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Heckerling Musings 2020 and Estate Planning Current Developments

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TABLE OF CONTENTS

March 25, 2020

Important Information Regarding This Summary

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Introduction

The 54th Annual Heckerling Institute on Estate Planning was held in Orlando during the week of January 13, 2020. This summary includes observations from that seminar, as well as other observations about various current developments and interesting estate planning issues (including planning under the SECURE Act). My goal is not to provide a general summary of the presentations. Rather, this is a summary of observations of selected items during the week as well as a discussion of other items. I sometimes identify speakers, but often do not (some topics are discussed by various speakers). I take no credit for any of the outstanding ideas discussed at the Institute — I am instead relaying the ideas of others that were discussed during the week.

1. Summary of Top Developments in 2019

Ron Aucutt (Lakewood Ranch, Florida) lists the following as his top ten developments in 2019 in his report, "Top Ten" Estate Planning and Estate Tax Developments of 2019, with detailed analysis, (found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)** :

(1) Enactment of the SECURE Act in December (see Item 3 below);

(2) The United States Supreme Court's affirmance of North Carolina court rulings that the state's income taxation of a trust solely because a beneficiary lives in the state is unconstitutional (see Item 24 below);

(3) The *Kress* and *Jones* cases on tax-affecting in business valuations (see Items 15 and 16 below);

(4) The "For the 99.8 Percent Act," introduced by Senator Bernie Sanders (see Item 2 below);

(5) The new Uniform Electronic Wills Act (see Item 37 below);

(6) Deductibility of estate and trust administration expenses by fiduciaries and beneficiaries (see Item 5.a.-b. below);

(7) Affirmation of full portability in the final anti-clawback regulations (see Item 4.c.(4) below);

(8) State taxation of QTIP trusts at the surviving spouse's death;

(9) Estate tax charitable deduction affected by subsequent actions that reduce the value charity receives; and

(10) Treatment of gifts, transfers at death, and transactions with grantor trusts in the final qualified opportunity fund regulations (see Item 35 below).

2. Legislative Developments (Other than the SECURE Act)

2019 was a year of interesting legislative proposals but no significant legislative developments UNTIL late December with the passage of the SECURE Act, which severely curtails long-term "stretch" planning for IRA distributions (and is discussed in detail in Item 3 below).

a. **Private Foundation Excise Tax on Net Investment Income**. Passed in connection with the massive spending bill (in addition to the SECURE Act) was the Taxpayer Certainty and Disaster Tax Relief Act of 2019 that, among other things, replaced the complex 2%/1% two-tiered tax on the net investment income of private foundations under §4940 with an average 1.39% tax, and a repeal of the extremely unpopular tax with respect to parking and public transit benefits provided by nonprofit employers. *See* Benjamin Davidson, *Parking Tax Purgatory*, TAX NOTES (Jan. 20, 2020).

b. **General Transfer Tax Proposals**. Having a Democratic majority in the House no doubt has changed the calculus of anticipated tax legislation, including legislation relating to the transfer tax. As always, a variety of transfer tax proposals have been submitted, ranging from repealing the estate tax or substantially reducing the rate to accelerating the sunset of the basic exclusion amount or even reducing the exclusion amount to $3.5 million.

c. **Some Notable Positions of Democratic Presidential Candidates**. Throughout the year, perhaps the most interesting legislative discussion came from the positions of the Democratic Presidential candidates. Some of them are listed.

- Former Vice President Joe Biden proposes ending the step-up in basis at death on capital gains exceeding $100,000, applying the payroll tax to earnings over $400,000, raising the corporate tax rate from 21% to 28%, taxing capital gains as ordinary income for taxpayers having income over $1 million, raising the top bracket to 39.6%, limiting reduction in tax liability from itemized deductions to no more than 28% of deductions, phasing out the §199A deduction for qualified business income above $400,000, imposing a 15% minimum tax on corporate book income for C corporations with over $100 million of book income, raising the tax rate on foreign profits, eliminating fossil fuel subsidies, and eliminating like-kind exchanges. The Biden proposals are estimated by the Urban-Brookings Tax Policy Center to raise approximately $4 trillion over a decade, and to result in a reduction of the after-tax income of the top 1% of households by 17% (compared to a drop of 0.5% for bottom 80% of households). *See* Jonathan Curry, *Biden's Tax Plans Total $4 Trillion in Tax Hikes, TPC Says*, TAX NOTES (March 9, 2020). *See generally Jennifer Epstein, Biden to Target Tax-Avoiding Companies Like Amazon With Minimum Federal Levy,* BLOOMBERG (Dec. 4, 2019) (outlining Biden proposal and estimated revenue impacts, including $400 billion revenue over 10 years from the stepped-up basis proposal); *The Biden Tax Plan: Budgetary, Distributional, and Economic Effects,* TAX NOTES (Jan. 24, 2020) (summarizing Penn Wharton Budget Model of revenue effects of Biden proposal, including $204 billion revenue over 10 years from the stepped up basis proposal). The Biden campaign had previously also proposed eliminating the cap on the Social Security payroll tax (so that the 7.65% tax [6.2% Social Security, 1.45% Medicare] would apply on all wages, not just up to the $132,900 limit [for 2019]). *See* Cooper*, Biden Seeks Boost in Capital Gains, Corporate Tax Rates,* TAX NOTES (Oct. 24, 2019); Nitti, *Reviewing The Democratic Candidates' Tax Plans: Joe Biden*, FORBES (Sept. 30, 2019).
- Senator Bernie Sanders would increase the income tax rates, with brackets of 40%, 45%, 50%, and 52%. He also would enact a 4% surtax on all taxable income, tax long-term capital gains and qualified dividends at ordinary income rates for taxable income over a certain level (over $250,000 for married filing

jointly), cap the maximum benefit of deductions at 28%, tax capital gains on gifts and bequests of appreciated property with a lifetime exclusion of $250,000 of gains (with the exclusion being reduced by the income of the donor or decedent)(note this would not just eliminate stepped-up basis but would accelerate gain recognition at death and upon making gifts). He has previously proposed a new financial tax on stock, bond and derivative trades, a new "carbon tax," and increasing the tax on net investment income from 3.8% to 10%.

- Senators Warren and Sanders have both proposed an annual wealth tax, and other candidates said they would consider a wealth tax (see Item 2.d. below).

- Presidential candidate Julian Castro jumped on the bandwagon of a "mark-to-market" system earlier proposed by Senator Ron Wyden. Senator Wyden has proposed taxing the annual increases in the value of taxpayers' assets under a "mark-to-market" system (exempting primary residences and 401(k) plans and with a deferral and lookback charge for the deferral for nonpublicly traded assets), and he would also raise the rates on capital gains to the rates on ordinary income. The Castro mark-to-market proposal would have been limited to publicly traded assets, with other assets being taxed on sale with a charge applied to limit the benefits of tax deferral.

- Michael Bloomberg proposes increasing the top rate on ordinary income from 37% to 39.6%, and to 44.6% on income above $5 million, increasing the rate on long-term capital gains and qualified dividends to the ordinary income rate for taxpayers with income over $1 million, lowering the estate and gift tax exclusion amount (but not stating how low), eliminating stepped-up basis at death, increasing the top corporate rate to 28%, eliminating the 20% pass-through deduction on business income under §199A, eliminating like-kind exchanges, and imposing a 0.1% tax on all financial transactions (with a gradual phase-in, starting at 0.02%).

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

   Senator Sanders subsequently also proposed an annual wealth tax with rates starting at 1% on net worth above $32 million and increasing in increments to 8% for net worth over $10 billion. His proposal would apply to about 180,000 households and raise an estimated $4.35 trillion over a decade. His plan would bolster reporting requirements, create a national wealth registry, increase IRS funding, and require the IRS to audit 30% of wealth tax returns for Americans in the top one percent net worth bracket and 100% of billionaires.

   An annual wealth tax would require tens of thousands of complex IRS examinations each year, compared to the once-per-lifetime estate tax audits, and would entail substantial administrative and enforcement difficulties. *See* Jonathan Curry, *Making a Wealth Tax Work May Require 'Rough Justice,'* TAX NOTES (Sept. 30, 2019).

An annual wealth tax would face constitutional challenges because the Constitution provides that any "direct tax" must be structured so that each state contributes a share of the tax proportional to the state's share of the population. Whether a wealth tax would be a "direct tax" is unclear, but many constitutional experts believe that it would be an unconstitutional direct tax. *See* Madison Spach, Jr., *The National Wealth Tax: Unconstitutional and Unworkable*, TAX NOTES (Nov. 20, 2019).

The direct tax issue was vigorously debated in the Constitutional Convention. The issue about direct taxes was part of the ugly history of negotiations about the counting of slaves (ultimately as three-fifths of a person) for purposes of both taxation and representation. Article I, Section 2, Clause 3 of the U.S. Constitution provides:

> Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other Persons.

Article 1, Section 9 adds:

> No Capitation, or other direct Tax shall be laid, unless in proportion to the Census or Enumeration herein before directed to be taken.

The Supreme Court has consistently held that an unappportioned national tax on real estate would be a prohibited direct tax. The first Supreme Court case to address the direct tax issue, *Hylton*, 3 U.S. 171, addressed a carriage tax. Some of the Justices reasoned that a direct tax would include a capitation tax (i.e., a poll tax) or a tax on land, and since that time cases have consistently treated a tax on real estate as a direct tax. Justice Roberts in the majority opinion of *National Federation of Independent Business v. Sebelius*, 567 U.S. 519 (2012), upholding the Affordable Care Act, cited *Eisner v. Macomber,* 252 U.S. 189 (1920) for the proposition that an unapportioned tax on the ownership of personal property would constitute a direct tax.

One explanation for the distinction between direct and indirect taxes is that "direct taxes" are taxes on things that cannot be avoided, like real estate, "your head," or other property. "Indirect taxes" would apply to things that are voluntary like excise taxes or transactional taxes. The rationale for apportioning federal taxes by population makes sense because a war had just been fought over "taxation without representation," so the approach was to prohibit federal taxes except to the extent that they are based on votes.

The wealth tax has been extremely controversial, and is highly unlikely to ever be adopted. If it were adopted, a mess would ensue for years until the constitutional issues were resolved. The tax would be extremely difficult to administer and would entail massive compliance expenses in annual valuations and returns. (Senator Sanders estimates that his version of the tax would apply to 180,000 households. Compare that with the fact that about 12,000 estate tax returns are now filed each year.)

e. **"For the 99.8 Percent Act."** Senator Sanders on January 31, 2019 introduced S. 309 titled "For the 99.8 Percent Act," which would reduce the basic exclusion amount to $3.5 million (not indexed) for estate tax purposes and to $1.0 million (not

indexed) for gift tax purposes and increase the rates: 45% on estates between $3.5 and $10 million, 50% on $10 million - $50 million, 55% on $50 million - $1 billion, and 77% over $1 billion. (The GST rate is not specifically addressed, so presumably it would be the highest marginal estate tax rate of 77% under §2641(a)(1), with a $3.5 million GST exemption.)

Rep. Jimmy Gomez (D. California) introduced a similar bill in the House (H.R. 4857, with 37 other sponsors) on October 25, 2019.

In addition, the bill would make ***major*** dramatic changes to the transfer tax system including:

- Adding a statutory anti-clawback provision for both estate and gift taxes;
- Increasing the potential reduction of the value for family farm and business property under the §2032A special use valuation rules from $1.16 million currently to $3 million (indexed);
- Increasing the potential estate tax deduction for conservation easements from $500,000 to $2 million (but not exceeding 60% of the net value of the property);
- Extending basis consistency provisions (and accompanying reporting requirements) to gifts;
- Valuing entities by treating nonbusiness assets and passive assets as owned directly by the owners (and valuing them without **valuation discounts**), with look-through rules for at least 10% subsidiary entities;
- Eliminating **minority discounts** for any entity in which the transferor, transferee, and members of their families either control or own a majority ownership (by value) of the entity (proposals restricting valuation discounts for family-held assets that were first introduced in the Clinton Administration);
- 10-year minimum term for **GRATs** with a remainder interest valued at the greater of 25% of the amount contributed to the GRAT or $500,000 (up to the value of property in the trust);
- Major changes for **grantor trusts** –
    - Estate inclusion in grantor's gross estate;
    - Distributions are treated as gifts from the grantor;
    - Gift of entire trust if it ceases to be a grantor trust during the grantor's life;
    - Those 3 rules apply for (1) grantor trusts of which the grantor is the deemed owner, and (2) third-party deemed owner trusts (§678 trusts) to the extent the deemed owner has sold assets to the trust in a non-recognition transaction, including the property sold to the trust, all income, appreciation and reinvestments thereof, net of consideration received by the deemed owner in the sale transaction;
    - The initial gift to the trust is also a gift, but a reduction will apply in the amount of gifts or estate inclusion deemed to occur (under the first three rules) by the amount of the initial gift;

- These rules apply to trusts created on or after the date of enactment, and to the portion of prior trusts attributable to post-date-of-enactment contributions and sales in nonrecognition transactions with the prior trust;

- Regardless of GST exemption allocated to a trust, a trust will have a GST inclusion ratio of 1 (i.e., fully subject to the GST tax) unless "the date of termination of such trust is not greater than 50 years after the date on which such trust is created"; this provision applies to post-date-of-enactment trusts, and prior trusts would have the inclusion ratio reset to one 50 years after the date of enactment; the provision is more aggressive than the Obama Administration proposal which had a limit of 90 rather than 50 years, and which merely reset the inclusion ratio to one after the 90-year term rather than applying an inclusion ratio of one from the outset if the trust did not have to terminate within the maximum allowed time; and

- The **annual exclusion** is "simplified" by providing a $10,000 (indexed) exclusion not requiring a present interest (but still requiring an identification of donees), but each donor is subject to a cumulative limit of twice that amount (2 times the current $15,000 amount, or $30,000) for gifts in trust, gifts of interests in pass-through entities, transfers subject to a prohibition on sale, or any other transfer that cannot be liquidated immediately by the donee (without regard to withdrawal or put rights).

This bill is significant, even if Senator Sanders is not the Democratic Presidential nominee; these are proposals that have been suggested by others from time to time, but have not been reduced to statutory text that can be pulled off the "shelf" to incorporate into whatever other legislation happens to be popular at the time. This proposal will not be enacted in the current Congress, but could portend future transfer tax considerations if Democrats secure control of both the House and Senate in future years. Remember 2012? The mad rush could be 10 times as bad if this bill starts getting serious consideration.

For a much more detailed discussion of the specific provisions in this proposal, see Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2019, with detailed analysis, (found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)** .

3. SECURE Act

The following summary of changes made by and planning implications of the SECURE Act are based primarily on presentations and resources from Natalie Choate (Boston, Massachusetts).

a. **Introductory Background**.

The **SECURE Act** (H.R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019) was a proposal to make various changes regarding retirement benefits. The bipartisan proposal was unanimously approved by the House Ways and Means Committee and passed the House by a vote of 417-3. Similar proposals had been introduced in the Senate.

The SECURE Act was included as Division O of the late 2019 "spending bill," H.R. 1865, the Further Consolidated Appropriations Act, 2010. That Act passed the House (297-120), the Senate (71-23), and was signed by the President on December 20, 2019.

The miscellaneous retirement plan changes in the SECURE Act include liberalized rules for multiple employers, a new small employer automatic enrollment credit, expanded participation in employer 401(k) plans to include long-term part-time workers, certain expanded uses of Section 529 plans (see the following paragraph), tax-free $5,000 permitted withdrawal within one year after the birth or adoption of a child by the participant, and required annual disclosures of estimated projected lifetime income under annuity elections.

The changes for 529 plans include treating the cost of apprenticeship programs as qualified education expenses and allowing distributions of up to $10,000 for repaying qualified education loans of the beneficiary or the beneficiary's sibling. Note that distributions from a 529 plan that is not owned by the student or a parent of the student are reported as untaxed income on the "Free Application for Federal Student Aid (FAFSA) Form that many colleges use for financial aid applications. College financial aid may be reduced by 50% of the untaxed income reported on the FAFSA Form, but repayments of student loans do not have to be reported. Accordingly, if a 529 Plan has been established by a grandparent, to avoid reporting a $10,000 plan distribution on the FAFSA Form, which may reduce financial aid by 50%, the student could obtain a student loan and use distributions from the plan to repay $10,000 of the loan.

The Act also repeals the provision in the 2017 Tax Act regarding the "Kiddie Tax" applying the income tax rates for trusts to the unearned income of children and allows taxpayers to elect to treat the repeal as effective for 2018 and 2019. (This has been called the "Gold Star" family provision because the 2017 Kiddie Tax changes had adversely impacted children who received government payments because they are survivors of deceased military personnel and first responders.)

MORE important for estate planners, the SECURE Act:

- Changes the age that determines the required beginning date (RBD) for minimum distributions (April 1 of the following calendar year) from 70½ to 72, effective for individuals who reach age 70½ after December 31, 2019 (the effect is that no one will have his or her RBD in 2021); (A similar Senate proposal would have extended the required beginning date age to 75 and removed it entirely for pensions worth up to $100,000); and
- Eliminates the prohibition on contributions to an IRA after age 70½ (but the $100,000 limit on qualified charitable distributions from an IRA would be correspondingly reduced [observe that changing the age for required minimum distributions from 70½ to 72 will not change the age at which qualified charitable distributions from IRAs will be permitted]). See Item 3.m. below for a discussion about IRA charitable rollover planning.

MOST important for estate planners, the SECURE Act **substantially limits "stretch" planning** for distributions from defined contribution plans (and IRAs) following the death of the plan owner (referred to as the "participant"). Under prior law, following the participant's death, plan benefits (including IRA benefits) could be paid over the life expectancy of a "designated beneficiary," to stretch the receipt (and, therefore, the income taxation) of retirement benefits, but the SECURE Act mandates that distributions to a designated beneficiary be made within 10 years following the death of the participant, with exceptions for five categories of "eligible designated beneficiaries." Distributions from the IRA are typically taxed as ordinary income, so the ability to stretch the receipt of those benefits as long as possible defers the time that the income tax must be paid. (Throughout this discussion of the SECURE Act, references to a "plan" or "plan benefits" will include an IRA.)

b. **Post-Death Minimum Distribution Requirements under Prior Law**. A grasp of the prior law minimum distribution requirements following the death of the participant is essential to understand the impact of the changes made by the SECURE Act. Most of this prior law is retained under the SECURE Act (except for the 10-year rule for designated beneficiaries, with special rules for the five categories of eligible designated beneficiaries). The rules are based on regulations proposed in 1987 and 2001 and finalized in 2002, almost 20 years ago. A simplified summary of the prior law follows [provisions impacted by the SECURE Act are briefly noted in italicized comments in brackets].

The treatment varies based on whether or not the beneficiary is a "designated beneficiary" (DB), meaning any individual but not an entity such as the participant's estate, a charity, or a trust that is not a "see-through" trust (described below).

(1) **Beneficiary Not a Designated Beneficiary**. If the beneficiary is not a DB (Non-DB), benefits must be paid within 5 years if the participant died before his or her required beginning date (RBD) or over the participant's remaining life expectancy if the participant died on or after the RBD. [*This does not change under the SECURE Act.*] The RBD was April 1 of the year after the participant reached age 70½ [*changed to age 72 in the SECURE Act*].

(2) **Beneficiary is a Designated Beneficiary Other Than a Surviving Spouse**. If the beneficiary is a DB and is not the surviving spouse, the benefits are paid over the DB's life expectancy (if a see-though trust is the beneficiary, over the oldest beneficiary's life expectancy). (If the participant's remaining life expectancy is longer, that period may be used. Reg. §1.401(a)(9)-5, A-5(a)(1).) [*The SECURE Act changes this to a maximum 10-year payout instead of the DB's life expectancy; whether the Act changes from allowing the participant's life expectancy if that is longer is unclear if the beneficiary is a DB.*]

(3) **Beneficiary is the Surviving Spouse**. If the beneficiary is the participant's surviving spouse, the DB rule described above can apply (that would be applicable, for example, if the beneficiary is a standard QTIP trust that does not mandate that all distributions must pass to the spouse), but even more favorable alternatives may also be elected in some circumstances. If the spouse is the sole beneficiary, the Single Life Table is used, but the life expectancy is recalculated annually. (The specific rules that apply when the spouse is the sole beneficiary are described in more detail in Item 3.c.(4)(i) below.)

Better still (in most circumstances), if the spouse chooses to treat the decedent's IRA as his or her own IRA (spousal election) or elects to rollover the decedent's IRA into the spouse's IRA (a spousal rollover), several significant advantages result. (1) Distributions do not need to begin until the spouse reaches his or her RBD. (2) Distributions are made at a slower pace because the Uniform Life Table may be used (which is based on the joint life expectancy of the individual and someone who is 10 years younger). Under the new tables that apply beginning in 2021 (see Item 3.b.(6) below), the life expectancy of a 72-year old person under the Single Life table is 17.1 years, and under the Uniform Life table is 27.3 years, so using the Uniform Life table allows taking withdrawals from the plan at a substantially slower rate. (3) The surviving spouse can designate his or her own beneficiary, and at the spouse's death, the remaining benefits (which may be much reduced if the spouse has lived to near his or her life expectancy) may be paid over the life expectancy of a DB. [*The third advantage is dramatically altered under the SECURE Act*.]

(4) **Three Tiers of Beneficiaries**. Natalie Choate summarizes these rules as reflecting three tiers of beneficiaries:

(i) Bronze – Non DBs (5-year rule if participant dies before RBD or the participant's remaining life expectancy if participant dies after RBD) [*no change under SECURE*];

(ii) Silver – DB (life expectancy payout) [*significantly limited under SECURE to 10-year maximum payout for most DBs*]; and

(iii) Gold – Surviving spouse (life expectancy with further advantages including delayed starting date, slower payout, and ability to name beneficiary who can receive payout based on the beneficiary's life expectancy) [*unchanged under SECURE except that at death of surviving spouse, 10-year rule applies*].

(5) **Trust Recipients**. The trust rules described below have not been changed by the SECURE Act (but the importance of which category applies to a particular trust may be impacted dramatically by the SECURE Act.)

(i) **See-Through Trusts**. Although DBs must be individuals, trusts that meet five requirements are classified as "see-though trusts." The individual beneficiaries of a see-though trust are treated as DBs of the plan or IRA (with a special rule as to which such individual's life is used to determine the life expectancy payout period). The five requirements are: (1) the trust must be valid under local law; (2) the trust is irrevocable or becomes so at the participant's death; (3) the beneficiaries are identifiable; (4) certain documentation is provided to the plan administrator; and (5) all trust beneficiaries must be individuals (but "mere potential successor beneficiaries" don't count, which generally means that only the initial remaindermen are counted, not remote successor remaindermen). While the individual beneficiaries are treated as DBs, two special rules do not apply for beneficiaries of a see-though trust – the trust cannot be treated as having separate accounts each having its own beneficiary, and spousal rollovers are not available for any trust, even a see-through trust.

(ii) **Conduit Trusts**. A conduit trust is the nickname (not formally called that in the regulations) of a trust that has one individual beneficiary, and the governing instrument requires that all plan or IRA distributions to the trust must be distributed from the trust to the individual beneficiary. The distributions are deemed paid "to"

the individual beneficiary, and the beneficiary is considered the sole beneficiary of the trust and the plan or IRA for minimum distribution purposes, regardless who receives any benefits if the beneficiary should die before all plan assets have been distributed to the trust (and to the beneficiary). A conduit trust is a see-through trust. Conduit trusts are straightforward to draft; they just require that plan distributions to the trust are distributed forthwith to the single beneficiary.

(iii) **Accumulation Trusts**. An accumulation trust is a trust that is not required to distribute all plan benefits as received, but permits the accumulation of distributions within the trust. All beneficiaries (except "mere successor potential beneficiaries") who might ultimately receive such accumulations are considered for purposes of the minimum distribution rules (and the oldest such beneficiary's life expectancy is used as the relevant payout period). These restrictions have led to considerable complexity in drafting accumulation trusts to assure that some older beneficiary or entity might not be a trust recipient, including under the possible exercise of a power of appointment.

(6) **New Life Expectancy Tables for Retirement Plan Required Minimum Distributions**. The Single Life and Uniform Life tables for calculating required minimum distributions are in Reg. §1.401(a)(9)-9(b)-(c). (The Uniform Life table, which is based on the life expectancy of an individual and someone 10 years younger, may be used only while the account owner is living or for a spousal rollover IRA. Otherwise the Single Life (or Joint Lives) Table must be used. The Uniform Life table allows taking withdrawals at a substantially slower rate. For example, the life expectancy of a 72-year old person under the Single Life table is 17.1 years, and under the Uniform Life table is 27.3 years.) Proposed regulations containing revised tables were issued in November 2019. The revised tables will apply to distribution calendar years beginning on or after January 1, 2021. The preamble to the proposed regulations states that the "life expectancy tables and applicable distribution period tables in the proposed regulations reflect longer life expectancies than the tables in the existing regulations that are generally between one and two years longer than under the existing regulations."

c. **Post-Death Minimum Distribution Requirements under SECURE Act; Limits on Stretch Planning**.

(1) **Overview—Three Tiers of Beneficiaries**. As described before, three tiers of beneficiaries may benefit from retirement plans, but the perks have changed under the SECURE Act.

(i) Bronze – Non DBs (the rules have not changed; 5-year rule if participant dies before RBD or the participant's remaining life expectancy if the participant dies after RBD).

(ii) Silver – DB (downgraded perks; life expectancy payout has been downgraded to payment within 10 years, but apparently the participant's remaining life expectancy can still be used if that is longer, Reg. §1.401(a)(9)-5, A-5(a)(1), although §401(a)(9)(H)(i)(II)'s direction that the 10-year rule for DBs "shall apply whether or not distributions of the employee's interest have begun" might conceivably be interpreted to override that regulation, see Item 3.g. below for further discussion).

(iii) Gold – Favored DBs (this tier has been expanded to five categories rather than just for the surviving spouse; the same rules apply for a surviving spouse except that at the death of the surviving spouse, benefits must be paid within 10 years of the spouse's death; for other EDBs, life expectancy payout as long as the original EDB qualifies as an EDB, but thereafter benefits must be paid within 10 years of when the beneficiary ceases as an EDB).

(2) **Overview of Changes**. The SECURE Act minimum distribution provisions retain the current Code structure as much as possible. These provisions are in Section 401(a) of the ACT (unfortunately, confusingly similar to the Section number of the Code (§401(a)) that contains the rules for qualified retirement plans).

Section 401(a)(9) of the Code contains the provisions about required distributions from qualified retirement plans (including IRAs). The SECURE Act adds a new §401(a)(9)(H), which includes six sub-paragraphs.

- (i) and (ii) – **10-Year Rule for DBs, Except for EDBs**. These subparagraphs say, rather obtusely with various cross references, exceptions, and special rules layered over the existing provisions, that if the beneficiary is a DB, the plan assets must be distributed within 10 years of the participant's death unless the beneficiary is an "eligible designated beneficiary" (EDB). A modified life expectancy payout applies as long as the beneficiary is an EDB.
- (iii) – **Death of or Otherwise Ceases to be EDB**. If an EDB dies or otherwise ceases to be an EDB before the plan has been entirely distributed, the exception for EDBs will no longer apply, but the plan must be distributed within 10 years after such EDB's death or cessation as an EDB (even if the next successor beneficiary is an EDB at that time).
- (iv) and (v) – **Special Rule for Trusts for Disabled or Chronically Ill Beneficiaries**. Special rules apply to multi-beneficiary trusts if at least one of the beneficiaries is a disabled or chronically ill individual (these provisions are discussed below); and
- (vi) – **Applicable to Defined Contribution Plans, Not Defined Benefit Plans**. These rules apply to defined contribution plans (including IRAs and Roth IRAs, but not defined benefit plans, i.e., pension plans).

Section 401(a)(9)(E) is amended to describe five categories of EDBs.

Section 401(b) of the SECURE Act has effective date provisions. The provisions generally apply to plans and IRAs for which the participant dies after 2019, but some effects may result even when participants have died before 2020 (discussed in Item 3.d. below).

That's it. Otherwise, all the minimum distribution rules stay the same. The distribution rules have not changed if the beneficiary is not a DB. Determining if a beneficiary is a DB has not changed. The various trust rules (for what is a see-through trust, a conduit trust, or an accumulation trust) have not changed.

(3) **Ten-Year Rule**. The SECURE Act applies its 10-year rule for making distributions to a DB by cross reference to the 5-year rule that applies for non-DBs (if the participant dies before his or her RBD), thus engrafting the body of regulatory law that applies for the 5-year rule. This has the effect of clarifying several issues.

- **Proportionate Distributions Not Required**. Distributions do not have to be made proportionately over the 10-year term; they could be made all in a lump sum at the very end of the term (which would have the effect of deferring recognition of the income, but would also result in "bunching" the income, possibly into a high income tax bracket). For Roth IRAs, deferral until year 10 would likely be the most effective strategy.
- **December 31 Due Date**. Distributions must be made by December 31 of the calendar year that contains the tenth anniversary of the relevant person's death. *See* Reg. §1.401(a)(9)-3, A-2. (Presumably that same December 31 due date will also apply to the new 10-year rule.)
- **Eleven Calendar Years for Payments**. The actual payout period could extend over 11 taxable years (if death occurs in 2020, the final payment must be made by December 31, 2030, so payments can be made in 2020-2030, or over 11 years). Spreading payments over more years increases the chances that lower tax brackets may apply.

(4) **Eligible Designated Beneficiaries**. The five categories of EDBs are described in new Code Section 401(a)(9)(E)(ii). They are (i) the surviving spouse, (ii) a participant's child who "has not reached majority," (iii) a disabled individual, (iv) a chronically ill individual, and (v) an individual not described above who is not more than 10 years younger than the participant. These beneficiaries qualify for a modified life expectancy payout.

Status as an EDB is determined at the participant's death. A DB who later satisfies one of the five categories of EDBs does not become an EDB for purposes of being able to use an adjusted lifetime payout rather than being subject to the 10-year rule. §401(a)(9)(E)(ii)(last sentence). (A special rule applies for minors – if the minor is disabled upon reaching majority, the minor exception continues through the period of disability, as discussed in Item 3.c.(4)(ii) below.)

(i) **Surviving Spouse**. To qualify for the spouse exception, the benefits must be payable "to" the surviving spouse, which likely requires that the beneficiary is the surviving spouse outright, or a conduit trust for the surviving spouse (because the conduit trust rules treat the conduit beneficiary as the owner of the trust and plan for purposes of the minimum distribution rules).

Conduit Trust as Beneficiary. If a conduit trust for the spouse is a beneficiary (or if the spouse is the outright beneficiary), the spouse could take advantage of special spousal rules delaying beginning distributions until the end of the year in which the deceased participant would have turned age 72 (§401(a)(9)(B)(iv)(I), as amended by the SECURE Act) and using the Single Life Table but recalculating the life expectancy annually (Reg. §1.401(a)(9)-5, A-5(c)(2) (first sentence, A-6). If the spouse dies before all benefits are paid, the required minimum distribution for the

year of death must be paid based on the recalculated life expectancy by the end of the year (if it had not previously been distributed that year), and the balance must be paid within 10 years of the spouse's death. (Before the SECURE Act, the benefits could be paid over the spouse's remaining life expectancy, with no recalculation following his or her death.)

Standard QTIP Trust (Accumulation Trust) as Beneficiary. A standard QTIP trust, that does not require that all retirement plan distributions to the trust be distributed to the spouse, would not qualify for this spousal special treatment, even if it is a valid see-though trust, Reg. §1.408-8, A-5(a). Under the SECURE Act, a standard QTIP trust does not qualify as an EDB and the 10-year rule would apply after the participant's death. A QTIP trust, that also required such distributions to the spouse of all plan distributions, would constitute a conduit trust that is an EDB and would qualify for the spousal special treatment.

Spouse as Outright Beneficiary. If the spouse is the outright beneficiary, additional alternatives are available (in addition to the option described above if a conduit trust for the spouse is the beneficiary). The spouse can elect to treat the IRA as his or her own, or may roll over the plan benefits into the spouse's own rollover IRA. Advantages include a delayed starting date (until the surviving spouse reaches age 72) and a slower payout (using the Uniform Life Table). See Item 3.b.(3) above. Under the SECURE Act the spouse would no longer have the ability to name a beneficiary who can receive payout based on the beneficiary's life expectancy, but the remaining benefits would have to be paid by the end of the year in which the tenth anniversary of the spouse's death occurs. If a beneficiary is an EDB at the time of the surviving spouse's death, the EDB rules should apply for that beneficiary (because the spousal rollover IRA is treated as the spouse's IRA, §§408(d)(3)(A), 408 (d)(3)(C)(ii)(II)).

(ii) **Minor Child of Participant**. This exception applies for a minor child *of the participant*, not a grandchild or any other person's child (such as a niece or nephew).

The exception applies until the child "reaches majority" within the meaning of a specified unrelated provision (an obscure ERISA rule), which has a regulatory provision treating the child as not having reached majority if the child has not "completed a specified course of education" and is under the age of 26. The 10-year rule applies, beginning when the child "reaches majority." Therefore, this exception could possibly extend to age 36. The meaning of a "specified course of education" is unclear.

In addition, if a minor child becomes disabled before reaching majority, the minority status continues as long as the child is disabled. Reg. §1.401(a)(9)-6, A-15.

This exception applies if the minor child is the outright beneficiary or is the beneficiary of a conduit trust (but not an accumulation trust). Whether the exception extends to a conduit trust with multiple "minor children" or to a conduit trust with multiple beneficiaries, only some of whom are "minor children" is unclear even if the trust must be separated into separate conduit trusts for the children at the participant's death. (It is hoped that regulations will provide relief; having four separate conduit trusts for four minor children would make no sense.) Some

planners have suggested providing that a conduit trust for a minor child could flip to an accumulation trust after the child reaches majority. However, Natalie Choate believes that the existing trust rules for retirement plan benefits do not clearly sanction that approach.

Query whether a naming a custodian for the minor will be recognized as a transfer to the minor in order to qualify for this exception? If the minor is named outright as the beneficiary of the plan, Section 7(a) of the Uniform Transfers to Minors Act appears to allow the plan to make the distribution to a custodian for the minor.

If a conduit trust is used to qualify for this exception, observe that the withdrawal rate will be very slow using the minor's life expectancy. Under the new Single Life Table, for example, a 15-year old has a life expectancy of 69.9 years, so the initial withdrawals would be about only 1/70th of the account. The withdrawal would likely be much less than the interest and dividend produced by the account, and the account would likely continue to grow during the period the minor qualified for EDB treatment. After the minor "reaches majority," further withdrawals from the account could be halted for 10 years, at which time the entire account would be withdrawn. That could possibly last until the "minor" child is 36 years old before most of the account balance would have to be distributed from the account to the trust and from the trust to the beneficiary.

What happens if more minor children are born to the participant after the participant's death is unclear, but the statute says that the determination of whether a DB is an EDB "shall be made as of the date of death of the employee."

Natalie Choate believes that the minor child exception is **not particularly helpful**. Few parents die while a child of the parent still a minor, and even rarer it is for both parents to die with a minor child. Participants with minor children often do not yet have significant retirement benefits. Benefits may have to be withdrawn within 10 years of the participant's death to pay college expenses in any event. Better than jumping through hoops to qualify for an exception that is extremely unlikely ever to apply, young parents should consider making sure they have a sufficient amount of term insurance (relatively cheap for young adults) to provide for their minor children.

(iii)-(iv) **Disabled or Chronically Ill Individuals**. The most helpful of the five categories of EDBs is that a modified life expectancy payout applies if the DB is disabled or chronically ill, thus providing favorable treatment for special needs trusts. The SECURE Act provides cross references to definitions of disabled or chronically ill individuals. For example, a person who qualifies for Social Security disability benefits qualifies for this exception.

The beneficiary's status as an EDB is determined at the participant's death. §401(a)(9)(E)(ii)(last sentence). If a DB later becomes an EDB (i.e., is later disabled) before all distributions have been made from the plan, the plan cannot switch to EDB status.

A special provision under §401(a)(9)(H)(v) for multi-beneficiary trusts for disabled and chronically ill beneficiaries gives these two categories of EDBs benefits not enjoyed by other EDBs: (i) A mandated division at the participant's death is given

effect, contrary to the result described for retirement plan distributions generally in Reg. §1.401(a)(9)-4, A-5(c) (for example if some of a single pot trust is divided into a separate trust for a disabled or chronically ill child, that separate trust would qualify for this exception); (ii) A single trust with multiple disabled or chronically ill individuals as beneficiaries qualifies for the exception; and (ii) An **accumulation trust** for disabled or chronically ill beneficiaries qualifies for the exception (whose life expectancy is used in that case is not clear, and the conservative approach, until the IRS gives further guidance, is to have remainder beneficiaries who are no older than the disabled or chronically ill current beneficiary or beneficiaries).

Being able to use accumulation trusts is particularly helpful for special needs trust planning. See Item 33 regarding special needs trust planning generally. Further IRS guidance is needed with respect to various issues for special needs trusts, including when and how the determination of whether a beneficiary is disabled or chronically ill must be made. As examples of the need for further guidance, many special needs trusts include a "backstop provision" allowing distributions to other beneficiaries of amounts that would cause the disabled beneficiary not to qualify for government assistance programs or include a provision allowing distributions to other beneficiaries for tax planning in light of the high rates applied to undistributed trust income. How will those provisions impact qualification of a trust as an EDB in light of its disabled or chronically ill beneficiaries? Until further guidance is provided, consider revising special needs trusts to exclude (i) backstop provisions, (ii) provisions allowing excess assets to be distributed to non-disabled beneficiaries, or (iii) provisions allowing the payment of travel expenses of a travel companion for a disabled beneficiary.

The April 2020 issue of Trusts and Estates magazine will include an article by Nancy Welber (Farmington Hills, Michigan) about use of the disabled and chronically ill beneficiary exceptions in the SECURE Act.

(v) **Less-Than-10-Years Younger Beneficiary**. A classic example for this exception would be siblings of the participant who are older than the participant or not more than 10 years younger than the participant. Distributions made outright or to a conduit trust for such a beneficiary will qualify for this exception.

Different siblings may be treated quite differently. Distributions to a sibling who is 9 years and 364 days younger than the owner would qualify for the lifetime payout but distributions to a sibling who is 10 years and 1 day younger would have to be paid within 10 years.

(5) **Death of DB**. At the death of a DB who is not an EDB (someone Natalie Choate refers to as a PODB, or "plain ol' designated beneficiary"), the benefits must still be paid out within the **ORIGINAL** 10-year period (actually by December 31 of the 10th year) after the participant's death.

When an EDB ceases to be an EDB, the benefits must be paid within 10 years of **THAT** time and not over the EDB's remaining life expectancy (for example, 10 years following the death of a surviving spouse or beneficiary not more than 10 years younger than the participant). §401(a)(9)(E)(iii).

When the EDB ceases to qualify as an EDB (due to death or any other reason), whether the successor beneficiary would qualify as an EDB at that time does not matter—the 10-year rule applies when the original EDB is no longer an EDB.

d. **Application of SECURE Act to Pre-2020 Deaths**. The anti-stretch provisions of the SECURE Act generally apply to participants who die after 2019, EXCEPT that if the initial DB dies after 2019 and before the plan assets have been totally distributed, the remaining benefits must be paid within 10 years of when such DB dies (even though the participant died before 2020). (Under prior law, when the DB died, the DB's beneficiary could continue to receive benefits over the DB's remaining life expectancy.)

For a discussion of disclaimer planning for pre-2020 deaths, see Item 3.i.(2) below.

The effective date provisions are unclear about what happens if the participant had multiple DBs. For example, the beneficiary may have been an accumulation trust with various individuals as permissible current or remainder beneficiaries, and each of them is a DB, even though only the oldest DB's life expectancy is used to determine the payout period. Does the 10-year rule kick in when the oldest DB has died? When any DB has died? Or when all of the DBs have died? Natalie believes the provision should be interpreted to say that the 10-year rule begins to apply only when all DB's have died (in part because the minimum distribution trust rules have no concept of a "primary" beneficiary, just countable or non-countable beneficiaries). But Natalie notes, "My opinion is worth a lot to me, but I don't know how far it will get you."

e. **General Client Triage Approach**. The anti-stretch provisions of the SECURE Act are interesting in that they constitute a major broad tax change, but they affect everybody differently based on specific client situations and goals.

(1) **Little or No Impact.** Many people will not be affected at all.

- Many clients and their families have small enough plans and assets outside of plans that deferring the receipt of money otherwise available for living expenses is the least of their concerns.
- Most retirement plan beneficiaries are not making plan withdrawals only at the minimum rate permitted. The preamble to the proposed regulations containing the new life expectancy tables for determining life payout rates from retirement plans indicates that only about 20% of individuals required to take RMDs make withdrawals at the minimum required level. Most (or at least a substantial portion) of the remaining 80% of plan beneficiaries will not be affected by the SECURE Act's 10-year rule.
- For married couples, naming the surviving spouse as the outright beneficiary of the retirement plan is the most common arrangement. The same rules apply for the surviving spouse as in the past (except that the 10-year rule will apply as to any benefits still in the plan at the spouse's subsequent death, but the likelihood that substantial assets will remain in the plan after making life payments to the surviving spouse may be relatively small).
- If the participant has no surviving spouse, clients with substantial assets in retirement plans are likely to have adult (rather than minor) children and many individuals name their adult children as the outright beneficiaries of the plan assets following the deaths of both spouses (favoring simplicity over the benefits of trusts for receiving retirement benefits).

- A charity may be named as beneficiary, in which event the SECURE Act has no impact.

(2) **Emergency Impact**. For some clients, immediate emergency action is required. Individuals who have wanted to maximize the stretch planning may be using plans to stretch the receipt of taxable benefits over the life expectancies of young children or grandchildren. Those plans often entail naming a conduit trust for the young beneficiary, leaving the trustee and not the young recipient with the power to decide whether large withdrawals would be made from the plan (or IRA). The individual likely anticipated that relatively small annual distributions would be made to the trust (and distributed from the trust to the beneficiary) annually. Instead, under this planning scenario the entire plan value will be distributed within 10 years and distributed from the trust to the beneficiary (unless the beneficiary is an EDB). Natalie Choate's conclusion: "Almost invariably, conduit trusts will not work the way the client anticipated or wants."

(3) **Slight Tweaks Needed**. For some clients, relatively minor tweaks may be needed in light of the SECURE Act. For example, an individual might tweak the type of QTIP trust that is used for a surviving spouse. A classic QTIP trust (that does not mandate that all retirement plan distributions be distributed immediately to the surviving spouse) qualified for payout over the spouse's life expectancy under the old rules but would be subject to the 10-year payout requirement under the SECURE Act. An individual might prefer to tweak that plan to require the distribution to the spouse of all amounts received from the plan so that the QTIP trust would be a conduit trust and qualify for payments over the spouse's life expectancy (Single Life Table, recalculated annually).

Having broad distribution standards with an independent trustee in accumulation trusts may be helpful to provide more income-shifting flexibilities by making trust distributions (because almost all undistributed trust income is taxed at the highest marginal bracket).

If disabled or chronically ill persons are plan beneficiaries, tweaks may be needed to special needs trusts for them. For example, accumulation trusts may qualify for special treatment, without the need for conduit trust provisions.

f. **Conduit Trusts**. The use of a conduit trust as the beneficiary is especially sensitive under the SECURE Act.

(1) **Conduit Trusts Needed for Certain EDBs**. In some situations, using conduit trusts will be very important if a client wants to use a trust for a beneficiary – for example to qualify for EDB treatment (and a modified life payout) for a surviving spouse, a minor child of the participant, or someone not more than 10 years younger than the participant. (Accumulation trusts can be used for disabled or chronically ill individuals and still qualify for EDB treatment.)

If a conduit trust is used for a minor child of the participant, the planner should take into consideration that the entire account will have to be distributed outright to the child at the latest ten years after the child "reaches majority." The planner should weigh:

the advantage of employing an extremely slow withdrawal from the account until the child reaches the age of majority (because of the minor's 60- to 80-year life expectancy), with no further withdrawals for another ten years; against

the disadvantage that at the end of that period (which could be a much extended period for a very young child), the entire account will have to be distributed outright to the child without any further trust protection.

(2) **Conduit Trusts Will Not Generally Be Used in Other Situations; Can be Disastrous in Some Situations**. In other situations, using conduit trusts may be **disastrous**. For example, if the client wanted to have benefits paid over the life of a young child, the client likely wanted to use a trust for the young beneficiary for management purposes. Conduit trusts were much simpler than accumulation trusts in the past because subsequent beneficiaries and permissible appointees are not relevant for purposes of determining the relevant life expectancy payout period. Conduit trusts have often been used in the past because of their relative simplicity. (For example, if an accumulation trust were used and if the contingent beneficiary were older than the young beneficiary, the contingent beneficiary's life expectancy would have been used rather than that of the young beneficiary.) Under the SECURE Act all plan benefits must be paid within 10 years, and with a conduit trust, those benefits are paid immediately to the beneficiary. Therefore, the deferral advantage of using a very young beneficiary is largely lost (benefits must be distributed within 10 years regardless of the beneficiary's age), and all of the nontax benefits of trusts (including preserving assets, protecting from a beneficiary's squandering of the assets, and protecting from creditors) will be available for only up to 10 years. Using a conduit trust as the plan beneficiary for an individual beneficiary who is a spendthrift could lead to the individual's squandering funds after the plan and trust distribute all plan assets to the individual within 10 years.

Again, Natalie's axiom applies: **"Almost invariably, conduit trusts will not work the way the client anticipated or wants."** But conduit trusts can be helpful if they result in EDB treatment for the beneficiary with a payout over the beneficiary's life expectancy until the EDB status ends.

Locating and identifying clients with conduits trusts will be challenging. Firms do not keep track of clients who are using conduit trusts as plan beneficiaries. Contacting past clients with a message to contact the attorney if the client has a "conduit trust" will not work because most clients have no idea what a conduit trust is. (Furthermore, Natalie quips, "clients never read anything you send them anyway.")

g. **Accumulation Trusts Will Become More Common**. In most cases going forward (other than needing to qualify for EDB treatment for spouses, minor children, or beneficiaries not more than 10 years younger than the participant), plan benefits that are being paid to trusts will pass to accumulation trusts. The complexity of structuring accumulation trusts in the past is no longer applicable because the life expectancies of the primary beneficiary and successor beneficiaries are no longer relevant – plan benefits must be distributed within 10 years regardless. Presumably regulations will eventually clarify that the oldest potential beneficiary or appointee under a power of appointment does not have to be identifiable. Excluding beneficiaries who are older than some specified age will no longer be necessary.

The only requirement, for the trust to be a designated beneficiary, is that non-human beneficiaries are excluded as potential beneficiaries. (If the accumulation trust is not a designated beneficiary, the traditional non-DB rules apply.)

Going forward, accumulation trusts subject to the 10-year rule perhaps can be simpler – merely excluding any non-humans as potential beneficiaries (other than as "mere successor potential beneficiaries") or as possible appointees under a power of appointment. However, planners may want to hold off on simplifying provisions in accumulation trusts designed to limit who might be the oldest potential beneficiaries until we get further guidance from the IRS. Natalie Choate points out that a see-through trust must meet four requirements (see Item 3.b.(5)(i) above), one of which is that the beneficiaries must be "identifiable," and for members of a class, that means being able to identify "the class member with the shortest life expectancy." Reg. §1.401(a)(9)-4, A-1. Knowing the shortest life expectancy no longer matters for accumulation trusts subject to the 10-year rule, but until the regulation has been updated, the conservative approach is to utilize the limits we have used in the past regarding the oldest potential beneficiary

Furthermore, when accumulation trusts are used for disabled or chronically ill persons, a life expectancy payout applies, and if a person older than the disabled or chronically ill person is a remainder beneficiary (other than a mere potential successor beneficiary), that older person's shorter life expectancy might be used for determining the payout period. See Item 3.c.(4)(iii)-(iv) above. For example, the trust might provide that if the trust has a disabled or chronically ill person as beneficiary, within the meaning of §401(a)(9)(E)(i), no portion of the trust for that person shall ever pass under the terms of the trust or under the exercise of any power of appointment to any person who is older than the beneficiary.

Consider giving a "trust protector" the authority to revise the terms of the accumulation trust by the September 30 "finalization date" of the year of the owner's death (discussed in Item 3.i.(2) below) to eliminate unneeded restrictions in accumulation trusts based on IRS guidance available at that time.

To be or not to be a DB? Planning for an accumulation trust **to be a DB** would be important if the participant dies before his or her RBD (April 1 of the year after reaching age 72 under the SECURE Act) to use a 10-year rather than a 5-year payout, and if the participant dies after the RBD when he or she is over about age 81 and thus having a life expectancy of less than 10 years. (Under the new life expectancy retirement plan Single Life Table issued in November 2019 and that will apply beginning in 2021, an 81-year person has a life expectancy of 10.5 years.) On the other hand, if the participant dies after the RBD when he or she is 81 years or younger, the participant's remaining life expectancy is greater than 10 years, and using the non-DB payout rules would result in a longer payout than under the DB rules.

Conceivably, the trust could be planned **NOT to be a DB in that circumstance** (by having an entity (for example, a charity) as a discretionary beneficiary, as a successor beneficiary, or as a potential appointee under a power of appointment) in order to use the participant's remaining life expectancy, which would be longer than the 10-year rule that applies for a DB beneficiary.

- Observe, though, that the trust may qualify for the longer payout using the participant's remaining life expectancy even if the trust is a DB because the regulations allow using the longer of the DB's life expectancy or the participant's remaining life expectancy at the RBD. Reg. §1.401(a)(9)-5, A-5(a)(1).
- However, §401(a)(9)(H)(i)(II)'s direction that the 10-year rule for DBs "shall apply whether or not distributions of the employee's interest have begun" might conceivably be interpreted to override that regulation if the trust is a DB.
- But the "longer of" position in the regulations seems contrary to the "at-least-as-rapidly" statutory requirement that has long existed in §401(a)(9)(B)(i), so perhaps the IRS's "longer of" position in the regulations will continue despite the new statutory language saying that the 10-year rule "shall apply" for DB's "whether or not distributions of the employee's interests have begun."

Also, Nancy Welber has pointed out that the maximum participant remaining life expectancy, if the participant dies after his or her RBD (April 1 of the year after reaching age 72) is 16.3, and that payments would not begin until the following year, when the payout period would be 15.3 years. Natalie Choate suggests that future regulations might take the sensible approach of allowing the trust to use the longer payout in that circumstance even if it is a DB.

h. **Rethinking Beneficiary Planning – Brief Summary**.

(1) **Favor Simplicity; Example – Outright to Children**. A participant may prefer the simplicity of leaving plan benefits directly to children, rather than having the benefits paid to trusts for grandchildren (ostensibly to have benefits paid over their long life expectancies), since the benefits must be paid within 10 years in any event.

(2) **Combo Approach**. Melissa Willms (Houston, Texas) suggests that in some cases a combo approach might be appropriate. A portion may go outright to a child (among other things, to take advantage of the child's lower income tax brackets), and a portion might go in trust for the child (for the nontax advantages of trusts). Or one child's portion may be outright and another child's portion may be in trust.

(3) **Consider Income Tax Effects**. Estate planning focuses a great deal on the 40% estate tax, but keep in mind that the income tax is also almost 40%, and trusts reach the top bracket after only $12,950 of taxable income. Even if trusts would be helpful for nontax purposes (such as creditor protection, especially if the beneficiary's state does not recognize a creditor exemption for IRA benefits), consider that the trust may pay a 37% income tax whereas individual beneficiaries may be in much lower brackets. (This is also a consideration for what distributions can and should be made out of trusts for income shifting purposes.) If a trust is being used primarily for creditor protection, consider whether the creditor protection is worth the potential income tax cost, and whether that protection might be better afforded by other means (such as an umbrella liability policy where it covers the major creditor risk).

