Means Committee, this extension would also have included certain expenses in connection with homeschooling of a designated beneficiary or the enrollment or attendance of a designated beneficiary at an elementary or secondary public, private, or religious school; those extensions were abandoned by the House of Representatives when it was argued that they were potentially harmful to public schools.

   Section 302(b) extends the use of 529 Plans to the payment of principal or interest on a qualified student loan (as defined in section 221(d) of the Code) of a designated beneficiary or a sibling of a designated beneficiary. Payments on student loans under this provision (from all 529 Plans aggregated) are subject to a lifetime limit of $10,000 per student. Every dollar of loan reduction is no doubt appreciated, but $10,000 seems rather modest.

2. **Relief for "Gold Star Children."** Section 201 of SECURE repeals the changes to the "kiddie tax" made by the 2017 Tax Act, which subjected certain unearned income of children to the tax rates applicable to trusts and estates, not the tax rates applicable to their parents. This provision was added to the earlier versions of SECURE to address concerns that those 2017 changes unfairly increased the tax on government payments to survivors of deceased military personnel ("Gold Star children") and first responders. The repeal takes effect in 2020, but affected taxpayers may elect to apply it to 2018 and/or 2019.

3. **Paid for by Limiting Stretch IRAs to 10 Years.** Clearly the lightning rod in SECURE is the major revenue offset. To make up almost all of the revenue loss attributable to SECURE's reforms, Section 401 of SECURE (coincidentally amending section 401 of the Code) requires that, **except in the case of an eligible designated beneficiary**, a participant's entire interest in a defined contribution **retirement plan** or (under section 408(a)(6) and Reg. §1.408-8, A-1(a)) an **individual retirement account** must be distributed within 10 years after the participant's death – that is, **presumably** (under Reg. §1.401(a)(9)-3, A-2) **by the end of the calendar year which contains the tenth anniversary of the participant's death**. This is a change from the prior law that allowed distributions over the beneficiary's life expectancy. This change applies with respect to participants who die after December 31, 2019 – **yes, that was just 11 days after the President signed the Appropriations Act** – with a two-year postponement for certain collectively bargained and governmental plans.

    a. **"Eligible Designated Beneficiaries."** Under new section 401(a)(9)(E)(ii), an "eligible designated beneficiary," who is exempt from the 10-year payout requirement, is one of the following:

    - The participant's surviving spouse.
    - A minor child of the participant, during that child's minority. A 10-year mandatory payout period begins when the child reaches majority.
    - An individual who is disabled, within the meaning of section 72(m)(7).
    - A chronically ill individual, within the meaning of section 7702B(c)(2), except that, in the case of an individual who is considered chronically ill because of inability to perform certain daily living functions without substantial assistance from another individual because of a loss of functional capacity, the period of inability must be certified to be "indefinite" and "reasonably expected to be lengthy in nature."
    - Any other individual who is not more than 10 years younger than the participant.

    Although at first this looks like a reasonable list of particularly deserving beneficiaries, it is not without troubling elements. For example, while minority, implying dependence, is a sympathetic trait in any child, only children **of the participant** qualify for this exception. If an adult child has predeceased the participant, the successor designated beneficiary might well include a minor grandchild of the participant. Indeed, that is a very plausible scenario in the case

of a person at or near retirement age. Yet minor grandchildren are not exempt from the 10-year payout.

Similarly, it may be the case that the beneficiaries most likely to be less than 10 years younger than the participant are siblings, particularly the siblings of a participant who has no surviving spouse or descendants. Yet it surely is plausible that siblings could be more than 10 years apart in age. In a family of four siblings, all born four years apart, the oldest sibling could name the next two siblings as beneficiaries and they would be exempt from the 10-year payout, but the youngest sibling would not be. That difference seems arbitrary and unfair.

b. **Trusts and Fundamental Fairness.** But the biggest source of exasperation in this revenue raiser is its effect on long-term trusts that have been carefully drafted to provide real substantive security and protection for beneficiaries, not just tax benefits. Loss of the income tax advantage of required minimum distributions based on life expectancy is a fate common to all beneficiaries who are not eligible designated beneficiaries as a result of SECURE. But long-term trusts drafted to qualify for life expectancy distributions will be impacted in other ways, particularly those drafted as "conduit" trusts (which must distribute all required minimum distributions to the beneficiary when received). Thus, the participant's anticipated plan to provide security and protection to the beneficiary by distributions from the trust over many years will, as the result of a tax law change, result instead in distribution of the entire account balance to the beneficiary within 10 years. Although the participant can change this result by amending the trust terms (assuming the participant is still competent), the participant was given a mere 11 days between enactment and the effective date to do so. Ironically, the people who will be affected the most by this legislation may be the people who have been the most conscientious about providing security and protection for their families and have engaged the most knowledgeable and careful professionals to help them.

   It also should be acknowledged that the 10-year payout requirement arguably may have the effect of refocusing tax benefits on planning for **retirement**, not on leaving a legacy. While superficially appealing, however, that argument overlooks the fact that employees and other plan participants have voluntarily set money aside, or permitted money to be set aside in excess of amounts required by the plan, perhaps in part in reliance on the required minimum distribution rules that have now dramatically changed. That raises concerns about the fundamental fairness of this legislation that seemed to receive little or no attention from Congress in 2019.

c. **Revenue Estimate.** Finally, the Joint Committee on Taxation has estimated that this provision would raise revenue by about $15.7 billion in Fiscal Years 2020-2029. That is almost enough to offset the revenue losses from all the other provisions of SECURE, estimated to be about $16.3 billion. Often such a pay-for effect is enticing enough to redefine "fairness" in context.

But wait. The new rule that requires distribution "within 10 years after the death" of the participant says nothing about spreading payments over that 10-year period, as in the case of required minimum distributions computed with reference to life expectancies. Thus, with respect to the earliest application of SECURE, to participants who die in 2020, the tenth anniversary of their deaths is in 2030, the end of that calendar year (see Reg. §1.401(a)(9)-3, A-2) is December 31, 2030, and income tax returns are due in April 2031. If the participant has a spouse, the 10-year period may not start until both of them have died. And this legislation is estimated to raise $15.7 billion **by September 30, 2029**? Of course revenue estimates take account of all kinds of projected behaviors, but assuming $15.7 billion of income tax for a year or two before anyone technically has to pay it is really ambitious. Indeed, it appears that limiting the use of the "stretch" IRA that requires distributions **annually** over the life of the beneficiary may actually tend to **reduce** tax revenues in the first 10 years. Does SECURE really mean "Significantly Erroneous Congressional Use of Revenue Estimates"? What are we missing?

Learning what we are missing may be a contender for inclusion in next year's Top Ten!