Washington Update: Pending and Potential Administrative and Legislative Changes (With Selected Cases)

March 2020

Parts I through V are an excerpt from Estate Tax Changes Past, Present, and Future (March 2020) available at www.bessemertrust.com/for-professional-partners/advisor-insights.

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Table of Contents

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I. Requirements of the Regulatory Process

1. Executive Order 13789 of April 21, 2017, famous for ordering the action that led to the withdrawal in October 2017 of the August 2016 proposed section 2704 regulations, also directed the Treasury Department and the Office of Management and Budget (OMB) to "review and, if appropriate, reconsider the scope and implementation of the existing exemption for certain tax regulations from the review process set forth in Executive Order 12866 and any successor order."
2. Executive Order 12866, which was signed by President Clinton on September 30, 1993, requires generally that Treasury
   a. periodically provide the Office of Information and Regulatory Affairs (OIRA) within OMB with a list of its planned regulatory actions, including those it believes are "significant regulatory actions" (section 6(a)(3)(A) of Executive Order 12866),
   b. for each "significant regulatory action," provide to OIRA "(i) [t]he text of the draft regulatory action, together with a reasonably detailed description of the need for the regulatory action and an explanation of how the regulatory action will meet that need; and (ii) [a]n assessment of the potential costs and benefits of the regulatory action, including an explanation of the manner in which the regulatory action is consistent with a statutory mandate and, to the extent permitted by law, promotes the President's priorities and avoids undue interference with State, local, and tribal governments in the exercise of their governmental functions" (section 6(a)(3)(B) of Executive Order 12866), and
   c. for each "significant regulatory action" that is likely to have an annual effect on the economy of $100 million or more, include the following regulatory impact assessment (section 6(a)(3)(C) of Executive Order 12866, emphasis added):

      > (i) An assessment, *including the underlying analysis*, of *benefits* anticipated from the regulatory action (such as, but not limited to, the promotion of the efficient functioning of the economy and private markets, the enhancement of health and safety, the protection of the natural environment, and the elimination or reduction of discrimination or bias) together with, to the extent feasible, a *quantification* of those benefits;
      >
      > (ii) An assessment, *including the underlying analysis*, of *costs* anticipated from the regulatory action (such as, but not limited to, the direct cost both to the government in administering the regulation and to businesses and others in complying with the regulation, and any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness), health, safety, and the natural environment), together with, to the extent feasible, a *quantification* of those costs; and

(iii) An assessment, *including the underlying analysis*, of costs and benefits of potentially effective and reasonably feasible *alternatives* to the planned regulation, identified by the agencies or the public (including improving the current regulation and reasonably viable nonregulatory actions), and *an explanation why the planned regulatory action is preferable to the identified potential alternatives*.

3. Under section 3(f) of Executive Order 12866, a "significant regulatory action" to which the requirements described in subparagraphs b and c above apply is defined as

   any regulatory action that is likely to result in a rule that may:

   (1) Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;

   (2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;

   (3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or

   (4) Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive order.

4. The regulatory impact assessment, along with a draft of the proposed regulations, must be reviewed within OMB before a proposed regulation is published for public comment. In addition, the public must be informed of the content of the regulatory impact assessment and of any substantive changes made in the draft of the proposed regulations after that draft was submitted to OMB for review (section 6(a)(3)(E) of Executive Order 12866).

5. Obviously, that is not information we are accustomed to seeing in connection with tax regulations. Since a Memorandum of Agreement between Treasury and OMB in 1983, most tax regulations were viewed as exempt from rigorous OMB review, partly because they were viewed as interpreting a statute, and any burden on the economy therefore was attributable to the statute, not to the regulations.

6. A new Memorandum of Agreement, signed by the Administrator of OIRA and the General Counsel of the Treasury Department on April 11, 2018, supersedes the 1983 Memorandum of Agreement and generally affirms the application of Executive Order 12866 to tax regulatory actions.

   a. Under paragraph 3 of the new Memorandum of Agreement, the frequency of providing the list of planned tax regulatory actions referred to in subparagraph a above is quarterly.

b. Under paragraph 8, the new Memorandum of Agreement was effective immediately, except that the regulatory impact assessment described in subparagraph c above was not required until the earlier of April 11, 2019, or "when Treasury obtains reasonably sufficient resources (with the assistance of OMB) to perform the required analysis."

c. Under paragraph 4, the time allowed for OIRA review is generally 45 days, with the opportunity for Treasury and OIRA to agree to 10 business days "[t]o ensure timely implementation of the Tax Cuts and Jobs Act of 2017."

II. Design Changes in the 2017-2018 Priority Guidance Plan

The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2017, was released on October 20, 2017 (**https://www.irs.gov/pub/irs-utl/2017-2018_pgp_initial.pdf**). The Second Quarter Update was released on February 7, 2018 (**https://www.irs.gov/pub/irs-utl/2017-2018_pgp_2nd_quarter_update.pdf**) and added a new Part 1 to respond to the 2017 Tax Act. The Third Quarter Update was released on May 9, 2018 (**https://www.irs.gov/pub/irs-utl/2017-2018_pgp_3rd_quarter_update.pdf**). The Fourth Quarter Update was released on August 17, 2018 (**https://www.irs.gov/pub/irs-utl/2017-2018_pgp_4th_quarter_update.pdf**). Reflecting additional review mandated by President Trump, the organization and tone of the 2017-2018 Priority Guidance Plan differed from previous Plans. The introduction to the original October 2017 Plan provided the following explanation:

> Part 1 [ultimately Part 2] of the plan focuses on the eight regulations from 2016 that were identified pursuant to Executive Order 13789 and our intended actions with respect to those regulations. Part 2 [ultimately Part 3] of the plan describes certain projects that we have identified as burden reducing and that we believe can be completed in the 8½ months remaining in the plan year. As in the past, we intend to update the plan on a quarterly basis, and additional burden reduction projects may be added. Part 3 [ultimately Part 4] of the plan describes the various projects that comprise our implementation of the new statutory partnership audit regime, which has been a topic of significant concern and focus as the statutory rules go into effect on January 1, 2018. Part 4 [ultimately Part 5] of the plan, in line with past years' plans and our long-standing commitment to transparency in the process, describes specific projects by subject area that will be the focus of the balance of our efforts this plan year.

III. 2018-2019 Priority Guidance Plan

Treasury and the IRS released their Priority Guidance Plan for the 12 months from July 2018 through June 2019 on November 8, 2018, and the Fourth Quarter Update to the Plan (**https://www.irs.gov/pub/irs-utl/2018-2019_pgp_4th_quarter_update.pdf**) on August 28, 2019. The 2018-2019 Plan followed the five-part organization introduced in the 2017-2018 Plan. For purposes of the subjects addressed in this outline, except for numbering and minor wording changes, the 2018-2019 Plan was carried over to the 2019-2020 Plan.

IV. 2019-2020 Priority Guidance Plan

Treasury and the IRS released their Priority Guidance Plan for the 12 months from July 2019 through June 2020 (https://www.irs.gov/pub/irs-utl/2019-2020_pgp_initial.pdf) on October 8, 2019. The 2019-2020 Plan has six parts, following the five-part organization introduced in the 2017-2018 Plan with an additional Part 4 titled "Taxpayer First Act Guidance." The 2019-2020 Plan begins with the following introduction:

> We are pleased to announce the release of the 2019-2020 Priority Guidance Plan. As described below, the 2019-2020 Priority Guidance Plan sets forth guidance priorities for the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS). This plan continues to prioritize implementation of the Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2054, enacted on December 22, 2017, and is based on public input from solicited comments as well as Treasury and IRS's continued engagement with taxpayers since the enactment of tax reform. This plan also prioritizes implementation of the Taxpayer First Act, Pub. L. 116-25, 133 Stat. 981, enacted on July 1, 2019. In addition, the 2019-2020 Priority Guidance Plan continues to reflect the deregulatory policies and reforms described in Section 1 of Executive Order 13789 (April 21, 2017; 82 FR 19317) and Executive Order 13777 (February 24, 2017; 82 FR 12285).
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> The 2019-2020 Priority Guidance Plan contains guidance projects that will be the focus of efforts during the twelve-month period from July 1, 2019, through June 30, 2020 (the plan year). The 2019-2020 Priority Guidance Plan contains 203 guidance projects [compared to 239 in the 2018-2019 Plan]. As of September 30, 2019, 31 guidance items have been released.

a. Part 1: "Implementation of Tax Cuts and Jobs Act (TCJA)"

Part 1 of the 2019-2020 Plan, titled "Implementation of Tax Cuts and Jobs Act (TCJA)," contains 52 items, compared to 25 in the Fourth Quarter Update of the 2017-2018 Plan and 71 in the 2018-2019 Plan. Of particular interest to estate planners:

1. **Item 6: "Regulations clarifying the deductibility of certain expenses described in §67(b) and (e) that are incurred by estates and non-grantor trusts. Notice 2018-61 was published on July 30, 2018."**
    a. This item first appeared in the 2018-2019 Priority Guidance Plan.
    b. Notice 2018-61, 2018-31 I.R.B. 278, released on July 13, 2018, 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) in the 2017 Tax Act by new section 67(g).
    c. 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 fees for investment advice, including the portion of a "bundled" fiduciary fee attributable to investment advice (which now will mean total disallowance, not just the application of a 2-percent floor). Notice 2018-61 states flatly that "nothing in section 67(g) impacts the determination of what expenses are described in section 67(e)(1)."

d. Notice 2018-61 also indicated that regulations will address the availability of "excess deductions" to individual beneficiaries under section 642(h)(2) on termination of a trust or estate, and the Notice asked for comments on that issue. Meanwhile, however, the instructions for the 2018 Form 1041, dated February 5, 2019, and for the 2019 Form 1041, dated January 24, 2020 (**https://www.irs.gov/pub/irs-pdf/i1041.pdf**), appear to assume a favorable resolution of that issue.

   i. The specific instructions for line 22 of the 2018 Form, on page 26, and line 23 of the 2019 Form, Taxable Income, on page 27, 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.

   ii. On page 36 of the 2018 instructions and page 39 of the 2019 instructions, at the beginning of the specific instructions for Schedule K-1, Beneficiary's Share of Income, Deductions, Credits, etc., the instructions warn:

      > **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).

   iii. But later, on page 39 of the 2018 instructions and page 41 of the 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 23 [line 22 in the 2018 instructions]), 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 (**https://www.irs.gov/pub/irs-prior/i1040sca--2018.pdf**) for line 16 of the 2018 Form 1040, Schedule A ("Other Itemized Deductions"), dated December 10, 2018 (page A-12), and the instructions (**https://www.irs.gov/pub/irs-pdf/i1040sca.pdf**) for line 16 of the 2019 Form 1040, Schedule A ("Other Itemized Deductions"), 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 (**https://www.irs.gov/pub/irs-prior/i1040sca--2017.pdf**) 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.

2. **Item 17: "Guidance on computational, definitional, and anti-avoidance rules under §199A and §643(f). Final and proposed regulations were published on February 8, 2019. Notice 2019-07 was published on February 25, 2019."**

   a. A 184-page Notice of Proposed Rulemaking (including a 104-page preamble) was released on August 8, 2018 (REG-107892-18) and published at 83 Fed. Reg. 40884 (Aug. 16, 2018). The IRS received over 300 comments and heard from 28 witnesses at a public hearing on October 16, 2018. Final regulations were released on January 18, 2019, corrected on February 1, 2019, and published as Regs. §§1.199A-0, 1.199A-1, 1.199A-2, 1.199A-3, 1.199A-4, 1.199A-5, 1.199A-6, and 1.643(f)-1, T.D. 9847, 84 Fed. Reg. 2952 (Feb. 8, 2019), 2019-9 I.R.B. 670 (Feb. 25, 2019).

   b. Reg. §1.199A-1 provides that the term "trade or business" will be applied consistently with the guidance under section 162, which allows a deduction for ordinary and necessary business expenses. The regulations, however, expand the traditional definition under section 162 to include certain rental or licensing of property to related parties under common control. Notice 2019-7, issued contemporaneously with the final regulations, contains a draft revenue procedure prescribing safe harbor parameters for a real estate rental business. The regulations provide that the section 199A deduction is applied at the partner or shareholder level. The final regulations clarify that the rules of subchapters K and S apply in determining each partner's or shareholder's share of applicable items and that an entity with a single owner that is disregarded as an entity separate from its owner under Reg. §301.7701-3 is disregarded under section 199A also. The section 199A deduction does not affect the adjusted basis of a partner's interest in a partnership, the adjusted basis of a shareholder's stock in an S corporation, or an S corporation's accumulated adjustments account.

   c. Reg. §1.199A-2 prescribes rules for determining W-2 wages of a qualified trade or business for purposes of section 199A, generally using the rules that applied under former section 199 with respect to the domestic production activities deduction. Rev. Proc. 2019-11, issued contemporaneously with the final regulations, further explains methods that may be used to calculate W-2 wages for this purpose. Reg. §1.199A-2 also addresses many issues concerning the related factor used in computing the deduction – the unadjusted basis immediately after the acquisition (UBIA) of qualified property – including its allocation among relevant passthrough entities, the effect of subsequent improvements to the qualified property, and the effect of nonrecognition transactions such as like-kind exchanges.

   d. Reg. §1.199A-3 restates the definition of qualified business income (QBI) and provides additional guidance on the determination of QBI, qualified REIT dividends, and qualified publicly traded partnership income. The regulations describe in further detail the exclusions from QBI, including capital gains, interest income, reasonable compensation, and guaranteed payments.

   e. Reg. §1.199A-4 addresses rules for aggregating multiple trades or businesses for purposes of applying section 199A. Comments from the public had urged the IRS to apply the grouping rules for determining passive activity loss and credit limitation rules under section 469. The IRS concluded that the rules under section 469 were inappropriate for purposes of section 199A, but did agree that some aggregation should be permitted.

f. Reg. §1.199A-5 contains guidance related to a specified service trade or business (SSTB).

    i. In general, under section 199A, if a trade or business is an SSTB, none of its items are taken into account for determining a taxpayer's QBI. A taxpayer who owns an SSTB conducted through an entity, such as an S corporation or partnership, is treated as engaged in an SSTB for purposes of section 199A, regardless of the taxpayer's actual level of participation in the trade or business.

    ii. Notwithstanding that general rule, taxpayers with taxable income of less than \$157,500 (\$315,000 for married couples filing jointly) may claim a deduction under section 199A for QBI received from an SSTB. The section 199A deduction phases out for taxpayers with taxable incomes over this threshold amount. If a trade or business is conducted by a passthrough entity, the phase-out threshold is determined at the individual, trust, or estate level, not at the level of the passthrough entity.

    iii. The regulations contain a lengthy and detailed definition of an SSTB. Pursuant to section 199A(d)(2)(A), which incorporates the rules of section 1202(e)(3)(A), an SSTB is any trade or business in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, investment management, or trading or dealing in securities, or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. The regulations limit "reputation or skill" to trades or businesses involving the receipt of income for endorsing products or services, licensing or receiving income for the use of an individual's publicity rights, or receiving appearance fees.

    iv. The common law and statutory rules used to determine whether an individual is an employee for federal employment tax purposes apply to determining whether an individual is engaged in the trade or business of performing services as an employee for purposes of section 199A. In an effort to prevent taxpayers from reclassifying employees as independent contractors in order to claim a section 199A deduction, the regulations also create a rebuttable presumption that an individual who was treated as an employee for federal income tax purposes but is subsequently treated as other than an employee with respect to the same services is for three years still engaged in the trade or business of performing services as an employee for purposes of section 199A. The limitation to three years was added in the final regulations.

g. Reg. §1.199A-6 contains special rules for passthrough entities, publicly traded partnerships, nongrantor trusts, and estates.

i. Passthrough entities, including S corporations and entities taxable as partnerships for federal income tax purposes, cannot claim a deduction under section 199A. Any passthrough entity conducting a trade or business, along with any publicly traded partnership conducting a trade or business, must report all relevant information – including QBI, W-2 wages, basis of qualified property, qualified REIT dividends, and qualified publicly traded partnership income – to its owners so they may determine the amount of their respective section 199A deductions.

ii. The regulations require that a nongrantor trust or estate conducting a trade or business allocate QBI, expenses properly allocable to the trade or business, W-2 wages, and basis of qualified property among the trust or estate and its beneficiaries. The allocation is based on the ratio that the distributable net income (DNI) distributed or deemed distributed to each beneficiary bears to the trust's or estate's total DNI for the taxable year. Any DNI not distributed is allocated to the nongrantor trust or estate itself. The unadjusted basis immediately after acquisition of qualified property is allocated without taking into account how depreciation deductions are allocated among the beneficiaries under section 643(c).

iii. For purposes of the section 199A regulations, a qualified subchapter S trust (QSST) is treated as a grantor trust, and the individual treated as the owner of the QSST is treated as having received QBI directly from the trade or business and not through the QSST. The IRS and Treasury requested comments on whether a taxable recipient of an annuity or unitrust interest in a charitable remainder trust should be eligible for a section 199A deduction to the extent the taxpayer receives QBI from the trust.

h. The regulations under Section 199A are generally effective as of February 8, 2019, the date they were published in the Federal Register. But the preamble to the final regulations provides that for taxable years ending in 2018 taxpayers may rely either on the final regulations under Section 199A in their entirety or on the proposed regulations in their entirety.

i. Rev. Proc. 2019-38, 2019-42 I.R.B. 942, providing a safe harbor for certain rental real estate enterprises, was released September 24, 2019.

j. In addition to regulations under section 199A, the IRS and Treasury issued regulations under section 643(f) to prevent taxpayers from manipulating the section 199A deduction by the use of multiple nongrantor trusts.

i. Section 643(f), enacted by the Deficit Reduction Act of 1984, states:

> For purposes of this subchapter [subchapter J], under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal

> purpose of such trusts is the avoidance of the tax imposed by this chapter. For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.

ii. Proposed Reg. §1.643(f)-1(a), mirroring the statute, stated that

> two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.

iii. Proposed Reg. §1.643(f)-1(b) added, however, that:

> A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts.

iv. The effective downgrading of the "principal purpose" standard to a "significant income tax benefit" standard in the proposed regulations was quite controversial and was likely to be challenged if it had been finalized without change. But the final regulations dropped that proposal and are limited to mirroring the statute in Reg. §1.643(f)-1(a), with only the clarification that "a principal purpose for establishing such trusts" means "a principal purpose for establishing *one or more of* such trusts." The preamble to the final regulations reported that "the Treasury Department and the IRS … are taking under advisement whether and how these questions should be addressed in future guidance."

v. Unlike the regulations under section 199A, which are generally effective on February 8, 2019, the date they were published in the Federal Register, this multiple trust rule mirroring the 1984 statute applies to taxable years ending after August 16, 2018, the date the proposed regulations were published. Moreover, the preamble to the final regulations added:

> Nevertheless, the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations.

3. **Item 44. "Guidance under §§1400Z–1 and 1400Z–2 concerning Opportunity Zones. Proposed regulations were published on October 29, 2018 and May 1, 2019."**

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

a. **2017 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.

   i. 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.

   ii. Of course, Congress might extend the December 31, 2026, recognition date, as 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).

b. **2019 Regulations.** Regulations implementing these provisions were published as proposed regulations in May 2019 and finalized in December 2019. T.D. 9889, 85 FED. REG. 1866 (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.

c. **"Inclusion Event."** 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)).

d. **Gifts.** 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.

e. **Transfers at Death.** 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.

f. **Grantor Trusts.** An 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)."

i. 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.

ii. 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.

iii. 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."

g. **Tacking Holding Periods.** 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).

h. **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."

i. 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, possibly 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.

ii. 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.

iii. 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.

iv. 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).

v. 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."

i. **Application to 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 regarding the implications for estate planning in general include:

    i. 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.

    ii. 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, in effect, produce a carryover basis at death.

    iii. 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*.

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

4. Item 46. "Final regulations under §2010 addressing the computation of the estate tax in the event of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor's date of death. Proposed regulations were published on November 23, 2018."

a. This is an amplification of Item 16 in the 2017-2018 Plan, which was described as "Guidance on computation of estate and gift taxes to reflect changes in the basic exclusion amount." This amplification made it clear that the target of the regulations would be the phenomenon known as "clawback" of the benefits of the doubled federal gift tax exemption during 2018 through 2025 if the "sunset" of those benefits occurs in 2026 as currently scheduled and the donor dies in 2026 or later.

b. Regulations to prevent "clawback" were proposed in November 2018 (REG-106706-18, 83 Fed. Reg. 59343 (Nov. 23, 2018)) and finalized in November 2019. Although neither the statute nor the regulations use the word "clawback," the regulations carry out the mandate of the 2017 Tax Act in new section 2001(g)(2), which provides that Treasury

> shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

c. The proposed regulations would add a new paragraph (c) to Reg. §20.2010-1 (with the current paragraphs (c) through (e) redesignated as (d) through (f)), providing that if the total of the unified credits attributable to the basic exclusion amount that are taken into account in computing the gift tax payable on any post-1976 gift is greater than the unified credit attributable to the basic exclusion amount that would otherwise be used under section 2010(c) in computing the estate tax at the time of the donor's death, then the amount of the credit attributable to the basic exclusion amount that is allowable in computing that estate tax is not determined under section 2010(c) but is deemed to be that greater total of gift tax unified credits attributable to the basic exclusion amount.

d. Proposed Reg. §20.2010-1(c)(2) provided the following example:

> Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $10 million in basic exclusion amount allowable on the dates of the gifts. A dies after 2025 and the basic exclusion amount on A's date of death is $5 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $5

million basic exclusion amount applicable on the decedent's date of death, under paragraph (c)(1) of this section, the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A.