(4) **BDOT Planning to Minimize Income Tax Effects**. As an alternative for using a trust as beneficiary but avoiding taxing trust income (including IRA benefits) at the highest marginal rate, consider using a Beneficiary "Deemed-Owner" Trust (BDOT)

as the recipient. A BDOT is structured to provide that the beneficiary can withdraw all taxable income each year, and the taxable income of the BDOT should be reported by the trust beneficiary under §678(a) and be taxed at the beneficiary's rates rather than at the trust's high rate. BDOTs are discussed in Item 23.e.–g. below, and in particular regarding the SECURE Act, in Item 23.f.(10). For an excellent discussion of the income tax issues facing accumulation trusts and the use of BDOTs, see Ed Morrow, *Using BDOTs for Optimal Asset Protection and Income Tax Minimization After Passage of the Secure Act*, LEIMBERG INC. TAX PL. NEWSLETTERS #192 (Feb. 18, 2020).

(5) **Conduit Trusts**. Any individuals using conduit trusts should review the plan and confirm that it is still appropriate under the SECURE Act, understanding that all plan benefits would be paid to the beneficiary within 10 years of the participant's death unless the beneficiary is an EDB, in which event a conduit trust may be required for EDB treatment to use an adjusted life payout for a surviving spouse, minor child (until reaching majority), or person not more than 10 years younger than the participant. For a minor child, the planner should not knee-jerk into using a conduit trust, but should weigh the advantage of the added period of deferral against the fact that all of the account would be distributed to the child within 10 years of reaching majority.

(6) **Accumulation Trusts**. In most cases going forward, plan benefits that are paid to trusts will pass to accumulation trusts (again, unless the trust primary beneficiary is an EDB). The terms of accumulation trusts can be simplified to delete complicated restrictions (for example to assure that no older beneficiaries are possible under the trust). Accumulation trusts going forward must merely prohibit any non-individuals as permissible beneficiaries. For example, Mickey Davis (Houston, Texas) indicates that unless future regulations provide otherwise, his trust forms for trusts designed to accept retirement plan benefits as an accumulation trust will remove references to age and life expectancies of beneficiaries and will provide in essence, "if I die before my RBD, or after my RBD when my life expectancy is less than 10 years, this trust will not have any entities as beneficiaries or permissible appointees." An alternative is giving a "trust protector" the authority to revise the terms of the accumulation trust by the September 30 "finalization date" of the year of the owner's death (discussed in Item 3.i.(2) below) to eliminate unneeded restrictions in accumulation trusts based on IRS guidance available at that time.

IRS guidance eventually may clarify that the trust does not have to include provisions making it a non-DB to take advantage of a possible slightly longer payout that might be permitted for non-DBs, in case the participant dies after the RBD and has a remaining life expectancy longer than 10 years. See Item 3.g. above. Having broad distribution standards with an independent trustee in accumulation trusts may be helpful to provide more income-shifting flexibilities by making trust distributions (because almost all undistributed trust income is taxed at the highest marginal bracket).

(7) **Disproportionate Allocation of Benefits to EDBs, Particularly Lower Bracket EDBs**. A plan or IRA owner might leave plan benefits disproportionately to a disabled beneficiary or a sibling with modest income, and leave other non-taxable assets to other beneficiaries in high income tax brackets.

(8) **TEA Pot Trusts**. A corollary of the preceding approach is the use of two discretionary pot trusts with family members as potential beneficiaries. One trust (an accumulation trust) would receive retirement benefits, and the other trust would receive other (non-taxable) assets. The trust agreements would give the trustee discretion over how to distribute funds from the trusts among trust beneficiaries, and the trustee could make distributions in the most tax-efficient manner. For example, IRA distributions from the first trust might be distributed to low-bracket beneficiaries and assets from the second equalization trust might be distributed to higher bracket beneficiaries. Alan Gassman (Clearwater, Florida) refers to this as the twin tax efficient accumulation (TEA) pot trust system, or the TEA POT Trust. Alan Gassman, Christopher Denicolo, & Brandon Ketron, *Feeling InSECURE with Estate Planning for Your Large IRA? Consider the "TEA POT" Trust System*, *Unless Paying Taxes Is Your Cup of Tea*, LEIMBERG EMPLOYEE AND RETIREMENT PL. NEWSLETTERS (Jan. 7, 2020).

(9) **Charity**. The only way to beat having to pay income tax on retirement benefits is to leave the benefits to charity. The charity is a tax-exempt entity and pays no income on receiving the benefits. Alternatively, a charitable remainder trust could be used to avoid paying income tax on receipt of the plan benefits and payments could be made to an individual beneficiary for life, but a significant enough value is left to the charity that the participant must have some charitable intent for this arrangement to make sense. See Item 3.j.(2) below.

i. **Post-Mortem Fixes and Considerations After Participant's Death**. If appropriate adjustments have not been made before the participant's death, several alternatives exist for making post-mortem adjustments to the plan beneficiaries.

(1) **Post-Mortem Reformation**. Despite the IRS's position in PLR 200742026 that it would no longer consider post-death reformations of retirement plan beneficiary designations, Natalie Choate believes that the IRS will accept a reformation if it reflects a reasonable settlement of a bona fide contest or controversy ("but family members have to genuinely hate each other for this to work," Natalie says). In addition, many PLRs have accepted reformations to correct scrivener errors. A lot of reformation proceedings may occur in the future in light of the huge law change for retirement plan minimum distributions under the SECURE Act, but planners cannot just ignore the SECURE Act thinking that they can fix any problems with a post-mortem reformation.

(2) **"Clean Up" Before September 30 Finalization Date**. The beneficiaries who are counted in determining the DBs of the plan are "the beneficiaries designated as of the date of death who remain beneficiaries on September 30 of the calendar year following the calendar year of the [participant's] death." Reg. §1.401(a)(9)-4, A-4(a). If certain beneficiaries of a trust would not constitute DBs, they could be removed as beneficiaries prior to the September 30 "finalization date" (1) by making full distribution to that beneficiary of its interest in the plan, or (2) by the beneficiary's disclaimer of the plan benefits.

As an example of possible disclaimer planning, if a participant died before 2020 leaving the surviving spouse as the beneficiary, the benefits can be paid over the spouse's life expectancy under favorable rules (using the Uniform Table with a spousal rollover, etc.). At the surviving spouse's subsequent death, however, the 10-year rule will apply and all remaining benefits must be paid within 10 years of the

spouse's death. Alternatively, the spouse could disclaim and if the effect of the disclaimer is that the benefits would pass to young beneficiaries (or to a trust using a young beneficiary's life expectancy to determine the payout period), the benefits could be paid over the life expectancy of such young beneficiary (possibly over 50-70 years). (If the participant had not received the annual distribution in the year of death, the RMD must be taken by the beneficiary for the year of death. The IRS has ruled that it will not treat the acceptance of that RMD for the year of death as acceptance of plan benefits that would preclude a valid disclaimer of the rest of the plan benefits. Rev. Rul. 2005-36.)

(3) **Consider When to Take Withdrawal**. Another important post-mortem consideration is when to take the withdrawal from the plan or IRA. It must be taken by the end of the 10th year (if the plan has a designated beneficiary who is not an EDB). If the benefits are withdrawn soon after the participant's death, the benefits will be taxed at ordinary income rates, all at once, BUT the future growth possibly could be taxed at capital gains rates long in the future (or some could be tax-free if the fixed income portion of the portfolio is invested in municipal bonds). What average growth rate would be required from the investments over the next 10 years for the income taxes savings on capital gain rates (plus the 3.8% tax on net investment income) vs. ordinary rates on the growth to overcome the lost time value of the ordinary income tax being paid up front by the time you get to the end of the 10-year period? Or could lower income tax rates be applied if the amount is withdrawn from the plan over a number of years in the first ten years (really 11 taxable years, as mentioned in Item 3.c.(3) above)?

We should be able to calculate what the growth rate of the investments would need to be, over the next 10 years, for the taxes savings on capital gain vs ordinary rates on the growth to overcome the lost time value of the ordinary income tax being paid up front by the time you get to the end of the 10-year period.

j. **Charitable Planning**. A charity is a good beneficiary of a retirement plan, because the plan benefits are taxed as ordinary income on receipt by an individual, but a charitable beneficiary is tax-exempt and pays no income tax.

(1) **Mechanics of Naming Charity as Beneficiary**. The preferable way to name a charity as beneficiary of a retirement plan or IRA is to name a donor advised fund of an institutional provider. If a charity is named directly, some IRA providers require massive amounts of information regarding the charity and all of its directors to comply with the KYC rules under the Patriot Act. Communities foundations or other institutions sponsoring DAFs are familiar with complying with those rules.

(2) **Charitable Remainder Trust or Charitable Gift Annuity**. A charitable remainder trust (CRT) makes annual annuity or unitrust payments to an individual for the individual's life expectancy or for a term of years (up to a maximum of 20 years). The trust must be structured so that the value of the charitable remainder interest is worth at least 10% of the value contributed to the trust. The IRS has published a sample CRT form. Natalie strongly suggests using the IRS sample form, with a few tweaks suggested in LEIMBERG CHARITABLE PLANNING NEWSLETTERS #80 (by Larry Katzenstein) and #88 (by Richard Fox) in 2006.

The plan benefits could be paid to the CRT immediately following the participant's death, thus satisfying the RMD requirements for the plan. The CRT is a tax-exempt entity, and does not pay income tax on receipt of the plan benefits.

When distributions are made to the individual beneficiary, a "tier system" applies to carry out the income tax attributes of the CRT's assets to the individual beneficiary. Ordinary income is deemed distributed first. As payments are made over the life of the beneficiary, all or almost all of the amounts paid to the individual likely will represent the plan benefits and will be taxed as ordinary income.

The use of the CRT is not primarily a way to beat the SECURE Act and save income taxes.

An article by Prof. Christopher Hoyt in the April 2020 issue of Trusts and Estates magazine will explore the use of CRTs under the SECURE Act.

For a discussion of an alternate arrangement of leaving an IRA to charity for a gift annuity, see Katzenstein, *Testamentary Gift Annuities as Alternative to a "Stretch" Charitable Remainder Trust?*, LEIMBERG CHARITABLE PLANNING NEWSLETTERS #292 (Feb. 10, 2020) (advantages of charitable gift annuity over CRT include possible better income tax treatment, no need of having a separate trust and trustee, and the annuity can be deferred, graduated, or "flexible" by having a deferred annuity and allowing the annuitant to choose to delay the start date, but with a commensurate increase in the annuity amount).

k. **Roth IRAs**. The 10-year rule anti-stretch provisions in the SECURE Act apply to Roth IRAs. The accelerated payments from the Roth IRA following the owner's death would not bear a 37% immediate tax, but the opportunity for future tax-free buildup over a long period of time would be lost.

   Roth conversions may still make sense for taxpayers who are in considerably lower income tax brackets (due to lower income, NOLs, loss carryovers, etc.) than the beneficiaries. (If an accumulation trust is the beneficiary, the trust reaches the maximum 37% bracket at a mere $12,950 of taxable income in 2020, so the participant might be in a significantly lower bracket. However, the time period for the tax-free growth would generally be limited to 10 years following the person's death because of the 10-year rule.)

l. **Trusteed IRAs**. The SECURE Act applies to trusteed IRAs the same as custodial IRAs. The only difference is that the plan provider is a fiduciary who has responsibility for investment and distribution decisions rather than just serving as custodian of the IRA. A distinction is that trusteed IRAs are often marketed as a way of getting stretch payouts without the client's having to prepare a separate complicated trust agreement. The nontax advantages of the trusteed IRA arrangement still exist, but not the stretch purpose (except for EDBs).

m. **IRA Charitable Rollover**. The SECURE Act does not eliminate the IRA charitable rollover, but the $100,000 limit on qualified charitable distributions from an IRA that can be excluded from income will be correspondingly reduced by any contributions to IRAs after a person has reached age 72. Changing the age for required minimum distributions from 70½ to 72 will not change the age at which qualified charitable distributions from IRAs will be permitted.

Particularly for nonitemizers, donors over age 70½ should consider making their charitable donations with IRA charitable rollovers at least up to the amount of the minimum required distribution and up to a maximum of $100,000 per year. Even though the nonitemizer donor does not get an income tax deduction, the donor will avoid recognizing income on the distributions. Especially if the donor has reached the RBD (April 1 of the year after reaching age 72 if the person had not reached age 70½ in 2019), the donor will avoid recognizing income on the required distributions from the IRA.

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

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

4. Anti-Clawback Regulation

a. **Detailed Discussion**. For a detailed discussion of the anti-clawback regulation and planning observations in light of the regulation, see Item 4 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Basic Description**. If a client makes an $11 million gift in 2020 (when the gift exclusion amount is $11.58 million) but dies in 2026 after the basic exclusion amount has sunsetted to $5 million indexed (say $6.8 million), the $11 million is added into the estate tax calculation as an adjusted table gift, but the estate exclusion amount is only $6.8 million. So will estate tax be owed on the difference?

The anti-clawback proposed regulation was released by the IRS on November 20, 2018. The final regulation was released almost exactly a year later on November 22, 2019, and was published in the Federal Register on November 26, 2019, largely adopting the approach of the proposed regulations with a few clarifying revisions. T.D. 9884, RIN 1545-B072, 84 FED. REG. 64995 (Nov. 26, 2019). A citation error was corrected in the final regulation in February, 2020. 85 FED. REG.6803 (Feb. 6, 2020).

The operative sentence stating the anti-clawback rule is in Reg. §20.2010-1(c)(1). Ron Aucutt refers to this provision as "somewhat sacrificing readability for precision." No joke in terms of "sacrificing readability," but a news release issued contemporaneously with the release of the proposed regulations explained that the 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."

Example. A simple example in the final regulation addresses an individual (A) who made cumulative post-1976 taxable gifts of $9 million that were sheltered from gift tax by the cumulative total of $11.4 million in BEA allowable on the dates of the gifts. A dies after 2025 when the BEA is $6.8 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (i.e., the tentative tax on $9 million) exceeds the credit based on the $6.8 million BEA applicable at the date of death, the credit applied in computing the estate tax is based on a BEA of $9 million, "the amount used to determine the credits allowable in computing the gift tax payable on A's post-1976 gifts." Reg. §20.2010-1(c)(2)(i)Ex. 1.

This example is the same as Example 1 in the proposed regulations, except that hypothetical inflation adjusted BEA amounts are used in the final regulation.

c. **Several Observations**. The final regulation generally adopts the approach of the proposed regulations with a few clarifying revisions.

(1) **Window of Opportunity**. Most important, the final regulation confirms that a window of opportunity exists for transfer planning before the BEA reverts to $5 million indexed. "[T]he increased BEA is a 'use or lose' benefit that is available to a decedent who survives the increased BEA period only to the extent the decedent "used it" by making gifts during the increased BEA period." Preamble to Final Regulation at 4.

If an individual gives $11 million now, and dies after the BEA is $6.8 million, under the anti-clawback regulation the BEA for estate tax purposes is the larger of the $6.8 million amount at death or the $11 million amount applied against gifts, so the BEA covers the $11 million adjusted taxable gift and no gift or estate tax is owed on the $11 million. On the other hand, if the individual retains the $11 million asset until death, the $11 million is included in the gross estate but the BEA is only $6.8 million, and estate tax is owed on the remaining $4.2 million.

Any individual client with over $3.5 million and any couple having over $7.0 million should at least consider this window of opportunity. (Various Congressmen have proposed reducing the BEA to $3.5 million.)

(2) **Inflation-Adjusted BEA Amounts in Examples**. Example 1 in the proposed regulation does not reflect inflation adjustments to the BEA to "more simply" illustrate the operation of the regulation. The final regulation uses hypothetical inflation adjusted amounts (assumed to be $11.4 million before 2026 and $6.8 million on the date of death after 2025) in the various examples in the final regulation. Reg. §20.2010-1(c)(2)(i)Ex.1.

(3) **No "Off-the-Top" Use of Increased BEA**. The two different places in the preamble to the final regulation confirm that the IRS does not adopt a rule allowing "donors to utilize the increase in the BEA without being deemed to have utilized the base BEA, so that the base BEA would remain available for transfers made after 2025." Preamble to Final Regulation at 8. Consider not making the split gift election, so that all gifts come from one spouse, utilizing that spouse's excess exclusion amount that is available until 2026. For this purpose, it is better for one spouse to make an $11 million gift than for both spouses to make $5.5 million gifts.

(4) **Portability; Impact of Decrease in BEA on DSUE Amount**. The final regulation clarifies that "a DSUE amount elected during the increased BEA period will not be reduced as a result of the sunset of the increased BEA." Preamble to Final Regulation at 5. Examples 3 and 4 of the final regulation confirms this result. Reg. §20.2010-1(c)(2)(iii)Exs.3-4.

(5) **Ordering Rule Requiring Use of DSUE Before Increased BEA**. If a surviving spouse has a DSUE amount from a predeceased spouse, the individual would generally prefer to apply the increased BEA to gifts made when the increased BEA is available (because, as discussed above, use of the increased BEA is a "use or lose" proposition), leaving the individual with continue to hold the DSUE amount, but that is not permissible. The preamble to the final regulation reminds that the portability final regulations require that "any DSUE amount available to the decedent for [a] calendar period is deemed to be applied to the decedent's gifts before any of the decedent's BEA is applied to those gifts (citing Reg. §§20.2010-3(b) & 25.2505-2(b)). Preamble to Final Regulation at 6). Example 4 of the final regulation reiterates that result. Reg. §20.2010-1(c)(2)(iv)Ex.4.

(6) **Post-Gift Inflation Adjustments**. The final regulation confirms that inflation adjustments to the BEA after the time that gifts are made cannot be used after the increased BEA period under the special rule for avoiding clawback until after the inflation adjustments have increased the BEA to the amount of BEA applied against gifts during the increased BEA period prior to 2026.

(7) **Application of Increased GST Exemption to Prior Gifts.** Because of the wording of the effective date provision in 2017 Tax Act, technical issues existed as to whether someone could allocate increased GST exemption to transfers that were made before 2018. Several commenters asked the IRS to confirm that the increased GST exemption during the increased BEA period can be applied to gifts made before 2018. The preamble to the final regulation states that this issue is beyond the scope of these regulations, but the IRS made its position clear: "There is nothing in the statute that would indicate that the sunset of the increased BEA would have any impact on allocations of the GST exemption available during the increased BEA period (citing the Joint Committee on Taxation "bluebook" for its interpretation of the 2017 Act as allowing "a late allocation of GST exemption (increased by the increase in the BEA)"). The American Bar Association Tax Section has requested the IRS to confirm this conclusion in official guidance.

(8) **Anti-Abuse Rule**. The preamble notes that a commenter recommended that the anti-clawback rule be revised so that it would not apply to gifts that are included in the gross estate, such gifts as with retained life estates or with retained powers or interests or certain gifts "within the purview of chapter 14" (not identified in the preamble as gifts valued at a higher amount under §§2701 or 2702). The preamble concludes that although "such a provision is within the scope of the regulatory authority granted in section 2001(g)(2), such an anti-abuse provision would benefit from prior notice and comment. Accordingly this issue will be reserved to allow further consideration of this comment." The commenter referred to in the preamble was not identified in the preamble, but was the New York State Bar Tax Section, as discussed in paragraph d immediately below.

d. **Comments to IRS Recommending Not Allowing Unified Credit Increase for Exclusion Used in Prior Gifts That Are Included in the Gross Estate**. For an individual who wants to take advantage of the "window of opportunity" available with the $10 million (indexed) gift and estate exclusion amount before it reverts to $5 million (indexed) in 2026 but without really giving up rights with respect to the gifted asset, one alternative is to make a gift of an asset while retaining the income from or use of the asset (in a manner that does not satisfy §2702). The gift will be a completed gift of the full value of the transferred asset if §2702 is not satisfied and if the donor's creditors cannot reach the assets. The asset will be included at its date of death value in the gross estate under §2036(a)(1), but the date of gift value will not also be included in the estate tax calculation as an adjusted taxable gift. §2001(b) (last sentence). The effect is that the asset has been given to someone else, the date of death asset value is included in the gross estate, but at least the date of gift value is offset by the estate tax unified credit, which is increased by the amount of exclusion applied against lifetime gifts if that amount exceeds the exclusion amount available at death (for example, due to a decrease in the basic exclusion amount in 2026). The post-gift appreciation in the asset is all that is effectively subject to estate tax. See Item 8.g.(1) below.

This is clearly the result under the existing anti-clawback regulations; the preamble to the proposed regulations made clear that the increased BEA was applied for prior gifts "**whether or not included in the gross estate**." (That approach has some support in the statutory language of §2001(b)(2) which, in the estate tax calculation process, provides for a subtraction of the hypothetical gift tax on all "gifts made by the decedent after December 31, 1976" not just on "adjusted taxable gifts," which would exclude gifts that are includible in the gross estate (§2001 last sentence).) Will that change?

Another approach, which would end up with gifts in the gross estate while still taking advantage of the window of opportunity, is making a gift by a legally enforceable note. If the donor dies before the note is paid, the assets that will be needed to pay the liability are still in the gross estate, and the same estate tax calculation applies so that the client would have taken advantage of the window of opportunity. See Item 8.g.(2) below. A similar approach is making gifts valued under chapter 14 at different than fair market value. See Item 8.g.(3) below regarding gifts valued under §2701.

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

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

In addition, the comments point out a similar effect might result under §2701 from a gift of common stock while retaining preferred stock in the entity, which could leave the donor with "the right to earnings and income of the entity through the retention of preferred interests." If the Service wishes "to limit the benefits of locking in temporarily increased exclusion amount," the Section recommends "that the Treasury and Service study the problem further." The NYSBA Tax Section comments are available at **http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2019/1410_Report.html**. See Item 8.g. below for a description of some of these alternatives for "locking in" use of the increased gift exclusion amount.

The preamble to the final regulation states that the suggestion to exclude gifts that are included in the decedent's gross estate from the operation of the anti-clawback regulation is within the scope of the regulation but "such an anti-abuse provision would benefit from prior notice and comment. Accordingly, this issue will be reserved to allow further consideration of this comment." Preamble to Final Regulation at 10.

This means that planners will be uncertain whether this planning strategy is viable until further IRS guidance, which could be years away (if ever – the IRS might conceivably never give further guidance and just leave the NYSBA Tax Section's comment as a "chill" on using these alternatives). Planners should be cautious in using these approaches as a way of making use of the increased gift exclusion amount until the IRS issues further guidance.

5. Other Administrative Guidance Regarding 2017 Tax Act Changes

a. **Executor or Trustee Fees and Other Miscellaneous Estate or Trust Expenses**. Despite the adoption of §67(g) in the 2017 Tax Act, Notice 2018-61, effective July 13, 2018, clarifies that the Treasury and the IRS "intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct expenses described in section 67(e)(1) and amounts allowable as deductions under section 642(b), 651, or 661…." The Notice reasons that under the statutory definitions of "miscellaneous itemized deductions," "itemized deductions" and "adjusted gross income," the expenses of estates or trusts to which §67(e) applies are not "miscellaneous itemized deductions" at all, so §67(g) cannot apply to them. The Notice is effective July 13, 2018, but estates and non-grantor trusts may rely on the notice for taxable years beginning after December 31, 2017. For further discussion of this issue, see Item 5.a. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. .

b. **Excess Deductions or Losses at Termination of Estate or Trust**. Section 642(h) provides that on the termination of an estate or trust, a net operating loss carryover or capital loss carryover (§642(h)(1)) or the excess of deductions over income for the last taxable year (§642(h)(2)) are allowed as deductions to the beneficiaries succeeding to the property of the estate or trust "in accordance with regulations prescribed by the Secretary." Are those miscellaneous itemized deductions that are disallowed under §67(g)?

Regulations provide that the excess deductions in the last year of the estate or trust that are allowed to the beneficiaries are "allowed only in computing taxable income … [and are] not allowed in computing adjusted gross income." Treas. Reg. §1.642(h)-2(a). Therefore, the reasoning of Notice 2018-61(that trust expenses allowed under §67(e) are allowed in arriving at adjusted gross income and are therefore not miscellaneous itemized deductions) would seem not to apply. Those deductions are not mentioned in §67(b) and are miscellaneous itemized deductions, so their deduction is seemingly not allowed for 2018-2025 under new §67(g). Indeed the Joint Explanatory Statement specifically includes "[e]xcess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust" as one of the "above listed items" that cannot be claimed as a deduction under §67(g). The discussion about *estate/trust* deductions in Item 5.a. above does not apply, because these are deductions to the individual beneficiaries, not to the trust.

Notice 2018-61 observes that the miscellaneous itemized deductions that are not deductible under §67(g) appear to include the §642(h)(2) excess deduction. However, the **IRS is studying whether to treat** deductions that would have been treated under §67(e) in the hands of the estate or trust (and therefore not a miscellaneous itemized deduction of the estate or trust) should be treated similarly for the individual beneficiaries (i.e., allowed in computing adjusted gross income and therefore not subject to §67(g)).

Despite the inconsistent regulation, the 2018 and 2019 Form 1041, Schedule K-1, and the related instructions appear to allow beneficiaries to treat excess deductions carried out to beneficiaries following the final year of an estate or trust as miscellaneous itemized deductions not subject to the §67(g) suspension of miscellaneous itemized deductions through 2025. The instructions for Box 11, Code A of the 2018 and 2019 Schedule K-1 direct beneficiaries to report their share of excess deductions on line 16 of the 2018 Form 1040 Schedule A for miscellaneous itemized deductions that are still allowed. However, the Form 1040, Schedule A, line 16 instructions do not address this deduction. An official with the IRS Chief Counsel's Office has advised Vince Lackner (Pittsburgh, Pennsylvania) that unless the regulations are changed, excess deductions may not be claimed by beneficiaries on Schedule A of Form 1040 for 2018-2025, reasoning that "the regulations trump [any contrary form] instructions" (i.e., the Form 1041 Schedule K-1 instructions).

If §67(e) applies to certain expenses of an estate or trust, and if the estate or trust terminates and passes to another trust, can those expenses be deducted by the recipient trust under §67(e)? Presumably not, because §67(e)(1) seems to refer to expenses incurred in the administration of the estate or trust claiming the deduction.

However, if the IRS should decide to treat expenses as having the same "character" under §67(e) for beneficiaries as for the original estate or trust, that same analysis would presumably apply for trust beneficiaries as well as for individual beneficiaries.

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

c. **State and Local Taxes Deduction**. The $10,000 limit on state and local tax (SALT) deductions has led some states to consider implementing laws providing relief from state income tax to the extent of contributions to a specified charitable fund, in hopes that the taxpayer could deduct the full charitable contribution without any $10,000 limitation. The IRS issued final regulations, published in the Federal Register on June 13, 2019, blocking these types of arrangements by disallowing a federal charitable deduction when the donor expects to receive an offsetting credit against state and local taxes. The regulations are based on the generally recognized "quid pro quo" rationale of not allowing a charitable deduction to the extent that the donor receives a benefit from the donation. Notice 2019-12, 2019-27 I.R.B. 57 provides a safe harbor for payments made by certain individuals. See Item 5.c. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** for further discussion of this issue.

d. **Final Regulations on Reportable Policy Sales–Transfer for Value**.

(1) **Background**. The 2017 Tax Act includes provisions 1) mandating reporting of "reportable policy sales" (generally speaking, investors buying policies) and 2) changes to transfer for value rules so that death proceeds will be taxable income. Reportable policy sales under the 2017 Tax Act are sales of life insurance policies to someone who has no substantial family, business, or financial relationship with the insured. Final regulations have MIND-NUMBING details about reportable policy sales.

Planners have been concerned about what the transfer for value changes would mean for changes to the transfer for value exceptions aside from reportable policy sales.

Proposed regulations were issued March 22, 2019, and final regulations were published Oct. 31, 2019. T.D. 9879 (Oct. 15, 2019), 84 FED. REG. 58460 (Oct. 31, 2019).

(2) **Several Observations about Practical Impact on Planners**

(i) **Transfer for Value Generally**. Life insurance death benefits are generally income tax free under §101(a)(1), but not if the policy was transferred for value, §101(a)(2). Two important exceptions from the transfer for value rule under §101(a)(2)(A)-(B) are the (1) "basis exception" (if the basis is determined in whole or in part by reference to transferor's basis), and (2) "permitted transferee exception" (including a transfer to the insured). However, new §101(a)(3) says that the

exceptions do not apply to a reportable policy sale. The new regulations generally do not impact the transfer for value exceptions other than just for reportable policy sales. But a few changes are helpful generally.

(ii) **"Cleansing the Transfer-for-Value Taint."** If a transfer for value occurs, a later transfer back to the insured removes the taint. Final regulations have provisions and an example confirming that, even if the transfer back to the insured is not the last transfer of the policy. However, if a policy was transferred in a reportable policy sale, the "fresh start" applies only if the insured pays fair market value for the interest.

(iii) **Buy-Sell Agreements**. PLR 7734048 suggested that obligations under a buy-sell agreement could generate a transfer for value. The final regulations relax that result by saying that a transfer for value is a transfer for "cash or other consideration reducible to money value."

(iv) **Transfer to Grantor Trust**. A transfer to a grantor trust is treated as transfer to the insured for purposes of the permitted transferee exception to the transfer for value rule. *See* PLR 201423009.

(v) **Transfer to Nongrantor Trust**. A transfer to a nongrantor trust is not a reportable policy sale as long as each beneficiary has a substantial family, business, or financial relationship. But it may still be a transfer for value because the nongrantor trust is not treated as the insured for purposes of satisfying the transferee exception.

e. **Qualified Business Income**.

(1) **General Description**. A complicated provision in new §199A provides tax-favored treatment of business income from passthrough entities (sole proprietorships, partnerships, limited liability companies, or S corporations) that are not subject to taxation under Subchapter C and that will be taxed at the individual tax rates of the owners, which could be as high as 37%. The deduction under §199A reduces the wide discrepancy (21% vs. 37%) in the top rates at which business income would be taxed, depending on whether the business is taxed as a C corporation or as a proprietorship or passthrough entity. Very generally (but with various limitations and exceptions), the §199A deduction is a deduction for the individual owner's tax calculation equal to 20% of the individual's qualified business income from a pass-through entity; the 20% deduction results in an effective top rate of (1 – 0.20) x 37%, or 29.6%. This deduction is subject to various limitations, the most important of which apply to taxpayers with taxable income over a certain threshold amount ($157,500 single/$315,000 for joint returns, indexed - $163,300/$326,600 for 2020). One limitation is based on the wages paid by the business or wages plus the basis of its property. A second limitation is that for certain specified service businesses no deduction is allowed (designed to remove incentives to prevent converting what would otherwise be normal service compensation income into business income). The deduction is allowed to individuals, trusts and estates.

The Internal Revenue Service Advisory Council Public Report dated November 2019 summarizes the impact of §199A as follows:

> The IRS estimates that almost 23.7 million taxpayers may be eligible to claim the deduction [citing TIGTA Report dated March 18, 2019, Reference Number 2019-44-022]. The Joint Committee on Taxation estimated a tax reduction of $27.7 billion in Fiscal Year 2018 and $47.1 billion in Fiscal Year 2019 and totaling $414.5 billion over Fiscal Years 2018 through 2027 [citing the same source].

For a much more detailed discussion of the qualified business income deduction under §199A see Item 7 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(2) **Regulations Overview**. The IRS on August 8, 2018, issued 184 pages of proposed regulations (including a 104 page preamble) to §199A and the multiple trust rule under §643. The issuance of complicated detailed proposed regulations to this complex Code section within only about eight months of the passage of the Act was amazingly fast.

Final regulations were issued on January 18, 2019, and a slightly revised version making a few corrections was issued on February 1, 2019. The final regulations were published in the Federal Register on February 8, 2019. In addition, Rev. Proc. 2019-11 was issued concurrently to provide additional guidance on the definition of wages, and Notice 2019-07 was issued concurrently to provide a safe harbor in a proposed Revenue Procedure under which a rental real estate enterprise may be treated as a trade or business for purposes of §199A (and that Revenue Procedure, Rev. Proc. 2019-38, was released on September 24, 2019). For a 22-item list briefly listing some of the changes in the final regulations see Item 7.e. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(3) **Provisions Impacting Trusts**. The final regulations made the following changes impacting trusts:

(i) ESBTs may continue to qualify for the §199A deduction (as in the proposed regulations) but the separate S and non-S portions of the ESBT are not treated as two separate trusts for purposes of applying the taxable income threshold test;

(ii) A trust's taxable income, for purposes of determining whether the trust's taxable income exceeds the threshold amount, is calculated after deducting any distribution deduction under §§651 or 661;

(iii) Separate shares of a single trust will not be treated as separate trusts for purposes of determining whether the trust exceeds the taxable income threshold;

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

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

The ability to determine a trust's threshold amount after deducting distribution deductions is important. The proposed regulations did not allow taking the distribution deduction into consideration for purposes of determining whether a trust exceeds the taxable income threshold amount. This change opens the door to planning distributions to leave the trust with taxable income below the threshold amount, if appropriate based on the trust's distribution standards. Distributions made within 65 days of the end of the taxable year, which will be March 5, 2020 for the 2019 taxable year, can be considered under the 65-day rule. §663(b) (distributions by an estate or trust within 65 days of the tax year, March 5 in leap years and March 6 in non-leap years, can be treated as having been made on the last day of the prior tax year).

The maximum tax savings per trust from the §199A deduction alone would not exceed $163,300 (the threshold amount for the trust is $163,300 in 2020) times a 20% §199A deduction times a 37% rate, or $12,084, or about $12,000 per trust.

f. **Qualified Opportunity Funds**. The three big tax advantages for investments in qualified opportunity funds (QOFs) under §1400 Z-1 and §1400 Z-2 are: (i) Deferral of existing gain until December 31, 2026; (ii) Exclusion of a portion of the existing deferred gain (10% or 15%, depending on how long the fund investment is held—to get the full 15%, the investment had to be made before December 31, 2019, so a big rush to purchase funds occurred in December); and (iii) Nonrecognition of gain in the QOF investment itself if the interest in the fund is held at least 10 years.

Proposed regulations were issued in October 2018 and April 2019, and final regulations were issued in December 2019. Some of the highlights of the regulations that are important for estate planners are summarized.

(1) **Inclusion Events**. The statute (§1400Z-2(b)(1)(A)) says that the deferred gain will be accelerated and recognized before December 31, 2026 if a "sale or exchange" of the QOF investment occurs. The regulation refers to these as "inclusion events."

(2) **Gifts as Inclusion Events**. A gift of an interest in a QOF is an inclusion event (unless the gift is to a grantor trust, as discussed immediately below). That seems difficult to justify under the statute that refers to "sales or exchanges" as accelerating the deferred gain, but the regulation reasons 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." If gifts were not treated as inclusion events, the deferred gain could be avoided just by making a gift.

(3) **Grantor Trust**. A gift to a grantor trust (including a §678 trust) is not an inclusion event.

(4) **Nonrecognition Transactions with Grantor Trusts**. Final regulations confirm that nonrecognition transactions between the "deemed owner" and the grantor trust are not inclusion events. This seems to include things such as –

– sales of QOF interests to a grantor trust,

– in-kind note payments from a grantor trust to the grantor,

– the grantor's exercise of a substitution power, and

– distributions of QOF interests to satisfy GRAT annuity payments.

(5) **Death**. Death is not an inclusion event, including transfers by reason of the owner's death. (This position is an interesting analogy for the position that in a sale to grantor trust transaction, the death of the grantor before the note is paid should not be an event accelerating any deferred gain attributable to unpaid note payments.)

(6) **Basis Step-Up at Death**. The final regulations state that there is no basis step-up at death in the QOF investment to the extent that the value at death exceeds the deferred gain. (ACTEC Comments had recommended that approach.)

(7) **More Detailed Discussion**. For a more detailed discussion of QOFs, see Item 35 below.

g. **Life Insurance-Basis of Life Insurance and Annuity Contracts Not Reduced by Mortality Charges, Rev. Rul. 2020-5**. The 2019 Tax Act amended §1016(a) to provide that the basis of life insurance and annuity contracts would not be reduced by mortality, expenses, or other reasonable charges under the contracts. This is important for determining the amount of income recognized upon the sale of such contracts. This change is contrary to the announced IRS position in Rev. Rul. 2009-13 (Situations 2 & 3) and Rev. Rul. 2009-14 (Situation 2). Rev. Rul. 2020-5, 2020-9 I.R.B. (Feb. 24, 2020) amends those prior revenue rulings to be consistent with the amendment to §1012(a), and to clarify that the basis is not reduced by the "cost of insurance charges," regardless of why the contract was purchased.

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

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

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

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

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

- Part 1 of the Plan addresses implementation of the 2017 Tax Act and lists 52 projects (down from 71 in the fourth quarter update of the 2018-2019 Plan).
- Part 2 deals with identifying and reducing regulatory burdens.

- Part 3 titled "Burden Reduction" increases the number of projects from 14 in the fourth quarter update of the 2019-2019 Plan to 25. This "burden reduction" section, as in the 2017-2018 and 2018-2019 Plans, lists final regulations regarding (1) basis consistency and (2) discretionary extensions of time to make GST exemption allocations (suggesting a likely relaxation of some of the controversial provisions in the proposed regulations for those matters).
- Part 4 lists seven guidance projects for prioritized implementation of the Taxpayer First Act (enacted on July 1, 2019), which made changes regarding various IRS operations including the establishment of a new Independent Office of Appeals.
- Part 5 includes projects regarding partnership audit regulations.
- Part 6 contains the traditional General Guidance projects in a variety of subject areas. Four items are in the "Gifts and Estates and Trusts" section. The first three are the same as in the 2017-2018 Plan, which include projects dealing with (1) the basis of grantor trust assets at death under §1014, (2) alternate valuation date matters under §2032(a), and (3) the deductibility of certain estate administration expenses under §2053. The fourth project, added in the 2018-2019 Plan and still in the 2019-2020 Plan, is: "Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests." The project is to update the §7520 actuarial tables based on updated mortality information, which must be done every ten years and that was last done effective May 1, 2009. The tables were not updated by May 1, 2019, and IRS officials have informally indicated that the IRS is waiting on data from another agency and that they do not know at this point when they will be able to complete the new tables. Presumably, the existing tables can be used until revised tables are published.

  An interesting omission of an important project is item 14 under "General Tax Issues" in the 2018-2019 Plan, dealing with final regulations for the 3.8% tax on net investment income under §1411. Also, a project under the subject of "Financial Institutions and Products" regarding regulations under §7872, which first appeared in the 2016-2017 Plan, was dropped from the 2019-2020 Plan.

For a general discussion of and commentary about the 2018-2019 Priority Guidance Plan, see Ronald Aucutt, *The 2018-2019 Priority Guidance Plan*, ACTEC CAPITAL LETTER NO. 45 (Nov. 13, 2018). Commentary about the 2019-2020 Plan is included in Ronald Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes (With Selected Cases)*, (October 2019) available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

IRS officials have confirmed that, following several years of focusing on guidance to implement the 2017 Tax Act, "regulation writers in the trusts and estates arena are pivoting back to guidance projects that were temporarily shelved." Jonathan Curry, *Final Anti-Clawback Estate Tax Regs to Address Portability Concern*, TAX NOTES (Nov. 18, 2019). Holly Porter, IRS associate chief counsel (passthroughs and special industries) has stated that "the secretary strongly feels if it's on the PGP, it will be finished within a year." *Id.*

For further details about the (i) basis consistency, (ii) basis of grantor trust assets at death, (iii) alternative valuation date, and (iv) §2503 administrative expense deduction projects, see Item 6.b.- e. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

When the basis consistency regulations are finalized, among other things planners hope that the requirement of filing reports for subsequent transfers will be relaxed. Interestingly, the Form 8971 does not specifically address the reporting of subsequent transfers.

b. **Inflation Adjustments**. Inflation adjustments for 2020 are announced in Rev. Proc. 2019-44. Some of the adjusted amounts are as follows:

- Basic exclusion amount and GST exemption-$11,580,000 (from $11,400,000 for 2019);
- Estates and trusts taxable income for top (37%) income tax bracket-$12,950 (from $12,750 in 2019);
- Taxable income threshold for §199A qualified business income-$326,600/$163,300 (married filing jointly/single) (from $321,400/$160,700 in 2019);
- Standard deduction-$24,800/$12,400 (married filing jointly/single) (from $24,400/$12,200 in 2019);
- Non-citizen spouse annual gift tax exclusion-$157,000 (from $155,000 in 2019);
- Section 6166 "two percent amount"-$1,570,000 (from $1,550,000 in 2019); and
- Special use valuation reduction limitation-$1,180,000 (from $1,160,000 in 2019).

c. **No-Rule List, ING Trusts**. The no-ruling revenue procedure for 2020 includes, as one of the items for which rulings or determination letters will not be issued, certain trusts that are typically structured to be non-grantor trusts as an alternative for saving state income taxes (these types of trusts are often referred to as DINGs or NINGs – Delaware incomplete non-grantor trusts or Nevada incomplete non-grantor trusts [Prof. Sam Donaldson points out that clients needing ING trusts who want to take advantage of Florida's absence of an income tax could be creating FLING trusts]). (Rev. Proc. 2020-3, §3.01(93)). The ruling says that rulings regarding the taxation of the trust under §671 (i.e., whether or not it is a grantor trust) will not be issued for such trusts that are structured to authorize distributions

> (A) at the direction of a committee if (1) a majority or unanimous agreement of the committee over trust distributions is not required, (2) the committee consists of fewer than two persons other than a grantor and a grantor's spouse, or (3) all of the committee members are not beneficiaries (or guardians of beneficiaries) to whom all or a portion of the income and principal can be distributed at the direction of the committee, or

(B) at the direction of, or with the consent of, an adverse party or parties, whether named or unnamed under the trust document (unless distributions are at the direction of a committee that is not described in paragraph (A)).

Accordingly, DING and NING transactions will be structured in the future to avoid the "bad facts" listed. *See* William Lipkind & Tammy Meyer, *Revenue Procedure 2020-3 – IRS Will Not Rule on Certain Provisions of Non-Grantor Trusts*, LEIMBERG INC. TAX PL. NEWSLETTERS #190 (Feb. 4, 2020).

Various IRS rulings over the last several years have approved ING trusts. *E.g.,* Letter Rulings 202006002-006 (community property in ING trust remains community property at first spouse's death for basis adjustment purposes; no ruling whether trust is grantor trust under §675 because that involves fact issues at death), 201925005-201925010, 201908002-201908008, 201852014, 201852009, 201850001-201850006, 201848009, 201848002, 201832005-201832009, 201744006-008.

d. **Administration's Fiscal Year 2018, 2019, 2020, and 2021 Budget Proposals**. The Administration releases a budget proposal each year (historically in a report titled "General Explanations of the Administration's Fiscal Year ____ Revenue Proposals" that is often referred to as the "Greenbook"), and during the Obama years, a number of estate and gift tax proposals were included. The budget proposals from the Trump Administration have not included specific tax legislation proposals. The FY 2020 budget, titled "A Budget for a Better America," was published March 11, 2019. The FY 2021 budget, titled "A Budget for America's Future," was published February 10, 2020. The "adjusted baseline projection" used in the budget

> assumes permanent extension of all individual income tax provisions in the Tax Cuts and Jobs Act that are currently set to expire on December 31, 2025 … [and] the estate and gift tax parameters and provisions in effect for calendar year 2025.
>
> The 2021 Budget supports the extension of the individual and estate tax provisions of the Tax Cuts and Jobs Act beyond their expiration in 2025, as described above, to provide certainty for taxpayers and to support continued economic growth.

Office of Management and Budget President's Budget, Analytical Perspectives, ch. 11 Governmental Receipts, at 127-128 (available at **www.whitehouse.gov/omb/budget/**).

e. **Few Revenue Rulings**. One of the (somewhat) relevant revenue rulings in 2019 was Rev. Rul. 2019-19 (Sept. 3, 2019). It provides that the failure to cash a distribution check from a qualified retirement plan does not avoid current income tax liability.

Interestingly, note that by September, the IRS was all the way up to number 19 in issuing revenue rulings. Contrast that with 50 years ago, in 1969, when 661 revenue rulings were issued throughout the year. (Ironically, Rev. Rul. 69-661 was a list of rulings that had become obsolete.)

Carol Harrington observes that some cases have referred to revenue rulings as merely "the position of a frequent litigant." *See Estate of McLendon v. Commissioner*, 135 F.3d 1017 (5th Cir. 1998) ("Whereas virtually every circuit recognizes some form of deference, the Tax Court stands firm in its own position

that revenue rulings are nothing more than the legal contentions of a frequent litigant, undeserving of any more or less consideration than the conclusory statements in a party's brief."). Under this approach, taxpayers are not bound by revenue rulings (they have not been through the formal comment and review process that regulations go through), but the IRS Chief Counsel Office has said that IRS attorneys cannot argue contrary to "final guidance," which includes revenue rulings (CC-2003-014), and case law has held that the IRS is bound by its own revenue rulings. *See Rauenhorst v. Commissioner*, 119 T.C. 157 (2002) (holding the Service bound by a taxpayer-friendly revenue ruling); Mitchell M. Gans, *Deference and the End of Tax Practice*, 36 REAL PROP. PROB & TR. J 731 (2002) (arguing that the Service should be bound by revenue rulings). *See also* letter from Deborah H. Butler, Office of Chief Counsel, October 17, 2002 (indicating, in the aftermath of *Rauenhorst*, that the Service will not disavow in litigation a taxpayer-friendly revenue ruling).

Some have suggested that Executive Orders 13891, "Promoting the Rule of Law Through Improved Agency Guidance Documents" (October 9, 2019) and 13892, "Promoting the Rule of Law Through Transparency and Fairness in Civil Administration Enforcement and Adjudication" (October 9, 2019) will lead to even less IRS guidance below regulations. *See* Jasper Cummings, Jr., *Deep State Revenue Rulings*, TAX NOTES (Feb. 11, 2020).

7. Estate Planning For Moderately Wealthy Clients

a. **Small Percentage of Population Subject to Transfer Taxes; Paradigm Shift for Planners**. The number of federal estate tax returns **filed** has dropped dramatically from 109,000 returns in 2001 to about 11,000 returns in 2016 and 2017. For deaths occurring in 2018, estimates are that 4,000 returns would be filed, with only about 1,900 taxable returns.

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

The $10 million (indexed) gift tax exclusion amount also means that many individuals have no concern with lifetime gifts ever resulting in the payment of federal gift taxes.

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

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

b. **Cannot Ignore GST Tax**. Even low-to-moderate wealth individuals cannot ignore the GST tax. Without proper allocation (either automatically or manually) of the GST exemption (also $10 million indexed), trusts created by clients generally will be subject to the GST tax (currently 40%) at the death of the beneficiary unless the trust assets are included in the beneficiary's gross estate.

Grantors who have previously created irrevocable trusts that are not fully GST-exempt may want to allocate some of the increased GST exemption amount to the trust. The Bluebook for the 2017 Tax Act (published in December 2018 about a year after the Act was passed) has a detailed footnote saying that is permitted, and the preamble to the anti-clawback final regulation suggests that the IRS agrees. See Item 4.c.(7) above.

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

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

Alternatively, using a credit shelter trust may be advantageous for various reasons including in blended family situations, as discussed in Item 8.d. the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** (along with a more detailed discussion of portability planning, including the advantages and disadvantages of various approaches).

For a detailed discussion of the temporary and proposed portability regulations see Item 6.h.-q. of the December 2012 summary, "Estate Planning Current Developments and Hot Topics" found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

For a detailed discussion of planning considerations, including major factors in bypass planning versus portability, methods of structuring plans for a couple to maximize planning flexibilities at the first spouse's death, ways of using the first decedent-spouse's estate exemption during the surviving spouse's life, whether to mandate portability, whether to address who pays filing expenses to make the portability election, state estate tax planning considerations, and the financial impact of portability planning decisions, see Item 5 of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** and Item 8 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. Rev. Proc. 2016-49 clarifies that portability can be used in connection with QTIP trusts. For a more detailed discussion, see Item 16.b. of the Current Developments and Hot Topics Summary (December 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

Portability elections must be made on a timely filed estate tax return. A simplified procedure is available to obtain an extension in certain situations if a return was not required to be filed. See Item 19.d. below.

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

For clients subject to a state estate tax, flexible QTIP trust planning could result in (i) a "standard" QTIP trust for the excess over the federal basic exclusion amount, (ii) a QTIP trust effective only for state purposes (sometimes referred to as a "gap trust") for the amount in excess of the state exemption amount but less than the federal exclusion amount if the state allows a "state-only QTIP election," and (iii) a Clayton QTIP that has expanded into broader terms for up to the state exemption amount. The last two of those three result in effectively having a federal bypass trust for an amount up to the full federal exclusion amount. The planner should run numbers to see how much savings is generated by using the state-only QTIP election, to determine whether the complexity of having that additional trust is worthwhile.

f. **Basis Adjustment Planning**. Planning to leave open the flexibility to cause trust assets to be included in the gross estate of a trust beneficiary if the beneficiary has excess estate exclusion will continue to be important to permit a basis adjustment at the beneficiary's death without generating any added estate tax.

Four basic approaches can be used:

(1) making distributions to the beneficiary (either pursuant to a wide discretionary distribution standard or under the exercise of a non-fiduciary nontaxable power of appointment, but beware that granting an inter vivos power of appointment exercisable during the settlor's lifetime might cause the trust to be a grantor trust, see §§674(a), 674(b)(3));

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

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

(4) triggering the Delaware tax trap by the exercise of a nontaxable power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment.

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

For an excellent discussion of the effect of a general power to appoint to creditors, and whether the power could be exercised only up to the amount of debt to a particular creditor, and the impact of that decision on the amount included in the gross estate under §2041, see Robert J. Kolasa, *Creditor General Powers of Appointment*, TRUSTS & ESTATES 16 (Feb. 2020).

To the extent that general powers of appointment are used for basis adjustment purposes, bear in mind that the existence of the general power may have creditor effects, but the actual exercise of a testamentary general power of appointment may be more likely to subject the assets to the decedent-beneficiary's creditors than if the general power is not exercised.

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

g. **Emphasis on Flexibility**. In light of the remaining inherent uncertainty regarding whether the basic exclusion amount will be reduced back to $5 million (indexed) after 2025, building in flexibility to trust arrangements will be important, particularly for estates in the $5-$22 million range. Provisions included in trusts to avoid estate taxes may be unnecessary (and sometimes harmful) for settlors or beneficiaries who have no estate tax concerns. Some of the ways of adding considerable flexibility are:

- using nontaxable powers of appointment;
- providing broad distribution standards by independent trustees;
- granting substitution powers to the settlor;
- authorizing trust decanting (which may be available under state statutes); and
- providing special modification powers to trust protectors (see Item 3.h.(8)-(11) of the Current Developments and Hot Topics Summary (November 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** and Item 3.j.(13) of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** for a more detailed discussion of powers and limitations that can be added for trust protectors to provide flexibility).

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

a. **Significance; Period of Low Values and Historically Low Interest Rates**. Transfer and freeze planning can (i) assist in shifting wealth to save estate tax for clients with assets in excess of the basic exclusion amount (perhaps only if the exclusion amount drops below its current high amount at some point in the future), (ii) provide creditor protection planning, (iii) assist in moving assets downstream during life, which is becoming more important as people have longer life expectancies and inheritances

are long-delayed, and (iv) provide income shifting by transferring wealth to family members who may be in lower income tax brackets. The most obvious nontax advantage of making gifts is to allow donees to enjoy the gifted assets currently.

A further possible window of opportunity is afforded by the current historically low interest rates and lower market values resulting from the economic downturn following the outbreak of the coronavirus pandemic.

b. **Window of Opportunity; Impact of Having DSUE Amount from Prior Deceased Spouse**. The gift tax exclusion amount will sunset back to $5 million (inflation adjusted, say about $6.8 million) in 2026 (unless changed by Congress prior to 2026), so gifts making use of the doubled gift tax exclusion amount are available only through 2025.

   See Item 4.c.(1) above regarding planning observations about taking advantage of the window of opportunity in light of the anti-clawback regulation.

   Any DSUE from a prior deceased spouse must be applied before the client's own exclusion amount. Therefore taking advantage of the window of opportunity would require making a gift large enough to use the DSUE as well as the client's exclusion amount. See Item 4.c.(5) above.

c. **Cushion Effect**. Perhaps the most important advantage of the increased gift tax exclusion amount for many individuals will be the "cushion" effect – the ability to make gifts in excess of $5 million, but considerably less than $11 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even for assets whose values are very uncertain).

d. **Significance of Defined Value Transfers**. Because of the substantial cushion effect of the very large gift tax exclusion amount, clients making transfers significantly less than the full exclusion amount will have much less incentive to add the complexity of defined value transfers to gift transactions. However, clients wanting to use most of the $10 million (indexed) exclusion amount likely will plan to use a defined value transfer to minimize the risk of having to pay gift tax. For a more detailed discussion of defined value clauses, see Item 14 of the Current Developments and Hot Topics Summary (December 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

e. **Transfers with Possible Continued Benefit for Grantor or Grantor's Spouse**. Couples making gifts of a large portion of their $10 million (indexed) applicable exclusion amount will likely want some kind of potential access to or potential cash flow from the transferred funds. Various planning alternatives for providing some benefit or continued payments to the grantor and/or the grantor's spouse are discussed in more detail in Items 14-25 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. Also, a preferred partnership freeze strategy is discussed in Item 3.q. of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

For a detailed discussion of SLATs and "non-reciprocal" SLATs, including a discussion of the §§2036 and 2038 issues and creditor issues, see Item 10.i. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and Item 16 of the Current Developments and Hot Topics Summary (December 2013) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

(1) **Enhanced Grantor Retained Income Trust**. For the client that is reluctant to relinquish substantial value, but wants to make a large gift to "lock in" use of the increased gift exclusion to take advantage of the window of opportunity, consider making a gift of an asset while retaining the income from or use of the asset (in a manner that does not satisfy §2702). See Item 4.d. above. For a detailed discussion of this approach, see R. Eric Viehman, *Using an Enhanced Grantor Retained Income Trust (E-GRIT) to Preserve the Basic Exclusion Amount*, STATE BAR OF TEXAS 25TH ANNUAL ADVANCED ESTATE PLANNING STRATEGIES COURSE, ch. 4.7 (April 2019).

(2) **Promise to Make Gift; Gift of Legally Enforceable Note**. Revenue Ruling 84-25 says that a gratuitous transfer of a legally binding promissory note is a completed gift. If the donor dies when the note is still outstanding, the estate is not entitled to a §2053 debt deduction for the note, because it was not contracted for full consideration. But the IRS reasoned in Rev. Rul. 84-25 that the assets that would be used to pay the note are still in the donor's gross estate, so the gift of the note would not be an adjusted taxable gift to be added back into the estate tax calculation. §2001(b) (last sentence). The anti-clawback regulation would mean that the BEA at death would be large enough to cover prior gifts made after 1976, including the note. Therefore, the effect is that the donor would have taken advantage of the window of opportunity if the gifted note is a substantial part of the approximately $11 million gift exclusion amount.

The possibility of making gifts by giving a legally enforceable note was widely discussed in 2012, when clients feared that the gift exclusion amount might revert to $1 million. Various articles analyzed this planning alternative in detail. *See* Austin Bramwell, *Donative Promise Can Lock in 2012 Gift Tax Exemption*, 39 ESTATE PLANNING 3 (August 2012); Austin Bramwell & Lisi Mullen, *Donative Promise Can Use Up Gift Tax Exemption*, LEIMBERG ESTATE PLANNING NEWSLETTERS #2001 (Aug. 23, 2012).

A Nebraska case in 2019 has a reminder that a mere gift of a promissory note usually is not legally binding:

> Typically, a promise to make a gift in the future is not legally enforceable. Long ago, this court recognized that a promise to make a gift in the future is ordinarily unenforceable, even when put in the form of a promissory note. But in charitable giving cases, courts frequently find such future promises to be enforceable as a pledge or subscription.

In re Estate of Ryan, 302 Neb. 821 (2019).

Austin Bramwell's position in the cited articles is that a promissory note is enforceable to the same extent that a contract is enforceable—so the note should be delivered in exchange for consideration. Austin suggests: "In order to make a taxable gift of a promise of money in the future, a donor has no choice but to demand, on the advice of counsel, that the donees take actions that they might otherwise be reluctant to perform. For example, in consideration for a $5.12 million note, the donees could, in principle, promise to keep kosher for the rest of the year, cancel their subscription to The New York Times, visit their mother on Mother's Day, or read Ayn Rand's *Atlas Shrugged*."

(3) **Transaction That Does Not Satisfy §2701**. Another approach that has been suggested by Ellen K. Harrison (Washington, D.C.) is making a transfer that intentionally fails to satisfy §2701. A donor would make a gift of a common interest in a partnership/LLC while retaining a preferred interest that does not meet the requirements of §2701. The effect under §2701 is that the preferred interest is treated as having a zero value (for example, because it is noncumulative). The donor would be treated under §2701 as making a gift equal to the donor's entire interest in the entity. (The donor would need to have remaining gift exemption equal to the value of the entity to avoid having to pay gift tax.)

At the donor's death, the value of the preferred interest is includable in the gross estate. A put right would assure that the value will be at least equal to the liquidation preference if the preferred payment right is noncumulative. Thus, a basis step up should be permitted equal to that value. There is no transfer tax on the income and appreciation to the extent it exceeds whatever the donor receives (if anything) in preferred payments. The mitigation rule in Reg. §25.2701-5(a)(3) makes the zero value rule less significant since the donor's estate will be reduced by the same amount by which the gift value was increased due to the zero value rule.

For an example of this strategy, see Item 10.j.(2) of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

(5) **Retained Income Trust**. A retained income trust alternative (different than the alternative discussed in Item 8.g.(1) above) is discussed in Item 25 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(6) **New York State Bar Association Tax Section Recommendation to IRS**. See Item 4.d. above for a discussion of the New York State Bar Association Tax Section comments to the IRS recommending revisions to the anti-clawback proposed regulations to eliminate these planning approaches. Planners should be cautious in using these approaches as a way of making use of the increased gift exclusion amount until we know whether the IRS adopts the recommendation not to extend the anti-clawback adjustment to gifts that are included in the gross estate or to situations in which assets have been valued under Chapter 14 (reserved in the November 2019 final regulation).

h. **Lifetime Gifts of Low Basis Assets; "Appreciation Hurdle**." The estate tax savings of gifts are offset by the loss of a basis step-up if the client dies no longer owning the donated property. Be wary of making gift of low-basis assets, particular if the donor is in old age or near death. For a discussion of David Handler's "appreciation hurdle" chart, see Item 10.k. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

i **Report Transactions on Gift Tax Returns with Adequate Disclosure**. Many planners encourage clients to file gift tax returns to report gift or non-gift transactions to start the statute of limitations. Otherwise, the possibility of owing gift tax on an old transaction is always present. In order to start the statute of limitations, the return must meet the adequate disclosure requirements of Reg. §301.6501(c)-1(f). For a detailed discussion of the background and planning issues around the adequate disclosure rules see Item 20.c. of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

A somewhat analogous issue is that the charitable income tax deduction is denied if detailed substantiation requirements are not met. Various cases have held, for example, that not supplying the basis and date of acquisition of donated property can cause loss of the charitable deduction. *E.g., RERI Holdings I, LLC v. Commissioner,* 149 T.C. 1 (2017), *aff'd sub nom. Blau v. Commissioner*, 924 F.3d 1261 (D.C. Cir. 2019); *Bond v. Commissioner*, 100 T.C. 32 (1993*)*; *Loube v. Commissioner*, T.C. Memo. 2020-3.

j. **Follow Formalities and Document Transfers**. In the course of structuring sophisticated transfer planning strategies, be sure to take the "simple" steps of following formalities (obtain necessary consents of co-owners, etc.) and document the transfer appropriately.

In *Knop v. Knop*, 830 S.E.2d 723 (Va. 2019), father made annual gifts of interests in a closely-held company to his three children. Eventually, the children collectively owned about 44% of the company. The father later wanted to give or sell some of the company's real estate for a scenic easement, but the bylaws required approval of holders of 90% of the stock and the children refused to consent. The father responded by asserting that the prior transfers were ineffective because stock certificates reflecting the transfers had not been prepared or delivered. The family

documented the ownership transfers by reflecting the change of ownership on the Schedule K-1s issued each year. The Virginia Supreme Court held that without delivery of the stock certificates, there was no relinquishment by the father of his interest in the company.

9. Malpractice Claims Related to Failure to Consider Basis Planning in Basic Estate Planning Representation and Related to Transferring Real Estate to a Grantor Trust

a. **Synopsis of *Stevenson v. Stanyer***. A malpractice claim was made that an attorney failed to render advice regarding basis matters in a general estate planning context in *Stevenson v. Stanyer*, 2019 WL 2895378, 2019 Wash. App. LEXIS 1744 (Wash. Ct. App. Div. 3 2019). A father transferred a lake house to a trust many years ago to avoid estate tax. The father died in 1989 and the mother died in 2016. After her death, the children decided to sell the lake house and discovered that they would owe $159,000 capital gain taxes. The decedent's son, as executor, sued the lawyer who had updated the 92-year-old mother's will (to leave her estate equally to her two children), power of attorney, and health care directive six months before her death. The complaint was that the attorney should have advised the mother to reach an agreement with her children to terminate the trust, take the lake house as her personal asset, and qualify for a basis step-up for the lake house at her death. The attorney defended that he had not been asked to do any tax work on behalf of the beneficiaries.

The court rejected the malpractice claim.

> There simply is no indication that her desire to avoid tax consequences for the children was ever communicated to Mr. Stanyer. Similarly, the e-mail communications between Stanyer and Stevenson, offered into the record by both parties, do not mention the issue of tax advice.
>
> Similarly, neither party has provided authority suggesting that estate planning advice necessarily encompasses consideration for the tax consequences faced by the beneficiary. Indeed, the question of whether the estate or the beneficiary was to bear the tax consequences could easily create a conflict of interest for an attorney trying to represent the interests of both.

The court concluded that it "is difficult to see how any general duty to provide tax advice for her estate would encompass tax advice for the beneficiaries of the trust she controlled."

b. **Synopsis of New Jersey Malpractice 2019 Complaint**. A complaint filed in a New Jersey case alleges, among other things, that (1) selling assets to a grantor trust may result in a loss of basis adjustment on the grantor's death, (2) adverse income tax consequences may result if the grantor trust is changed to a complex trust, (3) the income tax cost on negative basis real estate assets sold to a grantor trust may be significant if the trust ceases to be a grantor trust during the grantor's lifetime, (4) because certain planning techniques are commonly used does not assure they are appropriate for a particular client, and (5) the plaintiffs were not informed of these risks. Superior Court of New Jersey Law Division: Civil Part Bergen County, Docket No. Ber-L-02/01/2019. For a very interesting discussion of this complaint and a number of proactive practical steps that estate planning attorneys can take to reduce the risk of malpractice claims, see Martin Shenkman, Sandra Glazier & Howard Zaristky on *Raia v. Lowenstein Sandler LLP – Thoughts on a Recent Malpractice Case*, LEIMBERG ESTATE PLANNING NEWSLETTERS #2725 (May 16, 2019).

c. **Planning Observations**.

(1) **Basis Advice Will Become More Standard**. The importance of advising clients in estate planning matters of basis issues will at some point move toward becoming more standard advice that is within the standard of care for estate planning matters.

We think of matters involving the termination of an existing trust by agreement among all the beneficiaries, with the distribution of appreciated assets to the current beneficiary, as being rather sophisticated planning that would not be within the scope of a standard will update engagement. But a lawyer was sued in this case for that type of situation. Being cognizant of basis planning issues for estate planning clients will become more and more important.

(2) **Engagement Letter**. Engagement letters are often written broadly (to reflect that the attorney wishes to represent the client broadly). That can be disadvantageous if a dispute arises later about matters that the attorney should have advised the client about. If the engagement is a will update without tax planning, say so in the engagement letter.

(3) **Planning Alternatives to Have Achieved a Basis Step-Up in *Stevenson v. Stanyer*.** The complaint in *Stevenson v. Stanyer* alleged that the attorney should have advised that the trust be terminated and that the lake house be distributed to the mother. That approach would not seem to have worked. Even if the parties had considered terminating the trust, the lake house was the primary asset of the trust. The actuarial value of the 92-year old mother's interest in the trust must have been very small, and no reasonable settlement of rights in the trust would have resulted in distributing the lake house to the mother. If the lake house had been distributed to the respective beneficiaries in undivided interests, according to their actuarial values, and if the children had given their undivided fractional interests in the lake house to their mother, a basis step-up would not have been available at her death 6 months later because of §1014(e).

A judicial modification, however, to grant the mother a testamentary general power of appointment over the lake house would have resulted in estate inclusion in her estate and a basis adjustment at her death under §1014(b)(9). The children would have had the issue of whether they made gifts to their mother by agreeing in the settlement to relinquish their vested interests in favor of granting the mother a general power of appointment.

10. Designing Trusts for the Long Haul

David A. Handler of Chicago reminded us that it is important that trusts not be "commoditized." Too many variables are present. Drafters should have forms and should follow those forms (and not, as David emphasized, just use a document prepared for another client, which may have been altered for that client), but flexibility should also be permitted and encouraged. Here is a summary of his reflections and recommendations regarding some of the important design variables, including the contributions of his co-panelists in a separate session, Mary Elizabeth ("Beth") Anderson of Louisville and Jane G. Ditelberg of Chicago. (This summary reflects all of their comments as well as other observations.) Their Heckerling materials include many examples of language to be used in trust documents.

a. **Trustee Succession**. The identity of the trustee can matter more than any other trust terms. Flexibility is critical. A fixed list of successor trustees can be dangerous, because named successors can die, become unable or unwilling to serve, or become unsuitable to serve for other reasons. (An example might be a designation of the oldest male descendant. What if there isn't any, or if he can't be found?) In addition, clients are almost certain to change their minds and want to change the designation in an irrevocable trust. Beneficiaries and others affected by a trust (such as family members of beneficiaries) may also change their minds about the kind of trustee that makes them comfortable and willing to accept the terms of the trust.

   Giving the power to name successor trustees to the drafter, or the managing partner of the drafter's firm, may create difficulties if that person is hard to identify, knows nothing about the trust (or about trusts in general), or is unwilling to assume the responsibility and potential liability. Giving the power to, say, a majority of the beneficiaries may also be awkward, as the number and demographics of beneficiaries change and as the logistics of voting and of determining how to weigh each vote becomes more complicated and subjective. (For example, what if three grandchildren could outvote two children?)

   Another hazard to avoid is being too specific about the qualifications of a successor trustee. For example, requiring that a corporate trustee be chartered in a certain state could be awkward if a *federally* chartered institution is the best choice. Describing a successor trustee as a "bank" might exclude desirable S&Ls or private trust companies.

   In any event, if a list of successor trustees is named, either prescribed by the settlor or developed through a succession process, a good idea is to allow "persons higher on the list, to change the persons below." Likewise, the succession plan provided by someone lower on the list should be subject to being changed or superseded by the plan provided by someone higher on the list.

b. **Different Fiduciaries for Different Purposes**. "Control over trusts can be sliced and diced in many ways." One way is for multiple trustees to have power and responsibility with respect to different functions (assuming that is recognized by relevant state law).

   A **distribution trustee** could have responsibility for distributions. This could be broken down still further. One trustee could have the power to make distributions pursuant to a standard described in terms of health, education, maintenance, and support; this trustee could even be a beneficiary who is a permissible distributee, because the ascertainable standard will protect the trustee from unwelcome transfer tax consequences. Another trustee (not a beneficiary) could have the power to make additional distributions beyond, or without regard to, that HEMS standard.

   An **investment trustee** could have responsibility for investing the assets of the trust. Within certain limitations, that trustee could be the settlor without adverse tax consequences. *See Old Colony Trust Company v. United States*, 423 F.2d 601 (1st Cir. 1970) (no aggregation of purely administrative powers will render the value of the trust property includable in the gross estate); *Estate of Willard V. King v. Commissioner*, 37 T.C. 973 (1962) (the decedent's powers to manage the trust's investments did not allow him to control the beneficial enjoyment of the trust

property within the meaning of §2036(a)(2) or alter, amend, or revoke the trust within the meaning of §2038 because the powers had to be exercised in good faith and were subject to fiduciary duties); *United States v. Byrum*, 408 U.S. 125 (1972) (same).

An **administrative trustee** could "do the office work," with responsibility for maintaining custody of the trust property and records, maintaining an office for trustee meetings and other trust business, receiving and distributing notices, preparing and filing or arranging for the preparation and filing of any required tax returns, and originating or facilitating the preparation and distribution of trust accountings, reports, and other communications pertaining to the trust. The location and activity of this trustee may be most important in establishing a nexus with a state for purposes of allowing the trustee to avail the trust of that state's law (*see Lewis v. Hanson*, Del. Supr., 128 A.2d 819, 826 (1957), *aff'd sub nom. Hanson v. Denckla*, 357 U.S. 235, *reh'g denied*, 358 U.S. 858 (1958)) or possibly subjecting the trust income to state income taxation (see Item 24 below).

A **special trustee** could have responsibility for a specific asset or group of assets – for example, the right to "vote the stock of ABC Corp."

Authority for Dividing Duties among Cotrustees. The Uniform Directed Trust Act explicitly recognizes the ability of a settlor to divide the powers and duties of cotrustees and to "relieve a cotrustee from duty and liability with respect to another cotrustee's exercise or nonexercise of a power of the other cotrustee" in the same manner as for directed trustees in a directed trust. UNIF. DIRECTED TRUST ACT §12. The comments to the Uniform Directed Trust Act recognize that this changes the traditional law regarding the duties of cotrustees.

> *Traditional law.* Under traditional law, each cotrustee "has a duty to use reasonable care to prevent a cotrustee from committing a breach of trust and, if a breach of trust occurs, to obtain redress." Restatement (Third) of Trusts § 81(2) (2007). This rule applies even if the settlor limits the role or function of one of the cotrustees. "Even in matters for which a trustee is relieved of responsibility, … if the trustee knows that a co-trustee is committing or attempting to commit a breach of trust, the trustee has a duty to take reasonable steps to prevent the fiduciary misconduct." *Id.* cmt. b. Moreover, "even in the absence of any duty to intervene or grounds for suspicion, a trustee is entitled to request and receive reasonable information regarding an aspect of trust administration in which the trustee is not required to participate." *Id.* These rules for cotrusteeship contrast with the less demanding fiduciary standards for a directed trusteeship under Sections 9, 10, and 11 of this act.
>
> *Settlor autonomy.* This section allows a settlor to choose either fiduciary regime for a cotrusteeship—the traditional rules of cotrusteeship or the more permissive rules of a directed trusteeship. There seems little reason to prohibit a settlor from applying the fiduciary rules of this act to a cotrusteeship given that the settlor could choose the more permissive rules of a directed trusteeship by labeling one of the cotrustees as a trust director and another as a directed trustee. The rationale for permitting the terms of a trust to reduce the duty of a cotrustee that is subject to direction by another trustee is the same as the rationale for permitting the terms of a trust to reduce the duty of a directed trustee. In both instances a trustee must act according to directions from another person and therefore the other person, not the trustee, should bear the full fiduciary duty.
>
> Accordingly, if the terms of the trust so provide, a cotrustee may have only the duty required by the reasonable action and willful misconduct standards specified in Section 9, and be subject to the narrower rules governing information sharing and monitoring specified in Sections 10 and 11,

> with respect to another cotrustee's exercise or nonexercise of a power of that other cotrustee. If the terms of a trust indicate that a directed cotrustee is to have no duty or is not a fiduciary, then the effect will be to reduce the cotrustee's duties to those prescribed by Sections 9 through 11, just as would be the effect of similar language for a directed trustee.

States that adopted directed trust statutes before the uniform act was promulgated often do not specifically address the ability of a settlor to divide duties among cotrustees. *Compare, e.g.,* TEX. PROP. CODE §114.0031(f) (directed trustee not liable for acting in accordance with directions except for **willful misconduct**) *and* TEX. PROP. CODE §114.006(b) (each cotrustee must exercise reasonable care to prevent a cotrustee from committing a **serious breach of trust** and compel a cotrustee to redress a serious breach of trust).

c. **Trust Directors/Advisors**. A directed trust could be used to achieve the same goals as a division of responsibility among trustees – a distribution director or advisor, an investment director or advisor, etc. The same system of selection or listing could be used for the succession of trust directors as with the succession of trustees. Clarification of roles is important in this context that does not have as long a history as the use of regular trustees. Consider, for example, introducing the delineation of investment powers in a way that clarifies, for example, that "the Investment Trustee shall have **sole** responsibility and authority, and the trustee shall have **no** responsibility or authority…."

   Care must be taken to ensure that the trustee can safely rely on a trust director or advisor. For example, if the term "trust advisor" is used, or it is otherwise contemplated that such an appointee will sometimes or always only give the trustee "advice," then the trustee needs to be assured when "advice" can reliably be followed, or how to distinguish "direction" from mere "advice." If "advice" is all that is contemplated, then perhaps that "advisor" should be made a cotrustee to share in the decision-making.

   From a trustee's perspective, a requirement merely to consider "advice" may be the worst of all worlds. The trustee could still be held responsible if it follows the advice but that is subsequently found to be a breach of trust, and will be held to a particularly high standard of defending not following the advice if that advice in hindsight turns out to have been correct.

   Be aware of local variations. For example, in Florida a directed trustee is exonerated from following directions only if the director is also a trustee.

d. **Precautions When Dividing Roles**. In some cases, it will be necessary to create guardrails limiting the exercise of powers when the existence or exercise of the power might have undesired tax consequences. As David puts it:

   > the investment trustee/advisor's power should **exclude** (i) voting shares of stock in a company controlled by the investment trustee/advisor (in an individual capacity) within the meaning of Section 2036(b)(2) of the Code that was transferred to the trust by the investment trustee/advisor, except if in a bona fide sale for adequate and full consideration in money or money's worth; and (ii) exercising "incidents of ownership" (within the meaning of Section 2042 of the Code) with respect to insurance on the investment trustee/advisor's life.

In some cases identifying and clarifying what is an "administrative" function will be especially important. For example, if an investment is made in an LLC by an investment trustee (or pursuant to the direction of a trust director), who should sign the LLC agreement? Who should sign a subscription agreement? The administrative trustee? Who determines value in contexts where a determination of value is needed? Often that should be the investment trustee (or trust director) who chose and understands the investments.

Consider using similar guardrails in the governing documents of closely-held corporations and partnerships, to avoid exposing the estate of a minority owner or even a nonvoting owner to inclusion under §2036(a)(2) or §2038 as in *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017) (reviewed by the Court).

If the settlor of a trust contemplates investments that depart from the prudent investor rule, the trust instrument should spell that out. One application of that principle is that if a client creates more than one GRAT with the same trustee, the trustee should probably be permitted – indeed, encouraged or even required – to look at all the GRATs as a whole in applying any balancing requirement the prudent investor rule would suggest, or to emphasize that the purpose of the GRAT is to hold a concentrated position, which is appropriate for GRATs where the objective is to isolate volatility to maximize success. And in general, the trustee is best protected if the trust document explicitly **requires**, not just **permits**, investments that depart from the prudent investor rule, especially where a conflict of interest may be presented, as in the investment by a corporate trustee in its own stock (assuming that is the settlor's intent).

e. **Pot (Spray) Trusts**. A pot trust or discretionary spray trust – that is, a trust with several beneficiaries who do not have fixed proportional interests – may be a simplification and a good idea for a single asset like a personal residence (which could be held through an LLC) or a life insurance policy, or to facilitate multiple *Crummey* powers. But, in every family, differences among the family members will inevitably arise. They will have different spouses with different influences, will live in different cultures in different parts of the country or the world, will support different political parties or otherwise have different political views, and so forth. This will produce different views of standards of living, of costs of living, of what is frugality and what is spendthrift, etc. Assuming that each family member (or each family member on average) has four children, then after four generations a pot trust originally for one family member will have 256 (4x4x4x4) beneficiaries. That broadened and diverse "gene pool" (as David put it) provides the opportunity for a lot of diversity that affects their views of the trust, their views of the trustee, their perception of a need for a trust, and their investment needs and tolerances.

Here is David's advice.

(i) Having a single trust for the benefit of multiple beneficiaries (e.g., the settlor's children) may be practical and sensible when the trust is first established. There is one investment portfolio to manage, one tax return to file, one insurance premium to pay, and the trustee may have flexibility to distribute assets unequally among the beneficiaries if appropriate.

(ii) When the beneficiaries are older, they will have their own careers, families, incomes, assets, spending habits, risk tolerances and views about money. Forcing them to share out of the same pool will lead to conflict about differences in distributions/consumption, investment allocations and the like.

(iii) Therefore, most trusts that begin as spray trusts should divide into separate trusts for the beneficiaries at some point. Each subtrust would be administered independently, allowing the beneficiaries to conduct their lives free of judgment and conflict with their siblings about how the trusts are being used and invested. Of course, our clients can insert whatever rules regarding distributions they see fit, but each family is free to go its own way.

(iv) Timing: Trusts often divide when the settlor and/or settlor's spouse is deceased, but if they live their full life expectancies, that could leave their children sharing a trust until they are in their 60s. Give the trustee discretion to terminate and divide the trust before that time, or give the trustee the power to distribute some of the assets to subtrusts before the main trust terminates.

Subtrusts with different trustees can be helpful, but could get complicated if likely questions are not anticipated and provided for in the governing instrument – for example, from which of the trusts should income and/or principal first be distributed? And a power to distribute some but not all of the trust assets to such subtrusts or new trusts can allow new trustees and beneficiaries to "get their feet wet" with such a trust before receiving larger amounts. Such an experiment can help the trustee determine if additional distributions in the future would be a good idea.

When division of the trust or distribution to other trusts is authorized, consider clarifying that the trustee may, but shall have no duty to, consider such divisions or distributions. In addition, consider the potential for unwelcome results, such as a division of a trust into three trusts for three children, followed by one child's illness or disability that makes that child's needs greater than the individual trust can meet.

f. **Advancements**. Often, at certain milestones in life (such as getting married, starting a business, buying a first home, or having a child), a beneficiary might request an unusually large distribution from a trust. In the case of a pot trust, providing that the trustee may (David stresses "may," not "shall") treat such a distribution as an advancement, charged against that beneficiary's share when the trust terminates and is distributed, may be very helpful. In that way everyone's happy: the child (or other beneficiary) gets the money (for example, to help buy a house), but no one else is short-changed in the end. Without an advancements provision, the trustee may be unwilling to make the large distribution for fear that it will result ultimately in unfair treatment of the beneficiaries. Distributions for health care or education and distributions before the beneficiary attains a specified age should probably be excluded. Another issue is whether to charge interest; David typically doesn't, especially for the sake of simplicity.

g. **Behavioral Incentive Clauses**. This is an area where David cautions practitioners to "tread lightly." He tells parents: "My trusts are not going to correct your parental mistakes. What you couldn't accomplish raising your kids 24/7 for 20 years isn't going to be solved with a 50-page trust agreement."

Standards can be difficult to design, interpret, and enforce. For example, what does "religiously observant" mean? (David writes: "Ask ten people of the same religion … and you'll get ten answers.") How about "graduates from college"? What is "college" going to *be*, not to mention cost, in 50 years? (Remember that many billionaires did not finish college.) Also, incentives are based on the **settlor's** values, but some values can become out-of-date. If the standards are subjective or require policing, who will do the policing or make the decisions, and with what standards? Who will do the drug testing? Must the trustee hire detectives?

If the settlor wants to require beneficiaries to have prenuptial agreements, will "any old prenuptial agreement" do? Maybe a draft, or at least a summary of the required terms, should be included in the trust instrument. Consider using a carrot rather than a stick to encourage prenuptial agreements; instead of cutting off a beneficiary who marries without signing a prenuptial agreement, consider giving the trustee the authority to make a special distribution or give the beneficiary a withdrawal power (but no more than 5%) if the beneficiary does enter into a prenuptial agreement before marriage. For example –

> When a beneficiary and that beneficiary's fiancée execute a prenuptial agreement which the trustee is advised by legal counsel is valid, then on or after the date of such beneficiary's marriage, such beneficiary may by written instrument delivered to the trustee withdraw from the principal of the trust an amount equal to five (5%) percent of the trust's accumulated net income and principal, as it is then constituted. In addition, upon the request of the beneficiary, the trustee shall reimburse the beneficiary for any and all documented expenses and legal fees incurred by either party in securing such agreement.

Even if behavioral incentives are sometimes hard to design and implement, providing guidelines to help ensure that the trustee does not make unwise distributions should not present problems. But problems can arise from **forbidding** distributions unless the trustee verifies or the beneficiaries certify that they are **not** addicted – say, to gambling, or pornography. And the answer to a problem like substance abuse might not be to cut off the beneficiary, but to use trust funds to pay for something like a group home or other treatment.

On balance, though, a statement of values (or a statement of what the settlor wants the trust to accomplish) can be good. For example:

> The trustee should consider the societal norms in the geographical area in which a beneficiary resides, as I do not intend for the trustee to impose his own personal beliefs on a beneficiary as to what constitutes "gainful employment," "healthy lifestyle," or other subjective notions referred to above, although the trustee's beliefs are certain to be a part of such determinations.
>
> Of course, a beneficiary's age, health, abilities and other circumstances will affect his or her ability to accomplish one or more of the desired behaviors, and should be considered in construing and applying the foregoing to any particular beneficiary. I consider full-time parents to be productive members of society and gainfully employed, and do not intend that a beneficiary be discouraged from choosing to raise a family as his or her sole occupation.
>
> I do not expect a beneficiary to necessarily accomplish or exhibit all of the desired behaviors, and recognize that some desired behaviors may even conflict with others. It is my hope and intent that the trust property will be used to reward and enhance the quality of life of those beneficiaries that have exhibited, accomplished or are working toward accomplishing one or more of the desired behaviors, and to encourage and assist the beneficiaries to exhibit and achieve the desired behaviors. On the other hand, I also hope and intend that the trust property will not be distributed to a beneficiary who is engaging in self-destructive, abusive or illegal behavior ("undesired behaviors"), except for the beneficiary's health, education and basic support, which may include expenses for rehabilitation and treatment or care.

> If the trustee, in the trustee's discretion, determines (1) that a beneficiary is not capable of handling money or financial affairs prudently, or (2) that a beneficiary has financial problems or marital difficulties that could result in the diversion or dissipation of trust property or property distributed from the trust, then I recommend (but do not direct) that the trustee refrain from distributing property to the beneficiary until such problems have been resolved to the trustee's satisfaction.
>
> The trustee shall have no duty to inquire or monitor whether a beneficiary is exhibiting or accomplishing the desired behaviors or the undesired behaviors, as the guidelines set forth in this Article are not intended to limit the trustee's discretion to make distributions to the beneficiaries, but the trustee should consider the sentiments expressed in this Article.

h. **Matching Income**. Some settlors want to encourage productivity in beneficiaries by providing for distributions that match – dollar-for-dollar or in some stated or defined proportion – the income, usually the earned income, of a beneficiary. But care is required. For example, should a beneficiary maybe get a greater matching distribution for forsaking pursuit of a career as a CEO and becoming a welfare worker?

   In any event, attention might be given in the trust instrument to when (at what age, for example) matching distributions should start. Or whether and how the income of the beneficiary's spouse should be taken into account. Or how retirement will be treated. Or how disability (either of the beneficiary or of a spouse or child of the beneficiary) will be defined and handled.

   Again stating what is (or was) important to the settlor may be most important. What are the objectives of the trust? And if matching distributions are desired, consider simply **allowing** such distributions, not **requiring** them.

i. **Definitions of Beneficiaries**. Many clients want to leave their estate to the spouse and then to the kids. How should "children" and "descendants" (or "issue") be defined? (Uniform Acts can help.) Maybe, especially in the case of gift-splitting, they should be "children of the marriage." What about "unintended children"? And lawyers should remember that they often jointly represent both spouses. The Uniform Parentage Act has helpful language about embryos if the drafter wishes to address posthumous descendants.

   Should descendants' spouses be included? This is an issue of balancing. If descendants die sooner than expected financial arrangements may be required for in-laws who cannot support themselves. Often a client will want to benefit spouses they know, but not spouses they haven't even met – what if their oldest child is nine years old? One alternative is to give someone a limited power of appointment broad enough to include a spouse, perhaps with limits such as a maximum dollar amount or percentage of the trust or perhaps with a requirement that assets for a spouse must pass to a trust that limits the spouse's interest to no more than the net income or some described unitrust interest in the trust for the spouse's lifetime.

j. **Silent Trusts**. The motivation and purpose for prohibiting or limiting disclosure of the trust to beneficiaries is understandable. But informing the children about the trust, and using it as a way to educate children about stewardship may be very helpful for the children. Maybe, if children had known about the trust, they would have risked capital in a worthwhile business, or would have become teachers and taken a smaller salary. In addition, children will see the wealth, or they will get a check or a K-1, or they will hear something else about the trust, and then it is awkward if they can't

learn everything about the trust, including, sometimes, even the ability to decant or otherwise alter the trust. And such complications are aggravated if the same lawyer represents some or all of the children too. But in any event, an age-appropriate limitation might be desirable and fitting, such as limiting the provision of information up to age 30 (as under current Illinois law) or age 25 (as under §105(b)(8) of the Uniform Trust Code). And parents should be able to waive the limitations on disclosure with respect to their own children.

Fundamentally important, a trust must be enforceable in order to be a trust, and information is often necessary for enforcement.

The following is sample language intended to strike a balance:

> Trustee will have no duty to provide notice to beneficiaries other than as provided in this paragraph but Trustee, without liability, may provide notice to beneficiaries beyond that required in this paragraph. Trustee will, within nine months after acquiring knowledge of my incapacity or death, or upon creation of a new trust hereunder, notify as Trustee determines at least one current income beneficiary, or person entitled to discretionary distributions of income or principal, age 25 or older: (a) of the existence of the trust; (b) that the trust was created by me; and (c) that the person(s) notified has the right to request a copy of the provisions of the trust agreement that apply to the beneficiary and to request annual or more periodic reports of the trust assets, liabilities, receipts, and disbursements (including the source and amount of Trustee's compensation, a listing of the trust assets and, if reasonable, their respective market values). Trustee providing notice to Trustee will not be sufficient notice under this paragraph unless, at such time, no other beneficiary is entitled to notice under this paragraph. Unless unreasonable under the circumstances, Trustee will respond to written requests for information pertaining to the administration of the trust from any current income beneficiary or person entitled to discretionary distributions of income or principal.

An obvious practical tip, but panelists have seen this in trusts: Do not give a beneficiary, who is not supposed to know about a trust, a *Crummey* withdrawal power.

k. **Powers**.

Customize. The document should provide details on the identification of permissible exercises of a power and permissible objects of the exercise. Don't just exclude the beneficiary, estate, and creditors. Customize the limitations to the purposes of the trust.

Decanting. In addition to more traditional uses, can a limited power to appoint among various beneficiaries be exercised to create another trust for one or more of those beneficiaries? A kind of self-help decanting? Why not? If the power could have been exercised to give the beneficiary trust assets outright (or not), why can't the power be exercised to give the beneficiary a lesser interest, such as an interest for life in a discretionary trust? (This was the rationale of *Phipps v. Palm Beach Trust Co.*, 142 Fla. 782, 196 So. 299 (1940), citing RESTATEMENT OF TRUSTS §17.) But this should be explicit in the document, where it can be defined and regulated.

Exercise of Power of Appointment. The trust should make clear **how** a power of appointment is to be exercised. By a written document? By a will? Only by specific reference? Or by a residual disposition in a will (which may be the result under the law in some states but probably should be disallowed by the trust document)?

Care is also needed in the exercise of a power of appointment. For example, a limited power must not be exercised in favor of the powerholder's revocable trust, although it can be exercised in favor of a certain trust to be created under a revocable trust. Be careful that the exercise does not go beyond the specified objects of the power, and that the exercise in favor of a new trust will not violate the rule against perpetuities.

Changing Trust Situs. Giving the trustee the power to change the situs of the trust provides helpful flexibility, but the trustee should be relieved of the duty to constantly monitor the law in all the states in the country (for example, "the trustee shall be under no duty to monitor the law of any other jurisdiction to determine whether and when to exercise this power to change the trust situs"). Care also is needed in exercising such a power, including making sure that the change in situs does not adversely affect the trust's status with respect to the rule against perpetuities. For example, the ability to move a trust from Texas to Delaware might make the trust invalid under the Texas rule against perpetuities.

Amendment Powers. Be wary of granting a third party broad powers to amend a trust. Presumably, the settlor named the most trusted person as trustee, so will some "B" team member have the power to broadly re-write the trust? Powers to amend trusts as needed for specified tax purposes can be helpful (for example, maintaining S corporation eligibility or a charitable deduction).

l. ***Crummey* Withdrawal Powers**. Case law supports the proposition that a *Crummey* withdrawal power is effective for purposes of the gift tax annual exclusion even if the powerholder is not given notice of the power. *See Estate of Turner v. Commissioner,* T.C. Memo. 2011-209. Giving notice of withdrawal rights is encouraged, but the trust instrument should not make the withdrawal power contingent on the giving of notice and should not say that the trustee "must" or "shall" give notice, because that could invalidate the power if notice is not given or is defective in some way.

Also, do not give the powerholder a right to **release** the power. Under the general power of appointment rules (sections 2041(b)(2) and 2514(e)), a **lapse** of a general power of appointment qualifies for the 5%/$5,000 exception, but a **release** does not.

Including the spouse of the settlor as a holder of a *Crummey* power can be helpful to provide an additional annual exclusion, but GST exemption cannot be allocated during an ETIP if the spouse's power exceeds 5%/$5,000 or doesn't lapse within 60 days.

m. **General Powers of Appointment**. The flexibility in trusts for someone to create or grant general powers of appointment for a beneficiary may be helpful for basis adjustment planning or for planning with GST-nonexempt trusts. A general power in a trust subject to GST tax can helpful. Generally, inclusion in a decedent's gross estate is better than the GST tax – (1) the estate tax is never larger than the flat-rate GST tax, (2) a full basis step-up would apply, (3) estate tax credit for tax on prior transfers may shield against some or all of the estate tax, and (4) the beneficiary may have enough unused exclusion amount to avoid some or all estate tax. But even a power to take away that power might be a good idea, because circumstances might change – for example, if a beneficiary dies without descendants and the trust assets pass to others in the same generation, no GST tax will apply anyway.

n. **Grantor Trust Status**. David likes to use multiple ways of qualifying for grantor trust status. His favorite is §674 – the power in a nonadverse party to make discretionary distributions (with more than half of them related or subordinate). Under §674, one can turn grantor trust status off **and on** just by changing trustees. (David pointed out that saying grantor trust status can be toggled off, but can't be toggled back on, is a myth because §674 can depend on the identity of the trustees.) But checking the rest of the terms of the trust is critically important, for example for a limitation to a HEMS standard for individuals.

A power of substitution under §675(4)(C) can be good, especially because it is held by the grantor, not by the trustee, and therefore its release would not strain the trustee's fiduciary duties. Ensuring that someone can release a power on behalf of an incapacitated grantor or beneficiary is very important for flexibility. And in a directed trust make sure that a directed trustee has enough information "to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value," as required by Rev. Rul. 2008-22, 2008-16 I.R.B. 796. Again, as discussed in Item 10.d. above, give the investment trustee or investment director the authority to make that equivalent value determination, or provide that in making that determination the trustee may rely on the investment director or all other trustees may rely on the investment trustee.

David favors the incorporation of a provision permitting the grantor to be reimbursed for income taxes (within the guidelines of Rev. Rul. 2004-64, 2004-2 C.B. 7). But excluding the rights of the grantor's creditor to reach that reimbursement is very important.

o. **Incapacity**. David suggested putting the burden of establishing capacity on the person in question. For example, that person might be required, upon request, to produce a doctor's letter certifying competence within 90 days or that person is out.

o. **A Favorite Boilerplate Clause – Single Signatory**. If multiple trustees are named, allow them to delegate the power to sign documents on behalf of all trustees (which may be required by state law to be in writing or for some specified period of time). Example clauses follow.

> Unless a co-fiduciary elects otherwise in writing, any one co-fiduciary may sign any checks, agreements or other documents on behalf of the trust and such signature shall bind the trust in the same manner as though said check, agreement or other document had been signed by all of the co-fiduciaries acting in the same capacity, and no person or entity dealing with the signing fiduciary shall be obliged to inquire as to the other co-fiduciary's acquiescence to such action.
>
> OR
>
> Co-Trustees will act by [majority/unanimous] agreement, but no party dealing with any Co-Trustee will be required to ascertain whether or not the Co-Trustees are in agreement and all such parties may deal with any Co-Trustee as if each is possessed of full and complete independent power and authority. Whenever there are Co-Trustees, any Co-Trustee may delegate ministerial powers (such as to sign checks and other instruments and documents) to other Co-Trustee(s).

11. GST Exemption Allocations

a. Extensions for GST Exemption Allocation Elections. Letter rulings issued in 2019 allowed an extension of time to (1) allocate GST exemption (PLR 201923022), and (2) to elect out of automatic allocation (PLRs 201927014-201927015, 201929006).

b. **Recommendation to "Opt In" to Automatic Allocation**. Carol Harrington STRONGLY recommends that planners "opt in" to automatic GST exemption allocation. The rules are intended to help taxpayers by automatically making the GST exemption allocation in situations in which that most likely would be the desired result. If a planner creates a trust intended to be GST exempt, the election should be made to have automatic allocations apply to any transfers to that trust. If a transfer is made to the trust of which the attorney or accountant is unaware, GST exemption would be automatically allocated, which would be the desired result to avoid ending up with a partially taxable trust. Letter Ruling 201923022 is an example of someone having to pay the big fees to get a letter ruling allowing an extension of time to make a GST exemption allocation that would have been unnecessary if the automatic allocation election had been made.

The taxpayer has the flexibility to change an election in or election out of automatic allocation. As indicated by these rulings, extensions of time are available for making a late exemption allocation, or making automatic allocation elections. The only thing that cannot be extended is to undo an affirmative manual exemption allocation.

c. **GST Exemption Allocations for Transfers to GRATs**. One situation in which the automatic allocation election should not be made is for GRAT transfers.

(1) **Does the ETIP Rule Apply Before the Termination of the GRAT**? A strange regulation could be interpreted to mean that GRATs are not generally subject to the ETIP rules. Reg. §26.2632-1(c)(2)(ii)(A) says that the ETIP rules do not apply "if the possibility that the property will be included [in the gross estate of the grantor or the grantor's spouse] is so remote as to be negligible," which is the case if there "is less than a 5 percent probability that the property will be included in the gross estate."

The regulation could be interpreted to say that the ETIP rule applies only if a 5% or greater probability exists that the grantor will die within the 2-year GRAT term, in which event the assets would be included in the grantor's gross estate. There is probably less than a 5% chance that the grantor will die within two years (unless the grantor is older than about age 68). The regulation might suggest that a typical GRAT is therefore not subject to the ETIP rules.

The context of the definition of an ETIP in the regulation before the "so remote as to be negligible" clause may suggest that the intent is to inquire whether there is a 5% chance that the value would be included in the grantor's estate if the grantor were to die within the GRAT term (and typically a high likelihood of estate inclusion would exist if the grantor were to die during the GRAT term). But, the regulation does not literally say that.

As a practical matter, attorneys are not relying on this possible interpretation to allocate GST exemption at the creation of GRATs. (As discussed below, however, little downside may exist to making an allocation capped by the nominal value of the remainder interest.)

(2**) If the ETIP Rule Does Not Apply to GRATs, How Much GST Exemption Would Have to Be Allocated To Achieve an Inclusion Ratio of Zero**? The answer is not totally clear, but the denominator of the inclusion ratio is probably based on the full value transferred to the GRAT, not just the nominal value of the remainder interest. *See* §2642(a)(2)(B) (denominator of the applicable fraction is "the value of

the property transferred to the trust"). Some planners have suggested, however, allocating GST exemption to the GRAT when it is created just in case the ETIP rule does not apply and in case allocating exemption equal to the nominal remainder value is sufficient to cause the trust to be fully exempt. For example, a formula allocation could be made of "so much as is necessary to achieve a zero inclusion ratio, but not more than the value of the remainder." In light of the uncertainty over the amount of GST exemption needed in this circumstance, if GST exemption is allocated at the creation of a GRAT, it is essential to put a cap on the amount allocated.

(3) **Risk of Automatic Allocation of GST Exemption to GRAT**. If the GRAT remainder will pass in a manner that could potentially have distributions to skip persons, and IF the ETIP rule does not apply, there would be automatic GST exemption allocation when the GRAT is created. It is likely that the amount allocated would be the entire value of the property transferred to the trust, even though all of that current value (and more) will be distributed back to the donor—thus likely wasting GST exemption. To be sure of preventing this result, an election against automatic allocation of GST exemption could be filed when the GRAT is created.

(4) **Electing-Out of Automatic Allocation at End of ETIP**. The gift tax return that is filed for the GRAT when it is created can elect out of automatic allocation at the end of the ETIP—to avoid automatically allocating an undetermined amount of GST exemption when the GRAT terminates. *See* Reg. §26.2632-1(b)(2)(iii)(A)(1). The election in or out of automatic allocation can be changed before the ETIP ends. Reg. §26.2632-1(b)(2) and (3), and (c).

Practical Pointer: Do not allocate GST exemption to a GRAT at its creation, either by affirmative allocation or automatic allocation, unless the allocation is capped at a very nominal value of the remainder interest. (If the automatic allocation is made inadvertently or purposefully at the beginning of the GRAT, however, it can be changed before the end of the ETIP.)

(5) **Affirmative Allocation of GST Exemption Prior to End of ETIP**. If an affirmative allocation of GST exemption is made before the end of the ETIP, the allocation is irrevocable and cannot be changed. Reg. §26.2632-1(c)(1)(ii). Exemption should not be affirmatively allocated to GRATs (other than the possible strategy discussed above of allocating exemption equal to the nominal value of the remainder value in the unlikely event that might be enough to cause the trust to be GST-exempt.) However, Pam Schneider suggests that regulation is suspect and could be challenged if a large amount were at issue. (The statute states that GST exemption "shall not be made before the close" of the ETIP. §2642(f). "How can the IRS write a regulation that something you are not allowed to do is irrevocable because they told you that you are able to do it?")

(6) **Allocation at End of GRAT Term**. There is considerable uncertainty as to how GST exemption can be allocated at the end of the GRAT term if the goal is to make the allocation to some but not all trusts that receive the GRAT assets at the end of the GRAT term. (For example some of the assets might pass to the grantor's children outright and the balance might pass to long-term trusts. There would be no need to allocate any exemption to the portion passing outright to the grantor's children.) One possible alternative might be to sever the GRAT before the end of the trust term, but

it is not clear how that would be done (before the GRAT has split into separate trusts). The retroactive allocation rules do not seem to help; they apply if the child unexpectedly dies "out of order."

12. Effect of Modifying GST Exempt or Grandfathered Trusts

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

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

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

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

b. **Argument That Modifications Resulting from Unqualified Severance Should Result in Trusts with Same Inclusion Ratio**. A creative argument (that seems technically correct) is based on the qualified severance regulations (initially finalized August 2, 2007). The regulations were amended effective for severances occurring on or after September 2, 2008 to add a new paragraph (h) and new examples in paragraph (j) regarding non-qualified severances. *See e.g.*, Reg. §26.2642-6(j), Ex. 12 (the original and severed trusts have an inclusion ratio of 0.30, but nothing in the regulation suggests that the answer would change if the inclusion ratio were originally zero, so that the severed modified trusts would also have an inclusion ratio of zero). For further discussion of this issue, see Item 22.b. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

c. **Recent Ruling – First to Approve that General Power of Appointment Satisfies "Vesting" Requirement**. Modifications of a grandfathered trust will not cause the trust to lose its GST grandfathered status if one of the four safe harbors in Reg. §26.2601-1(b)(4)(i) is satisfied. The fourth of the safe harbors, and the one that is applicable in the broadest types of situations but which limits the types of modifications allowed, is the "(D) Other changes" safe harbor. A modification under that safe harbor may not shift any beneficial interest in the trust to a beneficiary in a lower generation, and the modification must not extend the time for "vesting" of any beneficial interest in the trust beyond the period provided in the original trust. Reg. §26.2601-1(b)(4)(i)(D)(1).

A common change that should be permitted under the fourth safe harbor is a modification of a trust to allow property to remain in trust past the distribution date in the original trust until a beneficiary reaches a later age. That is satisfactory if the beneficiary's interest is vested. If a trust modification results in assets ultimately passing to a beneficiary's estate, planners are comfortable that is a vested interest and that the modification does not extend the time of vesting. What about instead giving the beneficiary a general power of appointment?

PLRs 201947001-006 addressed the extension of a grandfathered trust, which would otherwise terminate at age 21, for the current beneficiary for life but with the beneficiary being given a testamentary general power of appointment. No ruling previously has ruled whether giving the beneficiary a general power of appointment (i.e., causing the property to be vested for estate tax purposes) also would satisfy the vesting requirement (which is a property vesting requirement) in the fourth safe harbor. These PLRs do that for the first time. The rulings reason as follows.

> Each share will be held in a separate trust for the lifetime benefit of the beneficiary for whom it is created and any remaining trust property including undistributed income will be subject to that beneficiary's general power of appointment at his or her death. Therefore, the value of such property will be included in the beneficiary's gross estate under § 2041(a)(2) and the beneficiary will be treated as the transferor of such property for GST tax purposes under § 2652(a)(1). Under these circumstances, we conclude that the modification of Article II of § 2.2(e) of Trust will not shift a beneficial interest in Trust to any beneficiary occupying a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification will not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original governing instrument of Trust.

Similar rulings were issued in 2020. PLRs 20201001-005.

13. Planning for GST Nonexempt Trusts

Many clients have large GST nonexempt trusts with an impending taxable termination and large GST tax bill looming. With the currently high GST exemption amount, many of these irrevocable trusts will be subject to a transfer tax when the individuals involved would not be, and those individuals' exemptions are not fully utilized. Many things can be done to help mitigate or postpone the GST tax. The transferor, trustee, and beneficiary all have various options available to them.

a. **Transferor**. If the transferor is still alive, various alternatives are available.

(1) **Late Allocation of GST Exemption**. Under Reg. §26.2632-1(b)(4)(ii)(A)(1), a transferor can make a late allocation of GST exemption to a lifetime transfer by making an election on a gift tax return, effective as of the date the return is filed. The amount of GST allocated will be based on the value of the trust property at the time of the late allocation. Under Reg. §26.2642-2(a)(2), the transferor may elect to use the first day of the month for valuation purposes, but the election will still be effective as of the date the return is filed (meaning the transferor cannot reduce or eliminate GST tax on a generation-skipping transfer that has already taken place). The late GST exemption allocation on a gift tax return is deemed to take effect before any generation-skipping transfer that occurs on that same day. Reg. §26.2632-1(b)(4)(ii)(A)(1).

(2) **Late and Retroactive Allocation of GST Exemption—9100 Relief**. Under Reg. §301.9100-3, the transferor may request an extension of time to allocate GST exemption. The benefit of a retroactive allocation is that it is effective as of the date of the original transfer, and GST exemption is allocated based on the value transferred on the original gift date. *E.g.,* PLR 201923022. Proposed Reg. §26.2642-7 would become the exclusive basis for seeking such extensions (except in cases covered by Rev. Proc. 2004-46) and is harsher for taxpayers than Reg. §301.9100-3, but these regulations have not yet been finalized. See Item 19 below regarding the requirements that must be satisfied to obtain an extension under the 9100 relief procedures.