Viewed another way, if what would otherwise be the basic exclusion amount for estate tax purposes is less than the total of the basic exclusion amount applied to post-1976 taxable gifts, it is increased for estate tax purposes under this new regulation to equal that total. And if, in the example, the gift had been $12 million instead of $9 million, then the entire assumed $10 million basic exclusion amount would be used with still some gift tax payable (the donor having never married), and the estate tax credit would be computed as if the basic exclusion amount were $10 million.

e. Under Proposed Reg. §20.2010-1(f)(2), the anti-clawback rule would take effect when it is adopted as a final regulation.

f. Contemporaneously with the release of the proposed regulations, the IRS issued a news release with the reassuring headline of "Treasury, IRS: Making large gifts now won't harm estates after 2025." The press release included an even simpler explanation that "the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA [basic exclusion amount] applicable to gifts made during life or the BEA applicable on the date of death."

g. Helpful Improvements in the Final Regulations

   i. In their practical effect, the regulations do what the statute asks – nothing more, nothing less. The statute compares a transfer at death after 2025 (subparagraph (A)) with a transfer by gift before 2026 (subparagraph (B)). And that's what the regulations address. For example, the regulations do not address the similar scenario of gifts both before 2026 and after 2025. If large amounts of the increased credit attributable to the new doubled basic exclusion amount are used to shelter gifts from gift tax before 2026 (like the $9 million gift in the example, now labelled Example (1)), then after 2025 the donor might have to wait for decades for the indexed $5 million amount to catch up so there can be more credit available for gift tax purposes.

   ii. Likewise, the text of the regulations and the examples (particularly the original Example (1)) are painstakingly limited in all cases to the amount of the credit that is attributable to the basic exclusion amount – that is, the amount (indexed since 2012) defined in section 2010(c)(3). Regarding portability, for example, that approach makes it clear that the deceased spousal unused exclusion amount (DSUE amount) defined in section 2010(c)(4) is not affected by this special rule and is still added under section 2010(c)(2)(B), in effect thereby generating an additional credit of its own in cases in which the anti-clawback rule applies. But the proposed regulations still left open the possibility that the words "lesser of" in section 2010(c)(4) would limit the DSUE amount available to the estate of a person who dies after 2025 (assuming no change in the law) to the sunsetted basic exclusion amount of $5,000,000 indexed for inflation in effect at the time of the death of the surviving spouse referred to in section 2010(c)(4)(A), despite the assertion in Reg. §20.2010-2(c)(1) that "the DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts – (i) The basic exclusion amount in effect in the year of the death of the decedent" (presumably the predeceased spouse), and despite the statement in the preamble to the June 2012 temporary regulations that "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." The limiting words "lesser of" in section 2010(c)(4) reflect the general notion held by congressional drafters that portability should not be allowed to more than double what would otherwise be the survivor's exemption, although that limitation might be viewed as unfair and inapplicable in the case of a predeceased spouse whose estate plan and executor's election forgo the immediate use of the larger exemption allowed before 2026.

iii. In that light, it is not particularly reassuring, standing alone, that the preamble to the final 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.

or even that the preamble to the 2012 temporary regulations (T.D. 9593) rather logically explains:

> 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.

But it is helpful and reassuring that the final regulations themselves (not just the preamble) add Examples (3) and (4), which illustrate scenarios where a 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.

iv. In addition, while the preamble to the final regulations 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)(i), has been changed to include hypothetical inflation-adjusted numbers. And 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.

h. Even if the proposed and final regulations follow section 2001(g)(2) very closely as to their practical effect, it is harder to say that they follow the context of the statute as to their approach and form.

i. Before the proposed regulations were released, there was speculation that the regulations under section 2001(g)(2) would mirror section 2001(g)(1) with which their statutory authority is linked and provide, in effect, that in calculating the estate tax the basic exclusion amount in effect at the time of death will be used to calculate the hypothetical "total gift tax paid or payable" on pre-2026 adjusted taxable gifts that is deducted under section 2001(b)(2) on line 7 of Part 2 of the estate tax return. And by increasing the amount on line 7, which is subtracted in line 8, the estate tax would be appropriately reduced to offset the clawback effect.

ii. The proposed regulations take a different approach. The preamble implies that other approaches were considered, but concludes that "in the view of the Treasury Department and the IRS, the most administrable solution would be to adjust the amount of the credit in Step 4 of the estate tax determination required to be applied against the net tentative estate tax." In the context of the new regulation, "Step 4" in the preamble most closely corresponds to line 9a of Part 2 of the estate tax return ("basic exclusion amount"); Step 2 corresponds to line 7.

iii. By increasing the amount on line 9a, rather than the amount on line 7, the proposed regulations would achieve the same result, of course, because both line 7 and lines 9a through 9e produce subtractions in the estate tax calculation. But completing line 7 already requires three pages of instructions, including a 24-line worksheet, and some increased complexity in what already has a reputation for being a tangled morass might be easier to process than adding a new challenge to line 9, which now requires less than one-third of a page of instructions. IRS personnel obviously see more returns than we do, they see the mistakes, and they hear the complaints. It is to be hoped that they contributed to forming the assessment that the line 9 approach is "the most administrable solution."

iv. That approach should work fine if the law is not changed and sunset occurs January 1, 2026. But, although Reg. §20.2010-1(c)(2) mentions that in the examples "the decedent's date of death is after 2025," the introduction to Reg. §20.2010-1(c) itself provides that the substantive rules apply whenever "changes in the basic exclusion amount … occur between the date of a donor's gift and the date of the donor's death." They are not limited to 2026 or to any other time period. The 2010 statutory rule in section 2001(g)(1) and the 2017 statutory rule in section 2001(g)(2) are not limited to any time period either. Therefore, if Congress makes other changes in the law, particularly increases in rates or decreases in exemptions, and doesn't focus on the potential clawback issue in the context of those changes, the generic anti-clawback regime of section 2001(g)(1) and (2) and these regulations could produce a jigsaw puzzle of adjustments going different directions that may strain the notion of administrability cited in the preamble.

5. Other Issues

a. Because the 2017 Tax Act did not repeal the estate and GST taxes, everything related to estate planning in the Priority Guidance Plan (discussed below), and some items dropped from the Plan or from previous Plans, continue to be relevant and important.

b. Similarly, because the Act did not repeal the 3.8 percent tax imposed on net investment income by section 1411, as some at one time had hoped, there will continue to be a need for guidance regarding that tax, particular for the vexing issue of identifying "material participation" under section 469(h) in the case of a trust or estate. Final regulations addressing many issues under section 1411 were issued on November 26, 2013, but did not address the issue of material participation in the context of trusts. The preamble (T.D. 9644) candidly acknowledged Treasury's sympathy with the problems of material participation and the difficulty of dealing with those problems, which it described as "very complex." The preamble to proposed regulations published on December 2, 2013, cited the preamble to the 2013 final regulations and deferred the issue of material participation by estates and trusts, including QSSTs, which it said "is more appropriately addressed under section 469." Even so, the guidance project described as "Guidance regarding material participation by trusts and estates for purposes of §469," which had been in previous Priority Guidance Plans, was omitted from the 2017-2018 Plan.

b. Part 2: "E.O. 13789 - Identifying and Reducing Regulatory Burdens"

1. Part 2 in the 2017-2018 Plan contained eight items, the first of which was expressed as "Withdrawal of proposed regulations under §2704 regarding restrictions on liquidation of an interest for estate, gift, and generation-skipping transfer taxes. Proposed regulations were published on August 4, 2016."

2. The very controversial proposed section 2704 regulations were withdrawn. 82 Fed. Reg. 48779-80 (Oct. 20, 2017). As a result, that item is omitted from the 2018-2019 and 2019-2020 Plans.

c. Part 3. "Burden Reduction"

1. In addition to announcing the intended withdrawal of the section 2704 proposed regulations, Treasury's October 2, 2017, second report in response to Executive Order 13789 stated that "Treasury continues to analyze all recently issued significant regulations and is considering possible reforms of several recent regulations not identified in the June 22 Report [Notice 2017-38]."
2. In that vein, Treasury and the IRS stated in the original 2017-2018 Priority Guidance Plan that "Part 2 [now Part 3] of the plan describes certain projects that we have identified as burden reducing and that we believe can be completed in the 8½ months remaining in the plan year" – that is, by June 30, 2018. The 2017-2018 Plan contained 19 such items, and the 2018-2019 Plan contained 14. Now Part 3 of the 2019-2020 Plan contains 25 items, including the following:
   a. Item 13 is "Final regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016." With the addition of the word "Final" in Item 4 of the 2018-2019 Plan, this is the same in the 2017-2018 Plan. The background and significance of these regulations are discussed in Part d below.
   b. Item 17, carried over from Item 8 in the 2017-2018 and 2018-2019 Plans, is "Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption." The background and significance of these regulations are discussed in Part e below beginning on page 31.

d. The Consistent Basis Rules

1. On July 31, 2015, the day that funding for the Highway Trust Fund was scheduled to expire, President Obama signed into law the Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41), extending that infrastructure funding for three months, with the $8 billion cost funded by various tax compliance measures. One of those was section 2004 of the Act, labelled "Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent," which of course has nothing to do with highways or veterans' health care other than raising money. The provision added new provisions to the Code.
   a. New section 1014(f) requires in general that the basis of property received from a decedent "whose inclusion in the decedent's estate increased the liability for the tax" may not exceed the value as finally determined for estate tax purposes, or, if there is no final determination (as in the case of property sold while an estate tax audit is still in progress or, within the statutory period for assessments, has not begun) the value reported on the estate tax return.
   b. New section 6035 requires every executor (or person in possession of property with the statutory duties of an executor) who is required to file an

estate tax return – that is, in general, if the gross estate plus adjusted taxable gifts exceeds the applicable filing threshold – to furnish to the IRS and to the recipients of property interests included in the decedent's gross estate a statement setting forth the value of those property interests reported on the estate tax return. This statement is due 30 days after the estate tax return is filed or, if the return is filed after its due date (including extensions), 30 days after that due date. Every such statement must be supplemented if a value is adjusted, for example on audit.

c. There are also penalties for failure to file a required statement and for reporting basis inconsistently with such a statement.

2. Previously (and **still the law** unless an estate tax return was or is filed after July 31, 2015), under section 1014(a)(1), the basis of property acquired from a decedent is simply "the fair market value of the property at the date of the decedent's death," with appropriate adjustments in section 1014 for the alternate valuation date and so forth. It is possible for the recipient of property from a decedent to claim, for income tax purposes, that the executor somehow just got the estate tax value too low, and that the heir's basis should be greater than the estate tax value. Usually, of course, such claims are made after the statute of limitations has run on the estate tax return. Such claims can be accompanied by elaborate appraisals and other evidence of the "real" date-of-death value that, long after death, is hard to refute. Invoking principles of "privity," the Service is able to insist on using the lower estate tax value when the recipient was one of the executors who signed the estate tax return, but otherwise it has had no tool to enforce such consistency.

3. *Van Alen v. Commissioner*, T.C. Memo. 2013-235, however, created confusion about the role of a duty of consistency in determining the basis of heirs.

   a. In *Van Alen*, a brother and sister had inherited a cattle ranch from their father in 1994, with a low "special use" estate tax value under section 2032A. They were not executors; their stepmother was. The heirs sold a conservation easement on the land in 2007 and argued that their basis for determining capital gain should be higher than the estate tax value. The court held their basis to the low estate tax value.

   b. A key to the outcome was that section 1014(a)(3) describes the basis of property acquired from a decedent as "in the case of an election under section 2032A, its value *determined* under such section." This contrasts with the general rule of section 1014(a)(1), which describes the basis as merely "the fair market value of the property at the date of the decedent's death," which arguably opens up the opportunity for a non-executor heir to argue that the value "determined" for estate tax purposes was simply too low. In addition, the court pointed to the special use valuation agreement, which the two heirs (one, a minor, by his mother as his guardian *ad litem*) had signed. Consistently with this rationale for its holding, the court cited Rev. Rul. 54-97, 1954-1 C.B. 113 ("the value of the property as determined for the purpose of the Federal estate tax … is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence"), and observed that "it might be reasonable for taxpayers to rely on this revenue ruling if they were calculating their basis under section 1014(a)(1)."

c. Surprisingly, however, the court also seemed to view heirs *who were not executors* as bound by a "duty of consistency" to use the value determined for estate tax purposes as their basis for income tax purposes. The court spoke of a "sufficient identity of interests" between the heirs and the executor and concluded that "[w]e rest our holding on the unequivocal language of section 1014(a)(3) …. And we rest it as well on a duty of consistency that is by now a background principle of tax law."

d. While "consistency" is superficially an appealing objective, the notion that it might apply generally to the basis of an heir who was not an executor may be more novel and more troubling than the court seems to have realized. The court acknowledged that "[t]here are lots of cases that hold that the duty of consistency binds an estate's beneficiary to a representation made on an estate-tax return if that beneficiary was a fiduciary of the estate." But the court then went on to say: "But the cases don't limit us to that situation and instead say that the question of whether there is sufficient identity of interests between the parties making the first and second representation depends on the facts and circumstances of each case." The problem is that the court cited the same three cases for both propositions, and all three cases involved the basis of an heir who *was* a co-executor. Thus, *Van Alen* appears to stand alone for applying a duty of consistency to the basis of an heir who was not an executor, although the *Van Alen* holding does have the alternative ground of the word "determined" in section 1014(a)(3), applicable only in special use valuation cases.

4. In the Obama Administration, the Treasury Department's annual "General Explanations" of revenue proposals associated with the President's budget proposals (popularly called the "Greenbook") included a provision, last found on pages 195-96 in the 2015 Greenbook (see **http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf**), to require the income tax basis of property received from a decedent or donor to be equal to the estate tax value or the donor's basis. The Greenbooks provided that the executor or donor would be required to report the necessary information to both the recipient and the Service.

   a. The Greenbook proposal would have been effective

      i. "as of the date of enactment" in the 2009, 2010, and 2011 Greenbooks,

      ii. "for transfers on or after the date of enactment" in the 2012 and 2013 Greenbooks, and

      iii. "for transfers after the year of enactment" in the 2014 and 2015 Greenbooks.

   b. Statutory language for this proposal appeared

i. in section 6 of the Responsible Estate Tax Act, S. 3533 (introduced on June 24, 2010, by Senator Bernie Sanders (I-VT)) and H.R. 5764 (introduced on July 15, 2010, by Congresswoman Linda Sanchez (D-CA)), applicable **"to transfers for which returns are filed after the date of the enactment of this Act"** and requiring a statement by the executor or donor on or before the due date of the return;

ii. in section 5 of the "Sensible Estate Tax Act of 2011," H.R. 3467, introduced on November 17, 2011, by Congressman Jim McDermott (D-WA), also applicable "to transfers for which returns are filed after the date of the enactment of this Act" but requiring a statement by the executor or donor **within 30 days after filing the return**;

iii. in section 1422 of Ways and Means Committee Chairman Dave Camp's Discussion Draft released February 26, 2014, also applicable to transfers for which returns are filed after the date of enactment and requiring a statement by the executor or donor within 30 days after filing the return but **applicable only to estate tax values and with the changes to section 1014 (but not the reporting requirement) applicable only to property that increases the estate tax**;

iv. in section 5 of the "Sensible Estate Tax Act of 2015," H.R. 1544, introduced on March 23, 2015, by Congressman McDermott, similar to the Camp Discussion Draft except that it did not exclude property that did not increase the estate tax; and

v. then as a "pay-for" in the "Highway and Transportation Funding Act of 2015, Part II" (Public Law 114-41), endorsed by then Ways and Means Committee Chairman Ryan on July 13, 2015, which became the Surface Transportation and Veterans Health Care Choice Improvement Act (with a 10-year revenue estimate of $1.542 billion).

5. The statute that was enacted followed the Camp Discussion Draft. As a result, compared to the 2014 and 2015 Greenbook proposals, new subsection (f) of section 1014 includes some twists.

   a. Like the Camp Discussion Draft and the 2015 "Sensible Estate Tax Act" (H.R. 1544), it applies only to property acquired from a decedent, not to gifts.

   b. Under section 1014(f)(2), like the Camp Discussion Draft, it "shall only apply to any property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate." In other words, these new rules apparently do not apply to property that passes to a surviving spouse or to charity, or to property that does not pass to the surviving spouse but is reported on an estate tax return filed only to elect portability. **(But, as in the Camp Discussion Draft, there is no such exception to the reporting requirement of section 6035.)**

   c. While the Greenbook versions, since 2014, would have been effective for transfers – that is, for gifts made and decedents dying – after the year of enactment, section 1014(f) (as in all the above introduced bills since the Responsible Estate Tax Act of 2010 and consistently with the 2009, 2010, and 2011 Greenbook proposals) is applicable to property with respect to which an estate tax return is filed after the date of enactment – that is, on or after August 1, 2015. A return filed after the date of enactment might have been due, and filed, on August 1, 2015, **making the statement due August 31, 2015**.

6. In response to that accelerated application, Notice 2015-57, 2015-36 I.R.B. 294, released on August 21, 2015, extended to February 29, 2016, the due date of any statements required by section 6035 that otherwise would be due before February 29, 2016. The Notice cited section 6081(a), which allows extensions of time only for up to six months except in the case of taxpayers who are abroad. February 29, 2016, is the closest date the calendar allows to six months after August 31, 2015. So Notice 2015-57 implied that it was the only extension there would be.
    a. Notice 2015-57 also stated that "[t]he Treasury Department and the IRS expect to issue additional guidance to assist taxpayers with complying with sections 1014(f) and 6035."
    b. Notice 2016-19, 2016-9 I.R.B. 362, released on February 11, 2016, provided: "Statements required under sections 6035(a)(1) and (a)(2) to be filed with the IRS or furnished to a beneficiary before March 31, 2016, need not be filed with the IRS and furnished to a beneficiary until March 31, 2016."
        i. In other words, the "due date" is not "extended" (confirming the implication of Notice 2015-57), but executors "need not" comply with any due date earlier than March 31, 2016.
        ii. Indeed, Notice 2016-19 affirmatively added that "[t]he Treasury Department and IRS recommend that executors and other persons required to file a return under section 6018 wait to prepare the statements required by section 6035(a)(1) and (a)(2) until the issuance of proposed regulations by the Treasury Department and the IRS addressing the requirements of section 6035" and that "[t]he Treasury Department and the IRS expect to issue proposed regulations under sections 1014(f) and 6035 very shortly."
    c. Notice 2016-27, 2016-15 I.R.B. 576, released on March 23, 2016 (three weeks after the publication of the proposed regulations discussed in paragraph 9 below), extended the same relief through June 30, 2016. The stated rationale was that "[t]he Treasury Department and the IRS have received numerous comments that executors and other persons have not had sufficient time to adopt the systemic changes that would enable the filing of an accurate and complete Form 8971 and Schedule A."
7. Meanwhile, the IRS developed Form 8971 (January 2016) for reporting the information for which the due date was originally August 31, 2015, then was February 29, 2016, and then "need not" be observed before June 30, 2016.

Form 8971 itself is to be filed only with the IRS. It includes a Schedule A that is to be given to each respective beneficiary (like a K-1), as well as to the IRS.

a. With respect to the biggest problem with the reporting deadline – namely, that executors, especially of estates large enough to be required to file an estate tax return, will not know just one month after filing the estate tax return which beneficiaries will receive which assets – Schedule A of Form 8971 states (emphasis in original):

> **Notice to Beneficiaries:**
>
> You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

b. The Instructions to Form 8971 candidly stated (emphasis added):

> All property acquired (*or expected to be acquired*) by a beneficiary must be listed on that beneficiary's Schedule A. If the executor hasn't determined which beneficiary is to receive an item of property as of the due date of the Form 8971 and Schedule(s) A, *the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution* on that beneficiary's Schedule A. (*This means that the same property may be reflected on more than one Schedule A.*) A supplemental Form 8971 and corresponding Schedule(s) A may, but aren't required to, be filed once the distribution to each such beneficiary has been made.

c. It is striking that the Instructions refer to property "expected to be acquired" while Schedule A refers to "property you received." This interchangeability of "acquired" and "received" could have been used as the basis for regulations that construed the requirement to file Form 8971 to apply only when property had been distributed by the estate or otherwise "received." See paragraph 9.b.i below.

8. Certain regulations were explicitly contemplated and authorized by the statute.

a. Section 1014(f)(4) states that "[t]he Secretary may by regulations provide exceptions to the application of this subsection."

b. Section 6035(b) states that "[t]he Secretary shall prescribe such regulations as necessary to carry out this section, including regulations relating to (1) the application of this section to property with regard to which no estate tax return is required to be filed, and (2) situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property."

9. Proposed regulations were released on March 2, 2016. Proposed Reg. §§1.1014-10 & 1.6035-1 (REG-127923-15).

   a. The proposed regulations provided some welcome, albeit modest, clarifications.

      i. Only the "initial" basis of property received from a decedent would be subject to these rules. Proposed Reg. §1.1014-10(a)(1). Subsequent authorized adjustments are not precluded. Proposed Reg. §§1.1014-10(a)(2) & 1.6662-8(b).

      ii. The consistency rules would not apply to tangible personal property for which an appraisal is not required under Reg. §20.2031-6(b) – generally household and personal effects other than "articles having marked artistic or intrinsic value of a total value in excess of $3,000." Proposed Reg. §1.1014-10(b)(2). Such assets will rarely be sold at a gain, and any loss on a sale of such personal property would be nondeductible in any event.

      iii. In addition to such tangible personal property, Proposed Reg. §1.6035-1(b)(1) would exclude from the Form 8971 reporting requirement:

         (A) cash (other than a coin collection or other coins or bills with numismatic value), which ordinarily has no basis apart from its face amount anyway;

         (B) income in respect of a decedent, which ordinarily would be reported as such on the beneficiary's income tax return anyway; and

         (C) property that is sold (and therefore not distributed to a beneficiary) in a transaction in which capital gain or loss is recognized, which ordinarily would therefore be reported as a taxable sale on the fiduciary's income tax return anyway.

      iv. The term "executor" is given its usual expanded meaning in section 2203. Proposed Reg. §1.1014-10(d).

      v. Form 8971 would not be required if the estate tax return was not required for **estate tax** purposes and was filed solely to make a portability election ("notwithstanding §20.2010-2(a)(1)") or a GST tax election or exemption allocation. Proposed Reg. §1.6035-1(a)(2).

      vi. If a beneficiary is a trust, estate, or business entity, Form 8971 would be furnished only to the entity and not to its beneficiaries or owners. Proposed Reg. §1.6035-1(c)(2).

      vii. An executor could state on Form 8971 that a beneficiary cannot be located, although the executor must also state the efforts taken to locate the beneficiary. Proposed Reg. §1.6035-1(c)(4).

      viii. A supplemental Form 8971 to report a change in value or otherwise correct or complete information on an original Form 8971 would not be required to be filed until 30 days after the property is distributed.