(3) **Late and Retroactive Allocation of GST Exemption to Pre-2001 Annual Exclusion Gifts – Rev. Proc. 2004-46**. Under Rev. Proc. 2004-46, the IRS provides a streamlined procedure for taxpayers to request a late allocation of GST exemption to pre-2001 gifts that qualified for the gift tax annual exclusion (but not the nontaxable gift exception in §2642(c)). If the taxpayer can meet all the requirements in Rev. Proc. 2004-46, the taxpayer need not request 9100 relief or pay the associated fee. The taxpayer would instead file a gift tax return for the year of the gift with a notation at the top that the return is "FILED PURSUANT TO REV. PROC. 2004-46."

(4) **Late and Retroactive Allocation of GST Exemption—Death Out of Order**. A special late allocation rule applies for situations in which a death out of order occurs. An example is when the transferor creates a nonexempt trust for the benefit of a child with assets going to grandchildren at a later date and then the child predeceases the transferor. Under §2632(d)(1), the transferor in such a situation (or the transferor's personal representative, if the transferor died in the same year as the child) can make a late allocation of GST exemption to previous transfers with retroactive effect. The transferor allocates GST exemption based on the value of the assets as of the original gift date, regardless of what the assets are worth at the date of the generation-skipping transfer. Possibly the biggest benefit of this type of retroactive allocation is that the transferor can allocate his or her exemption amount as of the date of the generation-skipping transfer, regardless of the amount of exemption he or she had on the date of the original gift.

b. **Trustee**. The trustee also may have planning opportunities to minimize GST tax.

(1) **Distributions to Non-Skip Beneficiaries**. After considering all tax implications, and if within the distribution standard of the trust agreement, the trustee can make distributions to non-skip persons before a taxable termination occurs.

(i) **Facilitate Lifetime Gifting**. If a non-skip beneficiary does not have enough assets in his or her own name to fully utilize his or her exemption amounts, making distributions to that non-skip beneficiary may enable him or her to engage in lifetime planning for descendants. Even if the beneficiary has no remaining gift tax exemption, the effective gift tax rate may be lower as it is tax-exclusive whereas GST tax triggered by a taxable termination is calculated on a tax-inclusive basis (the GST tax is paid out of the assets transferred to the beneficiaries).

(ii) **Intentional Estate Inclusion**. If the assets have a low basis, the non-skip beneficiary may retain the assets until his or her death, utilizing his or her remaining exemption amounts at death and allowing the assets to receive a new basis. Even if the beneficiary has no remaining estate tax exemption, the estate tax may be preferred due to certain available deductions that are not applicable to the GST tax (e.g., bequests to surviving spouses under Code §2056; bequests to charity under Code §2055; and estate administration expenses under Code §2053) and the ability to pay the estate tax in installments under Code §6166 (see Item 13.d.(3) below).

(iii) **Income Tax Planning**. If the non-skip beneficiary has significant income in a given year, distributions to the beneficiary could enable him or her to make gifts to charity.

(iv) **Possible Collapsed Transactions Argument by IRS**. Note, however, that the IRS may claim that a distribution followed by a gift should be collapsed and deemed to be a prearranged and simultaneous transaction, resulting in a distribution from the nonexempt trust to the end recipient. *Cf. Estate of Kite v. Commissioner*, T.C. Memo 2013-43 (QTIP context; surviving spouse's children as trustees distributed all principal to spouse and she sold the assets to her children two days later in deferred private annuity arrangements; transactions were treated as a disposition by the spouse of her income interests in the QTIP, triggering §2519; suggesting that the combination of a trust distribution to a beneficiary followed by transfers by the beneficiary might be treated as if the subsequent transfers were made by the trust).

(v) **Effect of Unauthorized Distributions**. To the extent distributions are made that are not authorized in the trust agreement, the IRS might argue that it should ignore the distributions. *See Estate of Lillian Halpern v. Commissioner*, T.C. Memo 1995-352 (distributions from general power of appointment marital trust to descendants; spouse consented but the distributions were not authorized; court recognized the distributions that were made when the spouse was competent but did not recognize distributions made after the spouse had become incompetent because a guardian could have set aside the distributions, so those distributions were included in the spouse's estate under §2041); *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278 (beneficiary-trustee made distribution to self, contrary to standards in trust, and sold those assets for private annuity; trust assets included in decedent's gross estate under §2036 and the distributed assets were not excluded from the decedent's gross estate merely because of ascertainable standards in the trust); *Estate of Hartzell v. Commissioner*, T.C. Memo. 1994-576 (court rejected IRS argument that assets distributed from marital trust to decedent during her lifetime and given to family were includable in her gross estate because the distributions were improper transfers from the trust; Ohio court would have approved the transfers because distribution standard of "comfort, maintenance, support, and general well being" would include distributions to assist her desire to continue giving gifts to family members to ensure family control of family businesses).

See Item 23.e.(4) below for a discussion of the *Magruder* and *Wyly* cases in which the failure to follow restraints on distributions caused trusts to be treated as grantor trusts for non-tax purposes.

(vi) **Effect of Consents by All Parties**. Lastly, gift tax consequences as well as possible income tax consequences may result if everybody consents to the distribution. On the other hand, ilf consents are not given, fiduciary concerns exist.

(2) **Medical and Education Distributions**. The trustee may pay the tuition and medical payments for skip person beneficiaries (assuming the distribution standards authorize the distributions). Under §2611(b)(1) and §2503(e), a trustee may make certain tuition and medical payments on behalf of a skip person. If such payments are made directly from the trust to the education or medical provider, they will not be deemed a generation-skipping transfer.

(3) **Use of Property and Loans**. In the event a beneficiary who is a skip person is in need of a distribution, the trustee may consider making a loan to the beneficiary or allowing the beneficiary to use trust property instead of making a taxable distribution. Note, however, nothing in the GST rules addresses whether a loan to a skip person or a skip person's use of trust property is itself a taxable distribution, resulting in some risk that the IRS may claim that a taxable distribution has been made. For analogous situations, consider that taxable gifts may result if a landowner does not charge her children fair market rent (*see e.g.*, *Wineman v. Commissioner*, T.C. Memo. 2000-193 (gift resulted from renting ranch to children at below-market rate)), and the beneficiary's rent-free use of property should not result in a deemed distribution for fiduciary income tax purposes (*e.g., Commissioner v. Plant*, 76 F.2d 8 (2d Cir. 1935); *Du Pont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976)).

(4) **Modify Trust—Grant Powers of Appointment**. Depending upon the confines of state law, the trustee may be able to decant or modify (judicially or non-judicially) the trust to grant a non-skip beneficiary a power of appointment. A nongeneral power of appointment could be exercised in favor of non-skip persons. If the non-skip beneficiary will not otherwise use his or her remaining exemption amounts, granting such beneficiary a general power of appointment may be beneficial to include the assets in his or her estate and utilize exemptions that otherwise would have been wasted. Another way to accomplish the same goal would be to appoint the beneficiary as trustee of a trust that does not have an ascertainable distribution standard (assuming the rare fact pattern that neither the governing instrument nor state law prohibits the beneficiary from serving as trustee or imposes a savings clause that would otherwise restrict the beneficiary trustee's discretion).

(5) **Modify Trust—Add Non-Skip Beneficiaries**. The trustee could also modify the trust by adding non-skip persons as beneficiaries, postponing a taxable termination. Some trust agreements may even include provisions granting the trustee or a trust protector the power to add beneficiaries, removing the need for a modification. The non-skip person must have an interest in the trust that is significant enough to be considered a beneficiary for GST tax purposes. Under §2652(c)(1), a person is a beneficiary for GST tax purposes if such person (A) has a current right to receive principal or income distributions, (B) is not a charity and is a permissible beneficiary, or (C) is a charitable remainder annuity trust, charitable remainder unitrust, or a pooled income fund. Note that Congress anticipated taxpayers adding beneficiaries

to trusts to postpone taxable terminations and added §2652(c)(2), stating that any interest created primarily to postpone or avoid GST tax shall be disregarded. Reg. §26.2612-1(e)(2)(ii).

(6) **Undertake Valuation Planning**. The trustee can engage in valuation planning for trust assets the same ways individuals do for lifetime gifting. The trustee could contribute trust assets to an entity and make taxable distributions of non-controlling interests to skip persons at a discount or ensure the trust has a minority interest in such entity as of the date of the taxable termination, also resulting in a discount. The same concept applies to the distribution or retention of fractional interests in real estate. Sections 2036 and 2038 do not apply in this GST context, so IRS arguments would likely rely on the theories of inadequate business purpose or step transaction, and taxpayers should also be mindful of §2703 and §2704 (other than §2704(a), which by its terms applies only for gift and estate tax purposes), as they do still apply in the GST context.

(7) **Combine Trusts**. In the event that the transferor created separate nonexempt trusts for his or her children that continue for the benefit of grandchildren, the trustee may consider combining the children's trusts to postpone the taxable termination until the last child's death (rather than a separate taxable termination at each child's death).

(8) **Taxable Distributions**. There may be some situations in which making a distribution to a skip person, intentionally triggering the GST tax, may be advantageous. That may be the case, for example, if the value of the assets is expected to increase dramatically or if distributions of minority or fractional interests in assets can be made now to claim a discount and such a discount would not be possible if the assets are instead distributed as part of a taxable termination.

(9) **Freeze Transactions**. The trustee can also employ various freeze transactions with the nonexempt trust assets, such as loaning cash or selling assets to an exempt trust or skip person. See Item 23.g. below

c. **Beneficiary**. Lastly, some planning techniques are available to the beneficiary as well.

(1) **Exercise Nongeneral Powers of Appointment**. If the trust agreement granted a non-skip beneficiary a nongeneral power of appointment, he or she can exercise it in favor of other non-skip persons or exercise it in a manner to add non-skip persons as beneficiaries to postpone a future taxable termination.

(2) **Release General Powers of Appointment**. If the beneficiary has a general power of appointment, the trust property will be included in the beneficiary's estate and subject to estate tax under §2041. The beneficiary could consider releasing the general power of appointment, making a taxable gift under §2514 in the event that paying gift tax presently rather than estate tax at death is desirable (or in the event the gift tax exemption is about to decrease and would otherwise go unused).

(3) **Assignment, Release, or Disclaimer**. Under §2511, a beneficiary could trigger a gift by assigning, releasing, or disclaiming his or her interest in the nonexempt trust property, utilizing his or her remaining gift tax exemption or intentionally triggering gift tax (see Item 13.b.(1)(i) above). The main obstacle with assignment is that the

beneficiary cannot assign his or her interest if the trust includes a spendthrift clause. *But see Restatement (Third) of Trusts* §58 cmt. c (2003) (beneficiary may reject a beneficial interest or power of appointment by a proper disclaimer even if trust has a spendthrift provision); PLR 8624014 (assignment of remainder interest in trust was completed gift despite existence of spendthrift provision). If the beneficiary has not accepted the interest in the trust, he or she may be able to release the interest or make a nonqualified disclaimer under a state disclaimer statute.

d. **Paying the GST Tax**.

(1) **GST Returns**. There are five different returns that directly implicate GST reporting: (a) Form 706, Schedule R (estate tax return); (b) Form 709, Schedule A Part 2 and Schedule C (gift tax return); (c) Form 706-GS(T) (generation-skipping transfer tax return for terminations); (d) Form 706-GS(D-1) (notification of distribution from a generation-skipping trust); (e) Form 706-GS(D) (generation-skipping transfer tax return for distributions). The last three "GS" forms are prefaced "706" but are not part of the estate tax return. The "GS" forms may be required when an estate tax return is not required and may be applicable even independent of any death.

For further information about the use of these various forms, see Item 80 of the ACTEC 2011 Annual Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(2) **Alternate Valuation Date Election; Due Dates and Extensions**. The Blue Book explanation for the Tax Reform Act of 1986 states that the alternate valuation date election under §2624(c) for a taxable termination occurring at the death of an individual is available even if the estate of that individual does not make the alternate valuation date election. The alternate valuation date election for GST tax purposes appears to be available on a trust-by-trust basis, and presumably a rule similar to that in §2032(c) applies so that both the amount of taxable terminations and applicable GST tax are reduced as a result of making the election.

Under §6151, the GST tax is due on the due date for the relevant GST tax return, irrespective of extensions. This due date will be April 15th of the year following the year in which a taxable termination or taxable distribution occurs. Under §6161(a)(1), the taxpayer responsible for paying the tax may request a discretionary six-month extension of time to pay from the IRS based on "reasonable cause," which can be extended further if the taxpayer is abroad. The IRS has not defined "reasonable cause" in the GST context, but in the gift tax context it will only allow a six-month extension of time to pay upon a showing that payment on the due date will result in an "undue hardship." Treas. Reg. 25.6161-1(b). Estate taxes can be deferred under §6161(a)(2) in one-year extensions up to 10 years, and the IRS has privately ruled that the 10-year deferral under §6161(a)(2) was available for GST tax incurred by reason of a taxable termination that occurred on the death of a decedent. PLR 9314050.

(3) **Section 6166 Deferral Not Available Except for Death Resulting in Direct Skip**. Under Code §6166, a taxpayer can defer payment of estate taxes if the estate owns an interest in a closely held business that exceeds 35% of the adjusted gross estate. Congress did not provide for the same deferral in the GST tax context except in the limited situation of a death that results in a direct skip. In such a situation, the GST tax imposed is treated as estate tax for purposes of §6166. PLR 200939003

(extensive discussion of relationship of §6166 and GST tax including legislative history). Section 6166 deferral is not available for any other GST taxes due. As discussed immediately above, the IRS may grant a discretionary payment extension for GST tax under §6161.

(4) **GST Tax Paid Results in Basis Increase**. Section 2654(a)(1) provides for a basis increase when GST tax is paid. This basis increase is equal to the portion of GST tax imposed on the amount that fair market value exceeds adjusted basis.

(5) **Basis Increase on Taxable Termination at Death**. A basis adjustment is allowed for property that is the subject of a taxable termination by reason of the death of a decedent. §2654(a)(2). If the inclusion ratio is less than one, the basis adjustment is multiplied by the inclusion ratio.

14. S Corporation Issues for Estate Planners

This summary includes observations of an outstanding presentation by Carol Cantrell (Houston, Texas) and by a panel at the 2020 Heckerling Institute, observations from a panel at the ACTEC 2019 Summer Meeting, and various other observations.

a. **Prevalence**. Over 5.1 million S corporation returns are filed every year, the most of any other type of entity. Based on the number of returns filed (Form 1120 for C corporations and Form 1120S for S corporations), there are about three times as many S corporations as C corporations**.** S corporation returns are growing strong at 5.9% per year, faster than the growth of partnership returns.

b. **Advantages of S Corporations**.

(1) **Advantages over C Corporations**. The huge advantage is the absence of the double-tax that applies for C corporations. Major advantages of S corporations over C corporations include (i) the possibility for increased cash flow to owners (because the "double tax" on taxable dividends does not apply to S corporations), important especially when owners retire, (ii) increased basis for reinvested earnings, (iii) better tax implications when the S corporation is sold, and (iv) the accumulated earnings tax does not apply to S corporations.

(2) **Possible Advantage over Partnerships – Self-Employment Tax**. An advantage of S corporations over partnerships and LLCs is the possibility of reducing self-employment taxes. The self-employment tax is a substantial tax – 15.3% on income up to the taxable wage base [12.4% under §1401(a) and 2.9% under §1401(b)] and 2.9% on all income above the taxable wage base, increasing to 3.8% for taxpayers having self-employment income over $200,000 (single) or $250,000 (married filing jointly) [§1401(b)].

The flow-through income from partnerships and LLCs, but not S corporations, is subject to the self-employment tax. (However, a limited partner's income is not subject to self-employment tax, except for guaranteed payments for services rendered to a partnership that engages in a trade or business. Also, the Tax Court recently extended the limited partner exception to a passive member of an LLC. *Hardy v. Commissioner*, T.C. Memo. 2017-16, discussed in Gorin, Hardy v. Commissioner: *Tax Court Rules for the First Time that Passive LLC Member is Not Subject to Self-Employment Tax*, LEIMBERG BUSINESS ENTITIES NEWSLETTERS #158 (March 28, 2017).)

A commonly held misconception is that an S corporation can be used to avoid the self-employment tax. Reasonable compensation (which is subject to the FICA tax) must be paid to employees, however, and the IRS often litigates whether reasonable compensation is being paid to owners of S corporations.

c. **Overview of Eligibility Rules**.

(1) **Number of Shareholder Limit**. Over the years, the number limit has increased to 100, and substantial "loopholes" apply. Spouses are considered as one shareholder, even after the spouse dies. A change was made in 2004 to treat all members of a family as one shareholder. Family is defined very broadly to include 6 generations down from a common ancestor.

(2) **No NRAs**. A nonresident alien is an ineligible shareholder. §1361(b)(1)(C). One solution is to have the S corporation dump its assets into an LLC and have the NRA contribute to the LLC for a proportionate interest to what would have been his interest in the S corp. The NRA rule can arise inadvertently. If S corp. stock is given to an employee as compensation, and the employee is married to an NRA in a community property jurisdiction, that would destroy the S election. (Even though an NRA is an ineligible shareholder, the 2017 Tax Act provides that an NRA can be a potential current beneficiary of an ESBT. See Item 14.f.(5)(iv) below.)

(3) **Eligible Shareholders; No Partnership or C Corporation Shareholder**. Eligible shareholders include individuals (U.S. citizens or residents), estates, certain trusts, and certain tax-exempt organizations. A partnership or C corporation cannot be a shareholder. The LLC wrapper approach described in paragraph (2) immediately above can be used to avoid direct ownership of S corporation stock by a partnership or C corporation as well.

(4) **One Class of Stock**. Voting rights are disregarded. The planner must be concerned particularly with three possible situations: disproportionate distributions, constructive distributions (such as below-market loans), and loans to the S corporation (in case the debt is later determined to be equity).

d. **S Election; Tax Year**. All owners must consent to having the entity taxed as an S corporation. This is done by filing Form 2553, which is due the 15th day of the third month after the entity is formed (or after conversion into an S corporation). This is a short timeframe, and planners must be careful to satisfy the election requirement. A trap in community property states is that the owner's spouse that has a community property interest must also sign the form.

The IRS has the authority to treat a late election as timely filed if reasonable cause existed for the late election. Revenue Procedure 2013-30 describes detailed procedures for this relief, providing that the S election can be treated as timely as long as it is filed within three years and 75 days of the date that it is effective if certain detailed procedures and requirements are satisfied.

Although some limitations apply, S corporations generally must be on the calendar year.

e. **Inadvertent Termination**. Making sure that the S corporation consists only of eligible shareholders and that the other requirements are satisfied is vitally important because otherwise the S election is terminated. If S status is terminated, the company would file a short period return as an S corporation and a C corporation return from the termination through the end of the year, and the corporation would be subject to the double taxation of C corporations for that second period. Once the S election is terminated, the corporation cannot make another S election for 5 years.

The corporation can request relief from inadvertent termination generally using the normal Letter Ruling process (with its $30,000 fee). (Panelists estimated that professional fees may be $50,000 - $100,000 in addition to the user fee, depending on the situation.) A simplified relief process without a user fee is available under Rev. Proc. 2013-30 for an inadvertent termination due to a late ESBT, QSST, or S election (but not for other reasons). For recent inadvertent termination rulings, see PLRs, 202004002, 202003001.

f. **Qualified Shareholders**. As indicated, eligible shareholders include individuals (U.S. citizens or residents), estates, certain trusts, and certain tax-exempt organizations.

(2) **Estates**. Estate are qualified shareholders for the reasonable period of administration. For example, with a 15-year deferral of paying estate tax under §6166, an estate could stay open and remain an S shareholder for a longer period of time. After such reasonable period of time, the shares are treated as owned by the distributees of the estate. If the assets would pass to a trust, the IRS may treat the prolonged estate as a de facto testamentary trust (and the trust must then make a QSST or ESBT election within two years of the deemed conversion date.

If a qualified revocable trust makes an election to be treated as part of the estate under §645, it becomes eligible to own S corporation stock as an estate, and can continue for as long as the §645 election can be in place (until two years after the date of death, but if an estate tax return is required to be filed, until six months after a closing letter is issued or the statute of limitations expires on the assessment of estate tax).

(3) **Testamentary Trusts**. As mentioned above, a testamentary trust remains a qualified S shareholder for two years beginning on the date of transfer to the trust. Reg. §1.1361-1(h)(1)(iv). By the end of that time, a QSST election must be made (by the beneficiary) or an ESBT election must be made (by the trust).

(3) **Grantor Trusts**. Wholly grantor trusts (as to all income and principal) are qualified shareholders.

(i) **Multiple Grantor Trust Trigger Powers**. If a trust is an eligible shareholder solely because it is a grantor trust, consider having more than just one grantor trust trigger to be conservative. Just relying on the substitution power is always subject to the factual issue of whether it is held in a non-fiduciary capacity.

(ii) ***Crummey* Powers**. To assure that the trust is a wholly grantor trust as to the one grantor, consider not having *Crummey* powers over the trust. Section 678(b) says that the original grantor trust rules applicable to the original grantor take

precedence over treating a beneficiary with a withdrawal power as the owner of the trust; however that applies only "with respect to a power over income" and a *Crummey* withdrawal power is a power over principal. Nevertheless, the IRS has issued numerous private letter rulings saying that the grantor power trumps over the *Crummey* power holder. Some of the earlier rulings explain that "income" means from any portion of the trust, not just fiduciary accounting income. Even so, some planners avoid using *Crummey* powers if it is vitally important that the trust be a grantor trust (such as where the stock holds S corporation stock, even though interestingly many of the *Crummey* trust/grantor trust rulings arose in the context of a trust that owns S stock and wanted to qualify for the grantor trust exception for qualified S shareholders.)

Even if the grantor-owner treatment trumps the beneficiary-owner treatment, what happens when the grantor dies? Does the grantor trust treatment as to the beneficiary become resurrected? At one time, the IRS issued a private letter ruling saying that the beneficiary would become the owner, but it later withdrew that portion of the ruling. Letter Ruling 9321050, revoking 9026036 on the §678 issue.

(iii) **Make "Protective" ESBT Election for Grantor Trust**. The trustee should consider making an ESBT election for a grantor trust, in case, for whatever reason, the trust ends up not being a wholly owned grantor trust. Having the "protective" ESBT election can also be helpful in convincing cautious tax advisors of a future potential buyer of the company that the trust is qualified to hold S stock and that the S election is valid. Protective ESBT elections are not available; the ESBT election is technically in effect, but the grantor trust rules will supersede the ESBT election as long as the trust is a wholly owned grantor trust. Reg. §1.641(c)-1(c). However, a reason not to make the protective ESBT election is that a grantor trust can use regular income taxation for the first two years after the grantor's death and obtain more favorable income tax treatment as a regular trust than as an ESBT. §1361(c)(2)(A)(ii). *See* Steve Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications* ¶ III.A.3.a.iii (2016)

(iv) **Death of Grantor**. Following the death of the grantor, the grantor trust continues as an eligible shareholder for two years after the date of death. The estate is treated as the shareholder for eligibility purposes during that period, but any flow-through income from the S corporation is reported to the trust, not the estate. By the end of the two-year period, a QSST election or ESBT election must be made to avoid an inadvertent termination of S corporation status.

(v) **Avoid Multiple Grantor Trusts as Owners of Disregarded Entity**. Avoid having multiple grantor trusts owning an S corporation through a disregarded entity. When the grantor dies, the trusts become nongrantor trusts, and the LLC converts to a partnership, which is not an eligible shareholder.

(4) **QSST**. A qualified subchapter S trust (QSST) is an eligible shareholder.

(i) **Requirements**. QSST requirements are (i) the trust can have only one beneficiary (but a single trust with separate shares can have separate beneficiaries for the separate shares), (ii) all fiduciary accounting income must be distributed to the

beneficiary (the trust does not have to require that all income be distributed, it just must in fact be distributed), (iii) any corpus distributions can be made only to the income beneficiary, (iv) the income interest must terminate on the earlier of the beneficiary's death or the termination of the trust, and (v) if the trust terminates before the beneficiary dies, all of the trust must be distributed to the beneficiary.

(ii) **Beneficiary Election; Beneficiary Taxed on S Corp Income**. The beneficiary must affirmatively elect QSST treatment; the election must be made by the beneficiary of the trust and filed with the IRS within 2 months and 15 days after the election is to be effective.

The beneficiary rather than the trust makes the election because the beneficiary, not the trust, will be taxed on the flow-through income from the S corporation.

(iii) **Reporting Income**. The QSST beneficiary is treated as the direct owner of the portion of the trust consisting of S corporation stock and is taxed on the flow-through income from the S corporation under §678(a). §1361(d)(1)(B). But if the trust sells (or otherwise disposes of) the S corporation stock, the trust (not the beneficiary) reports the gain or loss on the sale. The QSST files a Form 1041 but attaches a plain paper statement reflecting the separately stated S items, which is furnished to the income beneficiary to report on his or her Form 1040.

(iv) **Income Beneficiary Dies**. If the income beneficiary dies and the trust does not qualify as a QSST or ESBT, for eligibility purposes only the deceased beneficiary's estate is treated as the S shareholder for two years after the date of death. (The trust, not the decedent's estate, reports the trust income.)

(v) **Successor Income Beneficiary Can Elect Out**. If the stock passes in trust for a successor income beneficiary after the income beneficiary dies, the successor beneficiary may affirmatively elect (within 2 months and 15 days after becoming the successor income beneficiary) for the trust no longer to be a QSST. (That is in sharp contrast with the general procedure to terminate an S election, which requires the consent of more than 50% of the shareholders.)

(vi) ***Crummey* Withdrawal Powers**. No beneficiary should have a *Crummey* withdrawal power other than the sole income beneficiary of the trusts. (Otherwise the requirement that no corpus can be distributed to anyone other than the income beneficiary would be violated.)

(vii) **Power of Appointment**. The trust cannot give anyone a power of appointment to appoint assets to anyone other than the income beneficiary during his or her life.

(viii) **"Pocket Trusts."** Trust agreements often have provisions directing the creation of separate trusts for each beneficiary if the trust should ever own any S corporation stock, so that the separate "pocket trusts" would qualify as QSSTs.

(ix) **QTIP Trusts**. QTIP trusts satisfy all of the requirements for QSSTs, and the spouse beneficiary could make the QSST election.

(x) **Corporate Dividends and Income or Principal**. State law regarding income/principal allocation governs in determining the fiduciary accounting income of a trust (unless the trust agreement overrides the state law). Cash dividends from an entity are typically treated as income, but money distributed in complete or partial liquidation of the entity is principal. UPIA and the new UFIPA address the complete or partial liquidation issue.

(xi) **Practical Problem with QSST Beneficiary Having Sufficient Cash Flow to Pay Income Tax**. An S corporation typically makes distributions of enough cash so that the S Corporation shareholders can pay the federal income tax with respect to the S corporation income attributable to them. If the corporation distributes to a QSST its proportionate share of such "tax distributions" that it makes to all shareholders, the trust may not have enough remaining cash after paying administration expenses to distribute to the beneficiary so he or she can pay all of the income tax with respect to the S corporation income. Before making the QSST election, a beneficiary will typically want assurances that distributions will be made sufficient for the beneficiary to pay income taxes attributable to the S corporation income.

(xii) **Practical Problem for QSST Beneficiary on Beneficiary's Death**. Assume that the QSST beneficiary dies in January 2020 before the S corporation has made distributions sufficient for the beneficiaries to pay income taxes with respect to the 2019 S corporation income. The corporation subsequently makes its "tax distributions" in March 2020. The trust remaindermen (following the beneficiary's death) will generally be entitled to receive that income, leaving the beneficiary with insufficient cash flow to pay income taxes with respect to the 2019 S corporation income. In addition, if the remaindermen are beneficiaries of the income beneficiary's estate plan, consider including language to keep the trust in place (with its QSST election), during the post-mortem trust administration, so that income is not trapped in the trust during that time and taxed at high rates.

(xiii) **Deemed Dividends Probably Not Fiduciary Accounting Income**. Carol Cantrell's materials address the opportunity of an S corporation to declare deemed dividends and whether they are trust income that must be distributed to a QSST beneficiary.

> A QSST must distribute all of its trust income to the beneficiary. Cash distributions from an S corporation are trust income unless they exceed 20 percent of the S corporation's gross assets or the corporation indicates that it is a liquidating distribution. However, an S corporation can also make a "deemed" dividend without actually making one. This allows the corporation to deem out its Subchapter C earnings and profits (E&P) ahead of its AAA out of the normal order. The corporation is deemed to have made the distribution and the shareholders are deemed to have immediately contributed it back to the corporation. Deemed dividends are popular because they are taxed at the favorable 15 percent dividend rate and they allow the corporation to strip out its E&P without borrowing the money.
>
> But the question arises whether deemed dividends are trust income. Letter Ruling 200446007 held that a Subchapter S corporation's deemed dividend of E&P was not trust accounting income. Therefore, the trust was not required to distribute the deemed dividend to its beneficiary, but was still able to deem out its Subchapter C earnings and profits (E&P) ahead of its AAA for income tax purposes.

See Letter Rul. 200446007 (deemed dividend is not fiduciary accounting income and therefore not required to be distributed).

(xiv) **QSST Trust to Have Beneficiary as Deemed Owner of Grantor Trust**. One reason for using a QSST is if the beneficiary wishes to be the deemed owner of the grantor trust. For example, if the surviving spouse is the deemed owner of a classic credit shelter trust the surviving spouse's payment of the trust's income taxes can result in faster accumulation of assets in the credit shelter trust. Structuring a testamentary credit shelter trust as a grantor trust as to the surviving spouse can be difficult. One approach is to use a QSST. The credit shelter trust created at the first spouse's death and the surviving spouse might contribute assets to an S corporation in return for voting and non-voting interests. The surviving spouse, as the sole beneficiary of the credit shelter trust, would make the QSST election for the trust, which causes the credit shelter trust to be treated as a grantor trust as to the spouse with respect to the S corporation stock in the trust. §1361(d)(1)(B); Reg. §1.1361-1(j)(8). (After making the QSST election, all of the credit shelter trust income would have to be distributed annually to the surviving spouse – but the S corporation does not have to distribute all of its income.)

The surviving spouse could sell much of his or her remaining non-voting stock in the S corporation to the credit shelter trust. That stock would have a high basis at that point, because the S corporation was funded with high basis assets received from the decedent's estate. This permits the benefits of grantor trusts to some degree—but the trust is treated as a grantor trust only with respect to the S stock.

(xv) **Sale of S Corporation Stock by Beneficiary to QSST**. If a beneficiary consents to a qualified subchapter S trust (QSST) election, the beneficiary "is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election is made." Reg. §1.1361-1(j)(8), referring to §1361(d)(1). Accordingly, the beneficiary is taxed on the K-1 income of the trust from the S corporation. Could the beneficiary also sell additional S stock in that same corporation to the trust and avoid having the sale treated as a taxable transaction? Presumably that is allowed because the beneficiary is treated as the owner of the portion of the trust holding the S stock — both before the sale and after the sale of additional S stock to the trust. (Rev. Rul. 85-13 said that a sale by the grantor to a trust that was not a grantor trust in return for a note without adequate security caused the trust to become a grantor trust and shielded that very sale from being a taxable sale. This seems to be an easier situation because the trust indeed is a grantor trust as to the S stock both before and after the sale.) However, note that the QSST regulations do not explicitly address whether a sale to the trust of additional S stock in the same company by the consenting beneficiary will be taxed as a sale by the beneficiary to the beneficiary's grantor trust — and therefore non-taxable.

If the beneficiary sells S corporation stock to the QSST in return for a note, some planners recommend that the stock serve as collateral for the note. A QSST must distribute all net accounting income as determined under state law to the beneficiary, §1361(d)(3)(B), referring to §643(b). A sale of S stock to a QSST raises the question of whether distributions from the S corporation to the trust must be entirely distributed to the beneficiary or whether some portion could be used to make principal and interest payments on the note. The interest payments should be fine — because

they reduce net accounting income that must be distributed to the beneficiary. Some portion of the payment may also be used to make principal payments if the distributions are security for a note on which the QSST is the obligor. Gorin, *Planning Strategies that Reduce Both Income Taxes and Estate Taxes*, 49th ANNUAL HECKERLING INST. ON EST. PL., Special Session II-A, at II-A-38 (2015).

(xvi) **Paying Trustee Fees from QSST**. If an S corporation declares dividends that are payable to a QSST, cash dividends are received as fiduciary accounting income of the trust, and the QSST must distribute all income annually to the beneficiary. Under most state laws, trustee fees are allocated one-half to income and one-half to principal. The trust does not receive any principal cash, so how does it pay the one-half of the trustee fee that is to be paid from principal?

- If the issue is ignored, the beneficiary may be treated as making a contribution to the trust, which could have adverse gift tax consequences.
- One approach is to pay the entire fee from income and establish a liability from the principal account to the income account. Query, does it have to bear interest? When the S corporation stock is sold or when a large distribution is made that is characterized as principal, the principal account would be able to repay the income account.
- Another approach is to exercise a "power to adjust," to declare that a portion of the cash receipt is principal.
- Another is to convert the trust to a unitrust (assuming the distributions exceed 3% of the trust value on an annual basis). For example, with a 3% unitrust, the distribution would be income up to 3% of the trust value and the excess would be principal, which the trust could use to pay expenses that are charged to principal.
- Another creative approach is to have the S corporation make distributions in marketable securities. The general income-principal allocation rule is that *cash* dividends from an entity are treated as income but not in-kind distributions.
- If all else fails the S corporation could redeem a portion of the QSST's stock; the redemption proceeds would be principal.

(5) **ESBT**. An electing small business trust (ESBT) is an eligible shareholder.

(i) **More flexible**. The ESBT is much more flexible than a QSST. It can have multiple beneficiaries, it does not have to distribute all income, it can have *Crummey* powers for multiple persons, and it can have special powers of appointment. Because it can accumulate income, the trust can accumulate substantial assets over time.

(ii) **Generally Preferred over QSSTs**. Because of the added flexibility, ESBTs are typically preferred over QSSTs, unless (i) the trust is a QTIP trust that satisfies all of the requirements for a QSST in any event as long as the spouse is alive, (ii) the beneficiary is in a lower tax bracket, or (iii) the beneficiary prefers the "deemed owner" treatment of a QSST so that the beneficiary can pay the income tax. (The portion of the ESBT represented by the S corporation stock is taxed entirely at the highest marginal income tax rate.)

(iii) **Charitable Trusts**. CRATs and CRUTs are ineligible shareholders of an ESBT but a CLAT may own S corporation stock and elect ESBT treatment.

(iv) **NRA Individual Beneficiary Permitted; Special Rule for NRA if ESBT is Also Grantor Trust**. Nonresident aliens (NRAs) may be beneficiaries of an ESBT, effective January 1, 2018.

A special rule applies if an ESBT that is a grantor trust has an NRA as a current beneficiary. Wholly or partially-owned grantor trusts can make an ESBT election, but the grantor trust taxation rules override the ESBT provisions, so that S corporation income is taxed to the deemed owner of the grantor trust portion rather than being taxed directly to the ESBT. See Item 14.f.(3)(iii) above.

Regulations prevent the new rule from the 2017 Tax Act allowing an NRA to be a potential current beneficiary of an ESBT from allowing S corporation income in an ESBT that is also a grantor trust as to the NRA from being attributed to the grantor portion of the ESBT to escape Federal income taxation, which would be contrary to Congressional intent. Instead, the S corporation income of the ESBT that would otherwise have been allocated to an NRA deemed owner under the grantor trust rules will be included in the S portion of the ESBT that is taxed to the ESBT and will continue to be subject to U.S. income tax. Reg. §§1.641(c)-1(b)(1)(ii) and (2)(ii) and (l)(6), Ex. 6 and 1.1361-1(m)(1)(ii)(D), (2)(ii)(E)(*2*), (4)(i), (5)(iii), and (8). These provisions apply to all ESBTs after December 31, 2017. Reg. §§1.641(c)-1(k) and 1.1361-1(m)(9).

(v) **No Trust Interest Acquired by Purchase**. The trust can purchase S corporation stock, but no beneficiary can acquire its interest in the trust by purchase.

(vi) **Election by Trust**. The trust (not the beneficiary) makes the ESBT election. The election must disclose the potential current beneficiaries and disclose (without describing) any powers of appointment.

(vii) **Potential Current Beneficiary**. Any "potential current beneficiary" must be an eligible shareholder and all of them are considered in determining if the corporation exceeds the 100-shareholder limit.

(viii) **Taxed at Highest Rate**. Flow through income from the S corporation is taxed at the highest trust marginal rate (37% in 2020 for ordinary income, long-term capital gains are taxed at the applicable capital gains rate).

(ix) **No Distribution Deduction**. The trust gets no distribution deduction as to any S corporation flow-through income (thus assuring that the S corporation flow-through income is taxed at the highest marginal rate).

(x) **Toggling**. Toggling between QSST and ESBT treatment is permitted, but only once every 36 months and both the trustee and beneficiary must sign the election.

(xi) **Charitable Deduction Allowed Under §170 Rather Than §642(c)**. The 2017 Tax Act provided that the charitable contribution deduction of an ESBT is determined by rules applicable to individuals under §170, not the rules applicable to trusts under §642(c), effective for taxable years beginning after 2017. This will be favorable in various respects for charitable contributions made by the portion of an

ESBT holding S corporation stock. Several restrictions that apply under §642(c), but not under §170, are that (1) the distribution must be made from gross income, (2) the distribution must be made pursuant to the terms of the governing instrument, and (3) no carryover of excess contributions is allowed for trusts. Eliminating the gross income requirement means that a charitable deduction would be available for gifts of property, the same as for individuals. Eliminating the governing instrument requirement is helpful because the governing instrument requirement has been applied strictly. Excess charitable deductions can be carried forward for five years.

Possible negative effects of applying §170 rather than §642(c) to ESBTs are that the percentage limitations (but also the carryforward provisions) applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock, and the substantiation requirements that apply to individuals under §170 also are applicable to ESBTs.

This change in the 2017 Tax Act is permanent and does not sunset after 2025.

(xi) **Section 199A Deduction**. ESBTs qualify for the §199A deduction. Reg. §1.199A-6(d)(3)(v). The S component and the non-S component of the trust (for example, if the trust owns an S corporation with a business and owns other businesses in partnerships) are combined for purposes of determining if the trust exceeds the "threshold amount" for purposes of the limitations on the deduction under §199A.

(6) **Retirement Plans (Not IRAs), Charities**. Retirement plans (but not IRAs) and charitable organizations can be eligible shareholders, though that rarely happens (the income would generally be reported as unrelated business taxable income (UBTI)).

g. **One Class of Stock Problem Issues**. S corporations can have only one class of stock, except that they can have voting and non-voting shares. Therefore, shares must have identical distribution and liquidation rights.

Governing documents should state explicitly that only one class of stock exists.

No special allocations are permitted. If an S election is made for an LLC that has "partnership allocation" provisions, the election may be disallowed from the outset. Any federal partnership tax provisions and related distribution and allocation provisions in the operating agreement must be scrubbed very closely.

Avoid constructive distributions by a shareholder's *use* of assets for non-business purposes without reimbursing the corporation for the fair use value. If no reimbursement is made, other shareholders should receive equalizing distributions to avoid having multiple classes of stock.

If an LLC authorizes separate classes of interests but they are never issued, the one class of shares requirement would not be violated.

Certain exceptions are allowed for buy-sell agreements providing different terms for different shareholders, but planners must be extremely careful with any differences in buy-sell agreement provisions for shareholders.

h. **Shareholder's Death**. If a §754 election is in effect for the year in which a sale or exchange of a partnership interest occurs (including a liquidating distribution) or a partner dies, a basis adjustment is made under §734 to increase or decrease the transferee's share of the partnership's basis for its assets (the "inside basis") to match the transferee's basis for his partnership interest (the "outside basis"). Reg. §§1.743-1(b) and (d). No similar election exists for an S corporation.

Following the death of an S corporation shareholder, if the corporation sells a major asset (generating gain because the lack of any kind of §754 election), the effect of getting an inside basis step-up for the deceased shareholder's interest will be simulated if the S corporation liquidates in the same year as the sale.

Assume for simplicity that an S corporation owns a single asset worth $1 million and a zero basis.

- At the shareholder's death, the decedent's stock receives a basis adjustment to fair market value under §1014; assume that no discounts apply and the stock basis is $1 million. (Also assume the asset is not income in respect of a decedent because the stock basis adjustment at death must be reduced by the value attributable to items constituting IRD to the decedent. §1367(b)(4)(B).)
- If the S corporation sells the asset for $1 million, the gain flows through to the shareholder, resulting in a flow-through $1 million capital gain to the shareholder. §1366(a)(1)(A). (The character of the gain could be partly ordinary income to the extent that the sold assets are inventory, accounts receivable, or recapture income assets.)
- The shareholder's basis in his stock is increased by the amount of the flow-through income allocation (§1367(a)(1)(A)), so the stock basis becomes $1 million + $1 million, or $2 million.
- If the S corporation is liquidated, the shareholder will have a capital loss of $1 million ($1 million of liquidation proceeds - $2 million stock basis).
- If the sale of the asset and the liquidation of the corporation occur in the same year, the capital gain and capital loss will offset. (If the gain is partly ordinary income, only $3,000 of ordinary income could be offset by the capital loss.) The sale and liquidation do not have to occur in the year of death; they just need to occur in the same year for the capital gain to be offset by the capital loss.
- The result is that the shareholder ends up owning assets with a high basis, rather than owning an S corporation that holds low basis assets, and did not recognize net gain in achieving that result.
- If the decedent is a majority shareholder rather than the sole shareholder, the executor will have to consider the tax consequences of the liquidation on minority shareholders (who would not have received a stock basis adjustment under §1014 assuming they had not died).

Trap Regarding Liquidation of S Corporation Following a Shareholder's Death. If the liquidation does not occur until the year after the sale, the shareholder may have a big gain in the year of the sale and a big capital loss in the subsequent year, and the shareholder may not have other gains to be offset by the loss in the subsequent year. The capital loss may not be usable for years into the future.

i. **Hazards of Former C Corporations**.

(1) **Built-In Gains Tax**. The built-in gains tax can apply to S corporations that formerly were C corporations if the built-in gain asset is sold or distributed, but the recognition period is now only five years (rather than 10 years or seven years as under prior law). The corporation pays a tax equal to the highest rate for C corporations (now 21%) times the net recognized built-in gain for the taxable year or, if less, the corporation's taxable income for the taxable year. §§1374(b)(1), 1374(d)(2)(A). The corporate level tax imposed under §1374 passes through to shareholders as a loss with the same character as the corresponding gain giving rise to the tax, lessening the double tax impact to some extent. Possible ways to avoid or minimize this tax are (i) wait out the recognition period before selling or distributing the built-in gain assets, (ii) make a like-kind exchange under §1031 (now allowed only for real estate), but the §1374 taint is preserved in the asset received, thus merely deferring the tax, and (iii) the corporation could make a charitable contribution of the asset (the corporation would not have a gain so the §1374 tax would not apply, and the shareholders would reduce the basis of their stock only by the basis of the built-in gain asset, not by the full market value of the asset, thus assuring that the gain is not effectively later taxed upon a sale of the shares or a liquidation of the corporation).

(2) **LIFO to FIFO**. If the C corporation used the LIFO accounting method, it must change to the FIFO accounting method and must recapture the income that the corporation would have received if it had used the FIFO method (but the recapture amount can be reported over four years). §1363(d).

(3) **Passive Investment Income**. If the S corporation has "accumulated earnings and profits" (e & p) from when the corporation was a C corporation, and if the S corporation's "passive investment income" exceeds 25% of its total gross receipts, the corporation pays a tax equal to the highest tax rate for C corporations (now 21%) times the "excess net profit income," and if the tax is imposed for three years in a row, the S corporation must revert to being a C corporation. The general purpose is to limit the benefits of S corporations to those companies engaged in active businesses and not a place to park retained earnings from C corporation years for investment. This can be managed by (i) paying out all of the C corporation years accumulated retained e & p, or (ii) managing the gross receipts and the investments so that the passive income does not exceed 25% of the gross receipts (and for sure does not exceed 25% three years in a row).

j. **Basis Issues**. A shareholder's share of net loss flow-through from the S corporation is deductible only to the extent the shareholder has basis in his shares of the corporation. There are two elements of basis — stock basis and basis in debt (i.e., loans to the corporation).

If net losses exceed both stock and debt basis, they are suspended and carry to the next year. If you know the corporation will have a net loss for the year, how can you add basis sufficient to claim the loss currently? Have the shareholder make a loan to the corporation (a "straight loan"). But what if the shareholder does not want to commit more funds to a losing corporation? The shareholder cannot just contribute a note to the corporation. But one technique that can possibly work in some situations is if there is another shareholder who is a related party, the first shareholder who want more basis could buy some of that other shareholder's stock for a note. That gives the shareholder stock basis. Of course, that hurts the related party-because he or she may not have enough basis to use the losses, but that party may be in a lower bracket.

Debt basis: Every court (except the 11th Circuit in *Self*) says that an S corporation shareholder cannot get basis for guaranteeing the corporation's loans. Preferred approach: Banks should not loan directly to S corps. That results in lost basis. Instead the bank should make the loan to the shareholder and the shareholder should turn around and make the loan to the corporation. Furthermore, even refinancing an entity loan into a shareholder loan can turn the loan into debt basis.

k. **Shareholder Agreements**. Shareholder agreements for S corporations should include various special provisions including the following:

- Ownership of shares should be restricted so the shares cannot be transferred to an ineligible shareholder; having that provision in the agreement is important (i) to avoid "blackmail" by a shareholder who threatens to transfer shares to an ineligible shareholder, and (ii) for a corporation seeking inadvertent termination relief due to an unauthorized transfer to an ineligible shareholder;
- Each shareholder should give some representative who acts on behalf of the corporation an irrevocable power of attorney to complete the shareholder consent to the S election (a power of attorney coupled with an interest can be irrevocable); and
- The agreement may require the corporation to make distributions to shareholders so they can pay their income taxes on flow-through income from the S corporation.

l. **Charitable Planning Issues**.

(1) **Basis Not Reduced by Appreciation**. Following the Subchapter S Revision Act of 1982, charitable contributions by S corporations are deductible proportionately by the shareholders (§1366(a)(1)), but a shareholder's deduction is limited to the shareholder's basis in the S corporation stock and any corporate indebtedness to the shareholder. §1366(d)(1). For an excellent discussion of the complexities of charitable gifts by S corporations, see Christopher R. Hoyt, *Charitable Gifts Made by S Corporations: Opportunities and Challenges,* 36 ACTEC L.J. 477 (Winter 2010).

A shareholder's basis in its S corporation stock is generally reduced by any deductions passing through to the shareholder, but §1367(a)(2) states that the shareholder's basis would be reduced only by the shareholder's pro rata share of the basis of the contributed property, not the total unrealized appreciation in the contributed property. This is a very favorable benefit for S corporation shareholders. §1367(a)(2).

(2) **Trust Deduction for Flow-Through Charitable Deduction**. Rev. Rul. 2004-5 provides that a trust that is a partner is entitled to a charitable deduction for the trust's distributive share of the charitable gift from the partnership's gross income—even if the trust has no charitable beneficiaries. The deduction is not disallowed under §642(c) "merely because the trust's governing instrument does not authorize the trustees to make charitable contributions." The key to receive a charitable deduction for a trust under §642(c) is that the contribution must be from gross income. Similarly, the contribution from the partnership must be from partnership gross income in order for the trust to use the charitable deduction. Carol Cantrell anticipates that "presumably the same rules would apply to allow the trust to deduct its share of contributions made by an S corporation from the S corporation's gross income."

(3) **ESBT Charitable Deductions**. See Item 14.f.(5)(xi) above regarding ESBTs being governed by the rules of §170 rather than §642(c) for charitable deductions by the trust.

(4) **Charitable Gifts of S Corporation Stock**.

(i) **Exempt Organizations Can Be S Corporation Shareholders**. Prior to 1998, a charitable organization was not a qualified S corporation shareholder. Charities are now qualified shareholders (§§1361(b)(1)(B) and (c)(6)), but CRTs and pooled income funds are still disqualified shareholders (they cannot qualify under the grantor trust, QSST or ESBT rules).

(ii) **All Income is UBTI**. Charitable gifts of S corporation stock are rarely fair. A significant disadvantage is that the charity is taxed on *all* of the flow-through income of the S corporation as UBTI. §512(e). (This is contrasted to partnership interests owned by charities—only the flow-through income from partnerships that is attributable to UBTI activities is treated as UBTI to the chartable partner.) Further, capital gain realized on the sale of S corporation stock is also UBTI. §512(e)(1)(B)(ii).

(iii) **Using Supporting Organization to Reduce Charity's UBTI Tax Cost**. A strategy of reducing the UBTI tax cost to the charity is to have the S corporation stock held in a supporting organization (SO) for the organization. A corporate SO is entitled to a charitable deduction up to 10% of the UBTI, effectively reducing the tax cost by 10%. A trust SO is entitled to a charitable deduction for UBTI like individuals—thus generally qualifying for a 50% deduction if the SO supports a public charity, effectively cutting the tax cost by 50%. §512(b)(11).

(iv) **Excess Business Holdings**. Private foundations often may not hold S corporation stock because of the excess business holdings rule.

(v) **Excellent Resource**. For an excellent resource addressing the effects of charitable gifts of S corporation stock, see Christopher R. Hoyt, *Charitable Gifts by S Corporations and Their Shareholders: Two Worlds of Law Collide*, 36 ACTEC L.J. 693 (Spring 2011).

m. **Slow Freeze**. Robert Jamison coined the phrase "slow freeze" of one's interest in an S corporation. One method is to distribute cash or other assets in kind to the shareholder while others (presumably younger family members or trusts for their benefit) receive additional shares of stock having a proportionate equivalent value. Another approach is to redeem the parent's stock for the stock's fair market value. (If the corporation issues a note in satisfaction of the redemption price, very detailed rules must be followed carefully to make sure that the note is not treated as equity and a prohibited second class of stock.)

n. **S Corporation Redemption Before Life Insurance Paid to Shift Basis Step Up to Surviving Shareholders**. The inability of remaining shareholders to get a stepped up basis for their shares is a classic disadvantage of using a redemption rather than a cross purchase approach. However, this may be avoided with an S corporation in some circumstances. If (1) the corporation is on the cash method of accounting, (2) the buy-sell agreement is funded with life insurance and the stock is redeemed before the corporation receives the insurance proceeds, and (3) the shareholders make the election under §1377(a)(2) to apply the closing of the books approach, the effect is that the remaining shareholders receive a step-up in the basis of their stock. (At the death of a shareholder, the receipt of life insurance proceeds by the corporation will be exempt under §101(a). The receipt of the insurance proceeds will result in a pro rata increase in the stock basis of all shareholders. §1367(a)(1)(A) (provides for stock basis increase for items of pass-through income described in §1366(a)(1)(A), which section includes tax-exempt income such as life insurance proceeds.) Accordingly, the shareholders receive a stock basis increase even though the corporation is the owner of the policy and will repurchase the stock. The stock basis increase is allocated among the outstanding shares under the per share, per day basis.

The goal of this planning strategy is that the receipt of the insurance proceeds increases the basis of just the remaining shareholders rather than increasing the basis proportionately of all shareholders at the date of death. (Otherwise, the basis increase is shared with the estate—which already received a stepped up basis in the estate's shares to the date of death value.)