Proposed Reg. §1.6035-1(e)(4)(ii). (That, of course, should have been acknowledged as the appropriate occasion for **any** reporting under section 6035. See paragraph 7 above and subparagraph b.i below.)

ix. Indeed, a supplemental Form 8971 is not needed at all merely to report a distribution of property if a previous Form 8971 included that property as property that *might* be used to satisfy the beneficiary's interest. Proposed Reg. §1.6035-1(e)(3)(i)(B) & (ii), *Examples 1 & 2*.

b. The proposed regulations also included some surprising or disappointing features.

i. Echoing the Instructions, Proposed Reg. §1.6035-1(c)(3) states:

> If, by the due date [of Form 8971], the executor has not determined what property will be used to satisfy the interest of each beneficiary, the executor must report on the Statement for each such beneficiary all of the property that the executor could use to satisfy that beneficiary's interest. Once the exact distribution has been determined, the executor may, but is not required to, file and furnish a supplemental Information Return and Statement.

This is asserted even though a beneficiary who has not yet received (and may never receive) the property has no use for basis information and providing such information serves no discernable purpose of section 1014(f), and even though, like the Instructions, the preamble to the proposed regulations refers to "each beneficiary who has acquired (**or will acquire**) property from the decedent" and the statutory requirement of section 6035(a)(1) itself attaches only "to each person **acquiring** any interest in property." It seems that the regulations could have carried that linguistic comparison to its logical conclusion by requiring Form 8971 and Schedule A only with respect to property that is distributed – in other words, "received" – or "acquired." In that case, section 6035(a)(3) would be construed to require reporting for property **passing upon death or distributed before its value is reported on an estate tax return** within 30 days after the estate tax return is filed, whereas property **distributed after the estate tax return is filed** would be reported on a supplemented Form 8971 and Schedule A within 30 days after the distribution or perhaps on a year-by-year basis. That would be a much more workable rule.

ii. After-discovered and omitted property that is not reported on an (initial or supplemental) estate tax return before the estate tax statute of limitations runs (thus including all property and omissions discovered after the statute runs) would be given a value, and therefore an initial basis, of zero. Proposed Reg. §1.1014-10(c)(3)(i)(B). Moreover, if the after-discovered or omitted property would have increased the gross estate enough to cause an estate tax return to be required, but no estate tax return was filed, the estate tax value of **all** property subject to the consistency rule would be considered to be zero. Proposed Reg.

§10.1014-10(c)(3)(ii). **Thus, a very innocent omission by the executor could result in a very harsh penalty for beneficiaries. The statutory support for these zero basis rules is very questionable, because such property appears to be neither "property the final value of which has been determined for purposes of the [estate] tax" within the meaning of section 1014(f)(1)(A) nor property "with respect to which a statement has been furnished under section 6035(a)" within the meaning of section 1014(f)(1)(B).**

iii. Proposed Reg. §1.6035-1(f) would impose a seemingly open-ended requirement on a recipient of a Schedule A to in turn file a Schedule A when making any gift or other retransfer of the property that results wholly or partly in a carryover basis for the transferee. The preamble again cites the regulatory authority granted in section 6035(b)(2) and also a concern "that opportunities may exist in some circumstances for the recipient of such reporting to circumvent the purpose of the statute (for example, by making a gift of the property to a complex trust for the benefit of the transferor's family)." While such property does indeed continue to have a basis determined in part with reference to the value at the time of someone's death in the past, section 6035 imposes the reporting requirement only on an "executor," and section 1014(a) itself applies only to property acquired "from a decedent," creating great doubt about the statutory authority for Proposed Reg. §1.6035-1(f), especially when one of the explicit changes Congress made to Treasury's Greenbook proposal was to apply it only to transfers at death, not to lifetime gifts.

iv. The Greenbook proposals since 2009 explicitly contemplated a grant of regulatory authority "for situations in which the surviving joint tenant or other recipient may have better information than the executor." Congress seems to have captured that notion in section 6035(b)(2). Some observers read this as authorizing Treasury to relieve the tension between an executor and beneficiaries that a strict consistency rule might otherwise create by permitting beneficiaries to prove a higher value in some cases.

(A) In the preamble to the proposed regulations, Treasury recites that regulatory authority in section 6035(b)(2), but construes it in effect to apply only to a person with a legal or beneficial interest in property who is required to file an estate tax return under section 6018(b) in some cases.

(B) In addition, the preamble to the proposed regulations states:

> One commenter requested the creation of a process to allow an estate beneficiary to challenge the value reported by the executor. There is no such process under the Federal law regarding returns described in section 6018. The beneficiary's rights with regard to the estate tax valuation of property are governed by applicable state law. Accordingly, the proposed

regulations do not create a new Federal process for challenging the value reported by the executor.

In other words, the preamble not only confirms the potential for these rules to create tension within families (see paragraph c below), it documents Treasury's indifference to it.

c. A public hearing on the proposed regulations was held on June 27, 2016, and most of the foregoing points were made.

10. But no administrative guidance will or can address what many observers consider the fundamental flaw of the statute – it has the potential, especially when an estate tax return is audited, to pit family members and other beneficiaries against each other in an intolerable tension.

    a. The *Van Alen* opinion itself, discussed in paragraph 3 above reveals how mischievous a "consistency" requirement might be in this context.

    b. The court describes how the audit "went back and forth" and the low value of the ranch could have been a trade for higher values of three other properties. Indeed, the court said: "The bottom line was that the IRS got an increase in the total taxable value of the estate … and an increase in the estate tax" (although later the court said, with specific reference to the ranch, that "[b]oth Shana and Brett [the heirs], and their father's estate, benefited from a reduced estate tax."

    c. If the heirs benefited from the special use valuation, it was a coincidental detail that is affected by tax apportionment rules and other factors and may not be present in every estate. And, as *Van Alen* illustrates, executors often settle estate tax audits by trade-offs and for strategic reasons that could have nothing to do with an effort to find the "true" "fair market value" for purposes of section 1014(a)(1).

    d. To bind heirs who do not participate in that audit seems quite unfair, and to give the heirs a role in the audit would be monstrously impractical. Yet, enchanted by the Siren Song of "consistency" – not to mention the temptation of a conjectural revenue gain – Congress seems not to have thought this through.

11. The 2016 Greenbook renewed the proposal of past Greenbooks to also apply the consistency rules to property qualifying for an estate tax marital deduction and to gifts reportable on a gift tax return.

12. Executive Order 13789 of April 21, 2017, directed the identification of tax regulations issued on or after January 1, 2016, that (i) impose an undue financial burden on United States taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the Internal Revenue Service, and the recommendation of specific actions to mitigate the burdens identified. Notice 2017-38, 2017-30 I.R.B. 147, identified eight regulations that meet at least one of the first two criteria specified by the Executive Order, including the proposed section 2704 regulations, but not including the consistent basis regulations.

13. Now the Priority Guidance Plan suggests that Treasury and the IRS will revisit the proposed basis consistency regulations in the context of "burden reduction." **They cannot undo the ill-advised statute, but they could apply the statute in a reasonable way to provide a more practical reporting date and could reconsider the zero-basis rule and continuous reporting requirement that the statute does not appear to authorize. That would be "burden reduction."**

e. The Section 2642(g) Regulations

1. This project first appeared in the 2007-2008 Plan.
2. The background of this project is section 564(a) of the 2001 Tax Act, which added subsection (g)(1) to section 2642, directing Treasury to publish regulations providing for extensions of time to allocate GST exemption or to elect out of statutory allocations of GST exemption (when those actions are missed on the applicable return or a return is not filed).
   a. Before the 2001 Tax Act, similar extensions of time under Reg. §301.9100-3 (so-called "9100 relief") were not available, because the deadlines for taking such actions were prescribed by the Code, not by the regulations.
   b. The legislative history of the 2001 Tax Act stated that "[n]o inference is intended with respect to the availability of relief from late elections prior to the effective date of [section 2642(g)(1)]," and section 2642(g)(1)(A) itself directs that the regulations published thereunder "shall include procedures for requesting comparable relief with respect to transfers made before the date of the enactment of [section 2642(g)(1)]." Section 2642(g)(1)(B) adds:

      > In determining whether to grant relief under this paragraph, the Secretary shall take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. For purposes of determining whether to grant relief under this paragraph, the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute.

   c. Shortly after the enactment of the 2001 Tax Act, Notice 2001-50, 2001-2 C.B. 189, acknowledged section 2642(g)(1) and stated that taxpayers may seek extensions of time to take those actions under Reg. §301.9100-3. The Service has received and granted many requests for such relief over the years since the publication of Notice 2001-50.
3. In addition, Rev. Proc. 2004-46, 2004-2 C.B. 142, provides a simplified method of dealing with pre-2001 gifts that meet the requirements of the annual gift tax exclusion under section 2503(b) but not the special "tax-vesting" requirements applicable for GST tax purposes to gifts in trust under section 2642(c)(2).
   a. Gifts subject to Crummey powers are an example.
   b. In such cases, GST exemption may be allocated on a Form 709 labeled "FILED PURSUANT TO REV. PROC. 2004-46," whether or not a Form 709 had previously been filed for that year.

c. Post-2000 gifts are addressed by the expanded deemed allocation rules of section 2632(c), enacted by the 2001 Tax Act.

4. Proposed Reg. §26.2642-7 (REG-147775-06) was released on April 16, 2008. When finalized, it will oust Reg. §301.9100-3 and become the exclusive basis for seeking the extensions of time Congress mandated in section 2642(g)(1) (except that the simplified procedure for dealing with pre-2001 annual exclusion gifts under Rev. Proc. 2004-46 will be retained).

5. The proposed regulations resemble Reg. §301.9100-3, but with some important differences. Under Proposed Reg. §26.2642-7(d)(1), the general standard is still "that the transferor or the executor of the transferor's estate acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the Government."

   a. Proposed Reg. §26.2642-7(d)(2) sets forth a "nonexclusive list of factors" to determine whether the transferor or the executor of the transferor's estate acted reasonably and in good faith, including (i) the intent of the transferor to make a timely allocation or election, (ii) intervening events beyond the control of the transferor or the executor, (iii) lack of awareness of the need to allocate GST exemption to the transfer, despite the exercise of reasonable diligence, (iv) consistency by the transferor, and (v) reasonable reliance on the advice of a qualified tax professional.

   b. Proposed Reg. §26.2642-7(d)(3) sets forth a "nonexclusive list of factors" to determine whether the interests of the Government are prejudiced, including (i) the extent to which the request for relief is an effort to benefit from hindsight, (ii) the timing of the request for relief, and (iii) any intervening taxable termination or taxable distribution.

   c. Noticeably, the proposed regulations seem to invite more deliberate weighing of all those factors than the identification of one or two dispositive factors as under Reg. §301.9100-3.

6. "Hindsight," which could be both a form of bad faith and a way the interests of the Government are prejudiced, seems to be a focus of the proposed regulations. This is probably explained by the obvious distinctive feature of the GST tax – its effects are felt for *generations*, in contrast to most "9100 relief" elections that affect only a current year or a few years. There simply is more opportunity for "hindsight" over such a long term. Thus, the greater rigor required by the proposed regulations seems to be justified by the nature of the GST tax and consistent with the mandate of section 2642(g)(1)(B) to "take into account all relevant circumstances."

7. Proposed Reg. §26.2642-7(h)(3)(i)(D) requires a request for relief to be accompanied by "detailed affidavits" from "[e]ach tax professional who advised or was consulted by the transferor or the executor of the transferor's estate with regard to any aspect of the transfer, the trust, the allocation of GST exemption, and/or the election under section 2632(b)(3) or (c)(5)."

   a. The references to "any aspect of the transfer" and "the trust" appear to go beyond the procedural requirement of Reg. §301.9100-3(e)(3) for "detailed affidavits from the individuals having knowledge or information about the events that led to the failure to make a valid regulatory election and to the discovery of the failure." Presumably, a professional who advised only with respect to "the transfer" or "the trust" would have nothing relevant to contribute other than a representation that they did not advise the transferor to make the election, a fact that the transferor's own affidavit could establish.

b. Out of concern about returning to the supercharged "fall on your sword" days before the reformation of the 9100 rules reflected in Rev. Proc. 92-85, 1992-2 C.B. 490, the author of this outline recommended the relaxation of that requirement in a comment letter dated July 3, 2008.

8. Section 2642(g)(1) itself, having been enacted by the 2001 Tax Act, was once scheduled to "sunset" on January 1, 2011, then on January 1, 2013, and is now permanent.

9. These regulations ought to have been close to completion for a long time now.

   a. This item last appeared in the 2015-2016 Plan. It was removed in the 2016-2017 Plan, perhaps so these regulations could be issued at the same time as the ETIP-related regulations envisioned by the project discussed in Part IV.h.1 beginning on page 47. Or it might have been thought that the consistent basis and section 2704 regulations alone may have kept Treasury and the IRS busy through June 2017, while most of the objectives of the section 2642(g) regulations were being served anyway by Reg. §301.9100-3.

   b. Then these regulations were revived in the 2017-2018 Plan as a "burden reduction" project. How can this be, when the proposed regulations would generally be more burdensome than Reg. §301.9100-3, which Notice 2001-50 now allows to be used? **Perhaps the extensive experience of the IRS with ruling requests under Notice 2001-50 and Reg. §301.9100-3 has shown that less onerous requirements may be sufficient.**

f. Part 6: "General Guidance"

Part 6 of the Priority Guidance Plan, titled "General Guidance," like previous Plans, describes specific projects by subject area "that will be the focus of efforts during the twelve-month period from July 1, 2019, through June 30, 2020 (the plan year)." In a departure from the 2017-2018 and 2018-2019 Plans, the 2019-2020 Plan omits final regulations for the 3.8 percent tax on net investment income under section 1411 (item 14 under "General Tax Issues" in the 2018-2019 Plan). Under the heading of "Gifts and Estates and Trusts," the 2019-2020 Plan includes four items, all carried over from the 2018-2019 Plan.

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

   a. This project was new in 2015.

   b. In Letter Ruling 200434012 (April 23, 2004), involving a sale from one grantor trust to another, the Service included the caveat that "when either Trust 1 or Trust 2 ceases to be treated as a trust owned by A under § 671 *by reason of A's death* or the waiver or release of any power under § 675, *no opinion is expressed or implied* concerning whether the termination of such grantor trust treatment results in a sale or disposition of any property within the meaning of § 1001(a), *a change in the basis of any property* under § 1012 or § 1014, or any deductible administration expense under § 2053."

c. An installment note received by the grantor from a grantor trust in connection with a sale to a grantor trust receives a new basis – presumably a stepped-up basis – under section 1014 when the grantor dies. The note is not an item of income in respect of a decedent ("IRD") under section 691, which would be excluded from the operation of section 1014 by section 1014(c), because the fact, amount, and character of IRD are all determined in the same manner as if "the decedent had lived and received such amount" (section 691(a)(3); *cf.* section 691(a)(1)), and the decedent would not have realized any income in that case, as confirmed by Rev. Rul. 85-13, 1985-1 C.B. 184). See the analysis in Manning & Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements," 24 Tax Mgmt. Est., Gifts & Tr. J. 3 (1999).

d. Chief Counsel Advice 200923024 (Dec. 31, 2008) opined that "the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust [by reason of the replacement of an independent trustee with a related or subordinate party] results in taxable income to the grantor." After citing and discussing 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 (which addressed the reverse conversion to nongrantor trust status), the Chief Counsel's office noted (emphasis added) 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*." Because of the interrelationship with certain partnership transactions and section 754 basis elections, however, the Chief Counsel's office viewed the overall transaction as "abusive" and wanted to explore other ways to challenge it. But it nevertheless believed that "asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations."

e. This guidance project may somehow be related to the analytical gymnastics found in those authorities.

f. On the other hand, this proposal may simply be aimed at a clarification of the rules for foreign trusts.

   i. Rev. Proc. 2015-37, 2015-26 I.R.B. 1196, added "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code" to the list of "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise." That designation was continued in section 5.01(12) of Rev. Proc. 2016-3, 2016-1 I.R.B. 126, section 5.01(10) of Rev. Proc. 2017-3, 2017-1 I.R.B. 130, section 5.01(8) of Rev. Proc. 2018-3, 2018-1 I.R.B. 130, section 5.01(8) of Rev. Proc. 2019-3, 2019-1 I.R.B. 130, and section 5.01(9) of Rev. Proc. 2020-3, 2020-1 I.R.B. 131.

ii. Meanwhile, Letter Ruling 201544002 (June 30, 2015), similar to Letter Ruling 201245006 (July 19, 2012), held that assets in a revocable trust created by foreign grantors for their U.S. citizen children would receive a stepped-up basis under section 1014(b)(2) at the grantors' deaths. The ruling acknowledged the no-rule policy of Rev. Proc. 2015-37, but avoided it on the ground that the ruling request had been submitted before the no-rule policy was announced.

iii. It is hard to believe that it is a coincidence that Rev. Proc. 2015-37 was published in the Internal Revenue Bulletin on June 29, 2015, the *day before* Letter Ruling 201544002 was issued. If those two contemporaneous events are related, then the no-rule position of Rev. Procs. 2015-37, 2016-3, 2017-3, 2018-3, 2019-3, and 2020-3 might have been aimed only at foreign trusts, and so might this proposal first announced in the 2015-2016 Priority Guidance Plan a month later on July 31, 2015. **It is also possible that, even if the project originally had such a narrow focus, it has since been expanded in the Trump Administration.**

2. "Regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011."

a. This project first appeared in the 2007-2008 Plan.

b. The first set of proposed regulations related to this project, Proposed Reg. §20.2032-1(f) (REG-112196-07), was published on April 25, 2008. The preamble appeared to view these regulations as the resolution of "[t]wo judicial decisions [that] have interpreted the language of section 2032 and its legislative history differently in determining whether post-death events other than market conditions may be taken into account under the alternate valuation method."

c. In the first of these cases, *Flanders v. United States*, 347 F. Supp. 95 (N.D. Calif. 1972), after a decedent's death in 1968, but before the alternate valuation date, the trustee of the decedent's (formerly) revocable trust, which held a one-half interest in a California ranch, entered into a land conservation agreement pursuant to California law.

i. The conservation agreement reduced the value of the ranch by 88 percent. Since that reduced value was the value of the ranch at the alternate valuation date (which until 1971 was one year after death), the executor elected alternate valuation and reported the ranch at that value.

ii. Citing the Depression-era legislative history to the effect that alternate valuation was intended to protect decedents' estates against "many of the hardships which were experienced after 1929 when market values decreased very materially between the period from the date of death and the date of distribution to the beneficiaries," the court held that "the value reducing result of the post mortem act of the surviving trustee" may not be considered in applying alternate valuation.

d. The second of these cases was *Kohler v. Commissioner*, T.C. Memo. 2006-152, *nonacq.*, 2008-9 I.R.B. 481, involving the estate of a shareholder of the well-known family-owned plumbing fixture manufacturer. The executor had received stock in a tax-free corporate reorganization that had been under consideration for about two years before the decedent's death but was not completed until about two months after the decedent's death.

i. The court rejected the Service's attempt to base the estate tax on the value of the stock *surrendered* in the reorganization (which had been subject to fewer restrictions on transferability), on the ground that Reg. §20.2032-1(c)(1) prevents that result by specifically refusing to treat stock surrendered in a tax-free reorganization as "otherwise disposed of" for purposes of section 2032(a)(1).

ii. The court also noted that the exchange of stock must have been for equal value or the reorganization would not have been tax-free as the parties had stipulated (although, ironically, the executor's own appraiser had determined a value of the pre-reorganization shares of $50.115 million and a value of the post-reorganization shares of $47.010 million – a difference of about 6.2 percent). The court distinguished *Flanders*, where the post-death transaction itself reduced the value by 88 percent.

iii. The Tax Court in *Kohler* viewed the 1935 legislative history relied on in *Flanders* as irrelevant, because Reg. §20.2032-1(c)(1) (promulgated in 1958) was clear and unambiguous and because "the legislative history describes the general purpose of the statute, not the specific meaning of 'otherwise disposed of' in the context of tax-free reorganizations."

e. The 2008 proposed regulations would have made no change to Reg. §20.2032-1(c)(1), on which the *Kohler* court relied. But they invoked "the general purpose of the statute" that was articulated in 1935, relied on in *Flanders* but bypassed in *Kohler*, to beef up Reg. §20.2032-1(f), to clarify and emphasize, with both text and examples, that the benefits of alternate valuation are limited to changes in value due to "market conditions." The 2008 proposed regulations would specifically add "post-death events other than market conditions" to changes in value resulting from the "mere lapse of time," which are ignored in determining the alternate value under section 2032(a)(3).

f. New proposed regulations (REG-112196-07) were published on November 18, 2011. The preamble stated:

> … Some commentators expressed concern that the proposed regulations (73 FR 22300) would create administrative problems

> because an estate would be required to trace property and to obtain appraisals based on hypothetical property.…
>
> …
>
> Many commentators … suggested that the IRS and Treasury Department would better serve taxpayers and address any potential abuse [of the section 2032 election] by ensuring that the regulations address the issues described in this preamble rather than finalizing the approach taken in the proposed regulations.
>
> In view of the comments, the Treasury Department and the IRS are withdrawing the proposed regulations (73 FR 22300) by the publication of these proposed regulations in the Federal Register.

g. Thus, in contrast to the 2008 approach of ignoring certain intervening events – and thereby potentially valuing assets six months after death on a hypothetical basis – the new approach is to expand the description of intervening events that are regarding as dispositions, triggering alternate valuation as of that date. The expanded list, in Proposed Reg. §20.2032-1(c)(1)(i), includes distributions, exchanges (whether taxable or not), and contributions to capital or other changes to the capital structure or ownership of an entity, including "[t]he dilution of the decedent's ownership interest in the entity due to the issuance of additional ownership interests in the entity." Proposed Reg. §20.2032-1(c)(1)(i)(I)(*1*). But under Proposed Reg. §20.2032-1(c)(1)(ii), an exchange of interests in a corporation, partnership, or other entity is not counted if the fair market values of the interests before and after the exchange differ by no more than 5 percent (which would still subject a 6.2 percent difference as in *Kohler* to the new rules).

   i. If the interest involved is only a fraction of the decedent's total interest, an aggregation rule in Proposed Reg. §20.2032-1(c)(1)(iv) values such interests at a pro rata share of the decedent's total interest.

   ii. The proposed regulations also include special rules for coordinating with annuities and similar payments (§20.2032-1(c)(1)(iii)(B)) and excepting qualified conservation easements (§20.2032-1(c)(4)), and also many more examples (§20.2032-1(c)(5), (e) *Example (2)*, (f)(2)(B) & (f)(3)).

h. While the 2008 proposed regulations were referred to as the "anti-*Kohler* regulations," the most significant impact of these proposed regulations may fall on by efforts to bootstrap an estate into a valuation discount by distributing or otherwise disposing of a minority or other noncontrolling interest within the six-month period after death (valuing it as a minority interest under section 2032(a)(1)) and leaving another minority or noncontrolling interest to be valued six months after death (also valued as a minority interest under section 2032(a)(2)).

   i. Examples 7 and 8 of Proposed Reg. §20.2032-1(c)(5) specifically address the discount-bootstrap technique – Example 8 in the context of a limited liability company and Example 7 in the context of real estate –

and leave no doubt that changes in value due to "market conditions" do not include the valuation discounts that might appear to be created by partial distributions.

ii. Example 1 reaches the same result with respect to the post-death formation of a limited partnership.

i. The 2008 proposed regulations were to be effective April 25, 2008, the date the proposed regulations were published. The 2011 proposed regulations, more traditionally, state that they will be effective when published as final regulations.