A potential concern is constructive receipt. If it is as easy as making a telephone call to collect the death proceeds, does the corporation have constructive receipt before the redemption occurs? The IRS could argue that "all events" for liability to pay the proceeds occurred at the moment of death (unless the policy is in the contestability period). Possible responses to that concern: (1) Claims may be contested (but only about 3% are contested.) (2) Life insurance companies sometimes take a long time paying claims. (3) If a taxpayer sends a bill out on Dec. 20 and the debtor writes a check on Dec. 28 but the taxpayer does not receive it until Jan. 2, he reports it in the next year.

15. Valuation of S Corporation Shares; Applicability of Section 2703(b) to Family Transfer Restriction, *Kress v. U.S.* (E.D. Wis, March 26, 2019)

Kress v. U.S., 123 AFTR 2d 2019-1224 (E.D. Wisconsin March 26, 2019), is a very interesting case with respect to various valuation issues. It is a gift tax refund case, with the sole issue being the value of minority interests in S corporation stock. For an excellent detailed analysis of the case, see James Dougherty & Todd Povlich, *The Latest Development in Business Valuation: Burdens of Proof, Tax Affecting S Corporations, and Chapter 14 in* Kress, 44 BLOOMBERG TAX MNGT. ESTATES, GIFTS AND TRUSTS J. 179 (July 11, 2019) and see Item 33 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

a. **Tax-Affecting**. Both the taxpayer and government experts tax-affected the earnings of the S corporation to apply a C corporation level tax to compare the S corporation being valued to other C corporations that were used as comparables.

   The case had little discussion about the tax-affecting issue, but the court generally adopted the approach of the taxpayer's report, which included tax-affecting in its income approach analysis. The government's expert had applied an S corporation premium because of advantages associated with being an S corporation, but the court found the subchapter S status to be a neutral consideration because there were also disadvantages of S corporation status ("including the limited ability to reinvest in the company and the limited access to credit markets"), and it was "unclear if a minority shareholder enjoys those benefits."

b. **Application of Section 2703(b) to Family Transfer Restriction**. A Family Transfer Restriction provided that family members could transfer shares only to other family members. The court addressed whether the transfer restriction satisfied the §2703(b) safe harbor, finding that (1) it met the bona fide business arrangement test in §2703(b)(1), and (2) the "not a device" test in §2703(b)(2) was not applicable to the gift tax case because it applied only to transfers from decedents, but (3) the taxpayers did not meet the comparability test because "they have not produced any evidence that unrelated parties at arms' length would agree to such an arrangement."

   Even though §2703 prevented the court from considering the Family Transfer Restriction, the taxpayer's appraisers said that the restriction had little impact on the lack of marketability discount, and the court reduced the LOM discount by only 3% as a result of not taking into account the Family Transfer Restriction.

c. **Lack of Marketability Discounts**. The court applied lack of marketability discounts of 25% for 2007-2008 and 27% for 2009 (which numbers included a 3% downward adjustment because the Family Transfer Restriction was not being taken into account). There were two taxpayer opinions, and the court found one of them (by Emory) to be the "most sound." Emory had applied LOM discounts of 30% in 2007-2008 and 28% in 2009. Burns (the government expert) had used LOM discounts ranging from 10.8% to 11.2%.

16. Valuation of Timberland Using Income Approach Rather Than Net Asset Value; Tax-Affecting Approved for Valuing S Corporation and Limited Partnership, *Estate of Jones v. Commissioner,* T.C. Memo. 2019-101 (August 19, 2019)

The following discussion of and commentary about *Estate of Jones v. Commissioner* is excerpted from a summary and analysis of *Jones* by Ronald D. Aucutt available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

a. **Synopsis**. In May 2009, Aaron Jones made gifts to his three daughters, and to trusts for their benefit, of voting and nonvoting interests in Seneca Sawmill Co. (SSC), an S corporation, and Seneca Jones Timber Co. (SJTC), a limited partnership that owned timberland. He reported the gifts on his gift tax return with a total value of about $21 million, but the IRS notice of deficiency asserted a value of about $120 million and a gift tax deficiency of about $45 million. The Tax Court agreed with the taxpayer's appraiser that the value was about $24 million, and the resulting gift tax owed will apparently be less than $2 million.

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

For a detailed summary of the facts and a more inclusive description of the analysis in the opinion than the discussion below, see Item 34.b.- c. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **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 Robert Reilly (Willamette Management Associates). Several highlights of the opinion are summarized below.

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

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

The court concluded that:

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

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

But the court explained that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax-affecting the earnings of a flowthrough entity per se. Instead, Judge Pugh viewed the issue as fact-based, and noted that the court in those cases had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases. The court viewed those cases as concluding that (1) assuming a zero income tax rate on the earnings properly reflected the overall tax savings of operating as an S corporation (*Gross v. Commissioner*), (2) the taxpayer's expert did not justify tax-affecting the earnings in balancing the burden of the individual level tax with the benefit of the reduced total tax burden (*Estate of Gallagher v. Commissioner*), and (3) tax-affecting the earnings resulted in a post-tax cash flow but the expert applied a pre-tax discount rate (*Estate of Giustina v. Commissioner*). In *Jones*, on the contrary, Judge Pugh concluded that Mr. Reilly's detailed tax-affecting analysis was appropriate:

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

Footnote 5 emphasized that *Gross* was decided on the evidence before the court, which was far different than in the current case:

> In Gross the expert applied a hypothetical 40% corporate tax rate to earnings but did not apply any premium to reflect the benefit of avoided dividend tax. Thus the Court was presented with a choice between a 40% or a 0% corporate tax rate. Id. That is not the choice before us here.

As stated, *Jones* involves tax-affecting for both an S corporation (SSC) and a partnership (SJTC). The court's discussion of tax-affecting is addressed to the partnership, SJTC, which comes first in its opinion, probably so that the court could address first what it regarded as the "primary dispute" over the use of an income

approach to value SJTC. But it should not be overlooked – and, it is hoped, won't be overlooked by the IRS and the judges in future valuation cases – that in the discussion specifically targeting SSC the court stated, without qualification:

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

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

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

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

   If the Tax Court in *Jones* had accepted an asset-based valuation, the estate could have appealed that decision to the Ninth Circuit. It is certainly plausible that the taxpayer's victory in *Jones*, at least on the issue of the asset-based approach, is attributable in part to the rebuke the Ninth Circuit had given the Tax Court in *Giustina*.

d. **Economic Downturn Impact**. Neither is this the first time a court has been influenced in a gift tax valuation case by the gravity of the 2008 economic downturn. For example, judicial notice of that recession was a factor in *Kress v. United States* (discussed in Item 15 above), which was also a taxpayer victory that involved tax-affecting and the credibility and thoroughness of the taxpayer's valuation expert.

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

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

(2) **Prior Internal IRS Guidance**. Some 20 years ago, the IRS's internal valuation guide for income, estate, and gift taxes explained tax-affecting (without calling it that) this way:

> [S] corporations are treated similarly to partnerships for tax purposes. S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

The IRS's internal examination technique handbook for estate tax examiners added:

> If you are comparing a Subchapter S Corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes using the corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will avoid distortions when applying industry ratios such as price to earnings.

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

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

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

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

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

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

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

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

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

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

(5) ***Gallagher v. Commissioner***. The Tax Court largely went along with the IRS. For example, in *Gallagher v. Commissioner*, T.C. Memo. 2011-148, Judge Halpern, again, wrote (emphasis added):

> As we stated in *Gross v. Commissioner*, … the principal *benefit* enjoyed by S corporation shareholders is the *reduction* in their total tax burden, a *benefit* that should be considered when valuing an S corporation. [The estate's expert] has advanced no reason for ignoring such a benefit, and we will not impose an unjustified *fictitious* corporate tax rate burden on [the corporation's] future earnings.

(6) ***Kress v. United States***. Then, in 2019, *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. March 26, 2019), had little particular discussion of the tax-affecting issue, but the court generally adopted the approach of the taxpayer's report, which included tax-affecting in its income approach analysis. See Item 15 above.

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

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

(8) ***Cecil v. Commissioner***. Four years ago, the Tax Court tried a case, still awaiting decision, that includes tax-affecting for valuing S corporation stock as one of its issues. *Estate of William Cecil v. Commissioner*, Cause Nos. 14639-14 and 14640-14 (trial held February 2016). The only entries on the Tax Court's dockets since the filing of briefs in July 2016 have been papers in January 2018 to change the captions of the cases to reflect both William and Mary Cecil's deaths and Petitioner's Notices of Supplemental Authority on April 12, 2019 (probably *Kress*, discussed above) and August 20, 2019 (undoubtedly *Jones*), with IRS answers three days later in each case. In *Cecil*, both the taxpayer AND the IRS's expert used tax-affecting in their analysis. The Tax Court may have a hard time rejecting tax-affecting as a matter of law when both experts agree in its application. (Tax-affecting is not the only issue in the case.)

f. **No Mention of Section 2703**. Although there were transfer restrictions in the SSC and SJTC Buy-Sell Agreements that may have been restrictions that should have been disregarded under §2703 in valuing the stock, the IRS evidently did not raise the §2703 issue. In *Kress v. United States*, the court in 2019 held that §2703 applied regarding restrictions on transferring stock to anyone other than family members so that the restrictions could not be considered in valuing the stock (see Item 15.b. above). A year earlier, in 2018, the IRS successfully invoked §2703 in *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84, at least for purposes of summary judgment, so that certain restrictions (on being able to terminate a split dollar arrangement) were disregarded in valuing interests. However, the *Jones* petition was filed in late 2013 and the IRS's answer was in early 2014, years before the *Kress* and *Cahill* decisions.

g. **The Importance of the Appraiser**. The outcome in *Jones* is additional confirmation of the importance of thorough and credible appraisals in Tax Court litigation. The court observed that the taxpayer's expert's report was 182 pages and the government's expert's response report was 12 pages. The taxpayer's appraiser, 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, 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.

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

   - A legitimate 55-year-old family-owned operating business was the subject of the valuation.
   - Mr. Jones' actions apparently were not taken for him under a power of attorney or other agency arrangement.
   - Mr. Jones' gifts resulted in making his daughters and himself equal owners of the economic interests in both SSC and SJTC. There was no division like 99-1 to attract scrutiny.
   - The gifts 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 nothing is 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.

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

The estate's appraisal in *Jones* provides an excellent example of such a detailed approach that considered both the burden on net cashflow by the anticipated individual income taxes on the business income as well as the benefits of passthrough treatment. Mr. Reilly tax-affected the earnings of the partnership to reflect a 38 percent combined federal and state income tax rate 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."

j. **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.

17. Spendthrift Clause Protection Against Child Support Claim, Full Faith and Credit re Enforcement Actions, *In the Matter of Cleopatra Cameron Gift Trust*

a. **Synopsis of Case**. *In re Matter of Cleopatra Cameron Gift Trust,* 931 N.W.2d 244 (S.D. 2019) addresses an attempt to enforce a California judgment for child support against a South Dakota trust in South Dakota. The trust, created by Cleopatra's father

for her in California, contained a classic spendthrift clause. A divorce action began in California in January 2009. The court awarded custody of children to Cleopatra's husband and entered an interim order that the trust pay child support (more than $100,000 per year) to the husband out of her $480,000 annual beneficial interest in the trust. (The court also ordered the trust to pay $250,000 of the husband's attorney fees, but the California court of appeals reversed that order because the California statute allowing a court to compel trust distributions from a spendthrift trust was limited to support obligations.) Facts surrounding the divorce case and the trust administration are briefly summarized below.

- In April 2009, the court approved the resignation of Cleopatra and Corporate Trustee 1 and appointed Corporate Trustee 2 (after the new corporate trustee agreed to pay the child support).
- In October 2010, the divorce became final (and the trust continued making the child support payments).
- In July 2012, Cleopatra invoked her authority under the trust agreement to move the trust situs to South Dakota.
- In 2014, the South Dakota court approved Cleopatra's request that the court approve the change of situs and amendment of the trust instruments in various respects.
- In 2014, Corporate Trustee 2 resigned and was replace by South Dakota Corporate Trustee 3.
- In late 2014, South Dakota Corporate Trustee 3 resigned and South Dakota Corporate Trustee 4 was appointed.
- In November 2016, Corporate Trustee 5 became acting trustee and Corporate Entity 6 (Empire Trust) was appointed as trust protector.
- After being appointed trust protector in November 2016, Empire Trust reviewed the trust's spendthrift provision and refused to agree to the trustee's direct child support payments to the ex-husband. It regarded the direct payments as "improvident in light of the Trust's rapidly depleting assets."
- In January 2017, Corporate Trustee 5 stopped making direct child support payments to the ex-husband.
- In May 2017, Cleopatra petitioned the South Dakota court to resume court supervision of the trust and sought a court declaration that the trust is prohibited from making the child support payments directly to the ex-husband, which the court granted.

The South Dakota Supreme Court said the main issue is the constitutional Full Faith and Credit issue. It noted that the U.S. Supreme Court (*Baker by Thomas v. General Motors Corp*, 522 U.S. 222 (1998)) has recognized that a limitation on the Full Faith and Credit Clause is that the "time, manner, and mechanisms for ENFORCING judgments" (emphasis added) of the forum state can be applied (rather than of the other state that rendered the judgment). Justice Scalia's concurring opinion observed

that the purpose of the Full Faith and Credit Clause is to make the judgment of "one State conclusive evidence in the courts of another State," but that despite the preclusive power of one state's judgment, it "can only be executed in [the forum state] as its laws may permit." The court also cited the RESTATEMENT (SECOND) OF CONFLICT OF LAWS §99 ("The local law of the forum determines the methods by which a judgment of another state is enforced"). The court concluded that the order to pay Cleopatra's child support obligation out of the trust is a matter of *enforcing* the support obligation judgment against her, and "the means of enforcing judgments does not implicate full faith and credit considerations."

The court next considered whether South Dakota law allowed **enforcing** a child support order by ordering payment out of a trust for the obligor's benefit. The general rule in many states (reflected in RESTATEMENT (THIRD) OF TRUSTS §59) is that a spendthrift provision does **NOT** provide protection against several types of claims including "support of a child." But the South Dakota legislature, in adopting the 2017 enactment of its spendthrift trust statute, specifically said "the Legislature does not intend the courts to consult the Restatement (Third) of the Law of Trusts … § 59 … with respect to subject matters addressed by the provisions of [the spendthrift statutory provisions]." Therefore, the supreme court affirmed the lower court holding that the trust is prohibited from making child support payments directly to the ex-husband. The court made clear, though, that the holding has no impact on Cleopatra's support obligations, which remain intact and subject to continuing litigation in the California court.

Subsequent to the issuance of the South Dakota decision in *Cleopatra Cameron Gift Trust*, a California court sought to hold the trustee in contempt for failure to abide by the California judgment ordering payment from the trust. The trustee responded that the California court did not have personal jurisdiction over the trustee.

b. **Full Faith and Credit**. The Full Faith and Credit issue is a huge issue with self-settled trusts under domestic asset protection trust (DAPT) statutes. For example, if a person is the beneficiary of a DAPT in South Dakota and a debt judgment against the person is entered by a California court, is the South Dakota DAPT protected from satisfaction of that California judgment? *Cleopatra Cameron Gift Trust* does not involve a DAPT—but it suggests that the *enforcement* of any foreign action against a South Dakota trust may not involve full faith and credit at all, but involves the South Dakota law for enforcing judgments.

   No case has yet addressed whether a judgment in one state will be entitled to "full faith and credit" in an enforcement against a DAPT in another state (a DAPT state) where the trust is located. The decision in *Cleopatra Cameron Gift Trust*, however, is analogous. While the case does not involve a DAPT, the principles of the case could be extended to an attempt to enforce a foreign judgment against a DAPT in the DAPT state. A very important issue is whether the court in the jurisdiction where the underlying claim is considered has personal jurisdiction over the trustee of the DAPT. If so, the enforcement issues would be decided in that state as the "forum" state, with the result that the Full Faith and Credit Clause would not demand that the foreign judgment be satisfied out of the DAPT.

   See Item 18 below for a further discussion about DAPTs.

c. **Personal Jurisdiction**. As indicated above at the end of the Case Synopsis, a California court has sought to hold the trustee in contempt for failure to comply with the California judgment ordering payment from the trust. The trustee responded that the California court did not have personal jurisdiction over the trustee. While a California court may have personal jurisdiction over a National Association, it likely would not have personal jurisdiction over a South Dakota trust company that is not doing business in California. *See Kloiber v. Kloiber Dynasty Trust*, Cause No. 2013-CA-000436-MR (Ky. Ct. App. December 5, 2014) (suit to impose a constructive trust on assets of a dynasty trust; Kentucky court dismissed PNC Delaware as trustee for lack of personal jurisdiction). The personal jurisdiction issue would be vital, because if California has personal jurisdiction over the South Dakota Trust Company, California would be the forum state in the action, and applying the law of the forum state in an enforcement action would end up applying California law.

d. **Miscellaneous Observations**.

(1) **Spendthrift Clauses and Child Support**. Most states allow trusts to be reached to enforce child support payments against a trust beneficiary, despite a spendthrift clause. RESTATEMENT (THIRD) TRUSTS §59 (2003) ("the interest of a beneficiary in a valid spendthrift trust can be reached in satisfaction of an enforceable claim against the beneficiary for … support of a child …"). As the legislative history quoted above points out, the South Dakota legislature appears to be quite proud of not allowing child support to be paid out of a spendthrift trust for the obligor.

(2) **DAPT Trusts ARE Subject to Pre-Existing Debts**. In all of the DAPT states, DAPTs are subject to pre-existing debts. The South Dakota statute particularly mentions pre-existing child support obligations. Cleopatra could not have formed her own South Dakota trust to shield her assets from paying pre-existing child support obligations.

(3) **Changing Trust Situs Was Key**. The result of the case would have been different if California law continued to apply to enforcement actions against the trust. Here, Cleopatra—the beneficiary—had the right to change the trust situs under the trust agreement. However, she apparently did not change the trust situs in order to avoid having child support payments made directly from the trust because the payments continued for over four years before anyone noticed that the South Dakota trust should not have been making the child support payments directly to the ex-husband.

18. Domestic Asset Protection Trusts

a. **Domestic Asset Protection Trust (DAPT) Statutes – Overview**. Alaska was the first state to adopt domestic asset protection trust (DAPT) legislation 22 years ago, providing that a settlor's creditors would not be able to reach trust assets merely because the settlor was a discretionary beneficiary of the trust, if the trust met certain requirements. (Missouri practitioners point out that Missouri had DAPT legislation before Alaska, but dicta in a bankruptcy case undermined confidence in the statute.) Some form of DAPT legislation now exists in 19 states (the two newest states are Indiana and Connecticut): Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming. Those

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

For an excellent summary of the 19 DAPT statutes, see David Shaftel, *Twelfth ACTEC Comparison of the Domestic Asset Protection Trust Statutes* (updated through August 2019)(to access that excellent summary, go to **www.actec.org** and search for "David Shaftel").

A significant uncertainty about DAPTs is the extent to which a resident in a state that does not have DAPT legislation can create a trust under the laws of a DAPT state and still enjoy protection of the spendthrift clause. To date, no case has recognized protection against the non-resident settlor's creditors. Various cases have not recognized protection, but they have generally involved egregious fraudulent transfers that would not be allowed protection under the state DAPT statute in any event. (Comment 8 to §4 of the Uniform Voidable Transactions Act (UVTA) suggests that transferring assets from a non-DAPT jurisdiction to a self-settled trust in a DAPT jurisdiction would be a voidable transaction and would not be entitled to spendthrift protection.) For further discussion about Comment 8 and the UVTA, see Items 48-50 of the ACTEC 2017 Fall Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Alaska's Exclusive Jurisdiction Statute Unconstitutional, *Toni I Trust v. Wacker***. The facts of *Toni I Trust v. Wacker*, 413 P.3d 1199 (Alaska 2018), are outrageously egregious, but the Alaska Supreme Court ultimately held that an Alaska statute cannot bar a Montana creditor from bringing a claim under Montana law against a Montana debtor over property located in Montana, just because the property had been assigned to an Alaska trust. The court held that the exclusive jurisdiction provision in the Alaska DAPT statute is unconstitutional. For a more detailed discussion of the *Toni I Trust* case, see Item 28.b. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

c. **Conflict of Laws Issues**. A primary issue that has arisen in cases addressing DAPTs is the conflict of laws issue as to whether the law of the DAPT state where the trust is sitused or the laws of the debtor's state will apply. For example, *Waldron v. Huber (In re Huber)*, was a bankruptcy case concluding that Washington (the debtor's state) had a strong public policy against asset protection for self-settled trusts and applied the law of Washington rather than Alaska. *In re Huber*, 2013 WL 2154218 (Bankr. W.D. Wash. 2013)(Washington real estate developer created Alaska asset protection trust in 2008 when he was aware of collapsing housing market and that his prospects for repaying loans was fragile at best; trust found to be a fraudulent transfer voidable under both §544(b)(1) [state law fraudulent transfers] and §548(e) [transfer made within 10 years of filing petition for bankruptcy to a self-settled trust or similar device if made with actual intent to defraud creditors]; trust also held invalid under conflict of

laws analysis because trust had its most significant relationship with Washington, citing §270 of Restatement (Second) of Conflict of Law,s and Washington had strong public policy against "asset protection trusts").

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

In *Wells Fargo v. Retterath*, 928 N.W.2d 1 (Iowa 2019), the Iowa Supreme Court addressed the validity of a charging order against an Iowa LLC that was created by Florida residents. If Florida law applied, the LLC interest would be tenancy by the entireties property and not available to satisfy debts of one of the tenants individually. While the title of intangible assets will normally be based on the law of the domicile of the owners, the law of the jurisdiction where an LLC is located should be applied regarding the enforceability of a charging order against the LLC. That state is the state with the "most significant contacts."

d. **Full Faith and Credit**. No case has yet addressed whether a judgment in one state will be entitled to "full faith and credit" in an enforcement against a DAPT in another state (a DAPT state) where the trust is located. A similar issue was raised, though, in *In the Matter of Cleopatra Cameron Gift Trust*, which reasoned that the Full Faith and Credit Clause does not apply to the manner for *enforcing* judgments of another jurisdiction.

See Item 17 above for a more detailed discussion of the *Cleopatra Cameron Gift Trust* case, including the personal jurisdiction issue.

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

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

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

Will §2036 apply if the trustee has the discretion to make distributions to the settlor but state law does not permit the settlor's creditors to reach the trust assets under a DAPT statute? In Letter Ruling 98337007 the IRS concluded that whether assets in an Alaska DAPT would be excluded from the settlor's estate depended upon the facts and circumstances existing at the settlor's death. Letter Ruling 200944002

similarly refused to rule as to whether the trustee's discretion to distribute trust assets to the settlor, when combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement), may cause inclusion in the settlor's gross estate under §2036.

19. Extension Requests Under 9100 Relief

a. **9100 Relief-Overview**. Regulations §§301.9100-1 through 301.9100-3 provide procedures for obtaining extensions to make certain elections and applications for relief.

"9100 relief" is not in the Internal Revenue Code. It is a creature of IRS regulations. The number 9100 was selected because it was a number so far beyond any Code provisions that it would be a safe number to use for the regulation that would not be confused with regulations for any Code section.

9100 relief has evolved from an originally relatively narrow provision, providing extensions only for certain income tax elections. Regulations were originally issued in 1959 and amended in 1970 and supplemented by Rev. Proc. 79-63 for relief for extensions of time to make elections or other relief regarding the income tax. Revised regulations that were finalized in 1991 (and augmented by Rev. Proc. 92-85) provided further relief including relief for missed deadlines in other subtitles, including Subtitle B (containing the transfer tax rules).

The current 9100 regulations were finalized in 1997, incorporating many of the positions taken in Rev. Proc. 92-85. The 1997 regulations (1) expand the class of elections qualifying for relief, (2) provide less onerous standards for relief (dropping any perceived requirement that some planner "fall on its sword" with respect to a missed election), and (3) make a limited class of elections and relief applications automatic without the necessity of filing a ruling request.

Reg. §301.9100-2 provides for automatic 12 or 6 month automatic extensions in certain specified situations. Simplified 9100 applications are available for certain S corporation elections (Rev. Proc. 2013-30) and portability elections (Rev. Proc. 2017-34) in specific situations, without any requirement of filing a 9100 request or paying a user fee.

Reg. §301.9100-3 provides that requests for an extension of time will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional.

b. **"Prejudice Interests of the Government."** Some attorneys have commented to Carol Harrington that an extension request will save money for the taxpayer (or else the taxpayer would not be making the request), so doesn't that "prejudice the interests of the government"? That is not what is meant by prejudicing the interests of the government. Seeking 9100 relief to reduce or eliminate taxes, even taxes that are already due or past due, is clearly permitted. Prejudicing the interests of the government refers to putting the taxpayer in a better position than if the taxpayer had made the election timely.

The regulations describe two circumstances under which the interests of the government are deemed to be prejudiced: (1) the election would result in the taxpayer having a lower tax lability than if the election had been made timely; and (2) if the tax year in which the regulatory election should have been made or any tax year affected by the election, had it been made timely, are closed by the statute of limitations before the ruling is issued granting 9100 relief. Reg. §301.9100-3(c)(1).

c. **Extensions for GST Exemption Allocation Elections**. Letter rulings issued in 2019 allowed an extension of time to (1) allocate GST exemption and (2) to elect out of automatic allocation. See Item 11.a. above.

d. **Portability Election Extensions**. A large number of letter rulings granted extensions for making a late portability election for estate tax returns that were under the filing threshold. *E.g.,* PLRs 202005001, 201929017.

Bear in mind that no extension is available if the gross estate (plus adjusted taxable gifts) is over the filing threshold, even if no estate tax is due (for example, because of marital or charitable deductions).

Section 2010(c)(5)(A) requires that the portability election be made on a timely filed estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse. Rev. Proc. 2017-34 provides a relief procedure in certain cases if the return is filed by the second anniversary of the decedent's date of death and if the estate was not otherwise required to file an estate tax return. This is a very helpful relief measure (which avoids the necessity of the taxpayer paying a hefty user fee for a ruling under §301.9100-3 to obtain an extension of the time for filing the return to make the portability election). For a more detailed discussion, see Item 16.d. of the Current Developments and Hot Topics Summary (December 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

e. **Reliance on Qualified Professional**. An interesting issue that keeps arising in these portability extension requests is that the situation typically arises where the family had never talked with any professional about the portability concept or the need to file a return to make a portability election.

Reg. §301.9100-3(a) provides that the IRS may grant a reasonable extension of time to make a regulatory election, if the taxpayer provides evidence to establish to the satisfaction of the IRS that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government. Reg. §301.9100-3(b)(1) provides that a taxpayer is deemed to have acted reasonably and in good faith if any of five safe harbors situations are satisfied, one of which is that the taxpayer "[f]ailed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election." Reg. §301.9100-3(b)(1)(iii).

The fifth alternative safe harbor is that the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election. Reg. §301.9100-3(b)(1)(v). That fifth situation is relied on in many extension requests

under the 9100 regulations, but is inapplicable in the typical portability filing extension rulings. Most of the portability filing extension rulings do not address reliance on a qualified tax professional; in most of the rulings, the executor merely states that he or she did not file the return on time and that the return was below the filing threshold.

20. Judicial Modifications

Judicial modification cases arise repeatedly. Uniform Trust Code §411(b) authorizes the modification or termination of a noncharitable irrevocable trust upon the consent of all of the beneficiaries if modification is "not inconsistent with a material purpose of the trust" or if "continuation of the trust is not necessary to achieve any material purpose of the trust." UTC §706 permits removal and replacement of a trustee if there has been a substantial change of circumstances or if removal is requested by all qualified beneficiaries, a suitable replacement is available, removal best serves the interests of all of the beneficiaries, and removal "is not inconsistent with a material purpose of the trust." Both of those provisions turn on the "material purpose" of the trust.

In *Miller v. Maples*, 2019 WL 6267123 (Tenn. Ct. App.) the trust called for periodic distributions over ten years to the settlor's three children. The three children were cotrustees and could distribute all or any part of the assets to themselves for health, education, maintenance, and support. To settle a dispute over distribution decisions, the three children agreed to distribute all of the assets to themselves and terminate the trust early. Several grandchildren objected; they were children of one of the three children who had died before the terminating distribution was made (and their mother's share would have gone to a step-child under the mother's will). The court held that providing for periodic distributions was not a material purpose because the trust allowed full distribution at any time (albeit by an ascertainable standard). The court apparently overlooked the requirement that the termination be agreed to by all beneficiaries. UTC §411(e) allows termination without the consent of all beneficiaries if the interests of those who don't consent "will be adequately protected," but that standard would not have been met either. The case seems wrongly decided.

In *In re Trust Created by Fenske*, 930 N.W.2d 43 (Neb. 2019), the court refused to remove a corporate trustee and replace it with the husband of one of the trust beneficiaries who said that he would terminate the trust. The court held that the removal and replacement of the trustee violated a material purpose of the settlor.

Various cases in 2018 refused to allow judicial modifications of trusts where the strict requirements of modification statutes were not satisfied, as discussed in Item 20 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

Drafting Tip: "Anticipating these situations may require a drafter to specify in the trust document that delaying distribution *is* a material purpose, notwithstanding any authority in the trustee to distribute so much or all of the trust income and principal under an interim distribution provision, and notwithstanding a small-trust-termination provision. Another alternative would be to avoid the material purpose issue by lodging the power to modify, terminate, decant, or otherwise make changes in a third party, not the trustee, not the beneficiaries, and not a court. This typically is what a trust advisor or protector provision is meant to allow." (Quoting from the 2020 Heckerling Recent Developments summary.)

21. Tax Effects of Settlements and Modifications; Rulings Giving Retroactive Effect to Trust Modifications; Ruling Implicitly Extending Rationale of Revenue Ruling 95-58 to Section 2042

The tax effects of court modifications, other trust modifications, decanting, and settlements are summarized in Items 42-51 of the ACTEC 2015 Annual Meeting Musings summary found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. This Item includes several brief miscellaneous comments.

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

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

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

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

   The court order must be obtained *prior* to the event that would otherwise have been a taxable event in order for the IRS to be bound under the analysis in Revenue Ruling 73-142.

c. **Construction vs. Reformation/Modification Proceedings**. A construction proceeding interprets a document as signed. It often involves an ambiguous document. The IRS is essentially bound regarding the availability of a marital or charitable deduction, because the interpretation relates back to the date of execution of the instrument (assuming the four-part analysis of settlement agreements can be satisfied).

A reformation modifies a document, and the IRS position is that the reformation generally applies prospectively only. Accordingly, a post-death reformation may not result in an action causing assets to have passed to a surviving spouse or charity as of the date of death to qualify for an estate tax marital or charitable deduction. Some rulings have given reformations retroactive effect, however, in "unique circumstances."

d. **Oft Cited Old Case; Reformation for Scrivener's Error Not Given Retroactive Effect for Tax Purposes, *Van Den Wymelenberg v. United States,* 272 F. Supp. 571 (E.D. Wis. 1967)**. The trust agreement in this case did not give the beneficiaries access to the trust at age 21 and therefore did not satisfy the requirements of §2503(c). Upon learning of the error, the parties amended the irrevocable trust agreement "to correct … a mistake of fact in the original instrument." The court cited Eighth and Tenth Circuit Court of Appeals cases to support its conclusion that a retroactive reformation will not be recognized "when its impact is to alter the national revenue," but that the reformation will be recognized going forward from that date.

   In many more recent rulings, however, the IRS has been more generous in giving effect to retroactive reformations that carry out the settlor's intent. But taxpayers should be mindful of the old cases, and not rely on the IRS to bail out the poorly drafted instrument.

e. **Modification Rulings Giving Retroactive Tax Effect to Retroactive Modifications**. PLR 201837005 involved a *Crummey* trust in which a subsequent attorney discovered two mistakes: (1) the withdrawal power was not limited just to the gift tax annual exclusion amount, and (2) the withdrawal power lapsed entirely each year (which created a gift and estate tax problem to the extent of lapses greater than a "5 or 5" power). The state had a statute similar to §415 of the Uniform Trust Code, Modification to Correct Mistakes, authorizing reformation to conform the terms to the settlor's intention established by clear and convincing evidence where the terms were affected by a mistake of fact or law. The court reformation was "to eliminate the scrivener's error, retroactive to the date of the trust's creation," and the ruling observed that "[t]he purpose of the reformation is to correct the scrivener's error, not to alter or modify the trust instrument." The IRS ruled that (1) the powerholders did not have a general power of appointment except to the extent of the withdrawal powers as modified, (2) the reformation does not result in a gift (an issue that comes up in almost every ruling about a trust modification), (3) the lapse of withdrawal rights did not result in a gift (this is a clear retroactive effect of the ruling), (4) each beneficiary's portion of the trust would not be includible in the beneficiary's gross estate under §2041, and (5) a purported GST exemption allocation made improperly on the Form 709 (on the schedule for indirect skips rather than on the correct schedule for direct skips) would be deemed valid because the information on the return was sufficient to indicate that the donor intended to make the allocation.

   PLRs 201920001-201920003 similarly gave retroactive effect to a similar retroactive modification of a trust, to eliminate the lapse of a withdrawal power exceeding the 5 or 5 amount. The facts in that case involved gifts in 9 or 10 years. The modification also changed powers of appointment held by the beneficiaries to convert them from general to limited powers of appointment. The ruling held that the beneficiaries would not be deemed to hold general powers of appointment and were deemed not

to have made gifs as a result of the lapse of withdrawal rights. The ruling reasoned that the court found, by clear and convincing evidence, that the provisions in question were scrivener's errors and the reformation and modification was necessary to achieve the settlors' objectives.

Letter Rulings 201941008-201941023 involved a similar retroactive modification of a trust with a *Crummey* withdrawal provision that did not limit lapsed withdrawal powers to the greater of $5,000 or 5% of the trust assets. Gifts had been made in the prior four years. The trust was modified, contingent on a favorable IRS ruling, to provide that the withdrawal power would lapse each year only up to the greater of $5,000 or 5% of the trust. The ruling concluded that no taxable gifts resulted from lapse of withdrawal powers in the prior four years over the 5 or 5 amount (clearly giving a retroactive tax effect to the modification), and no part of the trust will be included in the child's gross estate under §2041. The ruling also concluded that the children did not become transferors to the trust so automatic allocation of GST exemption by the Settlors and other contributors to the trust were effective. The ruling reasoned that the court reformed the trust pursuant to a state statute allowing reformation of a trust, even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that the settlor's intent or the terms of the trust were affected by a mistake of fact or law. The evidence in the case indicated that the original terms of the trust, resulting from a scrivener's error, were contrary to the intent of the settlor, and the purpose of the reformation was to correct the scrivener's error, not to alter or modify the trust instrument.

f. **Modification Ruling Impliedly Extending Rev. Rul. 95-58 Analysis to Section 2042**. PLR 201919003 addressed a trust for which the settlor's child, who was serving as trustee, wanted to purchase life insurance on the lives of the child and child's spouse. The parties were concerned that §2042 might apply and the trust was modified to add an Insurance Trustee with full powers over the policy and to provide that the child's limited testamentary power of appointment would not apply to the policy or its proceeds. The PLR concluded that the child would have held incidents of ownership before the modification, but does not hold §2042 incidents of ownership as a result of the modification, mentioning the deletion of the power of appointment over the policy and because of appointment of the Insurance Trustee to hold powers over the policy.

The ruling also raises an interesting issue regarding the extension of Revenue Ruling 95-58 to §2042. Technical Advice Memo 8922003 had held, in reliance on Revenue Ruling 79-353, 1979-2 C.B. 325, that the ability of the insured to remove the trustee *without cause* and appoint someone other than the insured as successor trustee resulted in the insured holding incidents of ownership under §2042. Revenue Ruling 95-58, 1995-2 C.B. 1, revoked Revenue Ruling 79-353 (which addressed §2036 and §2038) and provided that those Sections would not apply to a grantor who could remove a trustee, but who had to appoint as a successor trustee someone who was "not related or subordinate to the decedent" within the meaning of §672(c).

The revocation of Revenue Ruling 79-353 seems to imply that the extension of its rationale to §2042 in TAM 8922003 is no longer valid. Furthermore, Letter Ruling 9832039 cited Revenue Ruling 95-58's revocation of Revenue Ruling 79-353 to

support its conclusion that the power to remove a trustee *for cause* did not trigger §2042. (However, the citation to Revenue Ruling 95-58 was not necessary because the power to remove a trustee *for cause* was probably not an incident of ownership even prior to Revenue Ruling 95-58.)

The IRS has not addressed the effect of a removal power *without cause* for purposes of §2042, but it would probably be treated the same as for §2036 and §2038 under Revenue Ruling 95-58. However, the IRS has not squarely ruled that Rev. Rul. 95-58 also applies for purposes of §2042. *See* PLR 200314009 (if trustee ceased to serve or was removed, insured could appoint successor trustee who was not related or subordinate to insured; held that §2042 did not apply; ruling did not clarify whether insured held a removal power, but the reasoning of the ruling seems to apply Rev. Rul. 95-58 for §2042 purposes).

In PLR 201919003, the ruling concluded that §2042 does not apply to the trust as modified, and the modified trust gave the child a removal power over an Insurance Trustee subject to the obligation to appoint a successor who is not related or subordinate. The holding, based on the facts of the ruling, in effect extends Rev. Rul. 95-58 to §2042, but the ruling analysis does not directly discuss that issue.

g. **Early Termination to Avoid Affirmative Answer to Line 13a, 13b, and 13e on Part 4 of Form 706**. Line 13a on Part 4 of the Form 706 asks if any trust created by the decedent during life were in existence at death. Line 13b asks if the decedent possessed any power, beneficial interest, or trusteeship over any trust in existence at death. Line 13e asks if the decedent ever during life transferred or sold an interest in a partnership, limited liability company, or closely held corporation to a trust described in line 13a or line 13b.

Terminating a trust before death may be a way to avoid having to give a positive answer to Line 13a and 13b and possibly Line 13e. (Line 13e is ambiguous as to whether it refers to specified trusts "in existence at the time of the decedent's death," or whether it is merely referring to "any trusts created by the decedent during his or her lifetime" [Line 13a] or "any trust not created by decedent under which the decedent possessed any power, beneficial interest, or trusteeship.") Terminating the trust, though, may be a high price to pay to avoid those questions, particularly if the trust is GST exempt. Decanting a trust into a new trust likely would not avoid giving a positive answer to those questions.

22. Judicial Termination of Trust, With All Parties Receiving The Actuarial Value of Their Interests, Results in All Parties Having Long Term Capital Gain Equal to the Full Value Received by Each of Them, PLRs 201932001-201932010

a. **Facts and Rulings Requested**. Letter Rulings 201932001-201932010 involve a trust distributing all income to son (G2) for life, with the remainder passing to son's descendants, per stirpes, which included his four grandchildren (G3) as the Current Remaindermen and eight great grandchildren (G4) as the Successor Remaindermen. The material purpose of the trust was to ensure that the son received an income stream for his support. The trust was created about 35 years ago (before September 25, 1985), and son no longer needed support from the trust. The parties proposed terminating the trust and paying to son, the Current Remaindermen (the son's four

living children), and the Successor Remaindermen (eight living grandchildren) the actuarial value of their respective interests. These amounts would be funded "on a pro rata or in-kind basis, as the Trustees shall, in their sole discretion, determine." The termination would be accomplished by a nonjudicial settlement agreement, which would be approved by a court upon finding that the continuance of the trust is not necessary to achieve any material purpose of the trust.

The taxpayers sought three rulings: (1) the termination will not cause the trust to lose is GST grandfather status, (2) no gifts will result, and (3) the termination "will cause Son and the Successor Remaindermen to recognize long-term capital gain, and will cause the Current Remaindermen to recognize capital gain on the unrealized appreciation of the assets received by Son and the Successor Remaindermen upon termination."

The ruling granted all three rulings requested. The first two were standard rulings. The third ruling is not an issue that is typically addressed in early trust modification rulings.

For an outstanding analysis of the rulings and of the IRS's views about trust commutations, see Ed Morrow, *Potential Income Tax Disasters for Early Trust Terminations*, LEIMBERG EST. PL. NEWSLETTERS #2753 (October 9, 2019) (hereinafter "Morrow, Early Trust Terminations") and Steven Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, ¶II.J.18 (2019) (available from author).

b. **Taxpayers Requested Gain Ruling**. That the taxpayers **requested** the IRS to rule that the parties would all have capital gain treatment resulting from the termination is most unusual. Informal indications are that an IRS representative suggested that ordinary income might result, so the taxpayers sought a ruling at least to limit the exposure to long-term capital gain treatment.

c. **General Non-Recognition Treatment for Trust Distributions, Including at Termination of the Trust, and for Trust Severances**. Trust distributions, including distributions on the termination of a trust, are generally not treated as sale or exchange taxable events. *See* §643(e)(trust distributions in kind have carryover basis unless gain is recognized); *Pierson v. Commissioner*, 253 F.2d 928 (3rd Cir. 1958). Exceptions exist, under which trust distributions may have tax implications. For example, established law makes clear that distributing appreciated property in satisfaction of a pecuniary amount results in gain (generally referred to as *Kenan* gain) to the trust. In addition, a non pro rata distribution of assets to beneficiaries when neither the trust instrument nor "local law" authorizes non pro rata distributions is treated as a deemed pro rata distribution to beneficiaries followed by exchanges by the beneficiaries, resulting in gain recognition by the beneficiaries. Rev. Rul. 69-486, 1969-2 C.B. 159.

Similarly, the severance of a trust generally is not a recognition event (or a distribution that carries out DNI to a severed trust, see PLRs 201928004 & 201722007). If assets are divided in a non pro rata manner, however, the severance may be treated as a recognition event by the beneficiaries unless the trustee has the

authority to make the non pro rata division under the governing instrument or local law. Income tax regulations, amended in connection with the adoption of the qualified severance rules for GST tax purposes, make clear that "severances of trusts" (whether or not a qualified severance) generally are not treated as exchanges for income tax purposes (including non pro rata funding of the severed trusts if the non pro rata funding is authorized by the governing instrument or "applicable statute").

> (h) Severances of Trusts –
>
> (1) In general. The severance of a trust (including without limitation a severance that meets the requirements of § 26.2642-6 or of § 26.2654-1(b) of this chapter) [regulations addressing qualified severances for GST tax purposes] is not an exchange of property for other property differing materially either in kind or in extent if –
>
> (i) An applicable state statute or the governing instrument authorizes the trustee to sever the trust; and
>
> (ii) Any non-pro rata funding of the separate trusts resulting from the severance (including non-pro rata funding as described in § 26.2642-6(d)(4) or § 26.2654-1(b)(1)(ii)(C) of this chapter), whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument. Reg. §1.1001-1(h).

d. **Uniform Basis Rule Issues**. The rulings did not describe in any detail the uniform basis rules under §1001(e), but an understanding of those rules is essential to understanding the logic of the rulings. Property acquired from a donor or decedent has a uniform basis, shared by the term and remainder interests based on the actuarial values of their interests.

   An odd feature of the uniform basis rule is that if a "term interest" (a life interest or term-of-years interest or income interest in a trust, but not including the interest of the remaindermen) is sold or disposed of (after October 9, 1969), the term interest holder's share of the uniform basis is ignored, and that term holder recognizes gain equal to the full amount received in the sale or disposition of the term interest. §1001(e). For example, if the income beneficiary of a trust has an actuarial value equal to 40% of the full value of trust interests, the beneficiary would have a uniform basis in the income interest equal to 40% of the basis of assets transferred to the trust (as adjusted for depreciation, etc. in the hands of the trust). But if the income beneficiary sells his interest for $1 million, the income beneficiary's share of the uniform basis is disregarded and the income beneficiary recognizes gain of $1 million. (The purchaser of the income interest would acquire the income beneficiary's share of the uniform basis.) *See* Reg. §1.1001-1(f)(1).

   This rule does not apply to the remainder interest. If the remainder interest sells or disposes of the remainder interest, the remainderman's share of the uniform basis **is** subtracted from the consideration received to determine the amount of gain.

   Consistent with these general rules, the IRS has issued a number of letter rulings dealing with commutations, in which the beneficiaries receive their actuarial interests in the trust, concluding that the term interest holder realizes gain equal to the total amount realized, but the remainder interest holder recognizes gain only to the extent the amount realized exceeds his share of the uniform basis in the interest trust

property. *See, e.g.*, PLRs 201136016 (noncharitable trust), 201136015 (noncharitable trust), 201136014 (noncharitable trust), 201136013 (noncharitable trust), 201136012 (noncharitable trust), 201026027 (noncharitable trust), 201026026 (noncharitable trust), 201026025 (noncharitable trust), 201026024 (noncharitable trust), 200833012 (net income charitable remainder unitrust), 200827009 (net income charitable remainder unitrust), 200739004, 200733014 (net income charitable remainder unitrust), 200727013, 200648017 (noncharitable trust), 200648016 (noncharitable trust), 200443023 (noncharitable trust), 200442020 (noncharitable trust), 200441024, 200403051, 200314021, 200231011 (nonqualifying split-interest charitable remainder trust), and 200210018 (noncharitable trust).

If the entire interest in the trust (i.e., both the income interest and the remainder interest) is transferred to a third person or persons, the rule saying that the basis of the term interest holder is ignored does not apply. The income beneficiary and the remaindermen would both apply their share of the uniform basis against the consideration received in the sale to determine the amounts of gain realized by them. *See* Reg. §1.1001-1(f)(3).

e. **Authorities Cited in Rulings' Analysis Regarding Gain Realization**. The rulings made reference to two prior revenue rulings, Rev. Rul. 72-243 (transfer of interest of current trust beneficiary to trust remainderman treated as amount realized from exchange of capital assets); Rev. Rul. 69-486 (non pro rata distribution of property, where instrument and local law did not authorize non pro rata distributions, was equivalent to pro rata distribution followed by exchange between beneficiaries in an exchange subject to §1001). The cited revenue rulings, by themselves, do not support the conclusion in the rulings regarding the commutation of the trust under the nonjudicial settlement agreement, and the logic of the rulings is rather puzzling. The application of the uniform basis rules and the tax treatment afforded to the amounts received by the beneficiaries for the value of their actuarial interests is confusing, to say the least, under PLRs 201932001-201932010.

f. **Deemed Constructive Purchase by Current Remaindermen of Interests of Son and Successor Remainder Treated as Sale of Exchange Transaction**.

(1) **Why Is it a Sale or Exchange? Clash Between Regulations**. A tension exists between

- the regulation providing that the severance of trusts generally does not result in the recognition of gain (§1.1001-1(h) , discussed in Item 22.c. above), and
- the regulation with the exception to the uniform basis rule, which regulation seems to assume that disposition of all of the trust assets among trust beneficiaries would be an exchange (and the term interest holder could not offset gain recognition with it portion of the uniform basis) (§1.100-1(f)(3)).

Without supplying any rationale, the rulings treat the Current Remaindermen (G3) as having purchased the interests of the son (G2) and the Successor Remaindermen (G4). The initial deemed purchase assumption is not apparent on the face of the transaction. Trust distributions, including distributions on the termination of a trust, are generally not treated as sale or exchange taxable events, aside from funding a

pecuniary amount with appreciated property or non-authorized funding with non pro rata interests. See Item 22.c. above. Why distributions of each beneficiary's interest (based on actuarial values) on an early termination of the trust is treated as a sale or exchange is not explained. Ed Morrow summarizes, "Beneficiaries in a commutation are not *transferring* property to another in the traditional sense as much as transmuting it into a different form." Morrow, Early Trust Terminations.

In explaining why these *distributions* from the trust are treated as a *sale* from the Son and Successor Remaindermen to the Current Remaindermen, the rulings reason:

> Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Son, the Current Remainder, and the Successor Remaindermen, in substance it is a sale of Son's and the Successor Remaindermen' s interests to the Current Remaindermen. Rev. Rul. 69-486.

That's it. "In substance it is a sale," citing Rev. Rul. 69-486.

Rev. Rul. 69-486 ruled that a non pro rata distribution of trust property, where the trust instrument and local trust law did not convey authority on the trustee to make non pro rata distributions, was treated as the equivalent of a pro rata distribution followed by an exchange between the beneficiaries. That seems irrelevant here; Ed Morrow describes that paragraph as a "red herring." He goes on:

> There is no indication that the parties proposed anything but a pro rata distribution and if there were pro rata distributions, this would not have changed the IRS conclusions in this PLR one iota. Even if the trust corpus were invested entirely in cash stored under the trustee's mattress, the IRS would have found that the son (G2) incurred a large capital gain equal to the value of his interest. Morrow, Early Trust Terminations.

The rulings do not address whether the instrument authorized non pro rata distributions, but in any event the non pro rata distributions were determined under a nonjudicial settlement agreement authorized by local law so the distributions were authorized by local law.

(2) **Why Are the Current Remaindermen Treated as the Deemed Purchaser**? Why is G3 the deemed purchaser of the interests of G2 and G4? Why is G2 not treated as the deemed purchaser? Or G4? (The tax result could be quite different if G2 were the deemed purchaser.) The rulings cite Rev. 72-243, which in turn relies on *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947) for the proposition that amounts received by the son "are amounts received from the sale or exchange of a capital asset to the Current Remaindermen." Rev. Rul.72-243 and *McAlister* were both situations in which the current trust beneficiary received dollars ($55,000 in *McAllister*) or "proceeds" (in Rev. Rul. 72-243) and the remainderman received the balance of assets in the trust. That is not the case in the rulings. All of the parties received assets equal to their respective actuarial interests. No one was clearly purchasing from anyone else, as appeared to be the case in Rev. Rul. 72-243 and *McAllister*.

(3) **Gain by Income Beneficiary**. The ruling reasoned that because all of the trust interest holders were not selling their interests to a third person, the current income beneficiary's (i.e., the son's) portion of the uniform basis is ignored, and the income beneficiary has long-term capital gain equal to the **full amount received**.

(4) **Gain by Successor Remaindermen**. The Successor Remaindermen (G4) are treated as having sold their interests to the Current Remaindermen (G3), and G4 will have an amount realized equal to the amount received, and the "gain will be determined under §1001(a) … as a result of the early termination. The ruling doesn't explicitly say so, but apparently the *gain* realized by the Successor Remaindermen upon the early termination is the amount realized (i.e., the total amount received) less their respective share of the uniform basis.

(5) **Treatment of Current Remaindermen**. The tax treatment of the Current Remaindermen seems rather murky. The following is the entire summary in the rulings of the tax treatment of the Current Remaindermen.

> In addition, to the extent that a Current Remainderman exchanges property, including property deemed received from Trust, for the interests of Son and the Successor Remaindermen, the Current Remaindermen will recognize gain or loss *on the property exchanged*. Accordingly, based on the facts submitted and representations made, for purposes of determining gain or loss, the amount realized by each Current Remainderman on the *exchange of property* for Trust interests held by Son and the Successor Remainderman on the *exchange of property* for Trust interests held by Son and the Successor Remaindermen will be equal to amount of cash and fair market value of the trust interests received in exchange for the transferred assets. Section 1.1001-1(a) and Rev. Rul. 69-486. (emphasis added).

The italicized words indicate that the Current Remaindermen, as the deemed purchaser, do not pay tax on amounts **received** in the commutation (as the fictional purchaser, they are just receiving what is left in the trust after they have bought out everyone else), but they "realize gain or loss on the property exchanged." So they recognize gain on the assets **paid out** to others less the amount of their uniform basis attributable to those assets.

(6) **Massive Taxation**. If you've been keeping track of the amounts realized, you recognize that the parties could be recognizing gain equal to a substantial percentage of the entire trust value! This depends on the amount of unrealized appreciation in the trust assets and the relative value of the current beneficiary's interest (because everything the current income beneficiary receives is gain with *no* basis reduction).

Ed Morrow (in Morrow, Early Trust Terminations) describes an example of the dollar impact of the IRS's analysis, assuming the entire trust is worth $20 million with a $5 million basis (after all, it is a 35-year old trust), and assuming that the actuarial value of the son's (G2's) interest is 40% of the trust ($8 million), that G3's interest is $11 million, and G4's interest is $1 million (great grandchildren receive anything only if a grandchild predeceases the son).

The $5 million of basis would be divided under the uniform basis rules proportionately, $2 million for G2, $2.75 million for G3, and $250,000 for G4.

G2 pays long term capital gains tax (20% + 3.8% + potentially state tax) on $8 million (because G2 cannot use his share of the $2 million basis).

G4 pays long term capital gains tax on $1 million, but is permitted to use their $250,000 share of uniform basis to offset gain, incurring $750,000 of long-term capital gain.

G3, as a deemed *buyer* rather than a seller, does not pay tax on receiving their share, but realizes gain on the $9 million of assets going to G2 and G4 to "buy out" their shares, minus the $2.25 million ($5 million x 9/20) of basis attributed to those assets, resulting in $6.75 million ($9 million - $2.25 million) net long-term capital gain, assuming that those assets have been held for more than one year.

"Thus, the total gain triggered among the family is $15.5 million ($8 million G2 + $750,000 G4 + $6.75 million G3). If we assume a 30% tax rate including state income tax on this $15.5 million of gain, that's a **$4.65 million price tag to terminate the trusts** that could have largely been avoided by waiting until son's death. …" Morrow, Early Trust Terminations (emphasis in original).

Assume, instead, that the assets were highly depreciated having a basis of $30 million and a current value of $20 million. "G2 would still incur $8 million of long-term capital gains and $12 million of basis would be wiped off the face of the Earth. Thus, the spectre of a large capital gains event is present even if done immediately after death, even if the trust is entirely funded in cash." *Id.*

g. **Income Tax Issue Often Not Addressed**. While a number of rulings, as cited above, have addressed the income tax effects of commutations of trusts, some of the rulings addressing the tax effects of an early termination of a trust by judicial modification do not address the income tax issue. Unlike in these PLRs, the income tax ruling apparently is not requested, and the IRS does not comment on the income tax issue in some early trust termination rulings.

h. **Alternatives**. Ed Morrow suggests various alternatives, other than an early trust termination, that might have avoided the IRS's income tax analysis. *Id.* Possibilities include:

- **Gift**. The son could have simply released his interest as the current beneficiary and made a gift to the remaindermen. Or the son could have made gifts of a portion or all of his interest to charity.
- **Sale to Third Party**. If the parties all sold their interests in the trust to a third party, the son would not have lost his basis. If the trust assets are liquid assets, a third party might be willing to buy the various interests at a slight discount (to make a small profit) and, under the merger doctrine, terminate the trust to receive back the purchase price paid to the parties plus the small profit.
- **Contribution to LLC**. The parties might have contributed their interests to an LLC, which in turn could have terminated the trust under the merger doctrine. The parties would then own interests in the LLC having a value equal to the actuarial values of their interests in the trust (ignoring fractionalization discounts).
- **Decanting**. If the trust included broad authority to make principal distributions to the current beneficiary, the trust (under some state laws) could be decanted to a trust giving the current beneficiary a limited power of appointment, which he could exercise over time to leave amounts, having a value equal to the actuarial value of the remainder interest, to the remaindermen, and the trustee could then exercise its broad discretion to distribute the remaining principal to the current beneficiary.

- **Amendment**. If the trust did not have a broad distribution authority, the trust could be amended judicially to give broad discretion to the trustee to distribute principal to the current beneficiary and remaindermen. The trustee could exercise that discretion to distribute the assets to the current beneficiary and remaindermen. Or the trust could be amended to permit loans to all beneficiaries, with or without interest.

- **Form over Substance**. Some of these transaction might to subject to a risk of a form over substance attack, but these alternatives possibly could be implemented over time to minimize that risk. Still, these stand a better chance of avoiding the income tax nightmare than a straight commutation.

i. **Resources**. For an outstanding discussion of the uniform basis rules for trust interests, including a discussion of the income tax effects of trust commutations, see Lester Law & Howard Zaritsky, Basis After the 2017 Tax Act – Important Before, Crucial Now, 53rd ANNUAL HECKERLING INST. ON EST. PL., Special Session at 1-39 to 1-46 (2019). As described above, outstanding resources regarding the income risks of early termination (with a detailed analysis of these PLRs) are Ed Morrow, *Potential Income Tax Disasters for Early Trust Terminations*, LEIMBERG EST. PL. NEWSLETTERS #2753 (October 9, 2019) and Steven Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, ¶II.J.18 (2019) (available from author).

23. Planning With Grantor and Non-Grantor Trusts

a. **Grantor Trusts Overview**. For a rather detailed discussion of grantor trusts, including powers and interests that trigger grantor trust treatment under §§674-677, beneficiary deemed owned trusts under §678, dividing partial grantor trusts, portion rules, toggling, sales to grantor trusts, and other uses and benefits of grantor trusts, see Items 11-23 of ACTEC 2016 Summer Meeting Musings (Including Fiduciary Income Tax "Bootcamp"), found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Powers or Interests That Cause or Do Not Cause Grantor Trust Treatment**. Prof. Sam Donaldson provides a helpful listing of powers/interests that will or will not cause grantor trust treatment and that will or will not cause estate inclusion for the grantor.

(1) **Powers/Interests That Will Not Cause Grantor Trust Treatment But Will Cause Estate Inclusion**. For example these powers may be helpful to cause inclusion in a beneficiary's estate for basis adjustment purposes. These powers include:

- Testamentary general power of appointment;
- Power to appoint income or principal to charity of the grantor's choosing; and
- Power to control timing of distributions.

(2) **Power/Interests That Will Not Cause Grantor Trust Treatment and Do Not Cause Estate Inclusion**.

- Administrative powers;
- Third party power to pay income for the support of an individual the grantor is legally obligated to support;
- Power to affect enjoyment following a contingency;
- Power to distribute principal limited by an ascertainable standard;
- Power to withhold income during minority or disability;
- Independent trustee power to distribute income or principal unless the grantor can remove/replace trustees; and
- Trustee power to distribute income according to a reasonable definite standard (unless the grantor or grantor's spouse is trustee).

(3) **Powers/Interests That Will Cause Grantor Trust Treatment and Also Will Cause Estate Inclusion**.

- Most reversionary interests (this is not particularly significant);
- Most powers to control distributions during the grantor's life;
- Testamentary power to appoint accumulated income;
- Grantor's power to deal with trust property for less than full consideration;
- Grantor's power to vote controlled corporation stock in a nonfiduciary capacity (but trigger grantor trust treatment only as to that stock); and
- Grantor's retained right to income.

(4) **Powers/Interests That Will Cause Grantor Trust Treatment and Do Not Cause Estate Inclusion**.

- Power to loan to grantor with inadequate security;
- Actual loan to grantor without adequate security or interest, outstanding on the first day of the year;
- Power of nonadverse third party to add a charitable beneficiary;
- Substitution power (exercisable in a nonfiduciary capacity);
- Power of nonadverse third party to deal with trust property for less than full and adequate consideration;
- Power of nonadverse third party (held in a nonfiduciary capacity) to vote stock or control investments in stock; and
- Power to use income to pay premiums on policies insuring the grantor and/or grantor's spouse.

c. **Basis of Assets in Grantor Trust at Grantor's Death Following Sale to Grantor Trust**. Prof. Sam Donaldson suggests three alternatives for determining the basis of assets in a grantor trust at the grantor's death following a sale to the grantor trust.

(1) **Cost Basis**. Section 1012 provides that a taxpayer's basis is its cost "except as otherwise provided." The trust is disregarded for income tax purposes until the grantor's death, when grantor trust status ends. Arguably, the trust's basis should be the unpaid principal balance as of the grantor's death. Prof. Donaldson concludes that no rulings or regulations confirm this approach and "few commentators raise it as a possible reporting position."

(2) **Fair Market Value**. Section 1014 provides a stepped-up basis for property acquired from a decedent. The trust's separate status as a non-grantor trust comes into existence at the grantor's death; until that point the trust has been disregarded for income tax purposes. Section 1014(b) provides a stepped-up basis for property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." A very well-known article takes the position that a strong argument exists that the first "transfer" from the decedent to the trust for income tax purposes does not occur until the grantor's death, and the trust has acquired the property "from a decedent." Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. TAX'N 149 (Sept. 2002).

An example of an asset not in a decedent's gross estate for estate tax purposes that receives a basis adjustment is foreign property left from a foreign person to a U.S. person—that property in the hands of the U.S. person has a basis equal to the date of death value even though it was not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006. *But see* CCA 200937028 ("since the decedent transferred the property into the trust," no basis step-up under §1014).

Prof. Donaldson thinks this result is unlikely. The transfer does not occur by bequest in a will or by intestacy. He thinks that at best, one could argue that a constructive transfer at death occurs from the trust to the decedent's estate and from the estate to the trust, which seems like a stretch.

(3) **Carryover Basis**. Section 1015(a) addresses the donee's basis for gifts, and §1015(b) provides that property acquired "by a transfer in trust (other than … by a gift, bequest, or devise)" has the same basis as it would in the hands of the donor. Several commentators argue that although the transfer of assets to the grantor trust was not recognized as a sale transaction for income tax purposes, it was nonetheless a transfer to the trust triggering §1015(b). *See* Austin Bramwell & Stephanie Vara, *Basis of Grantor Trusts at Death: What Treasury Should Do*, TAX NOTES (August 6, 2018) at 793, Laura H. Peebles, *Death of an IDIT Noteholder*, TRUSTS & ESTATES 28, 33 (August, 2005).

(4) **Issue on Priority Guidance Plan**. This issue has been on the Treasury-IRS Priority Guidance Plan since 2015, and it is on the 2019-2020 plan. See Item 6.a. above. Prof. Donaldson believes the IRS is most likely to adopt the carryover basis approach.

d. **Grantor Trusts and Decanting**. Prof. Sam Donaldson cautions being careful with decanting trusts to create grantor trust treatment. Some states' decanting laws consider this a change in the beneficial interest in the trust and therefore not a permitted decanting if the trust does not have an "absolute discretion" distribution standard prior to the decanting.

The Uniform Decanting Act specifically addresses grantor trust effects on the ability to decant.

- **Turning Off Grantor Trust Status**. The trustee can decant in a manner that "turns off" grantor trust status (but would still have to consider its fiduciary duties in doing so, which may preclude decanting to turn off grantor trust status in some situations). §19(b)(9)(A). If the trust is a grantor trust because it is a foreign trust under §672(f)(2)(A), however, the second trust must also qualify under that same section. §19(b)(7).
- **Turning On Grantor Trust Status**. The trustee may decant the assets of a non-grantor trust to a second trust that is a grantor trust, §19(b)(9), except that the trustee must give notice to the settlor and the settlor has the right to block the decanting if the second trust does not give the settlor the power to turn off the grantor trust status or eliminates the right of a third party to cause the first trust to be a grantor trust, §19(b)(10).
- **Grantor Trust to Grantor Trust**. The trustee may decant a grantor trust to another grantor trust unless the second trust removes the settlor's power to turn off grantor trust status that was in the first trust. §19(b)(10(A).

e. **Creation of Beneficiary "Deemed-Owner" Trusts under Section 678**. A person other than the grantor will be considered the owner of trust property under §678 under three different alternatives – a (i) BDOT, (ii) BDIT, or (iii) QSST.

(1) **Beneficiary Defective Owned Trust ("BDOT")**. Under Section 678(a)(1), "a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which . . . such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself . . . ." If a beneficiary has the power to withdraw all of the net taxable income from the trust which can be satisfied out of the entire accounting income, corpus, and/or proceeds of the corpus, such beneficiary will be considered the owner of trust property. Trusts with such provisions are commonly referred to as BDOTs.

For a detailed discussion of the use of BDOTs, see Item 16 of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(2) **Beneficiary Defective Inheritor's Trust ("BDIT")**. Under §678(a)(2), "a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which . . . such person has previously partially released or otherwise modified [a §678(a)(1)] power and . . . retains such control" that would cause the grantor to be treated as the owner pursuant to §671 to §677. If a gift is made to a trust and the beneficiary is granted a withdrawal right over the entire contribution, such power will cause the beneficiary to be considered the owner pursuant to §678(a)(1). Once the withdrawal right lapses, if income of the trust may be

distributed to the beneficiary, the beneficiary will continue to be considered the owner pursuant to §678(a)(2) in conjunction with §677(a). Trusts with such provisions are commonly referred to as BDITs.

For a detailed discussion of the use of BDITs, see Item 31 of the Current Developments and Hot Topics Summary (December 2013) found **here** and Item 16.n. of the Estate Planning Current Developments Summary (December 2018) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(3) **Qualified Subchapter S Trust ("QSST")**. Section 1361(d)(1)(B) provides that "for purposes of Section 678(a), the beneficiary of [a QSST] shall be treated as the owner of that portion of the trust which consists of stock in an S corporation . . . ." See Item 14.f.(4)(iii) above.

(4) Trust Treated as Deemed Owned Trust Under §678 Despite HEMS Standard; Beneficiaries/Trustees Did Not Pay Attention to HEMS Limitation. An ERISA case that turned on the ownership of various entities ignored trusts as separate taxpayers but treated them as being owned by the respective beneficiaries under §678 despite the fact that the beneficiaries' power to withdraw income and principal of the trusts was limited by a health, education, maintenance, and support ("HEMS") standard. *United Food & Commercial Workers Unions v. Magruder Holdings, Inc.*, Case No. GJH-16-2903 (S.D. Md. March 27, 2019). Four siblings were trustees of a Family Trust, the beneficiaries of which were four separate Special Trusts for the four respective siblings. The trustee could freely distribute income or principal equally to the four Special Trusts. The siblings in their individual capacity could withdraw income or principal from their respective Separate Trusts as needed for their own HEMS, and as trustees they could distribute income or principal for the HEMS of their spouses and descendants. The siblings made equal monthly distributions to themselves directly from the Family Trust without any consideration of their HEMS needs. The beneficiaries argued that the HEMS standard kept each of them from having "a power exercisable solely by himself to vest the corpus or the income therefrom in himself," as described in §678(a)(1).

The court disagreed.

> But Defendants introduce no evidence that the HEMS limitation was dutifully followed. To the contrary, [an accountant] explained that HEMS was not taken into consideration when payments were distributed to the Siblings…. He also stated that none of the siblings had ever discussed with him whether a payment complied with HEMS requirements…. The Siblings either could not recall having ever consulted with anyone regarding HEMS requirements, … , or admitted that they never declined a payment because of the HEMS requirements…. **Regardless of whether, as Defendants suggest, a dutifully followed HEMS provision nullifies the application of the Grantor Trust Rule as a matter of law, a HEMS provision that exists only on paper cannot be said to restrict the power exercisable by the Siblings as to the Family Trust**. Therefore, the Grantor Trust Rule applies, and the Family Trust's 49% ownership of F&S will be attributed evenly to the Siblings. (Emphasis added)

Observation: The *SEC v. Wyly* case similarly reasoned that a failure to comply with fiduciary constraints regarding trust distributions caused a trust to be treated as a grantor trust for non-tax purposes. *SEC v. Wyly,* 2014 WL 4792229 (S.D.N.Y. September 25, 2014). This case is discussed in Item 17 of Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(5) **Trust Treated as §678 Trust as to Sale Transaction Because Beneficiary Could Withdraw Proceeds of Sale; Sale from §678 Trust to Grantor Trust Afforded Non-Recognition Treatment Under Rev. Rul. 85-13**. A recently granted (but not yet published) private letter ruling (PLR 111315-19) addressed the sale from a trust (Trust 1) treated as owned by the beneficiary under §678 to an irrevocable grantor trust (Trust 2) previously created by the beneficiary. In the new ruling, Trust 1 prohibits a distribution of "Shares," but allows for a distribution of the proceeds from the sale of the Shares, and because the beneficiary had reached age 40, the beneficiary could withdraw the proceeds of the sale. A Subtrust of Trust 1 agreed to sell an LLC that held the Shares to Trust 2 in return for cash and a promissory note. The IRS reasoned that the Trust 1 Subtrust was treated as owned by the beneficiary under §678 for purposes of the sale even though the beneficiary could only withdraw the proceeds of the sale and not the Shares or LLC prior to the sale. (This was somewhat similar to the situation in Rev. Rul. 85-13,in which a trust was treated as a grantor trust with respect to a sale to the grantor for an unsecured promissory note, which was treated as a borrowing by the grantor that triggered §675(3).) No ruling or case has previously addressed whether non-recognition treatment under the reasoning of Rev. Rul. 85-13 would be applied to transactions between a §678 trust and the beneficiary-deemed owner of the §678 trust. This ruling does address that issue, concluding that "the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A."

The ruling's reasoning for applying Rev. Rul. 85-13's non-recognition treatment to this §678 situation is as follows:

> Rev. Rul. 85-13 states that although A did not engage in a direct borrowing of the Corporation Z shares, A's acquisition of the T corpus in exchange for the unsecured note was, in substance, the economic equivalent of borrowing trust corpus. Accordingly, under § 675(3), A was treated as owner of the portion of T represented by A's promissory note. Further, because the promissory note was T's only asset, A was treated as owner of the entire trust. Moreover, because A was considered owner of the promissory note held by the trust, the transfer of the Corporation Z shares by T to A was not recognized as a sale for federal income tax purposes because A was both the maker and owner of the promissory note. Citing Dobson v. Commissioner, 1 B.T.A. 1082 (1925), the ruling states that a transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction.

f. **Planning Opportunities with BDOTs**.

(1) **Beneficiary Pays Income Taxes on Trust Income**. When the beneficiary of a trust is treated as the owner, the beneficiary pays income taxes for the income generated by trust assets without such payment being considered a gift from the beneficiary to the trust.

(2) **Sales between Beneficiary and BDOT**. The beneficiary may be able to sell assets to the trust without recognizing gain. In order for the beneficiary to be treated as the owner of the entire trust for income tax purposes under §678(a)(1), the withdrawal power must apply to all net taxable income during the year, including capital gains. Having the corpus portion of the trust being treated as owned by the beneficiary for income tax purposes is extremely important if the beneficiary wishes to sell assets to the trust and have the transfer treated as a non-recognition event under the reasoning of Rev. Rul. 85-13.

Even if the beneficiary is treated as the deemed owner of the corpus, whether the Rev. Rul. 85-13 analysis would be applied to a beneficiary treated as the deemed owner under §678(a)(1) by reason of the power to withdraw income, rather than having the power to withdraw the entire contribution to the trust, is not certain. A planning alternative to minimize a potential argument that Rev. Rul. 85-13 does not apply is to have the beneficiary-deemed owner of the BDOT sell assets not directly to the BDOT but to a single member LLC that is created by the BDOT. Regulations clearly disregard transactions between the owner and the disregarded entity; the disregarded income tax protection of a single member LLC is broader than the grantor trust income protection. *See* Reg. §§301.7701-3(a) 301.7701-3(b)(1)(ii), 301.7701-2(a). If the beneficiary-deemed owner of the BDOT is considered the income tax owner of a single member LLC created by the BDOT, the single member LLC regulations seem to provide that a sale by the beneficiary to the LLC should be disregarded.

(3) **Testamentary Trust of Which Surviving Spouse Is Deemed Owner under §678**. Following a spouse's death, testamentary trusts created for the surviving spouse could be treated as owned by the surviving spouse for income tax purposes. If both the credit shelter trust and the marital trusts are treated as owned by the surviving spouse for income tax purposes under §678, the credit shelter trust could engage in estate freezing transactions with the marital trust.

(4) **Broad Use for Beneficiaries of Testamentary Trusts**. This approach might be used broadly for testamentary trusts, to permit the beneficiary to have the flexibility to enter into transactions with the trusts and to allow the trusts to grow more quickly by having the beneficiary pay income taxes with respect to trust income with the beneficiary's outside assets (to maximize the amount that would be excluded from the beneficiary's estate and to maximize the amount that might accumulate in GST exempt trusts).

(5) **Use with Inter Vivos Trusts**. A "standard" inter vivos grantor trust could provide that following the grantor's death, the beneficiary would have the withdrawal power over all taxable income or grant a protector the authority to grant such a withdrawal power to a beneficiary. The trust would be a grantor trust as to the original grantor for the grantor's lifetime and thereafter the trust would be (or could be if the protector granted the beneficiary a withdrawal right over taxable income) deemed to be owned by the beneficiary/powerholder under §678.

(6) **Borrowing from Trust**. In the event a beneficiary would like to borrow money and the lender does not want to charge the beneficiary interest, there is some concern that §7872 would apply and the IRS would take the position that this is a "tax avoidance loan." However, if the beneficiary is the deemed owner of a trust, loans from such trust to the beneficiary should be ignored for income tax purposes, mitigating this risk.

If the beneficiary borrows without paying a fair interest rate, might the IRS argue that the beneficiary has made a transfer to the trust and become a partial grantor of the trust for transfer tax purposes, thus raising a possible §2036 argument?

(7) **State-Sourced Income**. Some states impose state income tax on trusts if the trust earns income that is sourced within that state. If a beneficiary is given a withdrawal power over all income sourced in that state, that beneficiary should be the deemed owner for income tax purposes, not the trust. The trust would include no state-sourced income on its Form 1041; it would instead be included on the beneficiary's Form 1040.

(8) **State Income Tax Savings; Multiple Beneficiaries**. Another way the BDOT strategy can mitigate state income taxes arises when a trust has multiple trust beneficiaries, some in states with an income tax and at least one in a state with no income tax. Assume a trust has a Texas beneficiary, a California beneficiary, and a California trustee. If the Texas beneficiary has the right to withdraw all net taxable income, the trust will no longer be subject to federal income taxes. Even more significant is that none of the beneficiaries or the trust will pay California state income taxes.

(9) **Sale to Grantor Trust; Grantor's Death before Note Is Paid**. In a standard sale to an IDGT in exchange for a promissory note, a concern always exists that the grantor may die before the term of the note expires. Consider having a springing power in the surviving spouse, allowing the surviving spouse to withdraw all net taxable income from the trust, starting at the grantor's death. The grantor also bequeaths the note to the surviving spouse. The family continues to benefit from the grantor trust status of the trust, including interest payments on the note being disregarded for income tax purposes.

(10) **Using Accumulation Trusts in Light of SECURE Act**. Accumulation trusts will be easier to implement under the SECURE Act (see Item 3.g. above) and may be more widely used for receiving retirement plan and IRA benefits following the account owner's death. The purpose of using an accumulation trust is to be able to accumulate income in the trust to utilize the general advantages of trusts, but accumulated trust income is generally taxed at the highest marginal tax bracket (because the top bracket for trusts is reached at merely $12,950 (in 2020) of taxable income). Granting the beneficiary the power to withdraw all net taxable income using the BDOT strategy will move the tax burden out of the trust but allow the assets to remain in the trust. See Item 3.h.(4) above. The beneficiary would likely want to take some distributions to pay the income tax burden but would not be forced to take out the entire RMD. For an excellent discussion of the income tax issues facing accumulation trusts and the use of BDOTs, see Ed Morrow, *Using BDOTs for Optimal Asset Protection and Income Tax Minimization After Passage of the Secure Act*, LEIMBERG INC. TAX PL. NEWSLETTERS #192 (Feb. 18, 2020).

(11) **Third-Party (Example-Grandparent) with Power to Withdraw Taxable Income**. Although most strategies involve the beneficiary being the deemed owner, also consider granting a third party a withdrawal right over net taxable income. For example, client sets up a trust for client's children and grants client's parent a withdrawal right over net taxable income. Client's parent is now responsible for the income taxes for income generated by trust property for the benefit of client's children.

(12) **Beneficiary's Ability to Create "Upstream" Trust**. A beneficiary of a trust could exercise a limited power of appointment to appoint the assets to an upstream trust (with the beneficiary's modest-wealth parent having a testamentary general power of appointment), using a "BDOT provision," thus causing the parent to become the deemed owner of the trust under §678. (The parent could actually withdraw enough to pay the parent's additional income tax attributable to the trust.) The parent could exercise the general power of appointment in a way that would cause a future beneficiary to become the deemed owner of the trust under §678.

(13) **Administrative Advantage–Eliminate Need to File Fiduciary Income Tax Returns**. If the trust is a grantor trust as to the beneficiary under §678, the trust would not need to file a complete fiduciary income tax return (Form 1041) each year. Some planners may view this as a primary advantage of structuring the trust to be a grantor trust as to the beneficiary.

(14) **Trust Protector Flexibility to Create BDOT or Remove Withdrawal Powers Being Abused**. Due to the many benefits of beneficiary-owned trusts, consider granting a Trust Protector the power to grant a beneficiary the right to withdraw net taxable income to provide future flexibility. Also consider granting the Trust Protector the power to modify and retract such withdrawal right for further flexibility and protection against an abused withdrawal right.

g. **Utilizing BDOT Technique to Shift Value between Trusts**. Practitioners are often involved in various trust modifications or decanting trust assets to make improvements in the trust agreement or to mitigate certain risks or errors. However, limitations often apply regarding the changes that can be made, and many goals cannot be accomplished through a decanting or modification. One alternative may be to apply the BDOT concept to shift value from Old Trust to New Trust by causing Old Trust to be the owner of New Trust. New Trust would include provisions granting Old Trust the power to withdraw all net taxable income of New Trust. Old Trust can sell assets to New Trust in exchange for a promissory note (assuming Rev. Rul. 85-13 applies, as discussed in Item 23.f.(2)). This could be an especially useful technique when Old Trust is GST nonexempt and New Trust is GST exempt or when Old Trust is set to terminate in twenty years and New Trust is a dynasty trust. Another possibility is to shift value from a QTIP trust to a bypass trust in the typical estate plan for married couples. Both the QTIP and the bypass trust can be structured as BDOTs as to the surviving spouse, making the surviving spouse responsible for the income taxes for both trusts and enabling the trustee to sell assets from the QTIP to the bypass trust, further shifting appreciation.

The approach of having one trust as the deemed owner of another trust was approved in Letter Ruling 201633021. In that ruling, trust #1 had the power to withdraw from trust #2 "any dividends, interest, fees and other amounts characterized as income under §643(b) of the Code" and the net short-term capital gains and the net long-term capital gains. Trust #1 did **not** have the power to withdraw principal of trust #2 beyond the taxable income. The ruling concluded that all of the taxable income of trust #2, including the net capital gains, were taxed to trust #1 under §678(a)(1).

h. **Providing Tax-Free Benefits to Beneficiaries in High Tax States**. In the event a trust has avoided state income tax but a beneficiary is located in a high-tax state, a trustee could find creative ways to provide benefits to such beneficiary without carrying out taxable income to the beneficiary. Such methods include (1) allowing a beneficiary to use trust assets with no charge (*see Plant v. Commissioner*, 30 BTA 133 (1934), *acq*. 1976-1 C.B. 1, *aff'd* 76 F.2d 8 (2nd Cir. 1935); Letter Ruling 8341005), (2) making loans to the beneficiary, (3) electing to recognize gain on the distribution of property under §643(e)(3), and (4) trapping income by investing through an S corporation and making an ESBT election (because the ESBT's corporation taxable income is taxed at the trust level and the ESBT gets no distribution deduction). Some practitioners have expressed concern that allowing a beneficiary to use trust assets free of charge (such as a residence) could be deemed a constructive distribution from a trust. However, Carlyn McCaffrey offers four arguments for the position that use of a trust asset should not cause income to be imputed to the beneficiary.

(1) The beneficiary holds the beneficial interest in the property, and under the Code, the general principle is that the personal use and enjoyment of one's own property does not result in imputed income to the owner.

(2) The function of Subchapter J is not to create gross income but instead to allocate income that already exists between trusts and beneficiaries, based on whether the income is distributed. Because there is no income generated by the mere possession of property, there is no income to be divided.

(3) Pursuant to §643(e), distributions in kind are treated as distributions of an amount equal to the basis of the property distributed. The basis of property distributed when a trustee allows a beneficiary to use trust property is zero, therefore there are no amounts distributed.

(4) In 2010, Congress amended §643 to provide explicitly that a beneficiary of a foreign trust who is permitted to use foreign property would have imputed income equal to the fair market value of the benefit provided. If the use of trust property was already taxable under Subchapter J, Congress would not have needed to specify this for foreign trusts in 2010.

i. **Non-Grantor Trusts for Income Tax Savings**. For a discussion of various ways in which non-grantor trusts can be used to save income taxes, see Item 23 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

24. State Income Taxation of Trusts; Kaestner and Fielding Cases

a. **Background**. All of the 43 states plus the District of Columbia that impose an income tax on trusts tax the undistributed income of a non-grantor trust as a "resident trust" based on one or more of the following five criteria: (1) if the trust was created by a resident testator (for a testamentary trust), (2) if the trust was created by a resident trustor (for an inter vivos trust), (3) if the trust is administered in the state, (4) if the trust has a resident fiduciary, and (5) if the trust has a resident beneficiary. Observe that the governing law of the trust is not one of those criteria (except in Louisiana; also in Idaho and North Dakota that is a factor considered along with other factors).

A trust included in one of the first two categories is referred to as a "founder state trust" (i.e., the trust is a resident trust if the founder of the trust was a resident of the state).

A trend has arisen over the last 5-7 years of state cases finding that such statutes are unconstitutional, particularly the cases based solely on where the settlor resided when the trust was founded. For a listing of those cases, see Item 8.c. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. For a discussion of older cases that have addressed the constitutionality of founder state statutes, see Item 20.d. of the 2012 Heckerling Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

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

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

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

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

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

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

make clear that it is not addressing any of the other regimes for state taxation of trusts. The opinion provides minimal guidance as to the constitutionality of those various systems (or the North Carolina beneficiary-based system under other facts), but reiterates and applies traditional concepts that due process concerns the "fundamental fairness" of government activity and requires "minimum contacts" under a flexible inquiry focusing on the reasonableness of the government's action.

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

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

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

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

(i) Taxation of actual trust distributions to a state resident (*Maguire v. Trefry*);

(ii) Taxation based on the residence of the trustee (*Greenough v. Tax Assessors of Newport*); and

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

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

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

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

Although a few exceptions exist, a wide variety of state cases have found that systems based solely on the existence of a resident-settlor do not satisfy due process requirements. See Item 20.d. of the 2012 Heckerling Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)** for a history of such cases and see Item 22.a. of the Current Developments and Hot Topics Summary (December 2014) found **here** and Item 17.c. of the Current Developments and Hot Topics Summary (December 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** for a discussion of the trend of more recent cases finding such systems unconstitutional.

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

Even among settlor-based regimes, the constitutionality analysis may vary. Taxation of testamentary trusts by the state of the decedent's residence may have a somewhat greater possibility of withstanding constitutional challenge than inter vivos trusts because of the utilization of the state's probate courts in the establishment of the testamentary trusts. The courts have generally focused their constitutional analysis of state taxation of trusts under the Due Process Clause (and the involvement of the local courts in creating the trust is an additional contact with the state that may help support the existence of the required "**minimum contacts**" required for due process), but the state taxation must also be permitted under the Commerce Clause, which requires a **substantial nexus** between the activity being taxed and the taxing state, and the local court involvement might help in establishing that the required substantial nexus exists.

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

c. **Minnesota Courts Find Application of Founder Statute Unconstitutional, Supreme Court Refuses Appeal, *Fielding***. In *William Fielding, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, et al., v. Commissioner of Revenue*, (Minn. Tax Ct. May 31, 2017), the court concluded that the grantor-domicile sole basis under the Minnesota statute for treating an inter vivos trust as a Minnesota resident trust violated the Due Process clauses of the Minnesota and United States constitutions. Minnesota was not entitled to tax the income from the sale of stock (of a Minnesota corporation) or income from an out of state investment account. The Minnesota Supreme Court affirmed on July 18, 2018 (916 N.W.2d 323).

The state filed a certiorari petition with the United States Supreme Court. The Court did not address that petition while the *Kaestner* case was pending, but it denied the petition on June 28, 2019. For a more detailed discussion of the reasoning in *Fielding,* see Item 8.e. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

e. **Consider Filing Claims for Refund**. If a trust has previously paid state income tax, and the state statute may have questionable constitutional validity (for example, if it is a founder state), consider filing a claim for refund or at least a protective claim for refund.

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

25. Valuation Issues Regarding Merger Transactions, Cavallaro and CCA 201939002 (Anticipated Merger Must Be Considered in Valuing Stock)

a. ***Cavallaro,* T.C. Memo. 2019-144**. The *Cavallaro* case (T.C. Memo. 2014-189) involves a merger of companies owned separately by parents and children, and whether proper values were used in determining shares of the new company that each received. Gift tax returns were not filed at the time of the merger transaction. When shares of the merged company were later sold, the income tax examiner spotted the gift issue and referred it to gift tax representatives. The court discussed various reasons for its conclusion that the parents' company was undervalued in the merger. The Tax Court held that the parents made a gift equal to the difference between the value of the shares that they received in the merger and the value of the company they owned before it went into the merger.

The Court of Appeals determined that the parties should still have the ability to point out the defects in the IRS expert's appraisal, and the case was remanded for that consideration. See Item 32 of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. On remand the Tax Court (Judge Gustafson) reduced the value of the gift from $29.7 million to $22.8 million, or by $6.9 million, because of a technical mistake in the IRS's expert's report that used a method that was not statistically correct in determining the profit margin of the

children's company before the merger. After correcting that mistake (which adjusted the profit margin of the children's company from 7.5% to 9.66%, thus increasing the value of the children's company), the parties agreed that the effect was to reduce the gift amount by about $6.9 million. T.C. Memo. 2019-144 (October 24, 2019).

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

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

b. **CCA 201939002, Anticipated Merger Must Be Considered in Valuing Stock**.

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

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

The issue is whether the shares should be valued under Reg. §25.2512-2(b)(1) at the mean between the highest and lowest quoted selling prices on the date of the gift, or by taking into consideration the anticipated merger. Reg. §25.2512-2(e) states that if

the value determined from the mean between the high and the low selling prices does not represent the fair market value of the shares, then some reasonable modification of the value shall be considered in determining fair market value.

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

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

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

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

(2) **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. But what if neither a hypothetical seller nor a hypothetical buyer could have known about the merger discussions?

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.

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. Some possibility may have existed that the merger would fall through, and even if the merger were consummated, the extent to which the merger actually impacted the value of stock after the merger was announced would be uncertain. Indeed, the CCA acknowledges that "after the merger was announced, the value of the Corporation A stock increased substantially, though *less than the agreed merger price*" (emphasis added). But the anticipated merger would still be considered as a factor in determining the fair market value of the stock.

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

If the case for which this CCA was issued proceeds to trial, no doubt these facts will be fully explored by the court, and the court's discussion of the legal test of what is meant by "reasonable knowledge of relevant facts" in valuation cases may be quite interesting. But the likelihood of having a trial or reported case is unlikely in this situation involving a transfer to a GRAT, discussed immediately below.

(3) **GRAT Transfer**. Because of the valuation uncertainties in situations such as this, transferring such assets to a GRAT is particularly advantageous because of the "built-in savings clause" feature of being able to describe the annuity payment amounts as a percentage of the value that is contributed to the GRAT. An adjustment in the value of the amount contributed to the GRAT results in an extremely small difference in the amount of the taxable gift. (For this reason, the current dollar impact of the government's position is probably negligible, suggesting that this situation may not result in a trial or reported case.)

(4) **Impact of Public Market Price**. If the anticipated merger is publicly known, the public price has already taken the anticipated merger into account. If it is private information and not publicly known, how would a hypothetical purchaser know of the merger to take it into consideration? To make the assumption that the hypothetical purchaser will know about a possible merger that is not publicly known, in a world in which securities laws prevent the disclosure of that information if it is not publicly known, seems out of touch with reality.

(4) **Compare to Charitable Gift**. If the issue were valuing a charitable gift, does anyone think the IRS would allow bolstering the value of publicly traded stock because of an anticipated merger that is not public knowledge?

26. Family Limited Partnership and LLC Planning Developments; Planning in Light of *Powell v. Commissioner*

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

(1) **Bona Fide Sale for Full Consideration Defense**. The bona fide sale for full consideration defense is the key for defending both §2036(a)(1) and §2036(a)(2) cases. Almost every one of these cases that the taxpayer has won was based on the bona fide sale for full consideration exception to §2036. (The three exceptions are *Kelly, Mirowski,* and *Kimbell* (at least as to some assets). See Item 26.e. below.)

(i) **Bona Fide Sale Test – Legitimate and Significant Nontax Reason**. The key is whether "legitimate and significant nontax reasons" existed for using the entity, as announced in *Bongard v. Commissioner*, 124 T.C. 95 (2005). Having tax reasons for creating entities is fine; the test is whether "**a**" legitimate and significant nontax reason applied as well. The tax purposes are not weighed against the nontax purposes. For a listing (with case citations) of factors that have been recognized in particular situations as constituting such a legitimate nontax reason, see Item 8.g. of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

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

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

Agreement of Retained Enjoyment. If the bona fide sale for full consideration exception does not apply, the IRS must still establish an implied agreement of retained enjoyment in the assets that were transferred to the partnership or LLC. For

a summary list (with case citations) of factors that suggest an implied agreement retained enjoyment, see Item 8.g. of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(3) **Section 2036(a)(2)**. In a few cases, the IRS has also made a §2036(a)(2) argument, that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the income or property contributed to the entity. Two cases have applied §2036(a)(2) where the decedent had some interest as a general partner (*Strangi* and *Turner*), and one case applied §2036(a)(2) when the decedent held merely a limited partnership interest (*Powell*, as discussed in Item 26.c. below).

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

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

(ii) **Overview of *Powell* and *Cahill***. *Powell* (discussed in Item 26.c. below) and *Cahill* (discussed in Item 27.a. below) add a significant additional risk under §2036(a)(2), based on whether the decedent could act with third parties to undo whatever is causing a discount. The focus seems to be on the ability to join with others to cause a liquidation of an entity (or termination of an agreement, as in *Cahill*), and would seem to extend to the ability to join with others in amending documents to permit liquidation or termination. (The ability to amend the partnership agreement without consent of limited partners was one of the factors that the court mentioned in *Turner I* for applying §2036(a)(2)). One possible response is to provide in the underlying agreements that the decedent owns a class of interest that does not permit joining with others to liquidate the entity or amend the agreement. Query whether the absence of a right to vote on liquidation or amendment would be a §2703 restriction that is ignored under the *Cahill* reasoning?

Other cases have limited the broad application of the "in conjunction with" argument relied on in *Powell* and *Cahill*. (See Item 26.d. below for a discussion of the *Helmholz*, *Tully*, and *Bowgren* cases.) The taxpayer in *Morrissette* made these arguments (so far, unsuccessfully) in that pending Tax Court case, as discussed in Item 27.b. below.

(iii) **IRS Agents Are Making the *Powell* Argument**. John Porter tried *Estate of Wittingham v. Commissioner* in February 2018. The case was ultimately settled, but the IRS made the *Powell* argument with respect to an LLC created by the decedent, in which the decedent and her two sons were the managing members and held the Class A units with voting rights. The case involved the sale of units in return for a

private annuity even though the decedent had just found out that she had pancreatic cancer. The case ultimately settled with the taxpayer conceding that some prior purported loans were gifts and conceding about 20% of the private annuity issue because of uncertainty about some medical issues.

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

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

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

(1) **Synopsis**. *Estate of Powell v. Commissioner*, 148 T.C. 392 (May 18, 2017) is a "reviewed" Tax Court decision that may be the most important Tax Court case addressing FLPs and LLCs since the *Bongard* case 15 years ago. The Tax Court breaks new ground (1) in extending the application of §2036(a)(2) to decedents owning only limited partnership interests, and (2) in raising the risk of double inclusion of assets under §2036 *and* a partnership interest under §2033, which may (in the court's own words) result in "duplicative transfer tax." (The case was decided on cross motions for summary judgement, and is not an opinion following a trial.)

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

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

The §2036(a)(2) issue is infrequently addressed by the courts; it had been applied with any significant analysis only in four prior cases (*Kimbell and Mirowski* [holding that §2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that §2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 50% interest in the corporate general partner). *Powell* is the first case to apply

§2036(a)(2) when the decedent **merely owned a limited partnership interest**. In this case the decedent owned a 99% LP interest, but the court's analysis drew no distinction between owning a 99% or 1% LP interest; the court reasoned that the limited partner "in conjunction with" all of the other partners could dissolve the partnership at any time.

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

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

For a detailed discussion of the facts and court analysis in and planning implications of *Powell*, see Item 15.g. of the Current Developments and Hot Topics Summary (December 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

The net effect is that, under the *Powell* reasoning, §2036 will conceivably apply to almost all FLPs/LLCs, whether or not the client retains a general partner or managing member interest, unless the bona fide sale for full consideration exception to §2036 applies. Furthermore, the same reasoning would seem to apply to a contribution to practically any enterprise or investment involving other parties. For example, interests in C corporations, S corporations, or undivided interests in real estate would be subject to the same reasoning that the decedent could join with the other shareholders/co-owners (perhaps even if unrelated?) and dissolve the entity/co-ownership, with all parties receiving their pro rata share of the assets.

(3) **What to Do? Planning in Light of Powell**. For a more detailed discussion of planning steps in light of Powell, see Item 15.g. of the Current Developments and Hot Topics Summary (December 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(i) **No Revocable Transfer**. Confirm that the transfer is not revocable. Especially be wary if the gift is made under a power of attorney to confirm that it is not a voidable transfer. If community property is transferred to an entity, or a transfer of made of a community property interest in the entity, confirm that the transfer is authorized and cannot be set aside by a spouse if only one spouse participates in the transfer.

(ii) **Avoid Transfers under Power of Attorney**. A number of §2036 cases involve FLPs/LLCs that have been created by an agent under a power of attorney for the decedent. Avoid that if possible. If a power of attorney is used for making gifts, make sure that it authorizes gift transfers.

(iii) **Satisfy Bona Fide Sale for Full Consideration Exception**. Pull all stops to build the best possible case for satisfying the bona fide sale for full consideration exception to §2036. Planning should include (a) connecting the nontax purposes to the actual facts, (b) customizing the agreement to accomplish the nontax purposes, (c) having a real "pooling" of assets among family members if possible, (d) reflecting the nontax purposes in all communications, (e) acquiring some assets requiring active management and arrange the management activities to be consistent with the nontax purposes, (f) carefully following all formalities required in the agreement, timely file tax returns and information returns, properly maintain capital accounts (more than just listing capital accounts on tax returns), and conduct periodic meetings of the owners even though not legally required, and (g) maintaining a source of income or resources for living expenses other than from the entity.

(iv) **Transfer Voting Units**. If the client makes transfers of interests in the entity, generally give voting units, retaining only non-voting units. If voting units are retained, make sure that the client does not have the right to vote on issues that affect the power to amend or revoke the agreement.

(v) **Slicing and Dicing of Voting Rights**. If the donor retains any voting rights, create classes of voting rights. For example Class A limited partners would possess full voting rights normally provided to limited partners, and Class B limited partners (including the donor) could vote on all matters other than (a) the liquidation or dissolution of the entity, (b) distributions from the entity, (c) the right to approve a proposed transfer of an interest in the entity, or (d) the amendment of the entity agreement in a way that would alter either of those restrictions.

(vi) **Elimination of Unanimous Partner Approval Requirement for Dissolution**. The partnership agreement in *Powell* "allows for the partnership's dissolution with the written consent of all partners." The omission of this explicit requirement of unanimous consent for dissolution in the partnership or LLC agreement would at a minimum allow a sympathetic judge to point to a significant distinction from the facts of *Powell*. That is not a panacea however, because even if the partnership agreement is silent about dissolution, state law likely allows the dissolution with the consent of all partners.

(vii) **Avoid Having the Decedent or Decedent's Agent as General Partner**. *Strangi* focused primarily on the decedent's ability to take actions as general partner as a §2036(a)(2) trigger (even though the decedent in that case did not own a majority controlling interest of the entity that served as general partner). One of the court's reasons for applying §2036(a)(2) was that the son could make distribution decisions and also owed duties to the decedent under the power of attorney from the decedent.

Even if the client has given all of the limited partnership interests and has only a small general partner interest, the small general partner interest could conceivably cause §2036(a)(2) to apply to all prior gifts of limited partnership interests.

(viii) **If Any Retained General Partner Interest**. If the donor will continue to be a general partner or hold an interest in a general partner, investment and administrative powers should not trigger estate inclusion, and even distribution powers should not trigger estate inclusion if discretion over distributions is subject to a definite standard. If the donor retains an interest in the general partner and can participate in distribution decisions, consider providing that Class A limited partners must consent to establishing reasonable reserves (at least for more than a baseline established in a budget that is approved from time to time by all of the partners), or have someone else as a "special general partner" to establish reasonable reserves or to do other things that might be sensitive as to estate inclusion issues such as approving transfers of interests in the entity, determining whether to reinvest income, gain, and refinancing proceeds or to distribute them to partners.

(ix) **Special Voting Interests to Make Liquidation/Dissolution Decisions**. One planning alternative may be to have a special partnership or member interest that would have the *exclusive* ability to vote on liquidation or dissolution decisions or to amend the partnership with respect to such powers. The first rationale of the court's reasoning in *Powell* under §2036(a)(2) would then no longer apply—the decedent could not participate with anyone in deciding when to dissolve the partnership/LLC.

(x) **Removal of Managers**. Do not allow the donor as a limited partner to participate in the decision to remove a general partner or manager, or permit the donor to participate in removal decisions as long as a replacement must be appointed who is not related or subordinate to the donor.

(xi) **Trust Owners with Independent Trustee**. If all of the partners/members were irrevocable trusts with independent trustees, any dissolution proceeds would pass to the irrevocable trusts, and the decedent could not join with the trustee in making distribution decisions. Therefore, the court's "in conjunction with" analysis would no longer give the decedent the ability to designate who could receive the income or property contributed to the partnership/LLC.

Even if the trust includes the donor as a discretionary beneficiary (which might subject the trust to creditor claims) or even if the trust is an incomplete gift trust, the trustee would still have enforceable fiduciary duties.

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

(xiii) "**Claim Victory" and Dissolve FLP/LLC with Prior Successful Transfers**. If a client has previously created an FLP/LLC and has made gifts or sales of interests in the entity to trusts that have experienced substantial appreciation, consider dissolving the entity (at least three years before death) so that the trusts would own the value apart from the FLP/LLC, thus negating any possible §2036 taint.

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

For a discussion of the efficacy of this position, including the effects of Tech. Adv. Memo. 9515003, see Item 12.d.(3) of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

d. **Prior Cases That Have Limited the Broad Application of the "in Conjunction with" Phrase in §§2036 and 2038**. Section 2036(a)(2) was enacted with almost identical "in conjunction with" language as in §2038. Several §2038 cases have limited the application of this provision in determining whether a decedent held a joint power to terminate a trust. For example, a power in a trust agreement to terminate the trust with the consent of all beneficiaries was not a power to revoke, alter, or amend the trust in conjunction with others because state law conferred the right to terminate a trust with the consent of all beneficiaries, and the trust provision "added nothing to the rights which the law conferred." *Helvering v. Helmholz*, 296 U.S. 93 (1935), *aff'g* 75 F.2d 245 (D.C. Cir. 1934) (reasoning that this power exists under state law in almost all situations, and to hold otherwise would cause all trusts to be taxable). This exception seems analogous to the power under state law of all partners to agree to amend the partnership agreement or to cause the liquidation of the partnership.

Another example is *Tully Estate v. Commissioner*, 528 F.2d 1401 (Ct. Cl. 1976). In *Tully*, decedent was a 50% shareholder. The corporation and decedent entered into a contract to pay a death benefit to the decedent's widow. Even though the beneficiary designation was irrevocable, the IRS argued that it could be amended for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary. The court's analysis is analogous to the broad extension of §2036(a)(2) to FLPs:

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

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

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

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

The taxpayer's attorneys in *Powell* and in *Cahill* (which applied the *Powell* reasoning in the context of an intergenerational split dollar case about a year after *Powell*) did not make any arguments about these cases that have placed outer limits on the reach of §2036(a)(2) and §2038. However, the taxpayer's attorney in *Morrissette*, did argue that the cases precluded a sweeping application of §2036(a)(2) and §2038(a)(1) because of the ability to join together with others in undoing transactions, but the court summarily denied the taxpayer's §§2036(a)(2)/2038(a)(1) summary judgment motion on the basis of the *Cahill* decision without even mentioning these cases. See Item 27.b. below.

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

(1) *Church v. United States,* 2000-1 USTC ¶60,369 (W.D. Tex. 2000) (preserve family ranching enterprise, consolidate undivided ranch interests);

(2) *Estate of Eugene Stone v. Commissioner*, T.C. Memo 2003-309 (partnerships to settle family hostilities);

(3) *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), *vacating and rem'g* 244 F. Supp. 2d 700 (N.D. Tex. 2003) ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests);

(4) *Bongard v. Commissioner*, 124 T.C. 95 (2005) (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts);

(5) *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126 (maintaining buy and hold investment philosophy for family du Pont stock);

(6) *Estate of Mirowski v. Commissioner*, T.C. Memo 2008-74 (joint management and keeping a single pool of assets for investment opportunities);

(7) *Estate of Miller v. Commissioner*, T.C. Memo 2009-119 (continue investment philosophy and special stock charting methodology);

(8) *Keller v. United States*, 2009-2 USTC ¶60,579 (S.D. Tex. 2009) (protect family assets from depletion in divorces);

(9) *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 BL 223971 (W.D. Ark. Oct. 2, 2009) (centralized management and prevent dissipation of family "legacy assets");

(10) *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) (maintaining buy and hold investment philosophy for closely held stock);

(11) *Estate of Shurtz v. Commissioner*, T.C. Memo 2010-21 (asset protection and management of timberland following gifts of undivided interests);

(12) *Estate of Joanne Stone v. Commissioner*, T.C. Memo 2012-48 (desire to have woodland parcels held and managed as a family asset and various other factors mentioned);

(13) *Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (ensuring equal estate distribution, avoiding potential litigation, and achieving effective asset management); and

(14) *Estate of Purdue v. Commissioner*, T.C. Memo 2015-249 (centralized management and other factors).

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

Interestingly, six of those fourteen cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the *Miller*, *Joanne Stone*, and *Purdue* cases and authored the Tax Court's opinion in *Bongard*. Judge Chiechi decided both *Stone* and *Mirowski*. (Judge Wherry decided *Schutt*, Judge

Halpern decided *Black*, Judge Jacobs decided *Shurtz*, Judge Foley decided *Kelly*, and *Church* and *Kimbell* were federal district court opinions ultimately resolved by the Fifth Circuit. *Keller* and *Murphy* are federal district court cases.)

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

f. **Review of Court Cases Valuing Partnership Interests**. Despite the many cases that have addressed the applicability of §2036 to limited partnership or LLC interests, fewer cases have actually reached the point of valuing partnership interests. John Porter, an attorney in Houston, Texas who has litigated many of the family limited partnership cases, summarizes discounts that have been allowed by the courts in FLP/LLC cases as follows (the *Streightoff* and *Estate of Jones* case results have been added to the table):

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Strangi I	securities	Tax	31%
Knight	securities/real estate	Tax	15%
Jones	real estate	Tax	8%; 44%
Dailey	securities	Tax	40%
Adams	securities/real estate/minerals	Fed.Dist.	54%
Church	securities/real estate	Fed. Dist.	63%
McCord	securities/real estate	Tax	32%

Lappo	securities/real estate	Tax	35.4%
Peracchio	securities	Tax	29.5%
Deputy	boat company	Tax	30%
Green	bank stock	Tax	46%
Thompson	publishing company	Tax	40.5%
Kelley	cash	Tax	32%
Temple	Marketable securities	Fed. Dist.	21.25%
Temple	ranch	Fed. Dist.	38%
Temple	winery	Fed. Dist.	60%
Astleford	real estate	Tax	30% (GP); 36% (LP)
Holman	dell stock	Tax	22.5%
Keller	securities	Fed. Dist.	47.5%
Murphy	securities/real estate	Fed. Dist.	41%
Pierre II	securities	Tax	35.6%
Levy	undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Giustina	timberland; forestry	Tax	25% with respect to cash flow valuation (75% weighting to cash flow factor and 25% weighting to asset method); BUT reversed by 9th Circuit and remanded to reconsider without giving 25% weight to asset value
Koons	securities	Tax	7.5%; Estate owned 70.42% of voting interests and could remove limitation on distributions
Gallagher	publishing company	Tax	47%
Streightoff	securities	Tax	0% lack of control discount because the 88.99% LP interest could remove the general partner and terminate the partnership; 18% lack of marketability discount
Jones	Sawmill & timber	Tax	35% lack of marketability discount from noncontrolling interest value

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

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

a. ***Cahill* Synopsis and Settlement**. In *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018) (Judge Thornton), the decedent's revocable trust had advanced $10 million to an irrevocable trust under a split dollar agreement for the trust to purchase life insurance policies on the lives of the decedent's son and his wife. The estate valued the estate's right eventually to be reimbursed for its advances at only $183,700, because of the long period of time before the policies would mature at the insureds' deaths. The IRS argued, among other things, that the reimbursement right should have a value equal to the full cash surrender value of the policies (about $9.6 million) in part because of §§2036, 2038, and 2703. The court rejected the estate's motion for a partial summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) did not apply and that Reg. §1.61-22 applied in valuing the decedent's reimbursement rights.