3. "Regulations under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate."

a. This project first appeared in the 2008-2009 Plan as an outgrowth of the project that led to the final amendments of the section 2053 regulations in October 2009. The significance of present value concepts is elaborated in this paragraph in the preamble to the 2009 regulations (T.D. 9468, 74 Fed. Reg. 53652 (Oct. 20, 2009)):

> Some commentators suggested that the disparate treatment afforded noncontingent obligations (deduction for present value of obligations) versus contingent obligations (dollar-for-dollar deduction as paid) is inequitable and produces an inconsistent result without meaningful justification. These commentators requested that the final regulations allow an estate to choose between deducting the present value of a noncontingent recurring payment on the estate tax return, or instead deducting the amounts paid in the same manner as provided for a contingent obligation (after filing an appropriate protective claim for refund). The Treasury Department and the IRS find the arguments against the disparate treatment of noncontingent and contingent obligations to be persuasive. The final regulations eliminate the disparate treatment by removing the present value limitation applicable only to noncontingent recurring payments. The Treasury Department and the IRS believe that the issue of the appropriate use of present value in determining the amount of the deduction allowable under section 2053 merits further consideration. The final regulations reserve § 20.2053-1(d)(6) to provide future guidance on this issue.

b. But it is easy to see how the Treasury Department's and the IRS's "further consideration" of "the appropriate use of present value concepts" could turn their focus to the leveraged benefit in general that can be obtained when a claim or expense is paid long after the due date of the estate tax, but the additional estate tax reduction is credited as of, and earns interest from, that due date.

i. *Graegin* loans (see *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477) could be an obvious target of such consideration.

ii. If this project results in a deduction of only the present value of the payment, as of the due date of the tax, *and* the discount rate used in the calculation of the present value is the same as the rate of interest on the tax refund, *and* the interest is not subject to income tax (or the discount rate is also reduced by the income tax rate), then the invocation of "present value concepts" might make very little difference on paper. But it might require legislation to accomplish all these things.

iii. Since claims or expenses are rarely paid exactly on the due date of the tax, the *precise* application of such principles might be exceedingly complicated.

4. "Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests."

a. Item 4 was new in the 2018-2019 Plan.

b. The current mortality tables, based on 2000 census data, became effective May 1, 2009. Section 7520(c)(2) mandates revision of the tables at least once every ten years. Thus, this project appears to be that routine revision, to reflect 2010 census data and to be effective as of May 1, 2019, even though it was not completed by that date.

g. Omissions from the 2016-2017 Plan

The following items, which had been in previous Plans, were omitted from the 2016-2017 Plan:

1. Guidance on definition of income for spousal support trusts under §682.

a. This project was new in 2016.

b. Section 682 was repealed by the 2017 Tax Act.

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

a. This project first appeared in the 2015-2016 Plan.

b. This project was joined in the 2016-2017 Plan by an item under the subject of "Financial Institutions and Products" described as "Regulations under §7872. Proposed regulations were published on August 20, 1985." When the promissory notes project was dropped from the subject of "Gifts and Estates and Trusts" in the 2017-2018 Plan, that item under "Financial Institutions and Products" remained. It was carried over to the 2018-2019 Plan, but dropped from the 2019-2020 Plan.

c. It is well known that the Tax Court has held that section 7872 is the applicable provision for valuing an intra-family promissory note – specifically for determining that a note carrying the section 7872 rate may be valued at its face amount. *See Frazee v. Commissioner*, 98 T.C. 554 (1992). *See also Estate of True v. Commissioner*, T.C. Memo. 2001-167, aff'd on other grounds, 390 F.3d 1210 (10th Cir. 2004).

d. But Judge Hamblen concluded his opinion in *Frazee* by stating:

> We find it anomalous that respondent urges as her primary position the application of section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept.

98 T.C. at 590. Perhaps this project was intended to resolve that anomaly, probably by regulations.

e. Section 7872(i)(2) states:

> Under regulations prescribed by the Secretary [of the Treasury], any loan which is made with donative intent and which is a term loan shall be taken into account for purposes of chapter 11 [the estate tax chapter] in a manner consistent with the provisions of subsection (b) [providing for the income and gift tax treatment of below-market loans].

i. Proposed Reg. §20.7872-1 (proposed in 1985) provides that a "gift term loan" shall be valued for estate tax purposes at no less than (a) its unpaid stated principal plus accrued interest or (b) the present value of all the future payments under the note using the applicable federal rate in effect at the time of death.

ii. Answers to the proposed regulation might include the arguments that (1) the proposed regulation is not effective unless and until it is finalized, (2) the loan represented by the installment note is not a "gift term loan" because it uses an interest rate calculated to avoid below-market treatment under section 7872(e), and (3) with respect to section 7872(i)(2) itself, the loan is not made "with donative intent" because the transaction is a sale.

iii. Under section 7805, the proposed regulations could probably be expanded even beyond the strict mandate of section 7872(i)(2), and under section 7805(b)(1)(B) such expanded final regulations might even be made effective retroactively to the publication date of the proposed regulations in 1985 (although that would be an aggressive choice that undoubtedly would be roundly criticized). But, unless and until that happens, most estate planners have seen no reason why the estate tax value should not be fair market value, which, after all, is the general rule, subject to Reg. §20.2031-4, which states:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or

other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.

f. It is not clear that this guidance project was related to these developments, and in any event it did not cite Proposed Reg. §20.7872-1.

   i. It *is* clear that the IRS has long been interested in the valuation of promissory notes, and at times has seemed to embrace a market interest rate standard. *See* Letter Ruling 200147028 (issued Aug. 9, 2001; released Nov. 23, 2001).

   ii. The interest of the IRS was especially apparent after the docketing of *Estate of Davidson v. Commissioner*, T.C. Docket No. 13748-13, in which the IRS asserted $2.8 billion in estate, gift, and generation-skipping taxes owed. On July 6, 2015, the case was settled for just over $550 million. Addressing Mr. Davidson's sales both in Chief Counsel Advice 201330033 (Feb. 24, 2012) and in its answer in the Tax Court, the IRS argued that the notes should be valued, not under section 7520, but under a willing buyer-willing seller standard that took account of Mr. Davidson's health. *See also Estate of Kite v. Commissioner*, T.C. Memo. 2013-43.

g. Promissory notes are frequently used in estate planning, and guidance could provide welcome clarity.

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

a. This project was also new in 2015.

b. Defined value clauses have an interesting history. See, for example, Technical Advice Memorandum 8611004 (Nov. 15, 1985) (approving a transfer of "such interest in X Partnership … as has a fair market value of $13,000"); *Knight v. Commissioner*, 115 T.C. 506 (2000) (disregarding the use of such a technique to transfer "that number of limited partnership units in [the partnership] which is equal in value, on the effective date of this transfer, to $600,000"); *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev'g* 120 T.C. 358 (2003) (approving a defined value clause, with the excess going to charity); *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), *aff'd*, 586 F.3d 1061 (8th Cir. 2009) (approving a formula disclaimer in favor of charity); *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011) (approving a defined value clause, with the excess going to charity); *Hendrix v. Commissioner*, T.C. Memo. 2011-133 (approving a defined value clause, with the excess going to charity); *Wandry v. Commissioner*, T.C. Memo. 2012-88, *nonacq.*, AOD 2012-004, 2012-46 I.R.B. (approving a type of defined value clause, with the excess remaining with the transferor); *Estate of Donald Woelbing v. Commissioner* (Tax Court Docket No. 30261-13, stipulated decision entered March 25, 2016) and

Estate of Marion Woelbing v. Commissioner (Tax Court Docket No. 30260-13, stipulated decision entered March 28, 2016).

c. In affirming the Tax Court in *Petter*, albeit in the context of a rather narrow subpoint of a condition precedent within the meaning of Reg. §25.2522(c)-3(b)(1), the Court of Appeals for the Ninth Circuit concluded its opinion by quoting:

> "[W]e expressly invite[ ] the Treasury Department to "amend its regulations" if troubled by the consequences of our resolution of th[is] case." *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704, 713 (2011) (quoting *United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 838 (2001)).

Maybe, in this guidance project, Treasury was proposing to accept that invitation. Because of the widespread use of defined value formula clauses in estate planning, particularly (as we saw in 2012) to make use of increased exemptions that were about to sunset, guidance could provide needed clarity on this point also.

4. Guidance under §§2522 and 2055 regarding the tax impact of certain irregularities in the administration of split-interest charitable trusts.

This project was new in 2016.

5. Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.

a. The Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART" Act) enacted a new income tax "mark to market" rule when someone expatriates on or after June 17, 2008, and a new succession tax on the receipt of certain gifts or bequests from someone who expatriated on or after June 17, 2008. The new succession tax is provided for in section 2801, comprising all of new chapter 15.

b. Referring to the guidance contemplated by this project, Announcement 2009-57, 2009-29 I.R.B. 158 (released July 16, 2009), stated:

> The Internal Revenue Service intends to issue guidance under section 2801, as well as a new Form 708 on which to report the receipt of gifts and bequests subject to section 2801. The due date for reporting, and for paying any tax imposed on, the receipt of such gifts or bequests has not yet been determined. The due date will be contained in the guidance, and the guidance will provide a reasonable period of time between the date of issuance of the guidance and the date prescribed for the filing of the return and the payment of the tax.

c. This project first appeared on the 2008-2009 Plan. Treasury and IRS personnel initially referred to it as a top priority, but now it has been dropped from the Priority Guidance Plan, even though proposed regulations were published on September 10, 2015. Evidently the implementation of what amounts to a succession tax on transferees, not transferors or their estates, is quite complicated and challenging.

d. The proposed regulations (§§28.2801-1 through -7 and related procedural sections, REG-112997-10) are about 18,000 words long and were accompanied by a preamble of about 8,600 words. The preamble included the estimate that there would be 1,000 respondents annually.

e. Proposed Reg. §28.6011-1(a) provides that "covered" gifts and bequests must be reported by the recipient on Form 708, "United States Return of Tax for Gifts and Bequests from Covered Expatriates."

   i. Under Proposed Reg. §28.6071-1(a)(1), Form 708 is generally due on the 15th day of the 18th month following the close of the calendar year in which the transfer was received. But, fulfilling the promise of Announcement 2009-57, Proposed Reg. §28.6071-1(d) states that no Form 708 will be due before the date specified in the final regulations.

   ii. Under Proposed Reg. §28.2801-3(c)(1) and (2), if a gift or bequest is reported by the expatriate donor or executor of the expatriate decedent on a Form 709 or 706, and gift or estate tax is paid, it is not a covered gift or bequest and need not be reported on Form 708.

f. Proposed Reg. §28.2801-3(b) confirms that covered bequests include the receipt of assets the value of which would be included in a U.S. citizen's gross estate under section 2036, 2037, 2038, 2040, 2042, or 2044.

g. There are some oddities and surprises in the calculation of the tax.

   i. Under Proposed Reg. §28.2801-4(b)(2), the sum of both covered gifts and covered bequests is reduced by the annual exclusion amount provided for gift tax purposes under section 2503(b). But only one such reduction is allowed, regardless of the number of donors. In the case of a gift to a spouse who is not a U.S. citizen, that amount is determined under section 2523(i) (see Proposed Reg. §28.2801-3(c)(4) and -3(f), *Example 1*) and is 10 times the unrounded amount determined under section 2503(b).

   ii. Under section 2801(b), the tax is an obligation of the recipient. Nevertheless, under the calculation rules in Proposed Reg. §28.2801-4(b), the gift tax the recipient pays is not deducted from the amount subject to tax, as it would be in the case of a typical "net gift." The section 2801 tax, whether on a gift or a bequest, is "tax-inclusive."

   iii. Proposed Reg. §28.2801-4(a)(2)(iii) provides rules for computing the tax in the case of a covered transfer to a charitable remainder trust. The value of the transferred property is allocated between the noncharitable interest and the charitable remainder interest in the usual way and the tax is calculated on the noncharitable portion. Although the payment of the tax by the trust does not reduce the value of the gift for purposes of the calculation of the section 2801 tax (see paragraph ii above), it does reduce the value of the charitable remainder and therefore might actually *increase* the value of the covered gift.

   iv. Under Proposed Reg. §28.2801-6(a), the recipient's payment of the tax does not increase the basis of the transferred property.

h. One of the most vexing issues regarding the section 2801 tax has been figuring out how the recipient will know when a gift or bequest is a "covered" gift or bequest from a "covered" expatriate. Gifts and bequests normally have no tax consequences to the recipient.

i. Proposed Reg. §28.2801-7(a) provides this ominous and exasperating, but probably unavoidable, confirmation:

> (a) *Responsibility of recipients of gifts and bequests from expatriates*. It is the responsibility of the taxpayer (in this case, the U.S. citizen or resident receiving a gift or bequest from an expatriate or a distribution from a foreign trust funded at least in part by an expatriate) to ascertain the taxpayer's obligations under section 2801, which includes making the determination of whether the transferor is a covered expatriate and whether the transfer is a covered gift or covered bequest.

ii. Doing the best it can to be helpful, Proposed Reg. §28.2801-7(b) adds:

> (b) *Disclosure of return and return information*—(1) *In general*. In certain circumstances, the Internal Revenue Service (IRS) may be permitted, upon request of a U.S. citizen or resident in receipt of a gift or bequest from an expatriate, to disclose to the U.S. citizen or resident return or return information of the donor or decedent expatriate that may assist the U.S. citizen or resident in determining whether the donor or decedent was a covered expatriate and whether the transfer was a covered gift or covered bequest. The U.S. citizen or resident may not rely upon this information, however, if the U.S. citizen or resident knows, or has reason to know, that the information received from the IRS is incorrect. The circumstances under which such information may be disclosed to a U.S. citizen or resident, and the procedures for requesting such information from the IRS, will be as provided by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b)).
>
> (2) *Rebuttable presumption*. Unless a living donor expatriate authorizes the disclosure of his or her relevant return or return information to the U.S. citizen or resident receiving the gift, there is a rebuttable presumption that the donor is a covered expatriate and that the gift is a covered gift. A taxpayer who reasonably concludes that a gift or bequest is not subject to section 2801 may file a protective Form 708 in accordance with §28.6011-1(b) to start the period for the assessment of any section 2801 tax.

iii. The preamble further explains:

> Section 28.2801-7 provides guidance on the responsibility of a U.S. recipient, as defined in §28.2801-2(e), to determine if tax under section 2801 is due. The Treasury Department and the IRS realize that, because the tax imposed by this section is

imposed on the U.S. citizen or resident receiving a covered gift or covered bequest, rather than on the donor or decedent covered expatriate making the gift or bequest, U.S. taxpayers may have difficulty determining whether they are liable for any tax under section 2801. Nevertheless, the same standard of due diligence that applies to any other taxpayer to determine whether the taxpayer has a tax liability or a filing requirement also applies to U.S. citizens and residents under this section. Accordingly, it is the responsibility of each U.S. citizen or resident receiving a gift or bequest, whether directly or indirectly, from an expatriate (as defined in section 877A(g)(2)) to determine its tax obligations under section 2801. Thus, the burden is on that U.S. citizen or resident to determine whether the expatriate was a covered expatriate (as defined in section 877A(g)(1)) and, if so, whether the gift or bequest was a covered gift or covered bequest.

iv. In other words, if a family member expatriates, life will be tougher for other family members (or any objects of the expatriate's bounty) who do not expatriate.

v. Proposed Reg. 28.6011-1(b)(i) does provide that a recipient who reasonably concludes that a gift or bequest is not a "covered" gift or bequest may file a protective Form 708, and that such a filing will start the period for assessment of tax with respect to any transfer reported on that return.

i. Section 2801(e)(1) provides that a "covered gift or bequest" includes any property acquired "directly or indirectly." Section 2801(e)(4)(A) provides that a covered transfer includes a transfer to a U.S. domestic trust. Section 2801(e)(4)(B)(i) provides that in the case of a covered gift or bequest to a foreign trust, the tax is imposed on distributions *from* the trust "attributable to such gift or bequest."

i. Proposed Reg. §28.2801-5(c)(1)(i) provides that the amount of any distribution attributable to covered gifts and bequests is determined by applying a "section 2801 ratio" to the value of the distribution. Tracing of particular trust assets is not allowed.

ii. Under Proposed Reg. §28.2801-5(c)(1)(ii), the "section 2801 ratio," representing the portion of the trust and of each distribution that is deemed to be attributable to covered transfers, is redetermined after each contribution to the trust, in a manner resembling the calculation of the inclusion ratio for GST tax purposes.

iii. Proposed Reg. §28.2801-5(c)(3) provides:

> If the trustee of the foreign trust does not have sufficient books and records to calculate the section 2801 ratio, or if the U.S. recipient is unable to obtain the necessary information with regard to the foreign trust, the U.S. recipient must proceed upon the assumption that the entire distribution for purposes of section 2801 is attributable to a covered gift or covered bequest.

This encourages the expatriate transferor to cooperate with transferees.

iv. Proposed Reg. §28.2801-5(d) permits a foreign trust to elect to be treated as a U.S. domestic trust.

(A) Thereby the section 2801 tax is imposed on the value of the trust multiplied by the section 2801 ratio and on all current and future transfers to the trust from covered expatriates, but *not* on future distributions *from* the trust.

(B) The trustee of an electing foreign trust must designate and authorize a U.S. agent solely for purposes of section 2801. Proposed Reg. §28.2801-5(d)(3)(iv) states:

> By designating a U.S. agent, the trustee of the foreign trust agrees to provide the agent with all information necessary to comply with any information request or summons issued by the Secretary. Such information may include, without limitation, copies of the books and records of the trust, financial statements, and appraisals of trust property. … Acting as an agent for the trust for purposes of section 2801 includes serving as the electing foreign trust's agent for purposes of section 7602 ("Examination of books and witnesses"), section 7603 ("Service of summons"), and section 7604 ("Enforcement of summons") with respect to [a]ny request by the Secretary to examine records or produce testimony related to the proper identification or treatment of covered gifts or covered bequests contributed to the electing foreign trust and distributions attributable to such contributions; and [a]ny summons by the Secretary for records or testimony related to the proper identification or treatment of covered gifts or covered bequests contributed to the electing foreign trust and distributions attributable to such contributions.

Under such a rule, care would be advisable in agreeing to be a U.S. agent.

6. **And, under the heading of "General Tax Issues,"** deletion of the project described as "Guidance regarding material participation by trusts and estates for

purposes of §469." This is the guidance that could have shed light on the application to trusts and estates of the 3.8 percent tax on net investment income mentioned in Part IV.a.5.b on page 20.

h. Omissions from the 2015-2016 Plan

The following items, which had been in previous Plans, were omitted from the 2015-2016 Plan:

1. **Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP.**

   a. This project first appeared in the 2012-2013 Plan.

   b. Some context might be derived from a request for guidance from the AICPA, first made in a letter to the IRS dated June 26, 2007, which stated:

> The issues presented here are best illustrated by considering the following fact pattern:
>
> > Taxpayer creates an irrevocable trust, Trust Z, in which a qualified annuity interest (as defined in section 2702(b)) is payable to the taxpayer or his estate for 10 years. Upon the termination of the annuity interest, Trust Z is to be separated into two trusts, Trust A and Trust B. Trust A is for the exclusive benefit of Taxpayer's children and grandchildren. Trust B is for the exclusive benefit of Taxpayer's children. Trust A is to receive from Trust Z so much of the Trust Z's assets as is equal to Taxpayer's remaining GST exemption, if any. Trust B is to receive from Trust Z the balance of Trust Z's assets, if any, after funding Trust A. The taxpayer is alive at the end of the 10 years.
>
> Presumably, the transfer to Trust Z is an indirect skip to which GST exemption will be automatically allocated at the end of the ETIP. Will the automatic allocation rules apply to all the assets remaining in Trust Z at that time? If so and if the taxpayer wants to allocate GST exemption only to the assets going to Trust A, the taxpayer should timely elect out of the automatic allocation rules of section 2632(c), and then affirmatively allocate GST exemption only to the assets going into Trust A at the end of the ETIP. Is that possible?
>
> In the alternative, the automatic allocation rules may apply only to the transfer going into Trust A because Trust B is not by definition a GST trust. Because of the application of the ETIP rules, the transfer from the taxpayer for GST purposes would occur only at the time that the assets are funded into Trust A. If that is the case, then the taxpayer does not need to do anything affirmatively to ensure that GST exemption is allocated to Trust A and not Trust B as he or she desires.

It has been our experience that many trusts are structured in a manner similar to the above referenced fact pattern. By letter dated November 10, 2004, the AICPA submitted comments on the proposed regulations on electing out of deemed allocations of GST exemption under section 2632(c). In that letter, guidance was requested on these issues. The preamble to the final regulations (T.D. 9208) acknowledged this request for the inclusion in the regulations of an example addressing the application of the automatic allocation rules for indirect skips in a situation in which a trust subject to an ETIP terminates upon the expiration of the ETIP, at which time the trust assets are distributed to other trusts that may be GST trusts. According to the preamble, the Treasury Department and the Internal Revenue Service believed that this issue was outside the scope of the regulation project and would consider whether to address these issues in separate guidance.