The court reasoned that §§2036(a)(2) and 2038(a)(1) could apply because the decedent, in conjunction with the irrevocable trust, could agree to terminate the split dollar plan and the decedent would have been entitled to the cash surrender value of the policies (without waiting until the insureds' deaths), and because the advance of the premiums in this situation was not a bona fide sale for full and adequate consideration. (The court cited its recent decision in *Powell v. Commissioner*.)

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

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

b. ***Estate of Morrissette v. Commissioner*; Similar Arguments Regarding §§2036, 2038, and 2703**. The initial case in *Estate of Morrissette v. Commissioner,* 146 T.C. No. 11 (2016) determined that the economic-benefit regime applies to the split dollar arrangement in that case. The IRS made arguments under §§2036, 2038, and 2703, similar to its arguments in *Cahill*. The estate filed a motion for partial summary judgment that §2703(a) is inapplicable (but, unlike in *Cahill*, the taxpayer did not request a summary judgment regarding §§2036 and 2038). Three days after the entry of the *Cahill* decision, the Tax Court entered an Order in *Morrissette* on June 21, 2018 denying the taxpayer's motion for summary judgment that §2703(a) was inapplicable, observing that "the termination restriction prevented the decedent from

terminating the split-dollar arrangements unilaterally and receiving repayment of the premium or, if greater, the policy's cash surrender value," and concluding that "[t]he restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2)." Order in Docket No. 4415-14 (June 21, 2018) (Judge Goeke). The IRS filed a motion for partial summary judgment regarding §§2036 and 2038 on November 21, 2018, and the estate on January 15, 2019 filed its response in opposition to the IRS motion and its own cross motion for partial summary judgment that §2036(a)(2), 2038(a)(1), and 2703(a) do not apply.

The taxpayer's Memorandum in support of its motion emphasizes the prior cases that have limited the broad application of the "in conjunction with" clause to rights already provided by state law. The Memorandum makes strong arguments regarding (1) cases that applied outer limits in applying the "in conjunction with" phrase in §2038 and (2) , that the restriction on the trust's right unilaterally to terminate the split dollar agreements is provided under common law and is not a basis for applying §2703. Excerpts from the Memorandum are quoted at length in Item 13.c.(6) of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

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

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

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

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

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

c. ***Levine v. Commissioner***. Another pending intergenerational split dollar case is *Estate of Levine v. Commissioner*, Docket No. 013370-13. The Tax Court trial in *Levine* was held in November, 2017, and the post-trial briefs have been filed.

d. **Detailed Discussion of These Cases**. For a much more detailed discussion of these cases, see Item 13 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

28. Late Filing Penalties Abated Where Full Estate Tax Payment Was Made Timely (But After the Original Due Date) and Reasonable Cause Existed for Late Filing, *Estate of Skeba v. U.S.* (D.C. N.J. October 3, 2019, superseded by decision on January 7, 2020)

a. **Basic Facts**. In *Estate of Skeba v. U.S.*, 125 AFTR 2d 2020-380 (D.C. N.J. January 7, 2020), *superseding* 124 AFTR 2d 2019-6265, (D.C. N.J. October 3, 2019), the IRS assessed a penalty for filing an estate tax return late, which it calculated as 25% of the amount of the unpaid estate tax on the original due date of the estate tax return. This was despite the fact that all of the estate tax (and more) had been paid timely by the time the return was actually filed.

The fact chronology is summarized as follows:

- June 10, 2013 - the decedent died;
- March 10, 2014 – original estate tax return due date;
- March 6, 2014 – estate filed for six-month extension of time to file and a 14-day extension of time pay tax, and paid estimated payment of $725,000 (all of the estate's liquid funds were used make a payment for federal and state estate taxes on that date); the extensions to file and pay tax were granted June 25, 2014 and July 8, 2014, respectively;
- March 18, 2014 – estate paid $2,745,000 to the IRS (within the extended payment period);
- September 10, 2014 – estate did not request further extension of time to file, in light of ongoing will-contest litigation, which would have impacted the estate's ability to complete the filing and the executor's capacity to proceed, because an IRS representative purportedly told the estate's counsel "that so long as the payment was made in full, then the filing of the return beyond the extension deadline was permissible and would not subject the estate to any penalty," and

an IRS representative purportedly told the estate's CPA (who ultimately filed the estate tax return) "you're paid in, you're fine," and the accountant understood that as long as the estate tax was paid, a penalty for failure to timely file would not be assessed;

- The will contest litigation was delayed initially due to health concerns of one of the parties and later because of serious health concerns of the plaintiff's attorney. In June 2015, the attorney's office advised that his health had deteriorated to the point that he could no longer handle the litigation and new counsel would be needed, at which time the estate decided to go ahead and file the estate tax return based on information that it had at that time;
- June 30, 2015 – estate filed the estate tax return, reporting a net estate tax of $2,528,838 and reporting the prior payments of $3,470,000 ($725,000 + $2,745,000), or an overpayment of $941,162;
- August 3, 2015 – IRS responded to the return, acknowledging an overpayment before adjustment of $941,162, and assessing a penalty due to the late filing in the amount of $450,959.50, which was 25% of the "unpaid amount" of $1,803,838, (the IRS reasoned that the unpaid amount due on the **original** March 10, 2014 due date was $2,528,838 minus the $750,000 estimated payment made by that date).

b. **Court's Analysis**. Section 6651(a)(1) imposes the failure to file penalty. It reads:

> (a) ADDITION TO THE TAX. In case of failure—
>
> (1) to file any *return* required under the authority of subchapter A of chapter [which includes §6018(a) (estate tax returns)]… on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate ....

Section 6651(b) clarifies calculation of the penalty:

> (b) PENALTY IMPOSED ON **NET AMOUNT DUE**. For purposes of—
>
> (1) subsection (a)(1), the amount of tax required to be shown on the return shall be reduced by the amount of any part of the tax which **is paid on or before the date prescribed for payment of the tax** and by the amount of any credit against the tax which may be claimed on the return[.] (emphasis added)

The estate maintained that the penalty is based on the "net amount due" on the "date prescribed for payment." Because all of the tax had been paid by the extended due date, there was no "net amount due" on the "date prescribed for payment" and the failure to file penalty should have been a specified percentage of **zero**, so no failure to file penalty should have been imposed. Furthermore, the estate maintained that it had reasonable cause for the failure to file the return timely.

The IRS argued that the requirements of §6651(a)(1) and 6651(b) must be construed in connection with a general statute about the time and place for paying federal taxes, §6161(a), which provides the general rule that federal taxes should be paid "at the time and place fixed for filing the return (determined without regard to any extension of time for filing the return)." Section 6151(c) describes the meaning of "date fixed for payment of tax" as meaning the "last day fixed for such payment (determined without regard to any extension of time for paying the tax.)" The term

"date fixed for payment" of tax is used, for example, in §6161(b)(1)-(2) where it is clearly referring to the original date for payment of tax (e.g., §6161(b)(2) authorizes discretionary extensions of time for paying estate tax "for a reasonable period not to exceed 4 years from the date otherwise fixed for the payment").

The court observed that the IRS "cleverly reasons" that the last day for payment was March 10, 2014 and that the penalty should be based on the amount of tax unpaid on that date. "As such, the full payment of the estate tax on March 18, 2014 is of no avail because the 'last date fixed' was March 10, 2014."

The court rejected the IRS's "clever" argument because §6651(a)(1) is the statute that specifically addresses the late filing penalty and specifies that the "date prescribed" is to "be determined with regard to any extension of time for filing." The court reasoned that "the language of the statute in dispute is the one which is given precedence over a more generic statute like §6151." The IRS had also pointed out that "there is an administrative need to complete and close tax matters … [and] the matter, in the government's view, lingered and the administrative objective to timely close the file was not met." In effect, the IRS argued that the estate had lingered too long in filing the return and that penalties should therefore apply. Indeed, the court remarked on "the seemingly lackadaisical approach taken by Plaintiff to file the return." Even so, the statute says that the late filing penalty is based on a percentage of the tax that is not paid "on or before the date prescribed for payment of the tax," and the court's reaction was that "[t]here may be a need for some other penalty for failure to timely file a return, but Congress must enact the same."

The analysis could have ended there. But the court pointed out that the estate had requested the IRS to abate the penalties because the estate had reasonable cause for the untimely filing. The court's view in its October 2019 opinion was that the IRS's curt statement was insufficient and was arbitrary and capricious. The January 2020 opinion was less strident but reviewed various facts (that certain estate litigation was delayed due to the executor's health conditions and the estate had difficulty in securing appraisals) and concluded that reasonable cause existed for the filing delay.

c. **Prior Inconsistent Law**. Prior rulings and cases have adopted the analysis that §6151(c) applies and that the penalty is based on a percentage of the tax due on the original payment due date without considering extensions. The IRS announced that conclusion 38 years ago in Rev. Rul. 81-237, 1981-2 C.B. 245.

> Neither section 6651 of the Code nor the regulations thereunder specifically define the phrase "date prescribed for payment of the tax" with respect to the limitation in section 6651(b). However, section 6151(c) provides that any reference in the Internal Revenue Code to the date fixed for payment of such tax shall be deemed a reference to the last day fixed for payment (determined without regard to any extension of time for paying the tax). Therefore, the date prescribed for payment of tax for purposes of section 6651(b) is determined without regard to any extension of time for paying the tax.

That reasoning was followed by the Ohio District Court in *Estate of Ridenour v. U.S.*, 468 F. Supp.2d 941 (D.C. Ohio 2006) (reasoning under §6151(a) rather than §6151(c)). In *Liftin v. U.S.*, 754 F.3d 975 (Fed. Cir. 2014), footnote 1 explains that the estate did

not complain in the trial court or in the appeal about the IRS's use of the entire unpaid tax amount on the original payment due date in calculating the late filing penalty, and the court on its own motion asked about that issue at oral argument and requested supplemental briefing about §6151(c). A dissent concluded that no penalty should have applied where the entire tax had been paid by the time of the extended payment date. The court observed that in its supplemental brief, the IRS argued that §6151(c) precluded consideration of payments made after the original due date in calculating the late filing penalty (and the estate's supplemental brief about the issue reportedly made no reference to §6151(c) even though the court specifically asked about the applicability of §6151(c)). The court declined to address the question, though, seeing no reason "to depart from the important rules requiring timely presentation and development of issues." For a discussion of *Liftin*, see Phil Jones, *Federal Circuit Imposes Penalty on No-Tax-Due Return*, 121 J. TAX'N 170 (Oct. 2014).

d. **Reasonable Cause**. The failure to file penalty applies "unless it is shown that such failure is due to reasonable cause and not due to willful neglect." §6651(a)(1). The October 2019 decision reasoned that the IRS actions were arbitrary and capricious in denying the taxpayer's claim that reasonable cause existed for the delay. The January 2020 opinion applies a *de novo* standard of review rather than applying an "arbitrary and capricious" standard. Even so, the court looks to the same facts as were mentioned in the original opinion to conclude that the executor showed "reasonable cause for delay" in filing the return past the extended filing due date. Otherwise, the January decision is very similar to (and in large part identical to) the October 2019 opinion.

e. **Appeal Unlikely**. *Estate of Skeba* did not even cite, let alone attempt to distinguish, Rev. Rul. 81-237 or *Ridenour*. Even though the court's conclusion is directly contrary to those authorities, the likelihood that the IRS will appeal the case in an attempt to correct that court's analysis of §6151(c) is small because the court found that the estate had reasonable cause for the late filing in any event.

f. **Planning Pointers**.

- **Do Not Risk a Substantial Late Filing Penalty**. If the return is filed late (including extensions) without reasonable cause, a late filing penalty may be due even if the tax is timely paid (within the extended payment due date), and the late filing penalty can be very substantial. The penalty is 5% per month of the amount of tax that is unpaid "on the date prescribed for payment" and that is interpreted by the IRS (though the IRS position was rejected in *Estate of Skeba*) to mean on the original payment date, without considering any later payments made within an extended time for payment of the tax. The maximum 25% penalty is reached after only five months has passed without timely filing the return.
- **Timely Filed Return May be Important for Other Reasons**. If an estate owes no estate tax, while a late filing penalty may not be due if the estate owes no tax (or if all of the tax is timely paid by the original due, at least under the IRS interpretation), keep in mind that some elections may only be made on a timely filed return. *E.g.*, §2010(c)(5)(A) (portability election); Reg. §1.645-1(c)(1)-(2) (time for making §645 election to treat "qualified revocable trust" as part of the estate for income tax purposes). On the other hand, some elections must be made on

the first return filed if a return is not timely filed. Reg. §§20.2056(b)-7(b)(4) (QTIP election) and 20.2056A-3(a) (QDOT election). If the alternative valuation date election is not made on a timely filed estate tax return, it must be made on a return that is filed within one year of the due date (including extensions). Reg. §20.2032-1(a)(1). Some elections may be made on late-filed returns, without limit. *E.g.*, §2032A(d)(1) (special use valuation election for estates of decedents dying after 1981 does not have to be made on a timely filed return).

- **Do Not Risk Credibility by Appearing Cavalier About Timely Filing**. Even if no penalty applies for filing a return late, the preparer nevertheless should strive to obtain filing extensions. As in *Estate of Skeba*, an agent may be perturbed to the point of pressing for litigation if the taxpayer is cavalier and lackadaisical about filing a return with any degree of timeliness. However, filing extensions may only be granted for up to six months (except for certain exceptions for taxpayers who are abroad), so the estate tax return cannot be extended beyond 15 months after the date of the decedent's death. §6081(a).

29. Back to the Future: Family Governance in Estate Planning

Thomas C. Rogerson of Duxbury, Massachusetts, presented observations about the role of family governance, under the title of "Back to the Future." He noted that, even though for the last century estate **tax** planning has come to dominate what advisors and their clients – especially parents – seem to focus on:

> Before there were federal estate taxes there was **estate planning**, but it was about the people, the possessions, the process, the places, the memories, and the family purpose – family legacy and harmony. It wasn't just about the orderly and tax efficient distribution of and protection of an estate; it was also focused on the purpose of the decedent, the receivers (whether people or institutions), and the family.

Thus Tom went **"back"** to a time when there was no estate tax to worry about to focus on the **"future"** by **preparing the family for what's to come**. A major theme of planning should be "preparing the family for the wealth, not just preparing the wealth for the family." And because Tom has found that many people want to focus on this theme but have not heard about it from their advisors, he pointed out that this subject can also be a business-development or referral opportunity for advisors who offer it. Tom has found that it can be easier for someone to make a referral for this topic than merely to say something like "my attorney is better than yours" for an ordinary estate planning referral.

a. **Overall Problem and Objective**. At the 2019 Heckerling Institute, TD Bank polled attendees to learn the problems they encounter in representing and advising clients. According to this (unscientific) survey, the biggest problem identified was family conflict, not drafting documents. And "how do we avoid conflict **right now**?" Moreover, modern "hyper-individualism" (or "independence to the point of estrangement") makes people feel alone. It is important to join something, to be a part of a community. And one's first community is their **family**. "What you did is your history. What you set in motion is family legacy."

b. **Interdependence**. Using the Declaration of Independence as an example, Tom pointed out that it might better be viewed as a Declaration of **Inter**dependence. The pivotal assertion is that "**we** [not "I"] hold these truths to be self-evident." And the

very moving conclusion is that "**we mutually** pledge to each other **our** lives, **our** fortunes, **and** our sacred honor." Interdependence.

His materials include a graph showing the relationship between interdependence and wealth. He said that often when he explains this relationship people say "Wow, you're describing my family." At lower levels of wealth there is **interdependence by necessity**, reflected in shared assets. At the dinner table, conversations are consequential – if one family member borrows the family car, the others can't use it. And children all learn how to buy a car, because they hear their parents discussing the options and how to finance them.

At middle levels of wealth, there is little interdependence. Conversations are more social – for example, "how's your golf game?" These children don't learn how to buy a car, because their parents are reluctant to talk in their presence about spending those amounts of money. Money may not create the problem of separation and detachment, but it allows these conditions to persist.

At very high levels of wealth, interdependence is achieved, if at all, voluntarily and with understanding.

c. **Family Purpose**. The family should discuss the purpose of the family wealth. Tom has heard it said that "the last person that a client should see when they are doing estate planning is the estate planning attorney." Other substantive issues should be resolved first. Without that context, trusts, family foundations, family offices, and so forth can tear families apart. The discussions should start with the heart, not with the head.

d. **Family Meetings**. Tom warned that "if you're not having family meetings, you're extremely likely to fail." Make it about family – not about investment performance, estate planning, documents, money, and the like – especially at the first meeting. Celebrate people and family heritage and traditions. Build grace and trust as a bridge to drive the truck of truth over – be candid. In this way, you will build interdependence. Those meetings will then make it easier to have the meetings to talk about the estate plan and investments.

e. **Family Governance System**. The following elements are recommended for a family governance system:

- A family mission statement to serve as a guidepost for family decisions and actions.
- A family constitution and/or bylaws.
- A family council.
- A family advisory board of the family's "go to" outside advisors. This will acquaint the younger generations with the advisors and their various roles in the estate planning process and can thereby make the younger generation more comfortable with continuing relationships with those advisors after the older generation has passed away.

- Family governance policies for determining which family members vote, establishing procedures for making decisions and resolving conflicts, and developing a process for bringing in-laws on board.

f. **Six Steps to Healthy Family Governance**.

(1) **Self-Diagnose**. Before the first meeting, self-diagnose. Take the family through a personal and family assessment, assessing where they are today and what the gaps are between where they are and where they want to be.

(2) **Educate**. At the first meeting, educate. Show the assessment and cover what the family issues are and how to build buy-in to ownership and to empowerment ("BOE").

(3) **Style Assessment**. Take the family through a communication and leadership style assessment.

(4) **Values and Vision**. A big step is to take the family through a values exercise. Identify both the family values and a vision based on those values for the family going forward. Discuss a mission statement, strategy, and tactics.

(5) **Actions**. Encourage the family to select actions together that they are willing to take going forward. Examples are family philanthropy, family vacations, and family entrepreneurship.

(6) **Endow**. Endow this process. Taking the steps Tom recommends might be expensive, but perhaps not too expensive when compared to other ways money is spent. For example, over a 10-year period, if the investment portfolio is $20 million managed at a cost of 25-50 basis points, that cost is $500,000 to $1 million, attorneys' fees spent to save taxes might be $200,000-400,000, but often nothing is spent on governance.

Endowing the process is important because, even if the first generation is enthusiastic about this process and is willing to pay, for example, $90,000 a year to support it, the ball may be dropped when that generation dies and, for example, each of three kids doesn't want to contribute $30,000 a year. A "FAST" (described next) was recommended as a helpful vehicle.

g. **Family Advancement Sustainability Trust ("FAST")**. As a long-term approach to financing family governance, Marvin E. Blum (Fort Worth, Texas) described a Family Advancement Sustainability Trust ("FAST"). The FAST provides funds for future generations to manage their inheritance, finance family retreats and meetings, and train future generations in subjects like philanthropy and responsible stewardship. If possible, the FAST should be exempt from GST tax, and Marvin prefers to create it in a state with a strong directed trust statute. Often it will include an administrative trustee to keep records, file tax returns, and maintain custody of assets; an investment committee of, for example, two family members and a professional advisor; a distribution committee; and a trust protector committee.

The distribution committee might consist, for example (preferences will vary), of two family members, a legacy planning consultant, a like-minded peer to the settlor, and a professional advisor with knowledge of the family. Marvin views this committee as

the "guts" of the FAST, noting, however, that the FAST makes no distributions to beneficiaries as such – it pays for experiences, not things. (An exception could be when the FAST must make distributions to enable the beneficiaries to pay income tax when, for example, the FAST's payment of expenses for a family meeting is treated as taxable income to them.)

The role of the trust protector committee is to provide in the future for what we might miss in the drafting, even though we try to create a trust that lasts for several decades. This committee might consist, for example, of three professional advisors, such as the family's attorney, CPA, financial advisor, and/or trusted fiduciary. Family members may serve as consultants to the committee, but appointment of family members to the trust protector committee should be avoided in order to prevent the inadvertent creation of a general power of appointment.

In addition, Marvin recommends periodic peer review of the FAST, perhaps every five years. Administered by the trust protector committee, the peer review ensures that committee members are trained and remain accountable. The reviewers have no power other than to report.

The FAST can also be a good vehicle for holding shared-use real estate, like a vacation home, because it has sources of funds to pay the maintenance expenses (which may require greater funding of the FAST in that case), and the FAST committees can make the rules for determining use by the respective beneficiaries.

It is best if the FAST is created while the oldest generation (G1) is alive, but it may be better for G1 to just pay the expenses while they are alive. ("This is not just for the mega-wealthy. Everyone cares about saving their family.") Life insurance is useful for funding; it doesn't disrupt the rest of estate plan, and it preserves other assets for traditional inheritance purposes – that is, distributions. It can be second-to-die insurance, possibly including lives of G2 also. The insurance could be held in a separate life insurance trust, which pours into the FAST. It might be possible to repurpose an existing life insurance policy that is no longer needed for its original purpose.

Marvin suggested that maybe a 678 trust (a "BDIT") could be used to fund the FAST.

h. **Empowering Children**. Tom said it was important to let children make charitable contributions – perhaps $5,000 each, plus another $5,000 that they must agree on. Wendy suggested a "junior board" for the family foundation, consisting of younger generations with authority over a prescribed portion of the distributions. Likewise, Wendy suggested letting the next generation plan family vacations; give them a budget and let them make the plans and arrangements.

As for trusts, here is one approach. Assuming there are four children, create six trusts – one for each child, one donor-advised fund in which they all have a role, and one FAST as described in Item 29.g. above.

In other words, as the panel emphasized, build education at the family table, not an endowment to educate strangers or even a 529 plan to educate the kids somewhere else.

i. **Behavioral Health Issues**. Dr. Jonathan Green (Boston, Massachusetts) is the Chief of Clinical Operations at the O'Connor Professional Group; his specialties are addictive disorders, trauma, and complex mental health disorders. He affirmed the family governance structure as a helpful tool in identifying and treating depression, anxiety, substance abuse, and addiction. These problems are observed at higher rates in affluent families, where they are complicated by many factors, including money, isolation, social pressure and norms, parental and achievement pressure, status, and lack of purpose. Common family dynamics with behavioral health issues include denial, focus on crises, enabling or protecting patterns of behavior, lack of boundaries, attempt to control the uncontrollable, and sibling resentment.

The family governance system can help detect a health problem by recognizing such things as absence from or disruptive presence at social gatherings, business meetings, philanthropic discussions, and other family events; isolation and disconnection from siblings and parents; lack of a social network; inability to commit to completing any school, work, philanthropic, or recreational endeavor; legal issues; medical problems; job or school suspensions; overreaction to challenges; lack of coping skills; or overspending.

The family governance system can also provide the structure and discipline for staying proactive, before there is a crisis, by taking the following actions:

- Know the genetic history and predisposition towards behavioral health issues in the family.
- Talk openly with members of the family about their genetic history and what normal drinking and clinical stability look like.
- Discuss the impact on the family values and legacy of engaging in destructive behaviors.
- Create reasonable distributions of assets and systems of accountability to monitor spending, particularly for members of the next generation.
- Emphasize the importance of having a sense of purpose in the world.
- Get healthcare proxies and other releases for information before a crisis.

j. **Conclusion**. Marvin passed on this football analogy from James Grubman, a family legacy expert:

> Think of a football game. The focus is on the quarterback. The quarterback has perfect throwing skills. The football [the inheritance] is perfectly thrown to receivers [the next generations] at the other end of the field. But no one has prepared the receivers. In fact, they don't even tell them the ball is coming. ["They have never been to a practice," Marvin added.] As the ball comes their way, the receivers don't know how to catch it or what to do next if they do catch it. What are the odds the receiving team will catch the ball and carry it down the field to score a touchdown?

Family meetings and a family governance system, supported by a FAST, can train those receivers and increase the odds of success.

30. Horror Story of "The Fraud Plan" For Dealing With Art

Planners have all had conversations with clients who said not to worry about their art, it would disappear after their deaths. The client's children or others know to take the art immediately, not report it, and no one needs to worry about estate taxes on the art. Planners have to tell their clients that is fraud, and they are putting their family members at risk of committing tax fraud (this is "Go to Jail stuff").

Panelists described an actual real life story illustrating how badly this kind of plan can work out. A woman had a painting for her entire life. She always told her daughter not to report the art when she died, but to take it to the dealer down the street. She had talked with him for decades about the art and he agreed to "take it off her hands at the right price." After the mother died, the daughter took the painting to the dealer who purchased it from her for $300,000.

The following year, the daughter's CPA repeatedly questioned the daughter where the $300,000 in her bank account came from, and she came clean and said she sold her mother's painting to the dealer down the street. The CPA told her she would have to report the art as part of the estate and get an appraisal. She went to a reputable art group and asked for an appraisal.

"You have to tell your clients all the time – you cannot control the flow of art work or tangible personal property once it leaves their hands." That certainly happened here.

The dealer immediately took the painting to London with an auction house and it sold within 6 months for £865,000. For appraisal purposes, there is no better comparable for a work of art than the sale of the art itself, especially within six months of the date of death. So the appraisal value was £865,000. The daughter was distraught. She was subject to estate tax on the £865,000 as well as penalties and fees. The $300,000 the daughter received was immediately consumed by this process.

This is a horror story for everyone who thinks not reporting is the way to go. The worst part is that if the mother had obtained an appraisal where she could make an independent decision based on the accurate value of the item, she could have done smart estate planning and the daughter would have had an economic return that was more in line with the true value of the painting.

Courtney Booth Christensen (Winston Art Group in New York):

> "I can't tell you the number of times someone has asked me – 'Hi. My mother just died. What is the number of the white van service?'
>
> I say 'The white van? What do you mean?'
>
> The person says 'You know, the white van that shows up and takes the good stuff after mom and dad die.'
>
> It's not smart. It's not the thing to do."

31. Divorce Issues for Estate Planners

a. **"Gray Divorces."** Gray divorces refers to divorces for someone age 50 or older. The terms silver splitters and diamond divorcees also refer to divorces by older couples. Gray divorces now account for 25% of all divorces and the percentages of gray divorces is growing. In the last twenty years a doubling of gray divorcees has occurred, and a tripling of divorces has occurred for couples over age 65.

(1) **Reasons**. Reasons for the increase include (1) people are living longer, (2) changed circumstances (such as the empty nest or health issues), (3) divorce is less stigmatizing than previously, and (4) women have grown more financially independent so have more confidence to institute a divorce.

(2) **Unique Issues**. Issues that are unique, or at least more prevalent for gray divorces and during the pendency of the divorce for older people include (1) difficulty of recovering financially when divorce happens so late in life, (2) emotional loss after many decades of marriage, and (3) heightened risk that one party will die during the pendency of the divorce raising issues relating to intestacy, elective share, right to appointment as administrator, right to consent to health care, rights to joint-held accounts, and the ability to change beneficiary designations. (Under ERISA the participant's spouse must agree to name anyone other than the spouse as beneficiary. Divorce courts often entered an interim order enjoining any changes to life insurance policies during the divorce proceeding.)

(3) **Diminished Capacity**. Diminished capacity issues are also more likely to be present in gray divorces. Laws vary greatly regarding the interaction of guardianships and family law. Guardians are allowed to commence divorce proceedings in only 18 states. An important issue will be whether the state applies a "substituted judgment" standard (doing what the guardian reasonably believes the ward would do if able) or the "best interests" standard (doing what is in the best interests of the ward).

Mary Radford (Atlanta, Georgia) recommends the following best practices tips to enhance the decision-making ability of a client whose capacity is diminishing but not completely diminished.

1) Multiple short meetings

a) Ask the same questions and look for consistency

2) Time of day ("Sundowner's Syndrome")

3) Bright lighting and minimum background noise and interruptions

4) Speak clearly while facing client

5) Speak slowly and give client plenty of time to think before expecting a response

a) Don't finish the client's sentences for her

6) Avoid using legal terms without explaining them

7) Draw diagrams

8) Use larger font in documents

9) Offer the client alternatives to the client's desired course of action

a) Ask the client to reiterate those alternatives to you and why she has or has not chosen one

10) Allow clients ample time to review documents, both in advance and in the lawyer's office

11) Meet at client's home or facility in which client is residing

12) Without disclosing confidential information, consult with family members or caregivers as to how best to communicate with the client; when is best time to talk with client; how medications affect client, etc.

b. **Alimony and Voluntary Retirement**. Spousal support orders (alimony), ordered by a court or in a court approval of a settlement agreement, generally allow the court to modify or terminate the support obligation if the person seeking a change shows changed circumstances that warrant a modification.

Case law has developed the concept of "voluntary impoverishment" to address situations in which the payor no longer has the same ability to make support payments due to his her actions. These cases usually involve situations in which the payor is arguably voluntary unemployed or underemployed (but before an appropriate retirement age).

Is there an age at which a person should be able to retire and be able to be relieved of support obligations (or at least have them lowered)? What is that age? The customary retirement age used to be 65, but the full retirement age under the Social Security system is now age 67. Does it matter if the payor continues to work part-time? What consideration is given to the value of the assets each party has at retirement? What if the payee did little or nothing to feather his or her own nest to save any funds for retirement years (i.e., frivolous spending, financial mismanagement of assets, no initiative to earn income, etc.)? Few definitive answers exist to these questions. They are typically resolved by courts on a case-by-case basis. This is a highly litigated area with few certainties.

Alimony reform has been a growing trend of state legislatures and some of them have addressed retirement issues. Some states by statute limit permanent awards of alimony and end a payor's support obligation upon reaching retirement age. But many states have left to courts to decide whether retirement warrants modification or termination of a spousal award.

Attorneys representing couples who marry in younger years should anticipate the need for adjustment 25 or 30 years later, for example in retirement years. For example, a property settlement agreement could build in formulas for the adjustment of support after the payor reaches a specified age (such as 70).

c. **Trust Structuring Issues; Traditional Spendthrift Principles**. Under traditional trust law principles, trust assets will be more protected from claims of creditors of beneficiaries if the trust is a pure discretionary trust (rather than having ascertainable standards for distributions) and if the beneficiary is not the trustee (at least with a discretionary trust). In addition, spendthrift provisions provide protection against a beneficiary's creditors, but many states have adopted "exception creditors" including claims for child support and alimony that may reach trust assets despite the spendthrift provision.

UTC – Spendthrift Clause. Under the Uniform Trust Code, a spendthrift clause protects against a beneficiary's general creditors (§502(c)), but does not protect against exception creditors (including a spouse, child, a former spouse who has a judgment against the beneficiary for support or maintenance and certain others) (§503(b)). Exception creditors may obtain a court order attaching present or future distributions to or for the benefit of the beneficiary, which the court may limit as appropriate under the circumstances. §503(c). For support trusts (with a standard

for distributions that is *not discretionary*), a creditor apparently can seek to have a court compel the trustee to make a distribution under the distribution standard. *Cf.* §504(b) (trustee of *discretionary* trusts generally cannot be compelled to make distributions, whether or not a spendthrift clause applies).

UTC – Discretionary Trusts. The Uniform Trust Code also provides protection to discretionary trusts even in the absence of a spendthrift clause. §504(b). Furthermore, discretionary trusts protect against even exception creditors unless an abuse of discretion has occurred. §504(c). Discretionary trusts are trusts that give the trustee discretion in whether to make distributions, whether or not a distribution standard exists (such as for health, education, support, or maintenance) and whether or not the language of discretion is combined with language of direction (such as "shall, in the trustee's absolute discretion, distribute such amounts as are necessary for …"). *See* §506(a). For a trust with a standard of distribution that is also subject to the trustee's discretion, the trustee generally cannot be compelled to make distributions whether or not a spendthrift clause is present (even if the trustee has abused the discretion), but the trustee can be compelled to make distributions under the standard to satisfy a judgment for support or maintenance of the beneficiary's child, spouse, or former spouse (even if the trust has a spendthrift clause). §504(c). "Whether the trustee has a duty in a given situation to make a distribution depends on factors such as the breadth of the discretion granted and whether the terms of the trust include a support or other standard." §504 Comment. In any event, if a trustee voluntarily makes a distribution to a beneficiary, the assets can be reached by the beneficiary's creditors. §502 Comment.

Non-UTC States. In non-UTC states, a "pure" discretionary trust permits distributions under a trustee's "sole," "uncontrolled," or otherwise unlimited exercise of discretion, and does not include a governing standard for trust distributions. H.S. Shapo, G.G. Bogert, & G.T. Bogert, TRUSTS AND TRUSTEES §228.

Control as a Factor. Beneficiaries with substantial control over the trust who do not respect the trust formalities may subject the trust assets to potential creditor claims. *But see* UNIF. TRUST CODE §504(e) (creditors of beneficiary-trustee subject to ascertainable standard cannot reach trust assets). For example, assume that a beneficiary who is the trustee of a trust has an auto accident causing monumental damages and loses the tort trial resulting in a large judgment against him. The individual will likely be back in front of the same judge that tried the underlying tort case as the plaintiff tries to collect the judgment. The lawyer will ask if the individual was the sole trustee of the trust. Were proper trust procedures followed in administering the trust? Were trust accountings prepared? Were tax returns filed timely and correctly? Did the individual treat the trust as his personal checkbook? If the beneficiary/trustee has been sloppy in administering the trust, the trust may be penetrated. The trust does not provide absolute protection against creditors of the beneficiary. The fewer strings and less control that the beneficiary has over the trust, the more likely that the trust will stand up against creditor attacks on the trust.

Assets that would seem to be protected from beneficiaries' creditors under general spendthrift principles, however, may be more subject to claims in a divorce context.

d. **Increasing Attacks on Trusts in Divorce Proceedings**. The scenario described above with a trust beneficiary who has substantial control over the trust and who does not respect the trust also applies in the divorce context. The divorce judge in a court of equity is looking for equity and fairness and may be even more inclined than a judge in the traditional tort context to reach (or at least consider) the trust assets that are available to one of the spouses. Divorce courts apply equitable principles rather than traditionally accepted property law issues to which estate planners are accustomed. Family lawyers are taking CLE courses about how to find assets in trusts and how to attack trusts.

The issue can arise either in situations in which one of the spouses was the settlor of a trust or was the beneficiary of a trust established by a third party. In the settlor context, if one spouses creates a trust naming that spouse as a discretionary beneficiary in a DAPT state, will the trust assets be considered as marital assets? Or if one spouse makes a transfer to an inter vivos QTIP trust or to a SLAT for the benefit of the other spouse, will those assets be treated as a gift to the other spouse, or will they be treated as marital assets?

The protection that trusts afford in a divorce context varies substantially across the states, and the settlor will not know where the beneficiary may move and where the divorce proceeding will be. Clients should understand that trusts are not "divorce-proof," but things can be done in structuring the trust to provide the best arguments for protecting the trust assets in a divorce.

(1) ***Ferri v. Powell-Ferri***. Litigation in Connecticut and Massachusetts addresses the common law ability to decant in Massachusetts and the creditor effects (in a divorce proceeding) of decanting. *Ferri v. Powell-Ferri*, 72 N.E.3d 541 (Mass. 2017), followed the *Morse v. Kraft,* 466 Mass. 92 (2013), approach in finding that the broad discretion granted to trustees regarding distributions as desirable for the beneficiary's benefit and authority to "segregate irrevocably for later payment to" the beneficiary included by inference the power to decant to a new trust for a beneficiary, and the court could consider the affidavit of the settlor in making the determination of intent to allow a decanting power. The issue had been certified to the Massachusetts high court from the Connecticut Supreme Court in a divorce case. For a discussion of the *Ferri* case, see Item 30 of Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(2) ***Pfannenstiehl v. Pfannenstiehl***. The *Pfannenstiehl* divorce litigation in Massachusetts is illustrative of the issues that can arise regarding trust interests in the third-party context. The trial court considered the husband's interest in a discretionary spendthrift trust created by his father as a marital asset, and ordered the husband to pay about $1.4 million from the trust to his wife. The trust provided for distributions to husband and the father's other descendants for their "comfortable support, health, maintenance, welfare and education" in the trustee's "sole discretion" as they "may deem advisable from time to time." The Massachusetts Supreme Judicial Court reversed the trial court's prior finding that the trust interest was part of the marital estate. The court did leave open two important issues for the trial court's consideration on remand: (i) the trust could be considered as an expectancy in determining how to divide the assets that are subject to division, and

(ii) the court could revisit whether alimony is now appropriate in light of "any future stream of [trust] income from distributions." *Pfannenstiehl v. Pfannenstiehl,* SJC-12031, (Mass. Sup. Jud. Ct. Aug. 4, 2016). For a more detailed summary of *Pfannenstiehl*, see Item 7.i. of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.Bessemer.com/Advisor**.

(3) ***Levitan v. Rosen***. *Levitan v. Rosen*, 124 N.E.3d 148 (Mass. Ct. App. 2019), is consistent with established Massachusetts precedent, holding that "the wife's trust interest may properly be considered an asset subject to equitable distribution." The trust for the wife was created by her parents. The fact that she had a 5% annual withdrawal power and a nongeneral testamentary power of appointment appeared to make no difference to the court. Because the beneficiary was domiciled in Massachusetts and this involved a Massachusetts divorce, Massachusetts law applied despite the governing law specified in the agreement (Florida) or where the trust was administered. The court ruled that Massachusetts law made "the wife's entire interest in the trust, including her annual right to withdraw trust principal … part of the marital estate" for purposes of equitable distribution. However, the trust also contained a spendthrift provision, and the court concluded that "[t]hough the wife's share of the trust is includable in the marital estate, it may only be assigned to the wife in light of the spendthrift provision." Therefore, the wife would receive less of other marital assets. The case does not address what would happen if the trust interest was worth more than the combined value of all the other marital property.

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

32. Planning for Peripatetic Clients

a. **Significance – Many People Are Moving**. From a U.S. population of about 307 million people over one year of age, 35.9 million Americans (11.69%) moved between 2012 and 2013, and 4.77 million of those moved to a different state (statistics from the United State Census Bureau).

b. **Non-Legal Effects**. Non-legal reasons for moves include (i) medical conditions, (ii) being close to family, (iii) job opportunities, (iv) preferred lifestyle and recreational opportunities, and (v) cost of living. For older persons, consider that nursing home costs may be three to five times higher in some states (e.g., Alaska and Connecticut) than others (e.g., Oklahoma).

c. **Miscellaneous Legal Effects of Residency**. A person's residence can have profound legal effects. Examples of effects include state income and estate taxation, marital rights, entitlement to government assistance (like Medicaid), freedom to dispose of property, inheritance rights, execution of testamentary documents, post-mortem rights to publicity and likeness (California recognizes that but many states don't), probate procedures, ability to serve as a fiduciary, ability to control burial rights and medical decisions, ability to mandate arbitration, ability to disinherit someone, in terrorem clause validity, and creditors' rights (e.g., state exemption statutes, DAPT laws).

d. **State Estate Taxes**. About one-third of the states now have state estate taxes, but a few impose inheritance taxes (e.g., Kentucky and Pennsylvania). See Item 38 Below.

Generally, only the state of domicile can tax intangible personal property owned at death.

Multiple states may claim that the person is domiciled in the estate and subject to that state's estate taxes. Famously, in the 1930s Mr. Dorrance was held to be a resident of both New Jersey and Pennsylvania. *In re Dorrance's Estate*, 309 Pa. 151, 163 A. 303, *cert. denied*, 287 U.S. 660 (1932).

A difficult practical problem in these situations is that evidence used in the initial proceeding in State 1 to demonstrate that the decedent was the resident of State 2 will be used against the estate in the subsequent proceeding in State 2.

The burden of proving a change of domicile is on the person asserting the change, and the evidence must be clear and convincing.

e. **State Income Taxes**. Dramatic differences exist among the states regarding state income taxes. Changing income tax residency usually requires significant lifestyle changes, especially time spent in the new state. State taxing authorities have a way of finding people. The state will obtain cell phone records, car registration, plane tickets, etc. to find out where the person has been spending time. "Don't think you can fool them."

A person can be subject to income tax in various states. For example, a person domiciled in Connecticut is subject to state tax on worldwide income, but if the person spends more than 183 days in New York and had a permanent place of abode available for use, the person is also subject to New York income tax.

Transferring non-compensation income producing assets to an incomplete non-grantor (ING) trust is a way of minimizing state income tax if the trust is not subject to state income taxation in the state (and the *Kaestner* Supreme Court case confirms that a state must have significant contacts with a trust in order to tax its income). New York has passed legislation treating incomplete non-grantor trusts created by New York residents as grantor trusts for New York income tax purposes. That statute does not apply with respect to completed gifts to the trust (which may be a viable alternative for many with the availability of the very large $11+ million federal gift exclusion amount). Rev. Proc. 2020-3 adds certain ING trusts to the no-ruling list (see Item 6.c. above). A variety of PLRs over the last several years have approved ING trusts. *E.g.*, Letter Rulings 201925005-201925010.

d. **Marital Rights**. Variables among the states regarding marital rights include the grounds for divorce, property rights considered in divorce proceedings, pre- and post-nuptial agreements (for example, post-nuptial agreements are not recognized in Ohio), and spousal rights generally on divorce and at death. (Georgia provides the least marital rights at death, with no community property or spousal elective share rights). See Item 31 above regarding the impact of divorce on trust planning.

Clients moving from a community property state to a non-community property state may continue to have "community property rights" in the property, but will it be recognized as community property for tax purposes (i.e., for purposes of

§1014(b)(6))? Cf. Letter Rulings 202006002-006 (community property in ING trust remains community property at first spouse's death for basis adjustment purposes). In that situation, consider transferring assets to a community property trust recognized under the laws of a few states.

e. **Creditors Rights**. Jonathan Blattmachr suggests that Florida is the best debtor state (having tenancy by the entireties, unlimited homestead, broad listing of other exempt assets including the cash value of life insurance and annuity contracts), and California is the worst.

Nineteen states now have domestic asset protection trust statutes (see Item 18 above).

A possible planning alternative is for a person to contribute assets to a trust that does not permit distributions to the grantor, but grants to someone who does not otherwise have an interest in the trust a special power of appointment exercisable in a non-fiduciary capacity that is broad enough to be exercised in favor of the grantor. Jonathan Blattmachr recommends that "[a]lthough, in theory, such a trust should be protected from the grantor's creditors in all jurisdictions, including those which do not have asset protection trust legislation, it is recommended that the special power of appointment trust (SPAT) be created in one that does have such legislation." *See generally* O'Connor, Gans & Blattmachr, *SPATS: A Flexible Asset Protection Alternative to DAPTs*, 46 EST. PLAN. 3 (Feb. 2019).

f. **Specific Steps for Establishing Domicile**. Jonathan Blattmachr recommends considering the following to help in establishing one's domicile (either changing domicile or to build evidence that an established domicile is not changed if the person has contacts with another state).

- Spending a significantly greater portion of each year (Jonathan recommends twice as much) in the new (or established) domicile state.
- Acquiring a more substantial home in the new (or established) domicile state.
- Disposing of any home in the former domicile (or non-domicile) state and renting (not buying) another home in the former domicile state and, if possible, renting for only part of the year.
- Registering and voting in the new (or established) domicile state.
- Executing and filing a declaration of domicile with the appropriate office in the new (or established) domicile state.
- Revoking any declaration of domicile made in any other state.
- Declaring the new (or established) domicile to a United States census taker.
- Filing all tax forms at the IRS service center for the new (or established) domicile state.
- Filing a final (so marked) resident tax return in the former domicile state (and city, if applicable).
- Signing a new Will (and other documents) declaring the new (or established) domicile.
- Paying all taxes as a resident of the new (or established) domicile state.
- Registering cars, boats, etc. in the new (or established) domicile state.
- Acquiring a driver's license in the new (or established) domicile state and surrendering any issued in other states.
- Obtaining non-resident license privileges (e.g., fishing license) in non-domicile states.

- Resigning from, or changing to non-resident status for, clubs, churches, etc. in non-domicile states.
- Changing all documents, subscriptions, passport, listings (e.g., in Who's Who) etc. to reflect the new (or established) domicile state.
- Relocating personal belongings and family pets.
- Taking all other steps to show that the center of his or her activities has been changed to the new (or is established in the) domicile state.

33. Special Needs Trusts

a. **When Special Needs Trust Provisions Are Needed**. Means-tested public assistance programs (the two primary ones are Supplemental Security Income (SSI) and Medicaid) impose financial restrictions on qualifying for assistance. For most of the programs, the recipient cannot have more than $2,000 of "resources." The concern about having too many countable "resources" applies only if the person is receiving (or anticipating receiving in the future) means-tested public assistance. If the person is not receiving means-tested assistance or might possibly need it in the future, special needs provisions are not necessary in trusts.

b. **Importance of Access to Programs Available Only to SSI or Medicaid Recipients**. Some people with considerable wealth may think that a child or other relative with special needs would never be so impoverished that he or she would need to qualify for SSI or Medicaid. However, some of the best programs for individuals with special needs are only available to persons who qualify for SSI or Medicaid – and no amount of money can buy access to those outstanding programs. Without available government assistance, many special needs individuals literally will die. Available benefits include not just financial benefits, but various other important benefits such as medical care, transportation, training, group living facilities, and case management. Maintaining SSI and Medicaid eligibility is incredibly vital to the individual to get these other important benefits essential to living.

c. **Self-Settled Special Needs Trusts**. Self-settled special needs trusts (created by the beneficiary) must meet several requirements in order for the trust assets not to be counted as resources. The requirements include that (i) the beneficiary is under age 65, (ii) the trust is for the sole benefit of the settlor-beneficiary, and (iii) at the beneficiary's death, any trust assets must be used to repay any Medicaid assistance received (excess assets may pass to successor beneficiaries). Including a reimbursement provision is essential in self-settled special needs trusts but is not needed (and generally should not be done) in third party trusts.

d. **Keys to Drafting Third Party Special Needs Trusts**. A third party (created by someone other than the beneficiary) special needs trust does not need to include the three requirements mentioned immediately above for self-settled trusts. Three keys to drafting third party special needs trusts are (i) do not impose a duty on the trustee to support the beneficiary (discussed below regarding the appropriate distribution standard that should be used), (ii) do not give the beneficiary the power to access trust principal, and (iii) clearly express the settlor's intention to supplement, but not supplant, means-tested public assistance.

One panelist recommends (1) not including "Special Needs Trust" in the title of the trust, and (2) authorizing the trustee to fund an ABLE account for the beneficiary.

e. **Special Needs Distribution Standard**.

(1) **Mandatory Support Standard Does Not Work**. A mandatory "support" standard (e.g., "the trustee shall distribute income or principal as is necessary for the education or support of the beneficiary") should never be used in a special needs trust or else the trust assets will treated as countable resources of the beneficiary.

(2) **Discretionary Support Standard May or May Not Work**. A discretionary support standard (e.g., "as the trustees in their sole discretion shall deem proper for the beneficiary's health, support in reasonable comfort, best interests and welfare") may or may not work depending on the actual facts of the situation. A trust with that standard did not work in *Corcoran v. Dep't of Soc. Servs.*, 271 Conn. 679, 859 A.2d 533 (2004). The court reasoned

> Thus, the trustees' "sole discretion" is limited by the ascertainable standard of the plaintiff's "health, support in reasonable comfort, best interests and welfare…." … Absent the requisite testamentary intent to provide only for the plaintiff's supplemental needs, we agree with the department and conclude that the trust in question is a general support trust [and] … the trust corpus and income were available to the plaintiff for the purpose of determining her medicaid eligibility.

(3) **Purely or Totally Discretionary Standard Usually Works But Not in Some States**. A distribution standard giving the trustee total discretion whether to distribute assets to or for the benefit of a beneficiary, which would not give the beneficiary a right to compel a distribution, generally works to keep trust assets from being treated as countable assets. A Kansas statute, however, eliminated the use of a purely discretionary trust standard in a third party trust that benefits a person who is receiving Medicaid benefits.

(4) **Special Needs Distribution Standard**. Every state honors a special needs distribution standard to keep the trust assets from being counted as resources for Medicaid and SSI purposes. There are two types. The first is a strict special needs standard, an example of which is as follows from an actual Ohio case (*Young v. Ohio Dep't of Human Serv.* (1996)):

> The Trustee shall pay such amounts of the net income and, if necessary, principal of this Trust as she deems necessary for the benefit of JANET LEE YOUNG, *provided, however, that the Trustee shall not make any distributions of income or principal for the benefit of JANET LEE YOUNG which shall render her ineligible or cause a reduction in any benefit she may be entitled to receive, including, but not limited to, the following: institutional care provided by the State or Federal government, Social Security, Supplementary Security Income, Medicare, and Medicaid.* * * * Distributions of income or principal to or for the benefit of JANET LEE YOUNG shall be made liberally and generously, *but not for the purpose of providing for anything which could otherwise be provided for her by governmental or other assistance.* (Emphasis added)

Some strict special needs distribution clauses also add prohibitions on making distributions for "food or shelter" of the beneficiary.

The second type, which is actually preferred, uses a discretionary special needs standard, such as

> It is preferred that the Trustee not make distributions from the trust that cause a reduction or loss of any public assistance the beneficiary is receiving or entitled to receive. However, if the Trustee, in its sole discretion, determines that any distribution from this Trust will benefit the beneficiary and is in the beneficiary's best interest, then the Trustee may make that distribution even if doing so will cause a reduction or loss of public assistance benefits the beneficiary would otherwise receive or be entitled to receive.

f. **Clearly Express Intention Merely to Supplement Benefits**.

In addition to using a special needs distribution standard, the trust should also clearly express the settlor's intention regarding the use of the trust to supplement, but not supplant, the beneficiary's means-tested benefits. Craig Reeves (Kansas City, Missouri) describes this as "[p]ossibly the most important key to drafting a third party-settled special needs trust."

The North Dakota Supreme Court referred to such a clause, quoting the clause itself, as follows.

> Other plain language in the trust instrument demonstrates Wilhelmina Hecker's clear intent that the trust not be used for Herman's primary support. The trust unequivocally states that it is to be "a supplemental fund to public assistance," and that
>
> > "[i]t is the Grantor's express intent that because the beneficiary is developmentally disabled and unable to support and maintain himself independently, the Trustee shall, in the exercise of the Trustee's best judgment, seek support and maintenance from all available public resources, including the appropriate Regional Center for the developmentally disabled. In making distributions for the special needs defined herein, [the] Trustee shall take into consideration the applicable resource limitations of the public assistance programs for which the beneficiary is eligible."
>
> This language plainly indicates an intent not to provide primary support or maintenance for the beneficiary. … Rather, this language is consistent with what a number of jurisdictions now refer to as a special needs trust or supplemental needs trust [SNT].