2. **Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008.**

   a. This project first appeared in the 2007-2008 Plan.

   b. It reappeared in the 2017-2018 Plan and is discussed in Part IV.e beginning on page 31.

i. Other Notable Omissions

1. **Decanting**

   a. The 2011-2012 Priority Guidance Plan included, as item 13, "Notice on decanting of trusts under §§2501 and 2601." This project was new in 2011-2012, but it had been anticipated for some time, especially since the publication at the beginning of 2011 of Rev. Proc. 2011-3, 2011-1 I.R.B. 111, in which new sections 5.09, 5.16, and 5.17 included decanting among the "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise." Rev. Proc. 2020-3, 2020-1 I.R.B. 131, §§5.01(8), (13) & (14) continues this designation.

   b. On December 20, 2011, the IRS published Notice 2011-101, 2011-52 I.R.B. 932. Notice 2011-101 asked for comments from the public by April 25, 2012, on the tax consequences of decanting transactions – the transfer by a trustee of trust principal from an irrevocable "Distributing Trust" to another "Receiving Trust." Notice 2011-101 asked for comments on the relevance and effect of the following 13 facts and circumstances (as well as the identification of any other factors that might affect the tax consequences):

      i. A beneficiary's right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary);

      ii. Trust principal and/or income may be used to benefit new (additional) beneficiaries;

iii. A beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed;

iv. The transfer takes place from a trust treated as partially or wholly owned by a person under §§671 through 678 of the Internal Revenue Code (a "grantor trust") to one which is not a grantor trust, or vice versa;

v. The situs or governing law of the Receiving Trust differs from that of the Distributing Trust, resulting in a termination date of the Receiving Trust that is subsequent to the termination date of the Distributing Trust;

vi. A court order and/or approval of the state Attorney General is required for the transfer by the terms of the Distributing Trust and/or applicable law;

vii. The beneficiaries are required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;

viii. The beneficiaries are not required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;

ix. Consent of the beneficiaries and/or a court order (or approval of the state Attorney General) is not required but is obtained;

x. The effect of state law or the silence of state law on any of the above scenarios;

xi. A change in the identity of a donor or transferor for gift and/or GST tax purposes;

xii. The Distributing Trust is exempt from GST tax under §26.2601-1, has an inclusion ratio of zero under §2632, or is exempt from GST tax under §2663; and

xiii. None of the changes described above are made, but a future power to make any such changes is created.

c. Notice 2011-101 also "encourage[d] the public to suggest a definition for the type of transfer ('decanting') this guidance is intended to address" and encouraged responses to consider the contexts of domestic trusts, the domestication of foreign trusts, and transfers to foreign trusts.

d. Meanwhile, Notice 2011-101 said that the IRS "generally will continue to issue PLRs with respect to such transfers that do not result in a change to any beneficial interests and do not result in a change in the applicable rule against perpetuities period."

e. There were extensive public comments, and there is little doubt that Treasury and the IRS have continued to study decanting. But decanting was omitted from the 2012-2013 Plan and from subsequent Plans.

f. A new Uniform Trust Decanting Act (UTDA) was approved by the Uniform Law Commission at its annual conference in July 2015. The Act generally allows decanting whenever the trustee has discretion to make principal distributions, or even if the trustee does not have such discretion if it is appropriate to decant into a special-needs trust.

i. Generally decanting may not add beneficiaries, and Section 19 of UTDA includes extensive explicit safeguards, called "tax-related limitations," to prevent decanting from jeopardizing any intended beneficial tax characteristics of the trust. The beneficial tax characteristics explicitly addressed are the marital deduction, the charitable deduction, the annual gift tax exclusion, the eligibility of the trust to hold S corporation stock, an inclusion ratio of zero for GST tax purposes, preservation of the use of the trust beneficiary's life expectancy in determining minimum required distributions from a retirement plan or IRA, and the preservation, creation, avoidance, or termination of grantor trust status as the circumstances might warrant.

ii. UTDA in effect now provides the "definition" Notice 2011-101 asked for, and its publication should now pave the way for the long-awaited tax guidance for decantings done under UTDA or substantially identical statutes. And because of the care to avoid tax problems that UTDA exhibits, that guidance should not be as hard to complete or as harsh in its application as many might have feared.

2. Private Trust Companies

a. Privately owned and operated trust companies are becoming an option that families with large trusts are turning to in increasing numbers, and state law authority for such private trust companies is being continually refined. Every Priority Guidance Plan since the 2004-2005 Plan had included an item referring to private trust companies.

i. When this project first appeared, in the 2004-2005 Plan, it was described as "Guidance regarding family trust companies."

ii. In the 2005-2006, 2006-2007, and 2007-2008 Plans, it was described as "Guidance regarding the consequences under various *estate, gift, and generation-skipping transfer tax* provisions of using a family-owned company as the trustee of a trust." The omission of *income tax* issues from that formulation was a source of concern, because income tax issues have frequently been addressed in the relevant letter rulings. Indeed, in the first such letter rulings, Letter Rulings 9841014 and 9842007 (July 2, 1998), the only issue was whether a family-owned trust company was a "related or subordinate party" with respect to the living grantors of various trusts, within the meaning of section 672(c), an income tax rule.

iii. In the 2008-2009 and 2009-2010 Plans (published after Notice 2008-63, which is discussed below), the description was a more comprehensive "Revenue ruling regarding the consequences under various income, estate, gift, and generation-skipping transfer tax provisions of using a family owned company as a trustee of a trust."

iv. That reassurance of comprehensive treatment was maintained in the 2010-2011 Plan by describing the project as "Guidance concerning private trust companies under §§671, 2036, 2038, 2041, 2042, 2511, and 2601."

v. By dropping the reference to a revenue ruling, the 2010-2011 Plan suggested that Treasury and the IRS might be reviewing the basic approach of the proposed revenue ruling, which had attracted many diverse public comments after the publication of Notice 2008-63 (discussed below). But a revenue ruling as the vehicle for the guidance would be much easier to finalize than would, for example, amendment of the many regulations that would have to be amended.

vi. Following the first appearance of this project on the 2004-2005 Plan, the IRS identified the treatment of private trust companies for estate tax purposes under sections 2036, 2038, and 2041 as "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise." Rev. Proc. 2005-3, 2005-1 C.B. 118, §§5.07, 5.08 & 5.09. This designation has continued to the present. Rev. Proc. 2020-3, 2020-1 I.R.B. 131, §§5.01(10), (11) & (12).

b. The proposed revenue ruling in question was released with Notice 2008-63 on July 11, 2008, and published at 2008-31 I.R.B. 261 on August 4, 2008. The Notice solicited comments on the proposed revenue ruling, which affirmed favorable conclusions with respect to five tax issues faced by trusts of which a private trust company serves as trustee:

i. Inclusion of the value of trust assets in a grantor's gross estate by reason of a retained power or interest under section 2036 or 2038.

ii. Inclusion of the value of trust assets in a beneficiary's gross estate by reason of a general power of appointment under section 2041.

iii. Treatment of transfers to a trust as completed gifts.

iv. Effect on a trust's status under the GST tax either as a "grandfathered" trust or as a trust to which GST exemption has been allocated.

v. Treatment of a grantor or beneficiary as the owner of a trust for income tax purposes.

While these are not the only issues that the use of private trust companies can present, these are the most common issues. It was especially encouraging to see grantor trust treatment addressed, in view of the omission of income tax from the formulation of this project on the then most recent 2007-2008 Plan.

c. The proposed revenue ruling posited several trusts, illustrating both the introduction of a private trust company as the trustee of a preexisting trust and the creation of new trusts with a private trust company as the trustee. The trusts had the following features:

i. The trustee has broad discretionary authority over distributions of both income and principal.

ii. Each successive primary beneficiary has a broad testamentary power of appointment (although not as broad as a power to appoint to anyone other than the beneficiary's estate, creditors, and creditors of the estate).

iii. The grantor or primary beneficiary may unilaterally appoint (but not remove) trustees, with no restrictions other than on the ability to appoint oneself.

d. The proposed revenue ruling presented two situations – Situation 1, in which the private trust company is formed under a state statute with certain limitations, and Situation 2, in which the private trust company is formed in a state without such a statute but comparable limitations are included in the governing documents of the private trust company itself.

e. The basic premise of the proposed revenue ruling, as stated in the second paragraph of Notice 2008-63, was:

> The IRS and the Treasury Department intend that the revenue ruling, once issued, will confirm certain tax consequences of the use of a private trust company that are not more restrictive than the consequences that could have been achieved by a taxpayer directly, but without permitting a taxpayer to achieve tax consequences through the use of a private trust company that could not have been achieved had the taxpayer acted directly. Comments are specifically requested as to whether or not the draft revenue ruling will achieve that intended result.

f. Consistently with this basic premise, the proposed revenue ruling provided that the hypothetical private trust companies it addressed would generally avoid tax problems by the use of certain "firewall" techniques. For example:

i. A "Discretionary Distribution Committee" ("DDC") with exclusive authority to make all decisions regarding discretionary distributions "from each trust [meaning "all trusts"?] for which it serves as trustee." Anyone may serve on the DDC, but no member of the DDC may participate in the activities of the DDC with respect to a trust of which that DDC member or his or her spouse is a grantor or beneficiary, or of which the beneficiary is a person to whom that DDC member or his or her spouse owes an obligation of support.

ii. In Situation 2, an "Amendment Committee" with exclusive authority to amend the relevant sensitive limitations in the private trust company's governing documents (which are imposed by statute in Situation 1). A majority of the members of the Amendment Committee must be individuals who are neither members of the relevant family nor persons related or subordinate (within the meaning of section 672(c)) to any shareholder of the company.

g. A paragraph near the end of the proposed revenue ruling identified three factual details that were not material to the favorable tax conclusions, explicitly confirming that the conclusions would not change if those details changed. No doubt the list of immaterial factual details could be expanded. Some likely examples (not exhaustive):

   i. The designation of a "primary beneficiary" of each preexisting trust, possibly excluding so-called "pot" or "sprinkle" trusts.

   ii. The possible requirement of a single independent "Discretionary Distribution Committee" for all trusts administered by the private trust company, possibly excluding a differently conceived body with a similar effect, a different committee for different trusts, and any exception for trusts for customers other than family members administered by family-owned trust companies that offer fiduciary services to the public.

   iii. The explicit prohibition of certain express or implied reciprocal agreements regarding distributions, possibly excluding such prohibitions derived from general fiduciary law.

h. The project relating to private trust companies was omitted from the 2014-2015 Plan. Unlike decanting, however, it cannot be said that private trust companies are a priority, or that the contemplated guidance may be issued soon. But meanwhile, the principles reflected in the proposed revenue ruling, including the reliance on "firewalls," will be relied on by those contemplating and organizing private trust companies and employing them as trustees of family trusts. If and when the IRS does issue guidance in this area, it is likely that such guidance will not be harsher in any material way than the guidance in the proposed revenue ruling.

V. The 116th Congress (2019-2020)

a. 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 was that the federal government was funded through September 30, 2020, avoiding a government shutdown. But 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), the SECURE Act 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.

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

   a. **Repeal of the Age Limit on Making Contributions.** Section 107(a) of the SECURE Act 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 the Requirement to Make Minimum Distributions.** Section 114 changes the age that determines the beginning date for required minimum distributions from 70½ to 72.

   i. That seems simple, fair, and realistic in view of the ways people continue to work longer and defer retirement.

   ii. 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 the SECURE Act 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 the SECURE Act the first distribution calendar year is 2022 and the required beginning date is April 1, 2023 – a **one-year** deferral.

   iii. 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 the SECURE Act 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. Section 302(b) further 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. **"Kiddie Tax" Relief for "Gold Star Children."** Section 201 of the SECURE Act 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 repeal was added to the earlier versions of the SECURE Act 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 Ten Years.** To make up almost all of the revenue loss attributable to the SECURE Act's reforms, Section 401 of the SECURE Act (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 – 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.

      i. 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.

ii. 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. **Effect on Trusts.** 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.

i. 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 the SECURE Act. But long-term trusts drafted to qualify for life expectancy distributions will be affected 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.

ii. 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.

c. **Revenue Estimate.** The Joint Committee on Taxation has estimated that this provision would raise revenue by about $15.7 billion in Fiscal Years 2020-2029 – in other words, through September 30, 2029. That is almost enough to offset the revenue losses from all the other provisions of the SECURE Act, estimated to be about $16.3 billion.

i. But 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 the SECURE Act, 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.

ii. Of course revenue estimates take into account all kinds of projected behaviors, including spreading receipts over many years to benefit from lower tax brackets. 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.

b. More Death Tax Repeal Bills Introduced

In addition to a continuing hope to make the 2017 tax changes permanent, there remains for many a strong desire to repeal the estate tax altogether. In the 116th Congress, the principal expressions of that desire are the "Death Tax Repeal Act" (H.R. 218), introduced by Rep. Jason Smith (R-Missouri) on January 3, 2019, and the "Death Tax Repeal Act of 2019" (S. 215), introduced by Senator John Thune (R-South Dakota) on January 24, 2019, each with many co-sponsors.

1. Both bills would repeal the estate and GST taxes upon enactment and cap the gift tax rate at 35 percent with a $10 million lifetime exemption, indexed for inflation since 2011.

2. Like H.R. 1105 passed by the House of Representatives in April 2015, H.R. 631 introduced by Rep. Kristi Noem (R-South Dakota) (now the Governor of South Dakota) as the Republican leadership's repeal vehicle in January 2017, and the version of the "Tax Cuts and Jobs Act" (H.R. 1) passed by the House (but not the Senate) in November 2017, both of the current bills would retain the estate tax under section 2056A(b)(1)(A) on distributions from qualified domestic trusts (QDOTs) for spouses of decedents who died before the date of enactment, but only for ten years after the date of enactment. Both bills would immediately eliminate the estate tax under section 2056A(b)(1)(B) on the value of property remaining in QDOTs at the deaths of surviving spouses after the date of enactment.

3. Like H.R. 1105 in 2015, S. 215 (but not H.R. 218) would restore the enigmatic section 2511(c) that had been added by the 2001 Tax Act and repealed by the 2010 Tax Act, providing that "[n]otwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1." (Like H.R. 1105, S. 215 ignores the 2002 amendment, which changed "taxable gift" to "transfer of property by gift.")

c. Senator Sanders' "For the 99.8 Percent Act" Introduced

1. **The "For the 99.8 Percent Act."** On January 31, 2019, following the Democratic victories in the 2018 House 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 for many years 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. An identical bill, H.R. 4857, was introduced in the House of Representatives by Rep. Jimmy Gomez (D-California) on October 24, 2019.

    a. 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. 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.

    b. 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. 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. See Part IV.d beginning on page 21.

2. **Modifications to Rates and Exemptions.** Section 2 of Senator Sanders' bill would raise rates and lower exemptions.

    a. The marginal estate and gift tax rate would be increased to

        i. 45 percent (the top rate in 2007 through 2009 under the 2001 Tax Act signed by President George W. Bush) from \$3.5 million to \$10 million,

        ii. 50 percent (the top rate in 2002 under the 2001 Tax Act) from \$10 million to \$50 million,

iii. 55 percent (the top rate achieved in 1984 through 2001 under the 1981 Act signed by President Reagan) from $50 million to $1 billion, and

iv. 77 percent (the top estate tax rate in effect from 1941 through 1976) over $1 billion.

b. The basic exclusion amount would be reduced to

i. $3.5 million, not indexed, for estate tax purposes and

ii. $1 million, not indexed, for gift tax purposes.

c. An "anti-clawback" rule would be included.

d. The bill says nothing about the GST tax, which apparently would make the GST tax rate 77 percent and the GST exemption $3.5 million.

e. These proposals are more aggressive than, for example, those in section 3 of the "Responsible Estate Tax Act" (S. 3533) Senator Sanders introduced in June 2010, which would have provided for an effective top estate and gift tax rate of 65 percent (over $500 million), a GST tax rate of 55 percent, and a basic exclusion amount of $3.5 million that would apply for gift tax purposes too.

3. **Value of Farm, etc. Real Property.** Section 3, 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 ($1.18 million in 2020) to $3 million, still indexed for inflation from 1997 (so the number in 2020 would be about $4.7 million).

4. **Land Subject to Conservation Easements.** Section 4, 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.** Section 5 would add new sections 1015(f) and 6035(b) to extend the "consistent basis" rules of section 1014(f) and the accompanying reporting rules of section 6035(a) (discussed in Part IV.d beginning on page 21) to property received by gift.

6. **Valuation of Nonbusiness Assets; Limitation on Minority Discounts.** Section 6 is titled "Valuation Rules for Certain Transfers of Nonbusiness Assets; Limitation on Minority Discounts." It is virtually identical to section 7 of Senator Sanders' 2010 "Responsible Estate Tax Act."

a. Section 6 is also 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." And it is 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.

b. The bill would add a new section 2031(d)(1) to the Code, applicable to transfers after the date of enactment, to read as follows:

> (d) Valuation Rules for Certain Transfers of Nonbusiness Assets—For purposes of this chapter and chapter 12—
>
> > (1) In General—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092) [*see* Reg. §1.1092(d)-1(a) & (b)]—
> >
> > > (A) the value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and
> > >
> > > (B) such nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.

c. The bill would also add a new section 2031(e), to read as follows:

> (e) Limitation on Minority Discounts—For purposes of this chapter and chapter 12, in the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092), 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 (as defined in section 2032A(e)(2)) of the transferor and transferee—
>
> > (1) have control of such entity, or
> >
> > (2) own the majority of the ownership interests (by value) in such entity.

7. **Grantor Retained Annuity Trusts.** Section 7 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.

   a. Like the 2015 and 2016 Greenbooks, the bill would require any GRAT to

      i. have a term no shorter than 10 years (the proposal in the original 2009 Obama Administration Greenbook),

      ii. prohibit any decrease in the annuity during the GRAT term (a proposal added in the 2010 Greenbook),

      iii. have a term no longer than the life expectancy of the grantor plus 10 years (a proposal added in the 2012 Greenbook), and

      iv. 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).

b. 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.

c. The 2015 Greenbook had also added that "the proposal … would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust." That would diminish the availability of some techniques for managing long-term GRATs. The "For the 99.8 Percent Act" omits that proposal.

8. **Grantor Trusts in General.** Similarly, section 8 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.

   a. The bill would add to the Code a new chapter 16, containing a single section 2901.

   b. Section 2901 would apply to any portion of a trust if

      i. the grantor is the deemed owner of that portion under subchapter J, or

      ii. 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 perhaps some "BDOTs," whether as a matter of tax policy or simply to crack down on techniques known to be in use.)

   c. Tracking the Obama Administration Greenbooks, section 2901 would

      i. include the value of the assets of such portion in the gross estate of the deemed owner for estate tax purposes,

      ii. subject to gift tax any distribution from such portion to one or more beneficiaries [presumably beneficiaries other than the deemed owner] during the deemed owner's life, and

      iii. treat 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.

   d. Section 2901 would reduce the amount thereby subject to estate or gift tax by "the value of any transfer by gift by the deemed owner to the trust previously taken into account by the deemed owner under chapter 12." This is not an exception for the **portion** of the trust attributable to such a taxable gift; it is a "reduction" by the amount reported as a gift. In other words, section 2901 would "freeze" the amount excluded from its reach at its initial gift tax value (thus targeting "leveraged" transfers).

e. Section 2901 provides that it "shall not apply to (1) any trust that is includible in the gross estate of the deemed owner (without regard to [section 2901]), and (2) any other type of trust that the Secretary determines by regulations or other guidance does not have as a significant purpose the avoidance of transfer taxes."

f. Section 2901 would provide that "[a]ny tax imposed by [section 2901] shall be a liability of the trust." It does not specify whether any such tax, especially estate tax, would be calculated at the average or marginal tax rate.

g. Section 2901 would apply to

   i. trusts created on or after the date of enactment,

   ii. any portion of a trust attributable to a contribution on or after the date of enactment to a trust created before the date of enactment, and

   iii. any portion of a trust created before the date of enactment if a transaction referred to in paragraph b.ii above occurs on or after the date of enactment.

9. **Elimination of GST Exemption for Certain Long-Term Trusts.** Section 9 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."

   a. 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 as 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), thus apparently without any "wait and see" relief.

   b. 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.

   c. Special rules would be provided for portions of trusts treated as separate trusts and for transfers between trusts.

10. **"Simplifying" Gift Tax Exclusion for Annual Gifts.** Section 10 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 characterization of "simplifying."

   a. Like the Greenbooks, the bill would introduce a **per-donor** limit on the annual exclusion, as a further limitation on the $10,000 (indexed for inflation since 1998) **per-donee** exclusion of current law.

   b. 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).

c. Like the Greenbooks, the bill 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.

d. Like the Greenbooks, the bill would leave in place the per-donee annual exclusion (currently $15,000) for outright gifts of cash or marketable securities, for example.

e. The bill 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, but apparently would not include a present-interest requirement at all, although it apparently would still require identification of donees to apply the $15,000 per-donee limit.

f. The bill would not change the unlimited exclusion in section 2503(e) for tuition and medical expenses paid directly to the provider.

g. The bill would not alter the gift-splitting rules in section 2513.

VI. The Other Way to Make Tax Law: Fact-Specific and Judge-Specific

a. The Basics: *Gregory v. Helvering*

In the famous case of *Gregory v. Helvering*, 293 U.S. 465 (1935), Evelyn Gregory wanted to sell stock that was held by a corporation of which she was the sole owner. She sought to reduce the income tax she would pay on withdrawal of that stock from her corporation (basically a dividend) followed by the desired sale. To that end, she created another corporation. Three days later, the first corporation transferred to the new corporation the stock she wanted to sell, for which the new corporation transferred all **its** stock to her. Another three days later, the new corporation dissolved and distributed that stock to her, and she immediately sold it. She claimed that this series of transactions was entitled to favorable tax treatment as what today we would call a "D reorganization," and she cited the then existing predecessor of section 368(a)(1)(D).

It took the Supreme Court barely 300 words to dispatch the taxpayer's argument:

> When subdivision (B) [the predecessor of section 368(a)(1)(D)] speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" … of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose – a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that

> corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.
>
> In these circumstances, **the facts speak for themselves** and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

But on the way to this demolition of the taxpayer's argument, the Court acknowledged that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." And that observation recalled the even more bold and memorable declaration of Judge Learned Hand, whose opinion the Supreme Court unanimously affirmed:

> **Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.**

Helvering v. Gregory 69 F.2d 809 (2d Cir. 1934).

The Lesson. So it's as simple as that! Any taxpayer by planning may choose a path to a substantive result that minimizes taxes. But if the planning does not have any substantive result, does not have any lasting effect on the conduct of a business or other underlying economic activity, such that the court just can't stand it, then the taxpayer's efforts are disregarded. That substantive result, that lasting effect on the conduct of a business or other underlying economic activity, is in modern times sometimes called a "legitimate and significant nontax reason" for engaging in a transaction at all, after the phrase the Tax Court used in *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005) (reviewed by the Court). The planner's job is to look at the facts of any particular transaction or set of transactions and guess which side it falls on. And that is what we turn to now in trying to understand the oft-discussed taxpayer losses in *Powell* and *Cahill*.

b. Snapshot of *Powell* and *Cahill*

1. *Powell* – Bad Facts Make Bad Law

In *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017) (reviewed by the Court), the decedent Nancy Powell and her son Jeffrey were both residents of California. Jeffrey, acting under a power of attorney from Nancy, contributed approximately $10 million in cash and marketable securities to a limited partnership and took back, on Nancy's behalf, a 99 percent limited partner interest. Jeffrey and his brother contributed unsecured promissory notes in exchange for the other 1 percent interest, with Jeffrey's 0.5 percent interest being the only general partner interest and his brother's 0.5 percent interest being another limited partner interest. On the same day, Jeffrey purportedly contributed Nancy's limited partner interest to a charitable lead annuity trust (CLAT), even though his authority to make gifts under his power of attorney was limited to “a class composed of the principal's [Nancy’s] children, any of such children's issue, or any or all to the full extent of the federal annual gift tax exclusion.” Already, Jeffrey on both sides of the transaction, the disproportionate contributions to the partnership, the flimsy contributions by the general partners, and the questionable transfer to the CLAT signaled this as a “bad facts” cases. But then Nancy died seven days later, with Jeffrey as executor. Seven concurring Tax Court judges viewed this as “what is best described as aggressive deathbed tax planning.”

Senior Judge Halpern, writing for only a plurality (eight judges, while nine judges concurred, seven in an opinion and two in the result only) found that section 2036(a)(2) applied to the decedent’s transfer, but for that reason did not address section 2036(a)(1) or 2038.

According to the opinion, the executor did not even contest the application of section 2036 or 2038, other than to point out that the limited partner interest had been given to the CLAT pursuant to the power of attorney and was not held by the decedent at death. Unfortunately for that litigation strategy, even if the transfer to the CLAT had been authorized by the power of attorney and therefore successful in cutting off exposure under section 2036, section 2035(a) then would have brought the value of the property back into the decedent’s gross estate anyway.

Section 2043 and Double Taxation. On his own, Judge Halpern explored a convoluted and seemingly unnecessary analysis of the effect of section 2043, which had not been raised, argued, or briefed by either of the parties. The opinion echoes themes like “recycling” and “pooling” that have been used to evaluate family limited partnerships in other contexts (*see*, *e.g.*, *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121) and offers its own metaphor of doughnuts and doughnut holes to refer, respectively, to retained interests and valuation discounts. While repeatedly using words like “limits” and “limiting” to refer to section 2043, the opinion, in footnote 7, observes that the result could be “a duplicative transfer tax” (translated double taxation) in some cases, although not this one.

2. Intergenerational Split-Dollar Arrangements: *Cahill* and *Morrissette*

Introduction to Intergenerational Split-Dollar Arrangements. Split-dollar life insurance arrangements have been in use a long time and were the subject of Treasury regulations in 2003. T.D. 9092 (Sept. 11, 2003); Reg. §§1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-1(q) & 1.7872-15. Simply put, a split-dollar arrangement is an arrangement by which the cost of life insurance is split between the insured and another party. In a common early use, the payor was the employer of the insured. Then split-dollar arrangements began to be used by individuals or within families for estate planning purposes. A recent variation, the subject of the *Cahill* and *Morrissette* cases, involves the payment of premiums by a member of one generation for insurance on the life or lives of members of a younger generation – intergenerational split-dollar arrangements.

In each of these cases a revocable trust, which of course became irrevocable when the grantor died, made payments toward premiums on life insurance owned by irrevocable trusts created by the same grantor and insuring lives of family members in the next generation. (In this summary, that revocable trust will be called the “**premium-paying trust**” and that irrevocable trust will be called the “**policy-**

owning trust.") In each of these two cases, upon the death of an insured a portion of the death benefit equal to the greater of the total premiums paid or the cash surrender value of the policy immediately before the insured's death would be payable to the premium-paying trust. Herein lies one perceived benefit of intergenerational split-dollar arrangements: because the insureds are members of the next generation, their deaths are actuarially likely to occur long after the grantor's death, and this reimbursement right of the premium-paying (now irrevocable) trust is valued for estate tax purposes at a significant discount reflecting the time-value of money.

Each split-dollar agreement in these two cases provided that it could be terminated during the insured's life by the mutual agreement of the trustees of the premium-paying trust and the policy-owning trust. If one of the split-dollar agreements were terminated during the insured's life, the policy-owning trust could opt to retain the policy. In that case the policy-owning trust would be obligated to pay the premium-paying trust the greater of the total premiums the premium-paying trust had paid on the policy or the policy's current cash surrender value.

In each case, gift tax returns reported the cost of the life insurance protection as gifts to the policy-owning trusts, in accordance with the presumably favorable "economic benefit regime" for the taxation of split-dollar arrangements under the 2003 regulations, Reg. §1.61-22. In each of these cases the Tax Court agreed that the economic benefit regime was appropriate because the policy-owning trusts received no additional economic benefit beyond the current life insurance protection, as explained in *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016). But that still left open the determination of the amount includable in the grantors' gross estates with respect to the arrangements, which in turn requires examination of the basis for inclusion.

Cahill. In the *Cahill* case, the grantor of the trusts was Richard F. Cahill, a resident of California. His son Patrick, a resident of the State of Washington, was the trustee of the premium-paying trust. In September 2010, Patrick, acting on behalf of Richard pursuant to a power of attorney, created the policy-owning trust, with Patrick's cousin and business partner as the trustee. The purpose of this policy-owning trust was to take ownership of three whole life insurance policies, one on Patrick's life and two on the life of Patrick's wife. Patrick and his cousin, as the respective trustees, executed the governing split-dollar agreements with respect to those policies, reserving for the premium-paying trust a portion of each death benefit equal to the greater of the total premiums paid by the premium-paying trust or the cash surrender value of the policy immediately before the insured's death. The total of the premiums for the three policies paid by the premium-paying trust was $10 million, the total death benefit was $79.8 million, and the aggregate cash surrender value at the date of Richard's death in December 2011 (15 months after the split-dollar transactions) was $9,611,624.

A distinction of the *Cahill* case, in contrast to *Morrissette*, is that the premium-paying trust in the *Cahill* case financed its payment of the $10 million in premiums by a $10 million loan obtained from an independent lender by Patrick as trustee and guaranteed by Richard through Patrick's exercise of his power of attorney on Richard's behalf. If any balance on that loan is outstanding at the death of the insured, the split-dollar agreements provide that the premium-paying trust will be entitled to a portion of the death benefits equal to that outstanding balance, if it is greater than the premiums paid or cash surrender value the premium-paying trust would otherwise be entitled to. If the split-dollar agreements were terminated during the insured's life and the policy-owning trust did not opt to retain the policy, it would be required to transfer its interest in the policy to that independent lender, and in that case the premium-paying trust would be entitled to any excess of the cash surrender value over the outstanding loan balance with respect to the policy.

For estate tax purposes upon Richard's death, his executor (Patrick) valued the premium-paying trust's right to recover death benefits as $183,700, reflecting the deferral of that recovery to the deaths of the younger Patrick and his wife. The IRS asserted that the value should be the cash surrender value at the time of Richard's death, $9,611,624.

The executor moved for summary judgment that sections 2036, 2038, and 2703 did not apply in valuing Richard's interests in the split-dollar arrangements and in the premium-paying trust. The Tax Court (Judge Thornton) denied the motion. *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018). Citing *Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005), and *Powell*, the opinion viewed the power of the decedent, through the revocable premium-paying trust, to terminate the split-dollar agreement and recover at least the cash surrender value as "clearly rights … both to designate the persons who would possess or enjoy the transferred property under section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under section 2038(a)(1)."

The court was not impressed with the executor's argument that the premium-paying trust could exercise that power of termination only in conjunction with the policy-owning trust, because sections 2036(a)(2) and 2038(a)(1) explicitly use the phrases "in conjunction with any person" and "in conjunction with any other person." For purposes of the summary judgment motion, the court found many disputed facts regarding whether Patrick stood on both sides of the transaction so as to prevent it from being a "bona fide sale for an adequate and full consideration in money or money's worth" for purposes of sections 2036(a)(2) and 2038(a)(1), including whether it was "a legitimate and significant nontax reason" for the transaction that "in the view of decedent's trustee and attorney-in-fact (Patrick Cahill), decedent would have wanted, had he been able to manage his affairs, to ensure sufficient liquidity <u>decades</u> from now when the insured parties (Patrick Cahill and his spouse) die, so as to smooth the transfer of a business (apparently to be owned by Patrick Cahill) to decedent's grandchildren (Patrick Cahill's children)."

On the subject of adequate and full consideration, Judge Thornton noted that the executor valued the premium-paying trust's right of recovery at less than 2 percent of the cash surrender value ($183,700 compared to $9,611,624), meaning that in the initial transaction the premium-paying trust would admittedly have received value less than 2 percent of what it had paid.

The same reasoning about adequate and full consideration led the court to find that the "at a price less than the fair market value" requirement of section 2703(a)(1) was met. In addition, the policy-owning trust's right to veto any termination of the split-dollar agreement was a "restriction on the right to sell or use such property" that therefore met the requirement of section 2703(a)(2). The court did not consider the exception for a "bona fide business arrangement" under section 2703(b) because the executor and the IRS had not addressed it, although that analysis might have been similar to the court's analysis of the "bona fide sale" exception in sections 2036(a)(2) and 2038(a)(1).

In a stipulated Decision of December 12, 2018, the court approved a settlement of the case by the parties. The Decision states the net outcome of the settlement of all issues, not just the split-dollar issues on which the executor had moved for summary judgment. The executor reportedly accepted the IRS value of $9,611,624, as well as a 20 percent accuracy-related penalty, and that is consistent with the stipulated Decision. And it is not a surprise, in view of skepticism about the transaction that is evident in the court's opinion.

Morrissette. In the *Morrissette* case, Clara Morrissette, a resident of Virginia, was the grantor of the trusts, including a revocable trust that she had established in 1994 with herself as the initial trustee, funded with all her shares in a group of family-owned moving and logistics companies with a history going back to 1943. In August 2006, a court appointed a company employee as the conservator of Clara's estate for a two-month term. Shortly thereafter, Clara's three sons, who were active in the business, became co-trustees of Clara's revocable trust, and the conservator established three irrevocable multigenerational trusts, one for each of Clara's sons and their families. All those trusts, Clara's sons, and other trusts holding interests in the business executed a shareholders agreement providing, among other things, that upon the death of any of the sons the surviving sons and their respective trusts would purchase the stock held by or for the benefit of the deceased son. On October 4, 2006, the three new irrevocable trusts became the policy-owning trusts by purchasing universal life insurance policies on the lives of the two other sons to fund the trusts' purchases under the shareholders agreement. On October 31, 2006, Clara's revocable trust became the premium-paying trust by forming two split-dollar arrangements with each policy-owning trust and contributing a combined $29.9 million to those trusts, which the trusts used to make the lump-sum premium payments on the life insurance policies.

Clara died on September 25, 2009 (almost three years after the split-dollar transactions). Her executors, who were her three sons, reported on the estate tax return a total appraised value of $7,479,000 for the split-dollar receivables.

The IRS asserted that she should have reported the $29.9 million as gifts (rather than the $636,657 of net economic benefit reported as gifts under the economic benefit regime for 2006 through 2009). The executors moved for partial summary judgment that the economic benefit regime applied, which the Tax Court granted pursuant to its 2016 decision.

With regard to the value of the split-dollar receivables included in the gross estate, the executors moved for partial summary judgment that section 2703 did not apply. Three days after the similar summary judgment motion was denied in *Cahill*, the Tax Court (Judge Goeke), citing *Cahill*, denied the motion. *Estate of Morrissette v. Commissioner*, Order, Docket No. 4415-14 (June 21, 2018). The court's order also notes that the IRS had raised sections 2036 and 2038 as alternative arguments.

The *Morrissette* case went to trial in Washington, D.C., in October 2019.

Note (*Levine*): A similar estate tax case including the issue of "the valuation of two split-dollar arrangements," *Estate of Levine v. Commissioner*, Docket No. 13370-13, was tried before Tax Court Judge Holmes in November 2017. Previously, a companion gift tax case had been decided on summary judgment in the taxpayer's favor, following the 2016 *Morrissette* decision that the "economic benefit regime" applied. *Estate of Levine v. Commissioner*, Order, Docket No. 9345-15 (July 13, 2016).

c. **Reflections**

1. **The Application of Section 2036(a)(2) in *Powell***

a. The application of section 2036(a)(2), implying control of an entity and not just benefit from the entity, was unprecedented in a case involving a decedent who held only a limited partner interest. Although *Strangi* had involved similar facts, Mr. Strangi had been a director and 47 percent shareholder of the corporate general partner. Moreover, while the Tax Court did rely on section 2036(a)(2) as an alternative to its section 2036(a)(1) holding in *Strangi*, the Court of Appeals for the Fifth Circuit, in footnote 7 of its affirmance, explicitly stated:

> Because we hold that the transferred assets were properly included in the taxable estate under § 2036(a)(1), we do not reach the Commissioner's alternative contention that Strangi retained the "right … to designate the persons who shall possess or enjoy the property", thus triggering inclusion under § 2036(a)(2).

The Fifth Circuit having probably done all it could, as it was disposed to affirm the Tax Court on other grounds anyway, it wasn't enough for the court in *Powell*. *Powell*, and *Cahill*, were appealable to the Ninth Circuit.

b. As noted above, Judge Halpern, having decided *Powell* on the basis of section 2036(a)(2), did not address section 2036(a)(1) or 2038.

2. **More on "In Conjunction With Any Person"**

a. In *Cahill* and *Morrissette* the "in conjunction with" issue is presented by the ability of the premium-paying trust (essentially the decedent) to terminate the split-dollar agreement "in conjunction with" the policy-owning trust. On that issue, the *Cahill* court summarized the executor's argument as follows:

> The estate contends that (1) because decedent's right to terminate the split-dollar agreements was held in conjunction with the trustee of MB Trust and (2) because it would allegedly never make economic sense for MB Trust to allow termination of the split-dollar agreements, termination was so unlikely that the termination rights had no value as of decedent's date of death.

b. The court rejected that argument, commenting that:

> if the estate were correct, then the words "in conjunction with any person" in section 2036(a)(2), and "in conjunction with any other person" in section 2038(a)(1), would have no force or meaning.

c. As a factual matter, the executor's argument makes sense. As long as the split-dollar agreement is in effect, the policy-owning trust holds the policy at no cost, which is a valuable no-maintenance asset, even though the realization of that value is deferred until the deaths of the insureds. If the policy-owning trust consented to terminate the split-dollar agreement but elected to retain the policy, it could put itself in the same position, but only by paying the premium-paying trust the greater of the total premiums the premium-paying trust had paid on the policy or the policy's current cash surrender value. So why would the policy-owning trust ever consent to termination? This is not at all comparable to, say, the dissolution of a partnership, in which all partners who approve the dissolution receive a current liquidating distribution.

d. That argument would probably prevail if sections 2036(a)(2) and 2038(a)(1) included an exception for a power held in conjunction with a person having a substantial adverse interest in the property, like section 2041(b)(1)(C)(ii) has in the case of a general power of appointment. But they don't, so we are pretty much back to the conclusion of the *Cahill* court that under that argument the words of sections 2036 and 2038 "would have no force or meaning."

e. Perhaps one might just as well respond to the executor's argument by asking why, as an economic matter, these split-dollar arrangements include that termination right at all. But those are not the facts of the cases. And even if there were no termination right, section 2703 would not necessarily be avoided.

3. *Byrum* "Fiduciary Duty" Limitation Distinguished

a. In *United States v. Byrum*, 408 U.S. 125 (1972), the United States Supreme Court ruled that the value of stock the decedent had transferred in trust was not included in his gross estate merely because he retained the right to vote the stock.

b. The Government had argued that by retaining voting control over the corporations whose stock he had transferred, Byrum was in a position to select the corporate directors, which gave him control over the corporation's dividend policy, which in turn gave him the ability, by increasing, decreasing, or stopping dividends, to "regulate the flow of income to the trust" and thereby shift or defer the beneficial enjoyment of trust income between the present beneficiaries and the remaindermen for purposes of section 2036(a)(2). The Government analogized this retained voting power to a grantor-trustee's power to accumulate income in the trust, which it said the Court had treated as a power to designate the persons who shall enjoy the income from transferred property.

c. The Supreme Court rejected the Government's reasoning, noting:

> Whatever power Byrum may have possessed, with respect to the flow of income into the trust, was derived not from an enforceable legal right specified in the trust instrument, but from the fact that he could elect a majority of the directors of the three corporations. The power to elect the directors conferred no legal right to command them to pay or not to pay dividends. A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests. Moreover, the directors also have a fiduciary duty to promote the interests of the corporation. However great Byrum's influence may have been with the corporate directors, their responsibilities were to all stockholders and were enforceable according to legal standards entirely unrelated to the needs of the trust or to Byrum's desires with respect thereto.

d. In the Tax Reform Act of 1976 and Revenue Act of 1978, Congress enacted section 2036(b), overturning the Supreme Court's holding in *Byrum* with respect to the right to vote. Section 2036(b) is explicitly limited to stock of a corporation.

e. In the *Powell* case, citing and relying heavily on the reasoning in *Strangi*, Judge Colvin distinguished the *Byrum* opinion (written, ironically, by Justice Powell) on three grounds:

   i. Besides being the general partner of the partnership, the decedent's son owed duties to her under the power of attorney that predated his creation of the partnership. Judge Halpern wrote that "[n]othing in the circumstances of the present cases suggests that Mr. Powell would have exercised his responsibility as general partner … in ways that would have prejudiced decedent's interests." Moreover, in *Byrum* dividend distributions would have been made only to Byrum's trust, and distribution decisions would still have been left to an independent trustee.

   ii. "Because decedent held a 99% interest in NHP, whatever fiduciary duties limited Mr. Powell's discretion in determining partnership distributions were duties that he owed almost exclusively to decedent herself."

   iii. Unlike the facts of *Byrum*, there was no evidence that the Powell partnership "conducted meaningful business operations or was anything other than an investment vehicle for decedent and her sons."

4. The Effect of *Powell* as a Precedent

a. Seventeen judges participated in *Powell*. Eight judges, counting Judge Halpern, joined Judge Halpern's opinion. Judges Foley and Paris concurred in the result only, while Judge Lauber, joined by six other judges, wrote a concurring opinion. Thus, while there was no dissent from what should have been a very easy decision in a case with extremely bad facts, Judge Halpern's opinion did not even speak for a majority of the judges. Judge

Lauber wrote that "[t]he Court's exploration of section 2043(a) seems to me a solution in search of a problem." Yet, particularly because of the section 2043 detour, we now have a Tax Court opinion, dignified by the caption "Reviewed by the Court," that reaches one of the most understandable outcomes, but by way of one of the least understandable opinions, ever seen.

b. Now, with stretched IRS resources and possibly reduced hope for relevant regulatory guidance, a path to finding control in a totally nonvoting interest and the temptation of a new and open-ended "duplicative transfer tax" theory are just what the audits of gift and estate tax returns need!

5. Waiting for an Outcome in *Morrissette*

a. There may be less cause for anxiety in the case of the intergenerational split-dollar issue.

i. Although there is a lot of talk about intergenerational split-dollar arrangements, they may not be nearly as common as family limited partnerships. For many clients, paying a large cash premium for no immediate return may not as appealing as just signing some documents and hoping for the best.

ii. If *Morrissette* is not resolved by summary judgment, which is unlikely, or by settlement, which seems unlikely but is always possible, the Tax Court's opinion may be more focused and less open-ended than the *Powell* opinions, and thus – good or bad – might provide greater clarity.

iii. In any event, the opinion promises to be a rare exposition of Chapter 14, almost three decades after it took effect on October 9, 1990.

b. The facts in *Morrissette* seem better than the facts in *Cahill*.

i. The decedent lived for almost three years after the transaction in *Morrissette*, rather than only 15 months as in Cahill (although both are better than the seven days in *Powell*).

ii. Although both *Cahill* and *Morrissette*, like *Powell*, involve transactions undertaken by representatives of the decedent on the decedent's behalf, Clara Morrissette's representative was a court-appointed conservator who, unlike Jeffrey Powell, did not serve as a trustee.

iii. The estate tax value of the receivable reported by the executors in *Morrissette* was about 25 percent of the premiums paid, compared to a little less than 2 percent in *Cahill*.

iv. The premium payments were not financed with borrowing in *Morrissette*, as they were in *Cahill*. See the elaboration of this point in paragraph d.7 below.

v. Perhaps most importantly, the context in *Morrissette* of a family-owned business that has been operating for 75 years should be more supportive of "bona fide sale" arguments under sections 2036(a) and 2038(a)(1) and a "bona fide business arrangement" argument under section 2703(b). It might come down to whether, even if the shareholders agreement is a bona fide business arrangement, the choice of an intergenerational split-dollar arrangement to fund it is so integral to the underlying shareholders agreement that such a favorable characterization must apply to that split-dollar arrangement as well.

vi. Some view the Court of Appeals for the Fourth Circuit, to which *Morrissette* would be appealable, as more open to estate planning and tax planning than *Cahill*'s Ninth Circuit.

d. What To Do

1. Have a legitimate and significant nontax reason.

a. Most of the taxpayer victories in section 2036 cases have rested on the exception for "a bona fide sale for an adequate and full consideration in money or money's worth." In *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005), the majority opinion by Judge Goeke (who now has the *Morrissette* case) embraced and applied the principle that (emphasis added):

> In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a **legitimate and significant nontax reason** for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred.

b. *Bongard* was a "reviewed" decision with vigorously expressed concurring and dissenting views. (Notably, Judge Halpern, the author of the plurality *Powell* opinion, dissented from the *Bongard* majority's interpretation of the bona fide sale exception.)

c. The following are examples of legitimate and significance non-tax reasons:

i. "Pooling" assets for efficiency and access to investments.

ii. Keeping special heirloom assets in the family.

iii. Institutionalizing intra-family communication.

iv. Simplifying transfers, including avoiding in-state or out-of-state probate.

v. Avoiding public litigation through alternative dispute resolution.

vi. Discouraging controversy with the "English Rule" (loser pays costs).

vii. Simplifying responses to divorce.

viii. Otherwise increasing asset protection.

ix. Allowing amendment without formalities of trust law.

d. It is good for a client to have such reasons, and the *Bongard* standard can offer a good opportunity to discuss with clients their true values, objectives, and priorities, for which saving tax is just a means, not an end.

e. Be wary of boilerplate that recites a lot of nontax reasons for tax reasons. It will be awkward when the signer of the document testifies that "I never read or talked about that."

f. Even if there is not a significant nontax reason ("maintaining the culture and values of the business for future generations" does not work for everyone), try to be sure that there are lasting substantive nontax changes in relationships or other consequences. If not, like Evelyn Gregory and Jeffrey Powell learned, a court might see through it, because "the facts speak for themselves."

2. Learn what people are doing in the commercial world.

a. The structures and terms of "similar arrangements entered into by persons in an arms' length transaction" can often be helpful in a family business planning or estate planning context too.

b. And incorporating those structures and terms, adapted as necessary, can certainly help with the fact-based and somewhat subjective test of section 2703(b)(3), as well as the "bona fide sale" tests of section 2036(a) and 2038(a)(1).

3. Avoid having the decedent's actions taken by an agent.

a. The incapacity of a parent (or other donor or actor) cannot be avoided or even predicted, and sometimes a parent's incapacity, illness, or decline can be a necessary catalyst for estate planning. But there can be more of an obvious genuineness about the claim, as in *Cahill*, that "this future business-succession plan is what Dad would have wanted" if Dad actually participated.

b. But if the parent's only contribution to the transaction was "All I want to do is to eliminate taxes," that would not add very much.

c. Acting while the parent is competent and engaged may reduce the likelihood, although it can never eliminate the possibility, of the parent's imminent death, or even death within three years, thereby potentially taking some issues off the table.

4. If action by an agent is unavoidable, don't make the agent the general partner.

a. It was Jeffrey Powell's dual role as his mother's agent under the power of attorney and general partner of the partnership that made it possible for Judge Halpern to complain that he "was essentially negotiating with himself," just as the *Strangi* court had observed that "decedent essentially stood on both sides of the transaction."

b. Of course when there is one really trusted and capable family member or other person in the picture, it's very easy to understand why that person would be the go-to selection for many or all positions of trust – attorney-in-fact, conservator, health care proxy, personal representative, trustee, general partner, etc. It might be hard to ask someone to be satisfied with a second choice. But case law shows how the appearance of multiple roles can be troublesome.

5. **If possible, eliminate the older-generation partner's ability to vote on dissolution.**

   a. This might be as simple as eliminating the rule under default state law that limited partners must approve a nonjudicial dissolution. That apparently would have removed the section 2036(a)(2) issue in *Powell*.

   b. The concern would remain that the ability of all partners of all classes to unanimously change any rules in the partnership agreement could have the same effect under section 2036(a)(2). But at least there would be the comfort of a true factual difference with *Powell* and an attenuated scenario courts do not seem to have latched onto yet.

   c. Persuading an able-bodied, clear-minded individual to give up all control can be a hard sell. But control must be relinquished sooner or later anyway, certainly by death. In some cases, maybe it is good to let the younger generation take full charge so the parent can see how it works out and possibility while the parent is still able to have a persuasive effect even without any legal standing or prearrangement.

6. **Fund the entity.**

   a. Judge Lauber, concurring only in the result in *Powell*, noted:

      > There are compelling reasons to question whether a valid partnership was ever formed here. In comparison with the $10 million in cash and securities that the decedent relinquished for her alleged partnership interest, the other two supposed partners – her sons and heirs – contributed nothing more than unsecured promissory notes.

   b. That impression could have been avoided with more robust contributions from the sons.

   c. Alternatively, the decedent could have secured the effect of robust funding by more than one partner by simply making gifts of partnership interests. That could be riskier in some circumstances. But there is nothing magical about 1 percent, and a larger percentage of interests in the hands of other partners might make the transaction less offensive to a court. It would be harder to say, as Judge Colvin did in *Powell*, that "whatever fiduciary duties limited Mr. Powell's discretion in determining partnership distributions were duties that he owed almost exclusively to decedent herself." And to the extent of any lifetime gifts of partnership interests, the partnership would no longer be so conspicuously a mere testamentary vehicle.

7. **If possible, avoid borrowing altogether.**

   a. In *Cahill*, Judge Thornton was really not impressed with the economics of the transaction. He asked:

(1) Were these arrangements actually intended to provide liquidity decades from now, or were they intended merely to eliminate the cash surrender value from decedent's estate? (2) The guaranteed return (3%) on the investment in the policies appears to be lower than the interest rate on the loan decedent used to purchase the policies (one month LIBOR plus 1.14%); taking into account all of the economic facts and circumstances, would this arrangement actually be capable of providing liquidity decades from now? How much liquidity, in present valued terms (i.e. valued to the date of execution)? At what cost, in present valued terms? And (3) why was an arrangement intended to provide liquidity potentially decades from now funded with a loan that required a balloon payment of the entire principal amount after only five years? That is, if decedent was acting as a prudent business person, why did he fund a long-term obligation with a short-term loan? Because such questions remain, summary judgment is inappropriate with respect to whether decedent's transfer of $10 million was part of a bona fide sale.

b. Many of these questions would have been eliminated or diminished if there had been no borrowing.

8. If possible, divest all interests in the entity during life.

a. Appropriate discounts might be easier to sustain in a gift tax context, and there would be nothing left at death for section 2036, for example, to apply to.

b. And, although there can never be a guarantee against mortality of course, it is preferable, as the Powell family learned, to do this at least three years before death if a gift tax is paid (section 2035(b)) or if section 2036, 2037, 2038, or 2042 might apply (section 2035(a)).

c. Even if all interests cannot be divested, transferring some of the decedent's interests could mitigate the bad impression of owing fiduciary duties solely to oneself, discussed in paragraph 6.c above.

9. Make all partners irrevocable trusts with independent trustees.

a. In that way, even if the decedent directly or indirectly, alone or in conjunction with others, could control distributions from the entity, that would still not "designate the persons who shall [beneficially] possess or enjoy the property or the income therefrom" as section 2036(a)(2) requires. The trustee does that, through the exercise of discretion over distributions. That was the case in *Byrum*.

b. The argument might still be made that the decedent, "in conjunction with" other partners and the trustee, could control all the steps to the ultimate distributions. But such an aggregation of independent parties whose authority does not overlap at all would be more aggressive than courts and even the IRS are known to have been, and would be expected to be a harder notion to sell to a court than the type of "conjunction" present in *Powell* and *Cahill*.

10. **Accept estate inclusion under section 2036 or 2038 and, in an environment of a high estate tax exclusion amount, take a stepped-up basis.**

    a. This would, in a sense, give the IRS what it deserves for aggressively applying sections 2036 and 2038, right?

    b. But there can be gamesmanship, even hypocrisy, and in any event risk, with such a strategy.

VII. Valuation, Including Tax-Affecting: *Jones*

In May 2009, Aaron Jones made gifts to his three daughters, and to trusts for their benefit, of voting and nonvoting interests in a lumber and timber business he had founded in 1954. He reported the gifts on his gift tax return with a total value of about $21 million, but the IRS notice of deficiency asserted a value of about $120 million and a gift tax deficiency of about $45 million. The Tax Court agreed with the taxpayer's appraiser that the value was about $24 million, and the resulting gift tax owed will apparently be less than $2 million.

The most significant issue to the taxpayer from a monetary standpoint is that the timber is valued under the income method rather than the net asset value method in this situation where there is an ongoing business operation and the facts are clear that the timber will not be liquidated and the transferee would have no ability to force the liquidation. But perhaps the most interesting issue for estate planners and especially the appraisal community is that the Tax Court concluded that "tax-affecting" the earnings of the S corporation and limited partnership was appropriate in determining the valuations of the entities under the income method. The Tax Court has been reluctant to accept tax-affecting following its decision twenty years ago in *Gross v. Commissioner*. That may be changing. *Estate of Jones v. Commissioner,* T.C. Memo. 2019-101 (August 19, 2019, Judge Pugh).

1. Basic Facts

a. Background. The core business involved in the 2009 gifts was Seneca Sawmill Co. (SSC) of Eugene, Oregon. Mr. Jones founded SSC in 1954 as a lumber manufacturing business; in 1986 it elected to be an S corporation. The Tax Court opinion describes the significant growth of the business since 1954 and includes considerable detail about the operation and business environment of the lumber business. At the time of the gifts in 2009, SJTC (introduced and described in the next paragraph) held approximately 1.45 billion board feet of timber over 165,000 acres in western Oregon.

Originally relying on timber from federal lands, SSC began purchasing its own land in 1989 when environmental regulations had reduced the access to federal lands. In 1992 Mr. Jones formed Seneca Jones Timber Co. (SJTC), an Oregon limited partnership, to hold timberlands intended to be SSC's inventory and to obtain debt financing secured by the timberlands. SSC was the 10 percent general partner of SJTC and contributed to SJTC the timberland it had recently acquired. SSC and SJTC share a management team and share their headquarters in Eugene, which was built in 1996.

SSC's shareholders could not sell, give away, or otherwise transfer their SSC stock, except in compliance with a Buy-Sell Agreement. Any sale of SSC stock that caused SSC to cease to be an S corporation would be null and void under the Buy-Sell Agreement, unless SSC and the holders of a majority of its outstanding shares consented. If an SSC shareholder intended to sell, give away, or otherwise transfer SSC stock to a person other than a family member, the shareholder had to notify SSC, which had a right of first refusal to purchase those shares. If SSC declined to purchase the shares, the other shareholders were given the option to purchase them. If either SSC or other shareholders exercised their option to purchase shares, the purchase price was the fair market value of the shares, which was to be mutually agreed upon or, if the parties could not agree, determined by an appraisal. Under the Buy-Sell Agreement, the reasonably anticipated cash distributions allocable to the shares had to be considered and discounts for lack of marketability, lack of control, and lack of voting rights had to be applied in determining the fair market value.

Under SJTC's partnership agreement, no transfer of SJTC partnership units was valid if it would terminate the partnership for federal or state tax purposes. The consent of all partners was required for the substitution of a transferee of SJTC partnership units as a limited partner. A transferee who was not substituted as a limited partner would be merely an assignee. Limited partners were also subject to a Buy-Sell Agreement, which mirrored SSC's Buy-Sell Agreement: Any transfers that would terminate SJTC's partnership status for tax purposes were void; SJTC and then the other limited partners were granted a right of first refusal before a limited partner could transfer units; and a determination of fair market value had to take into account lack of marketability, lack of control, lack of voting rights of an assignee, and the reasonably anticipated cash distributions allocable to the units.

b. The 2009 Gifts. On May 28, 2009, pursuant to succession planning that began in 1996, Mr. Jones formed seven family trusts, made gifts to those trusts of SSC voting and nonvoting stock, and made gifts to his three daughters of SJTC limited partner interests.

The following tables show the ownership of SSC and SJTC before and after the gifts:

Ownership of SSC Before and After the 2009 Gifts				
Shareholder	Voting Shares		Nonvoting Shares	
	Before	After	Before	After
Aaron Jones	4,900	3,600	39,468	8,700
Voting Trust		1,300		
Family Trust	600	600		
Rebecca Jones*	1,500	1,500	544	10,800
Kathleen Jones Hall*	1,500	1,500	544	10,800
Jody Jones*	1,500	1,500	544	10,800
* Aaron Jones's three daughters. Numbers for the nonvoting shares for each daughter include trusts for her and her family. After the gifts, Aaron and his daughters (or trusts for them and their families) each owned 12,300 total shares (voting and nonvoting).				

Ownership of SJTC Before and After the 2009 Gifts				
Partner	General Partner Units		Limited Partner Units	
	Before	After	Before	After
SSC	5,550.092	5,550.092		
Aaron Jones			43,290.717	12,487.707
Rebecca Jones			2,220.037	12,487.707
Kathleen Jones Hall			2,220.037	12,487.707
Jody Jones			2,220.037	12,487.707

c. Gift Tax Valuation Dispute. Mr. Jones timely filed a 2009 gift tax return, reporting values based on accompanying appraisals that had determined values of $325 per share of SSC voting stock, $315 per share of SSC nonvoting stock, and $350 per SJTC limited partner unit, resulting in total gifts of about $20,895,000.

The IRS's notice of deficiency asserted that the corresponding values should have been $1,395 per share of SSC voting stock, $1,325 per share of SSC nonvoting stock, and $2,511 per SJTC limited partner unit, resulting in total gifts of about $119,987,000 and a gift tax deficiency (including other much smaller items which were not disputed in the Tax Court) of $44,986,416.

Mr. Jones filed a petition in the Tax Court in November 2013. He died on September 14, 2014, and was replaced in the Tax Court proceeding by his estate and his personal representatives. The estate engaged another appraiser, Robert Reilly of Willamette Management Associates, whose appraisal, employing a discounted cashflow (DCF) method, determined values of $390 per share of SSC voting stock, $380 per share of SSC nonvoting stock, and also $380 per SJTC limited partner unit, somewhat higher than the values reported on Mr. Jones's gift tax return but far smaller than the values asserted by the IRS.

An appraiser engaged by the IRS, using a net asset value (NAV) approach, determined the value of an SJTC limited partner unit to be $2,530, slightly higher than the notice of deficiency. (The court explained that "Respondent did not submit a valuation of SSC and largely accepted the valuation methods and inputs Mr. Reilly used in his valuation of SSC.")

The following table summarizes those per-share and per-unit values:

	Gift Tax Return	Notice of Deficiency	Estate's Expert	IRS's Expert	Tax Court
SSC Voting	$325	$1,395	$390		$390
SSC Nonvoting	$315	$1,325	$380		$380
SJTC Limited	$350	$2,511	$380	$2,530	$380

2. The Tax Court Opinion

A four-day trial was held in Portland, Oregon, in November 2017, and Judge Pugh's opinion in *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101, was issued August 19, 2019, accepting all the values determined by Mr. Reilly.

In the court's view:

> The primary dispute between the parties is whether SJTC should be valued using an income approach or an asset-based approach. The parties have several other points of dispute: (1) the reliability of the 2009 revised projections, (2) the propriety of "tax-affecting", (3) the proper treatment of intercompany loans from SSC to SJTC, (4) the proper treatment of SSC's 10% general partner interest in SJTC, and (5) the appropriate discount for lack of marketability.

a. Income or Asset-Based Approach for SJTC. Whether an income or asset-based approach is used for valuing the timberland in SJTC makes an enormous dollar difference in this case. The court noted that the parties did not dispute that SJTC is a going concern, but also noted that "SJTC has aspects of both an operating company ("SJTC … plants trees and harvests and sells the logs") and an investment or holding company ("SJTC's timberlands are its primary asset, and they will retain and increase in value, even if SJTC is not profitable on a year-to-year basis")." The court stated:

> [T]he less likely SJTC is to sell its timberlands, the less weight we should assign to an asset-based approach. See Estate of Giustina v. Commissioner, 586 F. App'x 417, 418 (9th Cir. 2014) (holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record), rev'g and remanding T.C. Memo. 2011-141.

The court concluded that:

> SJTC and SSC were so closely aligned and interdependent that, in valuing SJTC, it is appropriate to take into account its relationship with SSC and vice versa …
>
> We, therefore, conclude that an income-based approach, like Mr. Reilly's DCF method, is more appropriate for SJTC than [the IRS's expert's] NAV method valuation. See Estate of Giustina v. Commissioner, 586 F. App'x at 418.

b. Reliability of 2009 Revised Projections. Mr. Reilly's valuation relied on revised projections that SJTC's management made less than two months after SJTC's annual report, out of concern that SJTC might violate its loan covenants. The revised projections were made in April 2009, and the gifts were made in May 2009. The IRS and its expert thought the revised projections "may have represented the worst-case scenario and were overly pessimistic."

The court acknowledged the ground for such alleged pessimism in its description of the background and history of the business, where it noted:

> As of the valuation date SSC's dimension and stud lumber were used primarily to build houses and, therefore, its lumber sales were almost completely dependent on housing starts.
>
> …
>
> As of the valuation date the United States was experiencing severe economic turmoil amidst the subprime mortgage crisis, especially in the housing market. Housing starts, which measure new residential construction projects during a given period, declined in the United States from 2.3 million units in early 2006 to 490,000

units in early 2009. The crisis required SSC to reduce production. It also reduced the hours that its employees worked so that it could avoid layoffs.

Regarding the IRS's objection to the 2009 revised projections, the court turned the objection around and concluded:

> The only ground for challenging the reliability of the revised projections is that the volatile economic conditions meant that they were not reliable for long. This is precisely why management wanted the revised projections. As they were the most current as of the valuation date, Mr. Reilly's use was appropriate.

c. "Tax-Affecting." Mr. Reilly "tax-affected" the earnings of SJTC and SSC by using a proxy for the combined federal and state income tax rates they would bear if they were C corporations, albeit taxed at individual, not corporate rates, in order to adjust for the differences between passthrough entities and C corporations (like the public companies used for comparison in the valuation process). The IRS objected to tax-affecting, arguing that there was no evidence that SJTC or SSC would lose its passthrough status and insisting that the Tax Court had rejected tax-affecting in cases such as *Gross v. Commissioner*, T.C. Memo. 1999-254, *aff'd*, 272 F.3d 333 (6th Cir. 2001), *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148 (corrected, T.C. Memo. 2011-244), and *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141.

But the court explained that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax-affecting the earnings of a flowthrough entity per se. Instead, Judge Pugh viewed the issue as fact-based, and noted that the court in those cases had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases. In *Jones*, on the contrary, Judge Pugh concluded that Mr. Reilly's detailed tax-affecting analysis was appropriate:

> We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flowthrough status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy. … Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate.

As stated, *Jones* involves tax-affecting for both an S corporation (SSC) and a partnership (SJTC). The court's **discussion** of tax-affecting is addressed to the partnership, SJTC, which comes first in its opinion, probably so that the court could address first what it regarded as the "primary dispute" over the use of an income approach to value SJTC. But it should not be overlooked – and, it is hoped, won't be overlooked by the IRS and the judges in future valuation cases – that in the discussion specifically targeting SSC the court stated, without qualification:

> Mr. Reilly used the same methodology to tax-affect his valuation of SSC except that he used a different rate for the dividend tax avoided because his analysis of the implied benefit for SSC's shareholders in prior years yielded a different rate. We accept Mr. Reilly's method of tax-affecting the valuation of SSC for the same reasons we accepted it for the valuation of SJTC.

d. Intercompany Loans. The IRS had argued that the intercompany debt (owed by SJTC to SSC) should be treated as a nonoperating investment asset and added to the value of SSC. Again emphasizing the interrelationship of the two companies, the court concluded:

> By eliminating SSC's receivable and SJTC's payable and treating their intercompany interest income and expense as operating income and expense, Mr. Reilly captured their relationship as interdependent parts of a single business enterprise. Because SJTC's intercompany interest income and expense were accounted for in the DCF method valuation, the intercompany debt need not be added in at the end as a nonoperating asset. See Estate of Heck v. Commissioner, T.C. Memo. 2002-34.

e. SSC's General Partner Interest in SJTC. The IRS had argued that SSC's 10 percent general partner interest in SJTC should be valued as a nonoperating asset and a **controlling** interest by valuing it at simply 10 percent of the value of SJTC, rather than on the basis of expected distributions as in Mr. Reilly's DCF valuation. Consistently with its view of SSC and SJTC as a single business enterprise, the court rejected that argument.

f. Discount for Lack of Marketability. The court noted that only 5 percent separated Mr. Reilly (35 percent) and the IRS's expert (30 percent) on the subject of lack-of-marketability discounts. The court adds that "Respondent contends that Mr. Reilly's 35% discount for lack of marketability was excessive and that he did not explain sufficiently how he arrived at the discount." There is no further elaboration of how the IRS found 35 percent to be excessive or how it defended its own expert's conclusion of 30 percent.

To the allegation that Mr. Reilly had not sufficiently explained how he arrived at a 35 percent discount, the court replied "We disagree" and provided a whole paragraph summarizing what Mr. Reilly had done (quoted in paragraph 4.e below). It then pointed out:

> [The IRS's expert] did not consider the restrictions on transferability in the SJTC Buy-Sell Agreement, and he conceded at trial that it would likely increase the discount by "something like 1%, 2%". Because [the IRS's expert] was guessing at changes to his discount during the trial to account for considerations that he left out, we conclude that the proper discount for lack of marketability was 35%.

g. Conclusion. The court concluded simply that "we therefore adopt the valuations in Mr. Reilly's report." A taxpayer victory, a decade after the gifts.

3. Analysis

a. Income or Asset-Based Approach. The differences between an income approach and asset-based approach can be huge, particularly in a case involving standing timber that obviously is not harvested every year. In *Jones*, Mr. Reilly agreed with a valuation submitted by the IRS that SJTC's timberland had an estimated market value of $424 million. Yet, using an income approach and comparisons to guideline operating companies, Mr. Reilly calculated the weighted enterprise value of SJTC to be $107 million – barely one-fourth the asset value.

This is not first time the Tax Court has chosen between an income and asset-based approach to the valuation of a Eugene, Oregon, timber business. *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141, also presented that issue, and the counsel for the estate, the counsel for the IRS, and the estate's expert were all the same as in the *Jones* case. Rejecting Mr. Reilly's view in *Giustina*, the Tax Court (Judge Morrison) gave a 25 percent weight to a $151 million value determined by an asset approach, compared to a value of $52 million determined by a cashflow method and given a 75 percent weight. As Judge Pugh's reference to *Giustina* (quoted in paragraph 2.a above) acknowledges, that decision was reversed (586 Fed. Appx. 417 (2014)) by the Court of Appeals for the Ninth Circuit's "holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record." In fact, quoting from a previous opinion, the Ninth Circuit stated in *Giustina*:

> As in *Estate of Simplot v. Commissioner*, 249 F.3d 1191, 1195 (9th Cir. 2001), the Tax Court engaged in "imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect" with the existing partners.

On remand in *Giustina*, Judge Morrison went along with the Ninth Circuit, T.C. Memo. 2019-114.

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*.

b. The 2009 Revised Projections. Neither is this the first time a court has been influenced in a gift tax valuation case by the gravity of the 2008 economic downturn. For example, judicial notice of that recession was a factor in *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. March 26, 2019) (discussed in paragraph c.vi below), which was also a taxpayer victory that involved tax-affecting and the credibility and thoroughness of the taxpayer's valuation expert.

c. Tax-Affecting. "Tax-affecting" refers to the step in the valuation of a closely-held business that seeks to adjust for certain differences between passthrough entities and C corporations. Typically, the passthrough entity in mind is an S corporation, but tax-affecting can be applied in the partnership context too. Significantly, *Jones* involved tax-affecting for both an S corporation (SSC) and a partnership (SJTC).

i. Core Justifications. While many discussions of tax-affecting are quite technical, the core justifications for tax-affecting are generally (1) that a hypothetical willing buyer in the willing-buyer-willing-seller construct of fair market value is looking for a return on the investment and necessarily will enjoy and therefore evaluate that return only on an **after-tax** basis and (2) that comparable data to use in the valuation process typically comes from public sources and therefore largely comes from C corporations, for which earnings are, again, necessarily determined on an **after-tax** basis. Corollaries to those justifications are that passthrough status (3) confers a benefit of a single level of tax compared to a C corporation, but also (4) limits the universe of potential buyers and investors, who might not be able to buy or invest without forfeiting or jeopardizing (or at least complicating) the S corporation status or other passthrough status. Thus, tax-affecting sometimes includes adjustments to accommodate those corollaries, or sometimes is followed by the application of, for example, an "S corporation premium" as the next step following the tax-affecting.

ii. 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.

iii. G*ross v. Commissioner*. While tax-affecting was not a new concept 20 years ago, it may have been overtly and directly raised and considered in a gift tax case for the first time in *Gross v. Commissioner*, T.C. Memo. 1999-254. In *Gross* the taxpayer's appraiser tax-affected the value of stock of an S corporation, by using an assumed undiscounted corporate income tax rate of 40 percent. Judge Halpern viewed that as "a fictitious tax burden, equal to an assumed corporate tax rate of 40 percent." He tied the idea of tax-affecting for an S corporation to the "probability" that the corporation would lose its S status and concluded that "[w]e do not … think it is reasonable to tax affect an S corporation's projected earnings with an undiscounted corporate tax rate without facts or circumstances sufficient to establish the likelihood that the election would be lost." He acknowledged that the taxpayer's appraiser had discussed the disadvantage of S corporations in raising capital, due to the restrictions of ownership necessary to qualify for the S election, but concluded:

> This concern is more appropriately addressed in determining an appropriate cost of capital. In any event, it is not a justification for tax affecting an S corporation's projected earnings under a discounted cash-flow approach. [The taxpayer's appraiser] has failed to put forward any cognizable argument justifying the merits of tax affecting [the corporation's] projected earnings under a discounted cash-flow approach.

He also pointed out, although not in such words, that tax-affecting was counter-intuitive, noting (emphasis added) that "[w]e believe that the principal **benefit** that shareholders **expect** from an S corporation election is a **reduction** in the total tax burden imposed on the enterprise."

Regarding the IRS internal guide and handbook (quoted in paragraph ii above), Judge Halpern stated:

> Both statements lack analytical support, and we refuse to interpret them as establishing respondent's advocacy of tax-affecting as a necessary adjustment to be made in applying the discounted cash-flow analysis to establish the value of an S corporation.

In a confusing set of opinions, in which the lead opinion was not "the holding of the court," the Court of Appeals for the Sixth Circuit affirmed. The judge who wrote the lead opinion stated:

> I must recognize that we are merely determining those factors that hypothetical parties to a sale of [the corporation's] stock would have considered as of the gift date. In this regard, I believe that past practices, which the IRS had not deemed to create a deficiency, are demonstrative of the idea that such hypothetical actors would have considered tax affecting [the corporation's] stock. This fact in conjunction with the testimony of the experts informs my conclusion that the court's decision to use a 0% tax affect in deriving the value of [the corporation's] stock was implausible.

A judge who wrote an opinion "concurring in part, dissenting in part," but joined by another judge, viewed the issue essentially as an issue of fact, stating:

> Valuing closely held stock incorporates a number of alternative methods of valuation, and the appellate courts have afforded the tax court broad discretion in determining what method of valuation most fairly represents the fair market value of the stock in light of the facts presented at trial. See *Palmer v. Comm'r of Internal Rev.*, 523 F.2d 1308 (8th Cir. 1975). Moreover, "complex factual inquiries such as valuation require the trial judge to evaluate a number of facts: whether an expert appraiser's experience and testimony entitle his opinion to more or less weight; whether an alleged comparable sale fairly approximates the subject property's market value; and the overall cogency of each expert's analysis." *Ebben v. Comm'r of Internal Rev.*, 783 F.2d 906, 909 (9th Cir. 1986).
>
> …
>
> Valuation is a fact specific task exercise; tax affecting is but one tool in accomplishing that task. The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction. The Tax Court did that and determined that tax affecting was not appropriate in this case. I do not find its conclusions clearly erroneous.

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

v. Further Tax Court Litigation. 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, 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.

In *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141, *rev'd on other grounds*, 586 Fed. Appx. 417 (9th Cir. 2014), *on remand*, T.C. Memo. 2019-114, Mr. Reilly had 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. With very little discussion, but citing *Gross*, the Tax Court disallowed that adjustment. The Court of Appeals for the Ninth Circuit agreed with the Tax Court, stating that "[t]he Estate itself admits in its brief that 'tax-affecting is ... an unsettled matter of law.' We therefore cannot say that the Tax Court clearly erred.…

vi. *Kress v. United States.* Then, earlier in 2019, *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. March 26, 2019), addressed tax-affecting in determining the gift tax value of stock in a family owned and operated S corporation, Green Bay Packaging, Inc. (referred to in the court's opinion as "GBP"). GBP is a vertically integrated manufacturer of corrugated packaging, folding cartons, coated labels, and related products, founded in 1933 and headquartered in Green Bay, Wisconsin. Gifts of stock to younger family members in 2007, 2008, and 2009 resulted in gift tax deficiencies assessed by the IRS. The donors paid those gift tax deficiencies and then filed claims for refund and ultimately sued for refunds in the federal district court in Milwaukee. Both the taxpayers' expert (John Emory of Emory and Co. in Milwaukee, who had been preparing valuation reports for GBP since 1999) and the Government's expert (Francis Burns of Global Economics Group in Chicago) had tax-affected GBP's earnings to apply a C corporation level tax to compare the S corporation being valued to C corporations that were used as comparables. For example, the court noted that "[u]nder the income approach, Burns … applied an effective tax rate to GBP as if it were a C-corporation and then applied an adjustment to reflect the value of GBP as an S-corporation." Overall, the court found that "Emory provided reliable valuations of the GBP minority-owned shares of stock" and accepted most of Mr. Emory's conclusions, including his conclusions regarding tax-affecting.

vii. *Jones,* Looking to Experts. Then, in *Jones*, back in the Tax Court with attorneys from the IRS rather than the Justice Department, Judge Pugh appeared to agree that tax-affecting had inappropriately become more an issue with examiners and lawyers than a factual inquiry informed by experts and that the experts needed to be listened to. She said:

> While respondent objects vociferously in his brief to petitioner's tax-affecting, his experts are notably silent. The only mention comes in [the IRS's expert's] rebuttal report, in which he argues that Mr. Reilly's tax-affecting was improper, not because SJTC pays no entity level tax, but because SJTC is a natural resources holding company and therefore its "rate of return is closer to the property rates of return". They do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers.

Rejecting that approach (as discussed in paragraph 2.c above), Judge Pugh viewed the issue as fact-based and distinguished the previous cases on their facts (which, among other things, explains why an opinion in a case the appraisal community and other observers view as so important is only a "T.C. Memo." opinion).

viii. 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*.

ix. *Cecil v. Commissioner*. On February 24-26, 2016, the Tax Court tried a case that includes tax-affecting for valuing S corporation stock as one of its issues. *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. As of February 28, 2020, four years later, there was still no decision, and the only entries on the Tax Court's dockets since the filing of briefs in May and July 2016 were 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*, discussed in paragraph vi above), and August 20, 2019 (undoubtedly *Jones*), with IRS answers three days later in each case. In *Cecil*, as in *Kress*, both the taxpayer **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 may have a hard time rejecting tax-affecting as a matter of law in *Cecil* when both experts agree in its application, but it still depends both on the facts and on the presentation of the facts, as illustrated in *Jones*.

4. Reflections

a. The Importance of the Appraiser. The outcome in *Jones* is additional confirmation of the importance of thorough and credible appraisals in Tax Court litigation. Willamette Management Associates had its beginning in Portland, Oregon, and Judge Pugh said of Robert Reilly (whom she called "Richard Reilly") that he "has performed approximately 100 business valuations of sawmills and timber product companies." In rather stark contrast, she said of the IRS's valuation expert only that he "has performed several privately held business valuations." As seen in the foregoing discussion, she found Mr. Reilly's work to be thorough and credible and adopted his judgment, for example, regarding his reliance on the rather atypical "revised projections" and his analysis of tax-affecting that brought her to conclude that "Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate."

But Mr. Reilly, the appraiser whose opinion and work impressed Judge Pugh, apparently had not been engaged before the gift tax return was filed, but was engaged, like counsel was engaged, for the litigation. Nothing gets attention like a $45 million notice of deficiency! It may even have given Mr. Reilly greater credibility that his valuation report actually came in a bit **higher** than the values on the gift tax return. But the Jones family may have been lucky that the new appraiser's higher value was not any more higher, as it could have been awkward to disavow it.

b. Good Facts. There were some "good" facts in *Jones* that should not be overlooked in evaluating its precedential application.

- There was of course a legitimate 55-year-old family-owned operating business.

- There is no indication that Mr. Jones' actions were taken for him under a power of attorney or any other agency arrangement.
- Mr. Jones' gifts resulted in making his daughters and himself equal owners of the economic interests in both SSC and SJTC. There was no division like 99-1 to attract scrutiny.
- These were not "deathbed" gifts. Mr. Jones survived the gifts by more than five years. When a deathbed scenario is encountered, it is not possible to go back. But the point remains that often the best estate planning is the earliest estate planning. The counterpoint is that decisions irrevocably made can later become a source of regret and friction, and the desirability of flexibility should not be overlooked.
- Mr. Jones actually paid some gift tax with his return. The opinion tells us that in 1996 the Jones family built a new headquarters and began succession planning. The succession process was evidently deliberate and not hasty (and, as noted, not a "deathbed" scurry). Mr. Jones may have been advised to choose 2009 when business was down and a willing buyer would have paid less for the business, and there is nothing wrong with that. In 2010 the gift tax rate was scheduled to drop from 45 percent to 35 percent (with the exemption remaining $1 million), but there was uncertainty, especially after the 2008 election, about what the law in 2010 would be. Overall, Mr. Jones seems to have been very well served by his advisors.

c. Detailed Appraisal Approach Regarding Tax-Affecting. Valuation experts have been critical of the refusal to allow any adjustment to reflect that an S corporation's income is subject to shareholder-level taxes, and many appraisers have been tax-affecting the earnings of S corporations despite the Tax Court's reluctance to accept tax-affecting. If the appraiser tax-affects earnings to be consistent with data available for the capitalization rate used in the capitalization of earnings method or the discount rate used in the discounted cash flow method, the appraisal should address in detail the reasons for doing so. Otherwise, the court will ask why the appraiser has adjusted for entity-level taxes when the entity pays no taxes. In addition, the report should take into consideration and balance any benefits that are associated with flow-through status.

The estate's appraisal in *Jones* provides an excellent example of such a detailed approach that considered both the burden on net cashflow by the anticipated individual income taxes on the business income as well as the benefits of passthrough treatment. Mr. Reilly tax-affected the earnings of the partnership to reflect a 38 percent combined federal and state income tax that the owners would bear to calculate the net cashflow from the partnership as well as the cost of debt capital that was used to determine an appropriate post-tax discount rate. He also took into consideration the benefit of avoiding a dividend tax, including "by estimating the implied benefit for SJTC's partners in prior years and considering an empirical study analyzing S corporation acquisitions" and applying a 22 percent premium to the business enterprise value (that was determined both by a weighted discounted cashflow method and by a guideline publicly traded companies method) to reflect the benefit of avoiding the dividend tax.

The court does not give a detailed description of the analysis used in tax-affecting the S corporation earnings, but said that Mr. Reilly used the same methodology except that "he used a different rate for the dividend tax avoided because his analysis of the implied benefit for SSC's shareholders in prior years yielded a different rate."

d. Detailed Appraisal Approach Regarding Lack of Marketability Discount. The *Jones* opinion also provides an excellent example of a detailed analysis of how an appraiser might arrive at an appropriate marketability discount:

> Mr. Reilly attached an appendix to his report in which he explained the reasoning behind the discount for lack of marketability. In doing so, he explained in detail the common empirical models--studies on the sales of restricted stock and on private, pre-IPO sales of stock--and the two theoretical models--the option pricing model and the DCF model--summarizing the methodology and results of individual studies. He then discussed the effect that restrictions on transferability have on a discount, as well as the other factors listed in Mandelbaum v. Commissioner, T.C. Memo. 1995-255, aff'd, 91 F.3d 124 (3d Cir. 1996). Mr. Reilly arrived at a 35% discount on the basis of the studies he previously discussed and on SJTC's unique characteristics, such as its Buy-Sell Agreement, its lack of historical transfers, a potentially indefinite holding period, its reported loss in the 12 months before to [*sic*] the valuation date, and the unpredictability of partner distributions.

e. Section 2703. The sometimes apparently random invocation of section 2703 is illustrated by a comparison of *Jones* with the District Court case of *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. March 26, 2019) (discussed in paragraph 3.c.vi above).

i. Interesting Dicta in *Kress*. 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.)

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) **had been met**. 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."

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!

ii. Nothing in *Jones*. In *Jones*, although there were comparable and relevant restrictions on transfer of family interests in the SSC and SJTC Buy-Sell Agreements (described in paragraph 1.a above), the IRS evidently did not raise the issue of section 2703. (The *Jones* petition was filed in late 2013 and the IRS's answer was filed in early 2014, before the IRS successfully invoked section 2703, at least for purposes of summary judgment, in *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018), discussed in Part VI.b.2 beginning on page 65).

VIII. Effect of Anticipated Merger on Value of Stock, CCA 201939002.

a. Synopsis. IRS Chief Counsel Advice (CCA) 201939002, dated May 28, 2019, and released September 27, 2019, concluded that stock on a listed exchange had to be valued for gift tax purposes by taking into consideration an anticipated merger of the underlying company that was expected to increase the value of the stock. The co-founder and Chairman of the Board of Corporation A, a publicly-traded corporation, transferred shares of stock of the corporation to a GRAT on "Date 1." Apparently extensive merger discussions had transpired before that date. The merger agreement apparently was based on a certain value being attributed to the shares of Corporation A, substantially greater than the value at which the shares were trading. Later, on "Date 2," the merger with Corporation B was announced, which resulted in the value of the Corporation A stock increasing substantially, though less than the agreed merger price.

Prior to Date 1, when the gift was made, "negotiations with multiple parties" had ensued and eventually "exclusive negotiations with Corporation B" occurred. Not stated in the CCA is whether the merger negotiations had proceeded to the point of having an agreed, or at least strongly anticipated, merger price being attributed to the shares of Corporation A on Date 1 when the gift was made.

The issue is whether the shares should be valued under Reg. § 25.2512-2(b)(1) at the mean between the highest and lowest quoted selling prices on the date of the gift, or by taking into consideration the anticipated merger. Reg. § 25.2512-2(e) states that if the value determined from the mean between the high and the low selling prices does not represent the fair market value of the shares, then some reasonable modification of the value shall be considered in determining fair market value.

Fair market value for transfer tax purposes is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Reg. § 25.2512-1. The CCA reasoned that the presumption of having "reasonable knowledge of relevant facts" applies even if the relevant facts were unknown to the actual owner of the property (citing *Estate of Kollsman v. Commissioner*, T.C. Memo. 2017-40, *aff'd*, 123 AFTR 2d 2019-2296 (9th Cir. June 21, 2019). Both parties are presumed to have made a reasonable investigation of the relevant facts, *id.*, and reasonable knowledge includes facts that a reasonable buyer or seller would uncover during the course of negotiations, even though not publicly available (the hypothetical willing buyer is presumed "to have asked the hypothetical willing seller for information that is not publicly available"). *Id.*

The CCA repeats the oft-stated general rule that post-transfer events may be considered only to the extent they are relevant to the value on the transfer date. *E.g. Estate of Noble v. Commissioner*, T.C. Memo. 2005-2.

The CCA cites two cases for authority that the value should be determined after taking into consideration the anticipated merger. *Silverman v. Commissione*r, T.C. Memo. 1974-285, *aff'd*, 538 F.2d 927 (2d Cir. 1976), *cert denied*, 431 U.S. 938 (1977) (gift of shares of preferred stock while in the process of reorganizing with the intent to go public; court rejected expert testimony that failed to consider the circumstances of the anticipated future public sale); *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), *aff'g,* 108 T.C. 244 (1997) (taxpayer was an officer and director of a corporation of which the board of directors had approved a merger agreement; after the merger was "practically certain to go through" but before the actual merger occurred, the taxpayer gave shares to charities; when the charities sold the shares, the taxpayer realized the gain under the assignment of income doctrine). While *Ferguson* was an anticipatory assignment of income case rather than a gift tax valuation case, the CCA pointed to the many factual similarities with *Ferguson* (a target search to find merger candidates, exclusive negotiations before the final agreement, generous terms of the merger, and an agreement that was "practically certain" to go through) in relying on it for the proposition that "the facts and circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through." The CCA concluded:

> Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger would undermine the basic tenets of fair market value and yield a baseless valuation.

b. Important Questions Left Open. The CCA fails to even mention one critical fact in its analysis. The donor was the Chairman of the Board of the publicly traded corporation, and federal securities laws may have prohibited the donor from disclosing confidential information regarding the merger to a purchaser. The CCA does repeat a statement from various cases that "[t]he willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the donor and the donee [citing *Estate of McCord* and *Estate of Newhouse*]," and that they are both "presumed to be dedicated to achieving the maximum economic advantage [citing *Estate of Newhouse*]." The CCA does not discuss this statement in light of the personal characteristics of the actual donor (as Chairman of the Board, subject to securities law limitations on disclosure of information about the publicly-held company), and the cited cases do not turn on any specific characteristics of the donor.

What if the merger discussions were highly secret and not even rumors of the discussions were available, so that no one who was not prohibited from disclosing the information knew about the discussions? The donor would know that the "mean between the high and the low" value was not appropriate, but no hypothetical third party could know that even with the exercise of reasonable diligence. A hypothetical purchaser who was dealing with a hypothetical seller who knew about the information but could not disclose it would not be able to find out about the information even if the buyer made diligent and persistent inquiries. An answer to this theoretical dichotomy may be that a hypothetical **seller** with this knowledge would never sell at a price well below the anticipated merger price, even though that information could not be disclosed to a hypothetical buyer. Therefore, the donor's knowledge of the information, even though it could not be disclosed, would still have to be taken into account in determining the fair market value.

Nevertheless, the CCA concludes categorically that "as of Date 1 [the date the GRAT was funded], the hypothetical willing buyer of the stock could have reasonably foreseen the merger and anticipated that the price of Corporation A stock would trade at a premium" and that "the hypothetical willing buyer …, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger." Although that may have been true on the full facts the IRS was considering, such confidence is not explained in the CCA itself. Under applicable case law, the CCA correctly views the willing buyer and willing seller in the valuation standard of Reg. § 25.2512-1 as "hypothetical." The regulation deems those hypothetical parties to have "reasonable knowledge of relevant facts," and the anticipated merger certainly seems to be "relevant" to the value of the shares. The question under the regulation is whether knowledge of the merger would be "reasonable" in the case of secrecy imposed by law or agreement. The CCA assumes that such knowledge would be "reasonable" without discussion and without even acknowledging the question.

It should also be noted that under this analysis a donor might be able to make a gift **knowing** that the reported gift tax value will substantially understate the real value because of insider information known by the donor. (At the other end of the spectrum, in addition to asserting an anticipatory assignment of income as in *Ferguson*, the IRS might be able to argue for a much smaller charitable deduction than the realistic full value of the stock.) That may be another reason that the conclusion of the CCA is entirely appropriate, but, again, without explanation or acknowledgment.

Moreover, even if the anticipated merger were taken into consideration, that would not necessarily mean that the anticipated merger price would be the fair market value at the time the GRAT was funded. There may have been some possibility that the merger would fall through, and even if the merger were consummated, the extent to which the merger actually affected the value of stock after the merger was announced would be uncertain. Indeed, the CCA acknowledges that "after the merger was announced, the value of the Corporation A stock increased substantially, though "**less than the agreed merger price**" (emphasis added). But the anticipated merger would still be considered as a factor in determining the fair market value of the stock.

One lesson from CCA 201939002 is that every word of a regulation can matter. If advice is received from the National Office of the IRS during the audit of a valuation issue, care must be taken to confirm that every assumption underlying the advice – whether explicit or implicit – is appropriate, and that a case against the taxpayer's position is not overstated, even inadvertently. As stated above, the conclusion of CCA 201939002 might be entirely appropriate on the full facts of the case, but vigilance and scrutiny would be needed to confirm that.

If the case for which this CCA was issued proceeds to trial, no doubt these facts will be fully explored by the court, and the court's discussion of the legal test of what is meant by "reasonable knowledge of relevant facts" in valuation cases like this may be quite interesting.