Hecker v. Stark Cty. Soc. Serv. Bd., 527 N.W.2d 226, 230 (N.D. 1994).

Clauses suggested by a panel discussing trust drafting are as follows:

> It is my intention that no part of the income or principal of this trust be used to supplant or replace public assistance benefits of any county, state, federal, or governmental agency that may otherwise be available to a beneficiary of the trust. For purposes of determining the eligibility of any beneficiary for any county, state, federal, or governmental agency benefits, no part of the principal or income of this trust may be considered available to such beneficiary and Trustee will deny any request by any public or governmental department or agency to release principal or income for which benefits would be available in the absence of this trust. Provided, however, this paragraph will not apply to any trust described in sections 2056, 2056A or 664 of the Code or to the extent it would cause the loss of a charitable or marital deduction or prevent the beneficiaries of my estate plan from being a "designated beneficiary" as defined in the regulations.
>
> Notwithstanding the other provisions of this Article, after [my child's] death, if any share is created for a beneficiary with a disability, regardless of age, who is receiving public assistance benefits because of such disability at the time of distribution, or, in the discretion of the Trustee, will likely become eligible in the future for public assistance benefits, then, instead of any other provision herein for the distribution of such beneficiary's share, the terms of this paragraph will control. The Trustee will pay over such beneficiary's share to the Trustee of an existing third-party special needs trust for the benefit of such beneficiary, or will establish a third-party special needs trust for such beneficiary to receive such share (including without limitation a private trust or a pooled trust account such as the [State Pool Trust]). The special needs trust selected by the Trustee to receive such share (whether then existing or established by the Trustee as a private trust or an [State Pooled Trust] or other pooled trust) must be established for the benefit of such beneficiary, with

income and principal to be applied for such beneficiary during such beneficiary's lifetime, in the complete discretion of the Trustee taking into account other resources and public assistance benefits available to such beneficiary, with any remaining funds in such trust or pooled trust account upon such beneficiary's death to be distributed in the same manner and to such beneficiaries as would have received such beneficiary's share hereunder if such beneficiary had predeceased [my child]. The Trustee has the authority to pay over the share, or a portion thereof, to an ABLE Act account for such beneficiary.

g. **Third Party Special Needs Trust for Spouse Must be Established By Will**. If a special needs trust is created by the settlor for the settlor's spouse, if the trust is not created by the settlor's will, it will be treated as a self-settled trust created by the spouse and therefore subject to the special requirements for self-settled special needs trusts. 42 U.S.C. §1396(d)(2)(A) (created by OBRA '93).Therefore, a third party special needs trust for the settlor's spouse must be created by the settlor's will, i.e. it must be a *testamentary* trust.

h. **ABLE Accounts**. ABLE accounts were authorized in 2014 legislation. They are tax-advantaged accounts (income on the account is not taxed) that can make distributions for "qualified disability expenses" of the beneficiary, which is limited to individuals with a disability whose disability began before turning 26 years of age. The key is that the account funds are generally not treated as a resources for purposes of SSI and Medicaid eligibility.

The total allowed contributions are $15,000 (inflation adjusted) per year, but a disabled person that earns income can also make contributions to the account up to the lesser of the earned income or the poverty line limit (generally about $12,490 in 2020). States set limits on the total account size. The first $100,000 of the account is exempted from the SSI $2,000 individual resource limit. If the account is over $100,000, qualification for SSI benefits is suspended until the account falls below $100,000, but eligibility for Medicaid medical assistance is not suspended.

Qualified disability expenses are defined broadly and include expenses for education, housing, transportation, employment training and support, assistive technology, personal support services, health care expenses, financial management and administrative services, and other similar expenses for improving the quality of the beneficiary's life.

The practical advantage of the ABLE account is that the account can afford a degree of self-control and personal autonomy because the beneficiary can pay directly for some expenses from the account without having to involve the trustee of the special needs trust for every expense that comes up. High-functioning disabled beneficiaries will enjoy that freedom.

h. **Resource**. For a summary of special needs trust planning considerations, see Items 50-57 of the ACTEC 2011 Fall Meeting Musings summary found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

34. Privilege, Information Security, and Ethics Issues for Estate Planners

a. **Rationale of Privilege Doctrine; Resource**. The underlying rationale of the attorney-client privilege doctrine is that lawyers can effectively represent clients only if a free flow of information exists between the client and lawyer.

For a general discussion of practical issues and best practices surrounding the attorney-client privilege and work product doctrines, see Items 13-17 of the ACTEC 2017 Fall Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Distinction from Confidential Information**. The lawyer's duty to maintain confidences is an ethical duty. The attorney-client privilege is an evidentiary doctrine, typically defined by statute. Communications subject to the confidentiality restriction are not necessarily privileged in a litigation context.

c. **Essential Elements; Waiver**. Three essential elements of the attorney-client privilege are (1) the existence of an attorney-client communication, (2) in which legal advice is communicated, and (3) that is kept in confidence.

While the privilege belongs to the client, it can be waived by others, such as agents of the client or the attorney. The most common cause of waiver is when third parties participate in the communication, and third party waiver can be especially common in the estate planning field (by including investment advisors, insurance representatives, caregivers, etc. in communications). The proponent of claiming privilege bears the burden of showing that the communication has been kept confidential.

The presence of third parties will not waive the privilege if their presence facilitates the legal representation. Examples include agents of the client or lawyer, a translator, or other "facilitators" needed for rendering of the legal advice.

d. **Testamentary Exception**. The attorney-client privilege generally survives the client's death, protecting client communications with the attorney no matter how relevant to the subsequent proceeding. The testamentary exception exists if the communication is relevant to an issue between parties who claim an interest through the same deceased client. The rationale of the exception is that "the decedent would have wished full disclosure to facilitate carrying out the client's intentions." RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §81. That logic of the exception would extend to revocable trusts as well.

Not all jurisdictions recognize the testamentary exception. Generally, the law of the forum, where a lawsuit is proceeding, will control as to evidentiary issues, even if the communication occurred in another jurisdiction. Estate planning attorneys must be aware that the privilege issue may arise in a lawsuit in a jurisdiction where the exception is recognized, and no privilege would exist as to testamentary matters. *See Huber v. Noonan,* 2018 WL 5262368 (Pa. Super. Ct. Oct. 23, 2018) (disclosure of communication with attorney in Pennsylvania allowed in legal proceeding in Florida).

e. **Fiduciary Exception**. The fiduciary exception to the attorney-client privilege recognizes that a communication is not privileged in a proceeding alleging a breach of trust by a fiduciary "if the communication (a) is relevant to the claimed breach; and (b) was between the trustee and a lawyer … who was retained to advise the trustee concerning the administration of the trust." RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS §84 (2000). The exception is grounded in two rationales: (1) the beneficiary is the lawyer's "real client," or (2) the trustee has a duty to disclose information to the beneficiary and that duty extends to the trustee's communications with its lawyer.

The fiduciary exception in the U.S. traces back to *Riggs National Bank v. Zimmer*, 355 A.2d 709 (Del. Ch. 1976) (three factors considered are (1) purpose of the legal advice, (2) whether litigation was pending or threatened between the trustee and beneficiaries at the time of the advice, and (3) whether the trust or the trustee paid for the legal advice).

The beneficiary may argue that the attorney is being paid by the trust for the beneficiary's benefit, so the beneficiary should be able to access any communications between the lawyer and the fiduciary. The counterargument is that the purpose of the privilege is to facilitate communications between a lawyer and fiduciary, and that the beneficiary is not necessarily entitled to access those communications.

A distinction made in some jurisdictions is whether the communication was intended to protect the fiduciary against a breach of duty claim by beneficiaries (in which case the exception would not apply and the communication would remain privileged). The scope of the fiduciary exception to the attorney-client privilege doctrine varies from jurisdiction to jurisdiction. Having the fiduciary pay individually for legal services for advice for the protection of the fiduciary enhances the likelihood that the exception will not apply. *See Mennen v. Wilmington Trust Co.*, 2013 WL 4083852 at *4-5 (Del. Ch. July 25, 2013) (whether the trustee personally paid for the advice usually is not dispositive).

The application of the fiduciary exception varies widely throughout the states. Florida and South Carolina recognize it by statutes. Decisions in some states accept it (e.g., Arizona, South Carolina, Pennsylvania), but in other states reject it (e.g., California and Texas). So far, Illinois courts have discussed the issue but have not clearly accepted it. The exception is recognized by the RESTATEMENT (THIRD) OF TRUSTS §82, but the UTC takes no position on the exception. UTC. §813, comments.

Court have generally held that the attorney-client privilege with fiduciaries passes to a successor trustee. However, even in jurisdictions that accept the fiduciary exception, a successor trustee is not entitled to receive privileged communications with the predecessor in the predecessor's personal capacity.

f. **Emphasize Privilege Significance to Client and Third Parties**. At the outset, the attorney should emphasize to the client how the privilege concept is protected and the importance of not disclosing attorney-client communications with third parties. "It is not because I don't like your friend/son/spouse/accountant. We must be careful throughout about preserving the privilege."

Third parties (such as other advisors for the client) must understand that necessarily a tension will exist between the concepts of collaboration and privilege and that facilitating the free flow of information is not always consistent with maintaining privilege.

The attorney may consider sending the client a note like this:

> Your communications with us about the substance of our representation will ordinarily be protected by the attorney-client privilege, meaning that neither you nor we will be required to disclose them to anyone. But the privilege can be waived if we disclose our communications to a third party, and if that happens, *[insert names of opposing party or people client views as adverse]*,

creditors, or someone else could gain access to them if you end up in litigation. So please make sure that you keep our emails and other written communications private. The same goes for things we say to each other in person or on the phone.

g. **Avoid Work Email Systems**. Clients should be advised not to use their work email system when communicating with attorneys. Most employers have policies that the email system can be accessed by company representatives, and various cases have held that a reasonable expectation of privacy may not exist and therefore the privilege does not attach to communications over a work-based email system. The same issue may exist with communications sent or received on a work computer. The safest approach is to restrict attorney-client communications to the client's personal email and personal computer.

h. **Protective Order**. If asked to disclose privileged information (or information that may be privileged) in a legal matter, always ask for a protective order. Almost any litigator is willing to give a protective order saying that the waiver of the privilege is limited to the particular litigation and only to the parties involved. That may help to protect against a claim that that the privilege has been waived in a subsequent matter.

i. **Information Security Best Practices**.

- Create strong passwords or use a password manager.
- Make sure that a device used for confidential information can be remotely locked or wiped if it is lost or stolen.
- Get a screen shield for the computer so others sitting nearby cannot read the screen.
- Do not use flash drives for personal or client information; they can easily be lost.
- When using shared computers, be sure to log off fully after use.
- If using WIFI, consider using a virtual private network (VIN) to enhance security.
- Do not talk about confidential matters in a room with Alexa or some other digital assistant.

j. **Practice Tips Re Discoverable Information**. Stacy Singer (Chicago, Illinois) points out several practical daily practice tips regarding discoverable information.

(1) **Voicemail**. Most voicemail systems are now "voice over internet," which means that all messages get saved. So don't think that voicemail is safer.

(2) **Personal Phone**. If a client texts you information on your personal phone, your personal phone is fully discoverable with everything on it.

(3) **Calendar Invites**. Be careful about descriptions in calendar invites. People may be very careful about what they write in emails, but then go into detail about problem issues to be discussed in a meeting when sending the calendar invite. That is discoverable.

k. **Preservation and Spoliation**. If litigation is reasonably anticipated, clients and attorneys have a duty to preserve evidence relating to the litigation. Failing to preserve material evidence is known as spoliation.

The types of communications that must be preserved are interpreted very broadly to include, for example, email, text messages, word processing documents, spreadsheets, Facebook posts, etc. Clients should turn off any "auto-delete" functions in their email accounts after being told of the need to preserve communications. Institutional clients should issue a written "litigation hold" to people who might have potentially relevant documents and exclude such documents from any routine document destruction protocols.

Attorneys or others may need to preserve communications even when litigation is not anticipated, in order to reconstruct what was told, what was considered, the advice given, and actions taken. Texts can be especially difficult to manage because they're more difficult to save. Some firms adopt a "no texts" policy.

l. **Speed Kills**. Be wary of responding too quickly to email requests for advice. Advice often concerns situations that are factually and legally complex, and opining before appropriate analysis can lead to disaster. A large percentage of malpractice lawsuits arise from such communications. "Before hitting 'send,' ask yourself whether you would be comfortable if your text or email ended up as an exhibit in a lawsuit."

35. Qualified Opportunity Funds

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

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

b. **General Description of Income Tax Benefits**. Two new Code sections, §1400 Z-1 and §1400 Z-2, provide federal income tax benefits for investing in businesses that are located in "opportunity zones" in distressed low-income communities that were previously identified. Potentially three income tax benefits arise from investing in a qualified opportunity fund.

(1) Deferral of existing gain until December 31, 2026 if an amount equal to the deferred gain is invested in a qualified opportunity fund;

(2) The possible exclusion of 10% or 15% of the deferred gain if the qualified opportunity fund investment is held at least 5 or 7 years, respectively; and

(3) The possible nonrecognition of gains in the fund investment itself if the fund investment is held at least 10 years.

For a further discussion of these advantages and an overview of requirements of qualified opportunity funds, see Item 29 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

c. **Proposed and Final Regulations.** A first set of proposed regulations was issued on October 19, 2018, and Rev. Rul. 2018-29 was issued contemporaneously. A second set of proposed regulations was issued on April 17, 2019, which made some changes to the 2018 proposed regulations and addressed a number of additional issues. *See generally* Lisa Starczewski, *The Second Set of Proposed Opportunity*

Zone Regulations: Where Are We Now?, BNA BLOOMBERG TAX MNGT. MEMO. (April 22, 2019). Final regulations were issued in December 2019. T.D. 9889, 84 FED. REG. 18652 (Jan. 13, 2020). The final regulations apply for taxable years beginning after March 13, 2020, but taxpayers may elect to apply them earlier.

d. **Inclusion Events; Gifts as "Inclusion Events."**

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

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

> Except to the extent provided in paragraph (c)(5) of this section [relating to grantor trusts], a taxpayer's transfer of a qualifying investment by gift, as defined for purposes of chapter 12 of subtitle B of the Code, whether outright or in trust, is an inclusion event, regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift. Reg. §1.1400Z2(b)-1(c)(3)(i).

This is quite surprising because the statute includes in income only the gain represented by an investment that is "sold or exchanged," and traditionally accepted principles do not treat gifts as sales or exchanges. The preamble to the proposed regulations made no effort to explain this discrepancy other than to misstate the statute as applying to any "disposition" of the owner's qualifying investment. Prop. Reg. Preamble at 55. The rationale given in the final regulations is 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." Reg. §1.1400Z2(b)-1(c)(1)(i). The preamble to the final regulations explains:

> 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.

Without the rule in the regulation treating a gift as an inclusion event if it changes the taxpayer, all recognition of the deferred gain could be avoided just by making a gift.

e. **Gifts and Nonrecognition Event Transfers to Grantor Trusts**. Even though gifts are generally treated as inclusion events, the regulations make an exception for gifts to grantor trusts. Reg. §1.1400Z2(b)-1(c)(5)(i). (The regulations more precisely refer to

trusts with a "deemed owner," thus apparently including trusts with a deemed owner under §678 as well as traditional grantor trusts; references to grantor trusts in this discussion include §678 trusts.) The rationale for this exception is explained by the preamble to the proposed regulations:

> The rationale for this exception is that, for Federal income tax purposes, the owner of the grantor trust is treated as the owner of the property in the trust until such time that the owner releases certain powers that cause the trust to be treated as a grantor trust. Accordingly, the owner's qualifying investment is not reduced or eliminated for Federal income tax purposes upon the transfer to such a grantor trust. However, any change in the grantor trust status of the trust (except by reason of the grantor's death) is an inclusion event because the owner of the trust property for Federal income tax purposes is changing. Preamble at 55-56.

The final regulations also add that "a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event…. 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." Reg. §1.1400Z2(b)-1(c)(5)(i). (The deleted sentence clarifies that this exception applies for "wholly" grantor trusts.)

An interesting aside of this position is that extending the nonrecognition event transfers exception to deemed owner trusts seems to be an implicit suggestion that the IRS would apply the rationale of Rev. Rul. 85-13, 1985-1 C.B. 184, to transfers by third party deemed owners to §678 trusts. *See Recent Developments* 2019, at 28-29, 54TH ANNUAL HECKERLING INST. ON ESTATE PL. (2020).

The preamble to the final regulations, in explaining the nonrecognition event exception, hints that the exception would apply to sales to grantor trusts, as well as other nonrecogntion events.

> 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.
>
> Preamble at 95.

Such transactions between a grantor (or deemed owner) and a grantor trust could include "sales to grantor trusts, in-kind note payments from a grantor trust to the grantor, the grantor's exercise of the power to substitute assets with a grantor trust, and distributions of QOF interests to the grantor from a grantor retained annuity trust ('GRAT') in satisfaction of annuity payments." Kevin Matz, *How the Final Regulations on Qualified Opportunity Funds Come Out on Trust and Estate Related Issues – A Review of the QOF Final Regulations' Disposition of ACTEC's Comments to the U.S. Department of Treasury and the IRS*, 54TH ANNUAL HECKERLING INST. ON ESTATE PL. SPECIAL SESSION II-F, at 4-5 (2020).

If the trust loses its status as a grantor trust, that will constitute an inclusion event. The proposed regulations state that "a change in the income-tax status of an existing trust owning a qualifying investment in a QOF, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event." Reg.

§1.1400Z2(b)-1(c)(5)(ii). Perhaps the "creation of grantor trust status" reference is to a non-grantor trust that has invested in an opportunity fund and that later becomes a grantor trust as to a deemed owner or to a grantor trust that becomes a grantor trust as to a different deemed owner under §678.

As a corollary to the following discussion that death is not an inclusion event, "the termination of grantor trust status as a result of the death of the owner of a qualifying investment is not an inclusion event." Reg. §1.1400Z2(b)-1(c)(5)(ii).

f. **Death Not an Inclusion Event**. The 2019 proposed regulations provide that a transfer of an investment in an opportunity fund "by reason of the taxpayer's death" is not an inclusion event. This exception includes the death of the investor, the transfer of the investment to the deceased owner's estate, the distribution by the estate to legatees or heirs, a distribution by the deceased owner's trust that is made by reason of the deceased owner's death, the passing of a jointly owned qualifying investment to the surviving co-owner by operation of law, and any other transfer of a qualifying investment at death by operation of law. Reg. §1.1400Z2(b)-1(c)(4)(i). Not included in the exception is a "sale, exchange, or other disposition" (other than a distribution as described above), or any disposition by the legatee, heir, beneficiary, or surviving joint owner. Reg. §1.1400Z2(b)-1(c)(4)(ii). The rationale stated in the preambles for not treating transfers by reason of the death of the investor as an inclusion event is "in part" that the recipient of the interest will have the obligation under §691 to include the deferred gain in gross income in the case of an inclusion event by that recipient.

   Consistent with the approach of not treating death as an inclusion event, "the termination of grantor trust status as a result of the death of the owner of a qualifying investment is not an inclusion event" (as mentioned above). Reg. §1.1400Z2(b)-1(c)(5)(ii).

g. **Extension of Concepts in Regulations Regarding Transfers at Death to Sales to Grantor Trust Transactions**. The treatment of grantor trusts in the regulations supports what has come to be thought as the general rule that losing grantor trust status **during life** may be a realization event (oft cited are Reg. §1.1001-2(c), Ex. 5, *Madorin v. Commissioner*, 84 T.C. 667 (1985), and Rev. Rul. 77-402 about the effect of losing grantor trust status during life for partnership tax purposes), but that the **death** of the grantor does not result in a realization event. Chief Counsel Advice 200923024 is cited as evidence of the government's support of this position. That CCA stated:

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

   Now a final regulation, which is much more authoritative than a CCA, states the government's position that the death of a grantor is not a realization event with respect to "deferred recognition assets" in a grantor trust.

   When note payments are made by a grantor trust after the grantor's death, is gain realized by the estate with respect to those subsequent payments? The analogy to the proposed regulations might suggest that gain realization applies as payments are

received (if the grantor trust after the death of the grantor or if distributees of the grantor trust sell their interests in an opportunity fund, that triggers the deferred gain at that time). A big distinction applies for sales to grantor trusts. If a grantor sells an asset and invests the proceeds representing the appreciation in an opportunity fund within 180 days, the gain recognition is deferred. For the opportunity fund investment, an inclusion event causes the acceleration of the recognition of gain that has been realized but the recognition of which has just been deferred. On the other hand, if a grantor sells an asset to a grantor trust, no gain occurs (under Rev. Rul. 85-13)—the issue is not merely deferring recognition of gain that has already occurred. At the grantor's death, the issue is whether the grantor's note from the trust gets a basis step-up wiping out the gain that might be realized when payments are received after the grantor's death. Arguably the note is not IRD to the grantor so it would get a basis adjustment at death. It is not IRD because the existence, amount and character of IRD are determined as if "the decedent had lived and received such amount." §691(a)(3). The decedent would not have recognized income if the note were paid during life (under Rev. Rul. 85-13) so the note should not be IRD. (See Item 23.c. above regarding theories as to the basis after the grantor dies of assets sold by the grantor to a grantor trust.)

h. **Tacking**. The donee of a gift of an interest in an opportunity fund to a grantor trust or by reason of the taxpayer's death are not inclusion events, and the recipient may tack the donor's or decedent's holding period, respectively, for purposes of excluding 5% or 10% of the deferred gain if the interest in the fund is held for 5 or 7 years, respectively, and for purposes of excluding gain after the time of the investment in the opportunity fund if the interest in the fund is held at least 10 years (as discussed in Item 35.b. above), Reg. §1.1400Z2(b)-1(d)(1)(iii).

i. **No Basis Step-Up at Death for Excess of QOF Value over Amount of Deferred Gain**. ACTEC suggested to the IRS that a partial step-up in basis should apply at death under §1014 to the extent that the value of the QOF at death exceeds the deferred gain amount. The IRS addressed this suggestion in the final regulation but concluded that because the statute specifies that the basis is zero except as otherwise provided (various adjustments are made if the investment is held for 5, 7, or 10 years), §1400Z-2(b)(2)(B), no adjustment would be permitted at death under §1014. Preamble at 102-03; Reg. §1.1400Z2(b)-1(g)(6).

j. **Miscellaneous Estate Planning Issues**.

(1) **Death before 12-31-2026 Deferral Recognition Date**. What if the investor dies before the December 31, 2026 deferral recognition date? The interest is treated as income in respect of a decedent (so no step up in basis occurs). The regulations clarify that the death of the investor does not accelerate recognition of the deferred gain, but when the deferred gain is recognized, what if the beneficiary is taxed on the original investor's deferred gain, but the qualified opportunity fund has not performed well and the fund is no longer worth the amount of the deferred gain? For example, what if the gain to be reported is $850,000, $900,000, or $1.0 million dollars (depending on how long the qualified opportunity fund investment was held), but the fund at that time is only worth $200,000? Fortunately, the statute caps the amount of the gain that is recognized so that it does not exceed the fair market value of the investment when the gain is recognized. §1400Z-2(b)(2)(A) (gain included in income is excess of (1) lesser of gain deferred or "the fair market value of the investment

determined as of the date described in paragraph (1)" over the taxpayer's basis in the investment). Even so, what if the taxpayer's investment in the QOF is illiquid and the taxpayer does not have to right to redeem the interest? Planners should consider liquidity needs that may arise when the deferred gain must be recognized (which would be no later than December 31, 2026).

(2) **Application to Trusts**. After a gain is recognized on investment property, the investor generally has up to 180 days to invest that amount in a qualified opportunity fund. If a trust realizes an investment gain which eventually will be reported to a beneficiary when a distribution is made carrying out the gain as part of DNI, does the 180-day period begin from the date that the trust sells the property recognizing the gain, or from the date that the distribution is deemed to be made to the beneficiary on the last day of the trust's taxable year, which would give the beneficiary a longer time to make the investment in a qualified opportunity fund? Even if the 180 days begins on the last day of the year, the taxpayer may have little or no time to decide to invest in a QOF after learning about capital gain that is carried out to the beneficiary upon receiving the Schedule K-1 (particularly if the trust makes the 65-day rule election). The final regulation adds a relief provision, by providing that partners of a partnership, shareholders of an S corporation, and beneficiaries of decedents' estates and non-grantor trusts have the option to treat the 180-day period as beginning on the due date of the entity's tax return, not including any extensions. Preamble at 42; Reg. §1.1400Z2(a)-1(c)(8)(iii)(B)(2).

(3) **GRATs**. Assuming the GRAT is a wholly grantor trust, the transfer of a QOF to a GRAT is not an inclusion event. Because of the nonrecognition transfers rule involving grantor trusts that was clarified in the final regulations, an in-kind distribution of a QOF interest to a grantor in satisfaction of an annuity payment is not an inclusion event. At the termination of the GRAT, the planner should make sure that the remaining assets pass to grantor trusts to avoid having an inclusion event at the GRAT termination.

(4) **Ask about QOF Interests**. An investment appearing on a financial statement will not stand out as being a QOF investment. Planners (and administrators following a client's death), should inquire about whether any investments owned by the client are QOF interests.

36. Uniform Law Commission Projects

a. **Uniform Electronic Wills Act**. The Uniform Law Commission approved the Uniform Electronic Wills Act in July 2019. The Act recognizes the validity of electronic wills. The testator's electronic signature must be witnessed contemporaneously (or notarized contemporaneously in states that allow notarized wills), and the document must be stored in a tamper-evident file. An optional provision that may be adopted by states allows remote witnessing. The Act specifically addresses the recognition of electronic wills executed under another state's law. See Item 37 below.

b. **Uniform Probate Code**. Amendments to the Uniform Probate Code were made in 2019, some of which were to coordinate the UPC with amendments to the Uniform Parentage Act (UPA) in 2017. The 2019 revisions achieved five principal objectives, summarized as follows.

(1) **Blended Families**. Blended families were taken into account not only in §2-102 (Share of Spouse), as in the 1990 revisions, but also in §2-103 (Share of Heirs Other Than Surviving Spouse).

(2) **Per-Capita-At-Each-Generation**. The per-capita-at-each-generation system of representation was incorporated throughout §2-103. Heirs in a generation closer to the decedent are favored compared to heirs in a more remote generation; heirs in a given generation are treated equally.

(3) **Outdated Terms**. Outdated terms were removed. Examples include the references to a decedent's "maternal" and "paternal" grandparents in the former version of §2-103, references to relatives of the "half blood" or "whole blood" in the former version of §2-107, and references to "genetic" parents in the former versions of §2-117 through §2-119.

(4) **Assisted Reproduction**. The rules in the UPA (2017) governing parent-child relationships created by assisted reproduction were incorporated by reference.

(5) **Intestacy and Class Gifts**. The intestacy and class-gift provisions were restructured to incorporate the innovations in the UPA (2017), such as the codification of the doctrine of de facto parentage and the recognition that a child may have more than two parents and, therefore, more than two sets of grandparents.

c. **Uniform Law Commission Drafting and Study Committees**.

(1) **Fundraising through Public Appeals Drafting Committee**. This committee is addressing various issues regarding internet-based crowdfunding sites.

(2) **Drafting Committee on a Tribal Probate Code**. The committee is drafting a model probate code for American Indian tribes.

(3) **Drafting Committee on Economic Rights of Unmarried Cohabitants**. A majority of states recognize some manner of economic rights of unmarried cohabitants, but little consistency exists among the states as to evidentiary standards, enforcement, and remedies. (Common law marriage continues in less than 10 states.)

- Article 1 has definitions and general provisions.
- Article 2 deals with enforcement of cohabitant agreements. An express agreement is shown by a preponderance of the evidence while an implied agreement requires clear and convincing evidence.
- Article 3 deals with claims for unjust enrichment, which are subject to the clear and convincing standard.
- Article 4, bracketed as optional, sets standards for a quasimarital state called a "presumptive equitable partnership." If the presumptive equitable partnership is shown by clear and convincing evidence, the remedies upon termination mirror the remedies available after a divorce, including the possibility of an order for support.
- Article 5 contains some standard uniform laws provisions.

(4) **Choice of Law and Choice of Court Clauses Study Committee**. This study committee was approved in January 2020.

37. Electronic Wills and Uniform Electronic Wills Act

Traditionally, wills must be on paper, either typed (or printed) or handwritten. Nevada was the first state to adopt a statute recognizing electronic wills. NEV. REV. STAT. §133.085(1) (2017). Electronic will statutes now exist in Nevada, Indiana, Arizona, and Florida (effective July 1, 2020).

Indiana recognizes electronic wills but not remote witnessing or remote notarization. Remote witnessing and notarization are recognized in Nevada, Arizona and Florida.

In 2017, legislation was passed by the Florida legislature that would have allowed persons to execute wills electronically without the physical presence of a witness or an attorney, but Governor Scott vetoed the Florida Electronic Wills Act on June 26, 2017. The law was introduced and passed again in 2019, and Governor DeSantis did not veto it. Remote on-line notarization became effective in Florida on January 1, 2020, and electronic wills, including remote witnessing and electronic signing, becomes effective on July 1, 2020. Legislation allowing electronic wills is being considered in other states as well. This topic is attracting a growing trend of interest.

The Uniform Law Commission approved the Uniform Electronic Wills Act in July 2019. The Act recognizes the validity of electronic wills. The testator's electronic signature must be witnessed contemporaneously (or notarized contemporaneously in states that allow notarized wills), and the document must be stored in a tamper-evident file. An optional provision that may be adopted by states allows remote witnessing. The Act specifically addresses the recognition of electronic wills executed under another state's law.

For an excellent overview of the history of electronic wills, legislative proposals being considered, and policy issues that must be addressed, see Bruce Stone, *Technology and Estate Planning – The Machines Are Coming, Will You Be Ready?,* LEIMBERG ESTATE PLANNING NEWSLETTERS #2625 (February 6, 2018).

A handful of cases in the U.S. have approved electronic wills, and have all involved situations in which elements of authenticity backed by clear and convincing evidence of intent were present. *Taylor v. Holt*, 134 S.W.3d 830 (Tenn. Ct. App. 2004); *Litevich v. Probate Court, District of West Haven*, 2013 Ct. Supp. 1362 2013 WL 2945055; *In re: Estate of Javier Castro, Deceased*, 2013-ES-00140 (Ct. Comm. Pl. Lorain County, Prob. Div., Ohio, June 19, 2013); *In re Estate of Duane Francis Horton, II*, 2018 WL 3443383 (Mich. Ct. App. July 17, 2018. These cases and the state statutes in Nevada, Indiana, and Arizona are summarized in Sandra Glazier, *Electronic Wills: Revolution, Evolution, or Devolution*, 44 TAX MANAGEMENT ESTS., GIFTS & TRUSTS J. 34 (January 10, 2019). See Suzanne Brown Walsh & Turney Berry, *Electronic Wills Have Arrived*, TRUSTS & ESTATES 12 (Feb. 2020).

38. State Estate, Gift and GST Taxes

Thirty-three states (2/3rds of states) now have no estate tax, but a few have inheritance taxes (e.g., Kentucky and Pennsylvania). No state that has a state estate tax had an exemption as large as the federal basic exclusion amount before 2020, but Connecticut increased its estate and gift exemption amount to the federal exemption beginning in 2020.

Connecticut is the only state with a state gift tax.

Hawaii appears to be the only state that has a state generation skipping transfer tax.

39. Savings Clause Rejected in Conservation Easement Case, Coal Property Holdings, LLC v. Commissioner and Railroad Holdings LLC v. Commissioner

a. **Synopsis of *Coal Property Holdings, LLC v. Commissioner***. In a case reminiscent of the *Belk v. Commissioner* Fourth Circuit Court of Appeals case five years ago, the Tax Court has rejected a savings clause as an impermissible "condition subsequent" clause (citing *Commissioner v. Procter*) in a conservation easement case. *Coal Property Holdings LLC v. Commissioner*, 153 T.C. No. 7 (2019). The court concluded that the easement did not satisfy the "protected in perpetuity" requirement of §170(h)(5)(A) and granted summary judgment denying any charitable deduction for the easement.

The taxpayer donated a conservation easement, with the easement deed providing that if the property were sold following judicial extinguishment of the easement, the donee organization would receive a share of proceeds under a formula. The formula in the deed for several reasons did not comply with the payment formula requirements in Treasury regulations that must be satisfied in the case of a judicial extinguishment of the easement.

The deed also provided that the amount to be paid to the donee would be the amount required by the regulations "if different from" the formula in the deed, and the taxpayer argued that the "Treasury Regulation override" mandates that the payment provisions be interpreted to conform to the regulatory requirements as construed by the court. The Tax Court concluded "that the text to which petitioner refers constitutes a 'condition subsequent' saving clause, which we and other courts have consistently declined to enforce." The taxpayer urged that the text in the deed "does not constitute an impermissible saving clause but rather sets forth a 'permitted interpretation provision.'" The court disagreed.

> Rather than interpreting an ambiguous provision, the text to which petitioner refers purports to countermand the effect of an unambiguous provision, but only in the event of an adverse future occurrence. This is a classic "condition subsequent" saving clause, and we decline to give it effect.
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> …
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> The [Fourth Circuit in Belk] refused to apply the saving clause as the taxpayers wished, ruling that to do so would be "sanctioning the very same `trifling with the judicial process" that the court had previously condemned. Ibid. (quoting Procter, 142 F.2d at 827).
>
> …
>
> Contrary to petitioner's view, this text cannot be characterized as an "interpretation directive" or an "interpretational aid" because there is nothing that needs interpretation; the terms of section 9.2 are clear and unambiguous. As in Belk, there is "no open interpretive question for the savings clause to `help' clarify." Belk, 774 F.3d at 230. Rather than interpreting an ambiguous provision, the text to which petitioner refers purports to countermand the effect of an unambiguous provision, but only in the event of an adverse future occurrence. This is a classic "condition subsequent" saving clause, and we decline to give it effect. See Palmolive Bldg. Inv'rs, LLC, 149 T.C. at 405; cf. Estate of Cline v. Commissioner, T.C. Memo. 1982-90, 43 T.C.M. (CCH) 607, 609-610 (1982) (giving effect to a provision that clarified "ambiguous *** language in a poorly drafted prenuptial agreement," as opposed to being "a savings clause that would undertake to change the property interests otherwise created").

The *Coal Property Holdings LLC* case does not involve a traditional defined value clause with a formula valuation, but it is the latest of various cases that have referred to the "condition subsequent saving clause" analysis in *Procter* following an adverse determination by the IRS or a court, and rejected an attempt to argue that the provision was merely an interpretive clause. *Coal Property Holdings LLC v. Commissioner*, 153 T.C. No. 7 (Oct. 28, 2019) (Judge Lauber).

For a discussion of the court's analysis in Coal Property Holdings, see Item 37.b. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Synopsis of *Railroad Holdings LLC v. Commissioner***. *Railroad Holdings LLC v. Commissioner,* T.C. Memo. 2020-22 (February 5, 2020) (Judge Gustafson) is very similar to *Coal Property Holdings*; indeed, Judge Gustafson said the easement deed in *Railroad Holdings* "bears the same essential flaw" as in the *Coal Property Holdings* case. The judicial extinguishment provision in *Railroad Holdings* excluded subsequent appreciation from the formula for determining how much of the proceeds would go to the property owner and easement holder, respectively. The deed included a clause saying that the easement would be liberally construed to protect the conservation values and to construe any ambiguous provision to uphold the intended conservation purposes: "If any provision of this Conservation Easement is found to be ambiguous, an interpretation consistent with its conservation purposes that would render the provision valid should be favored over any interpretation that would render it invalid." The taxpayer argued that this construction provision should cause the deed to satisfy the regulatory requirements. The court responded that the construction clause said to interpret any ambiguous provision to uphold the validity of the easement, but that validity of the easement is not at issue. The court squarely rejected that this "savings clause" would save the charitable deduction:

> [I]f … this language in part D was actually a saving clause that purported to cure the proceeds formula, then it would be unenforceable and could not salvage what would otherwise be a failure of the formula to provide SERLC [the charitable recipient of the easement] with the proportional value of extinguishment proceeds to which it is entitled. See Coal Property Holdings, LLC v. Commissioner, 153 T.C. at __ (slip op. at 27) (citing Belk v. Commissioner, 774 F.3d 221, 229 [114 AFTR 2d 2014-6952] (4th Cir. 2014), aff'g 140 T.C. 1 (2013)). A donor cannot reserve in an easement deed a right that section 170(h) does not permit (such as a right to more than his share of extinguishment proceeds) but then save his charitable contribution by mentioning the rule he has violated and calling for that rule to kick in and save the day if his violation subsequently comes to light.
>
> Part B(2) of article VI of the deed contains an unambiguous expression of the formula to apply to the proceeds of an extinguishment. If the terms of part B(2) had never come to light in a tax proceeding, and if later the easement had ever been judicially extinguished, there is no reason to suppose that a court distributing proceeds would have overruled the express terms of part B(2).

c. **Similar Cases**. Other conservation easement cases have reasoned similarly. *E.g.*, *Pine Mountain Preserve, LLLP v. Commissioner*, 151 T.C. 247 (2018); *Palmolive Building Investors, LLC v. Commissioner*, 149 T.C. 380 (2017); *Carter v. Commissioner*, T.C. Memo. 2020-21.).

d. **Application to Savings Clauses Generally**. Wills routinely include a clause providing that the provisions are to be interpreted in a manner to satisfy the marital deduction requirements. Some cases have pointed to that type of clause in

construing a document to determine qualification for the estate tax marital deduction. Most cases in other areas, however, have given short shrift to savings clauses to salvage tax benefits.

This fallacy of using savings clauses to bail out document provisions that clearly contain prohibited terms under the tax rules, but only if the IRS should ever raise the issue, was succinctly summarized by Judge Gustafson in *Railroad Holdings*:

> A donor cannot reserve in an easement deed a right that section 170(h) does not permit (such as a right to more than his share of extinguishment proceeds) but then save his charitable contribution by mentioning the rule he has violated and calling for that rule to kick in and save the day if his violation subsequently comes to light.

Observe the important distinction between two types of clauses. One type (bad) says something like "provisions should be interpreted to comply with charitable deduction regulations" or "the beneficiary not have any power that would result in including assets in beneficiary's gross estate." The other type (good) has specific limitations, such as "no matter what else is in this instrument to the contrary, if a beneficiary is trustee, the beneficiary-trustee shall have no power to make a distribution to himself or herself other than for health, education, support or maintenance." The latter type of "override" clause simply restricts powers that the person has under the clear terms of the instrument. That limitation has the **effect** of avoiding estate inclusion, but based on an explicit restriction on the powers that exist.

Including a clause stating the intent with respect to tax issues has no particular downside, and may help in interpreting ambiguous provisions. But don't blindly rely on the savings clause.

e. **Application to Defined Value Formula Valuation Clauses**. Various courts have refused to treat certain defined value formula clauses as "condition subsequent" clauses that must be rejected under *Commissioner v. Proctor*. *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009) (formula disclaimer and "excess value" portion passed to a charity); *Estate of McCord*, 461 F.3d 614 (5th Cir. 2006); *Petter v. Commissioner*, T.C. Memo. 2009-280 (formula gifts and sales with "excess portion" passing to charity), *aff'd*, 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Commissioner*, T.C. Memo 2011-133. These cases have addressed, in varying degrees of detail, the three reasons cited in *Proctor* that the condition subsequent clause violates public policy: (1) the provision discouraged the collection of gift tax because any attempt to collect the tax would defeat the gift; (2) the condition obstructed the administration of justice by requiring a court to pass on a moot case; and (3) the provision would reduce a Federal court's final judgment to a declaratory judgment.

Cases like *Belk* and *Coal Property* are not directly relevant to formula valuation clauses, but are interesting in their discussion of saving clauses generally and their strict rejection of clauses that change results after the fact based on court or IRS determinations (in contrast to defining what is transferred in the first place based on values as finally determined for gift tax purposes). The following is an excellent summary of conclusions from *Belk* (and by extension, *Coal Property Holdings* and *Railroad Holdings*) on savings clauses used in the estate planning context:

> *Procter* and its progeny are a subject of great interest to estate planners…. That interest has included intense curiosity about how the Fourth Circuit, which decided *Procter* in 1944, would view the issues today. *Belk* does not answer that question. In a case in which the holding of *Procter* appears not to have been challenged, the court simply found that the donors' effort to distinguish *Procter* did not work. And, notably, the issue in *Belk* was a substantive requirement of the conservation easement statute, not valuation.
>
> But meanwhile, *Belk* provides an occasion to reflect on the "savings clauses" that are routinely used in estate planning documents (and all kinds of other documents) apart from a valuation context. While each case will bring its own facts and attract its own analysis, *Belk* suggests that such clauses that are **intended to protect against inadvertent or incidental violations** of applicable requirements are fine. But they would not save a trust, for example, from such a **violation that is part of the core structure of the trust**. For example, the Belks' ability to shift their conservation easement from property to property appeared to be such a core element of their conservation easement arrangement – and such a flagrant violation of the "perpetuity" requirement of section 170(h)(2)(C) – that the savings clause could not save it.

Recent Developments – 2014, 49th ANNUAL HECKERLING INST. ON EST. PL. ¶105.4 (2015) (emphasis added).

40. In Determining Value of Nonvoting Interests in LLCs, Tax Court Repudiates IRS Valuations That Assumed the Voting Interest Would Also Be Acquired in the Same Willing-Buyer-Willing-Seller Transaction, *Grieve v. Commissioner*

The following discussion of and commentary about Grieve v. Commissioner is from an analysis by Ronald D. Aucutt available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

a. **Synopsis**. In *Grieve v. Commissioner*, T.C. Memo. 2020-28 (March 2, 2020), Judge Kerrigan upheld a donor's gift tax valuation of 99.8% nonvoting interests in two limited liability companies that he had given in 2013 to a GRAT and to another irrevocable trust. The assets held by the LLCs were largely cash, cash equivalents, and marketable securities. The donor's gift tax return applied entity-level discounts for lack of control and marketability totaling about 35%.

The Tax Court did not use an alternative approach the donor offered at trial that included discounting the value of interests in entities held by one of the LLCs being valued (resulting in "multiple-tiered discounts") and applying slightly different entity-level discounts. The court explained that it had found no justification for using a net value significantly lower than the value to which the taxpayer had previously admitted on the appraisal attached to the gift tax return (without any specific criticism of the multiple-tiered discounting approach).

The court firmly rejected a valuation offered by the IRS that assumed that a buyer of the 99.8% interest would start by seeking to buy the 0.2% controlling interest, which would have almost eliminated any entity-level discounts (leaving a discount of just over 1.4%).

b. **Facts**.

(1) **Background.** The donor, Pierson M. Grieve, resided in Florida when he filed his Tax Court petition, but from 1983 to 1996 he had been the chairman and chief executive officer of Ecolab, a public corporation headquartered in St. Paul, Minnesota. Ecolab stock was the underlying asset involved in the funding of the GRAT, and the Tax Court trial in March 2019 was held in St. Paul.

Around 1990, Mr. Grieve established the Grieve Family Limited Partnership to preserve and manage his family wealth. The general partner of the limited partnership was the Pierson M. Grieve Management Corp. (PMG). In the early 2000s, Mr. Grieve's daughter Margaret became involved in helping Mr. Grieve manage the family wealth, and in 2008 she purchased PMG from Mr. Grieve for $6,200 and became its president.

In 2012, Mr. Grieve created an irrevocable trust for the benefit of his children, with South Dakota Trust Co., LLC, as the trustee.

The LLCs in question, Rabbit 1, LLC (Rabbit), and Angus MacDonald, LLC (Angus), were created under the law of Delaware in 2013 and 2012, respectively. PMG owned the Class A voting units in each LLC, comprising 0.2% of the ownership interests of the LLC, and PMG's owner, Margaret, was the chief manager of the LLCs. The Class B nonvoting LLC units, comprising 99.8% of the ownership interests, were owned by Mr. Grieve's revocable trust in the case of Rabbit and by Mr. Grieve himself in the case of Angus. Margaret was the trustee of the revocable trust.

The assets of both LLCs were largely cash, cash equivalents, and marketable securities. The fair market values of those assets on the respective dates of transfer were $9,067,074 for Rabbit (as adjusted by stipulation in the Tax Court) and $31,970,683 for Angus.

Under the LLC agreements, the holders of all Class A voting units had to consent to the transfer of any units to anyone other than a lineal descendant of Mr. Grieve or his wife (who died in 2012), or a trust for the exclusive benefit of any one or more such lineal descendants and/or their spouses, or, in the case of Rabbit, a charitable organization

(2) **2013 Gifts.** On October 9, 2013, Mr. Grieve's revocable trust transferred its 99.8% nonvoting ownership interest in Rabbit to a two-year GRAT, with annuity payments defined as percentages of what the opinion describes as "the fair market value of assets transferred to the trust for Federal gift tax purposes." The percentage increased by slightly less than 20% from the first payment to the second payment, and the percentages were designed to "zero out" the GRAT – that is, to produce a gift tax value of the remainder equal to zero after applying the section 7520 rate of 2.4% for October 2013.

On November 1, 2013, Mr. Grieve transferred his 99.8% nonvoting ownership interest in Angus to the 2012 irrevocable trust, in exchange for a single-life private annuity that on that date had a fair market value of $8,043,675. Thus, Mr. Grieve made a gift to the irrevocable trust in the amount by which the value of the 99.8% interest exceeded $8,043,675.

c. **Positions of the Parties**.

(1) **Gift Tax Return.** Mr. Grieve's 2013 gift tax return reported values for the 99.8% nonvoting interests that were based on appraisal reports prepared by Value Consulting Group (VCG), using a cost approach and adjusted net-asset method to determine the fair market value of the assets of the LLCs and applying lack of control discounts of 13.4% for Rabbit and 12.7% for Angus and lack of marketability discounts of 25% for each LLC. To determine these discounts, VCG looked at studies

of closed-end mutual funds and closely held equity interests, including restricted stock studies. In the Tax Court, VCG's valuation of the Rabbit interest was adjusted slightly by a stipulated change (from $9,102,757 to $9,067,074) to the fair market value of Rabbit's assets as of the transfer date of October 9, 2013.

(2) **Notice of Deficiency.** The IRS issued a notice of deficiency substantially increasing the values of the LLC interests. See the table below.

(3) **Taxpayer's Position in the Tax Court.** In the Tax Court, Mr. Grieve offered additional valuation reports prepared by Will Frazier and others in the well-known valuation firm of Stout. These reports independently valued the assets held by the LLCs, including the application of minority interest and lack of marketability discounts to limited partnership interests and venture capital funds held by Angus (*i.e.*, employing multiple-tiered discounts) and determined combined values slightly less than the values VCG had used. The reports used a market approach and asset method similar to VCG's, but with different discounts for lack of control calculated separately for equity securities and for cash and short-term investments. The reports agreed with VCG's 25% lack of marketability discounts, supported by analysis that the Tax Court explicitly acknowledged "considered factors that we outlined in Mandelbaum v. Commissioner, T.C. Memo. 1995-255, aff'd, 91 F.3d 124 (3d Cir. 1996), [including] the holding period, the risk of the underlying assets, and the company's distribution policy." Finally, the Stout reports also introduced an income approach, which the court described as follows:

> Mr. Frazier used the nonmarketable investment company evaluation (NICE) method which he developed as a valuation technique applicable to entities that hold a portfolio of investment assets. The NICE method determines a price that an investor would pay for the subject interest that lacks control and marketability by taking into consideration the investment risks and expected returns. In applying the NICE method, empirical studies were used to determine the incremental required rates of return in the light of information asymmetry (lack of control) and the cost of illiquidity (lack of marketability).

Giving equal weight to those market and income approaches, the Stout reports determined fair market values of the transferred 99.8% interests on the transfer dates that were slightly less than the values VCG had determined, which had been used on the gift tax return.

(4) **IRS's Position in the Tax Court.** In the Tax Court the IRS relied on the approach of Mark Mitchell, which has reportedly exasperated the appraisal community in other cases where the IRS has invoked it. The court described Mr. Mitchell's approach this way:

> In his valuation reports Mr. Mitchell sought the price at which a 99.8% noncontrolling interest would actually be bought or sold. According to Mr. Mitchell there was no empirical data on the sale of a 99.8% noncontrolling interest. His valuations were based upon the premise that the reasonable buyer of a 99.8% interest could be expected to seek to maximize his or her economic interest by consolidating ownership through the purchase of the 0.2% interest. Mr. Mitchell also contends that a willing buyer would consider the likelihood of purchasing the 0.2% interest.
>
> Mr. Mitchell determined that a hypothetical willing seller would seek first to acquire the class A [voting] units for a premium. According to his reports and testimony, purchasing the class A units would result in consolidated control and further maximize the value of the class B [nonvoting] units by reducing any discount sought by a hypothetical willing buyer.

d. **Result in the Tax Court**. The Tax Court totally rejected Mr. Mitchell's approach. Judge Kerrigan bluntly noted that "[w]e do not engage in imaginary scenarios as to who a purchaser might be," citing *Estate of Giustina v. Commissioner*, 586 F. App'x 417, 418 (9th Cir. 2014), *rev'g and rem'g* T.C. Memo. 2011-141. (In a similar context in *Estate of Jones v. Commissioner,* T.C. Memo. 2019-101, discussed **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**, Judge Pugh had also cited *Giustina*, in that case rejecting rather than affirming an asset-based approach.) In *Grieve*, Judge Kerrigan added:

> Mr. Mitchell's valuations relied on an additional action [that is, in addition to a hypothetical sale of the 99.8% class B units]. He concluded that to determine the value of what a willing buyer would pay and what a willing seller would seek for the class B [nonvoting] units, a premium to purchase the class A [voting] units has to be taken into account. Elements affecting the value that depend upon events within the realm of possibility should not be considered if the events are not shown to be reasonably probable [citing *Olson v. United States*, 292 U.S. 246, 257 (1934)]. The facts do not show that it is reasonably probable that a willing seller or a willing buyer of the class B units would also buy the class A units and that the class A units would be available to purchase. To determine the fair market values of the class B units we look at the willing buyer and willing seller of the class B units, and not the willing buyer and willing seller of the class A units.
>
> Neither respondent nor Mr. Mitchell provided evidence to show support for his valuations. His reports did not include empirical data which back up his calculation of the 5% premium to purchase the class A units of either entity. He provided no evidence showing that his methodology was subject to peer review. Respondent cited no caselaw in support of Mr. Mitchell's methodology. Accordingly, we reject Mr. Mitchell's valuations of the class B units of Rabbit and Angus. See Estate of Hall v. Commissioner, 92 T.C. at 340; Estate of Deputy v. Commissioner, T.C. Memo. 2003-176, slip op. at 20; Estate of Smith v. Commissioner, T.C. Memo. 1999-368, slip op. at 40.

In contrast, Judge Kerrigan did not criticize Mr. Frazier's reports, although she concluded that:

> We are not convinced that the higher discount for lack of control for Rabbit and lower values in the Frazier reports should be substituted for the values that the parties stipulated and the discounts petitioner provided in the VCG reports. See Estate of Hall v. Commissioner, 92 T.C. at 337-338; Estate of Deputy v. Commissioner, slip op. at 12 n.6.

As a result, undoubtedly reassured by the very similar results in the Stout reports, the court accepted the values that had been reported on the gift tax return, with the slight adjustment that had been stipulated in the fair market value of the underlying assets owned by Rabbit.

The following table summarizes the parties' positions and the court's conclusion:

Values Determined for the 99.8% Nonvoting LLC Interests Transferred
(including the effective discount (rounded) from 99.8% of the value of the LLC's assets)

LLC (including the value of the LLC's assets)	Initial Positions		Positions in Tax Court		Tax Court's Conclusion
	Gift Tax Return (VCG)	IRS Notice of Deficiency	Taxpayer (Stout, Will Frazier)	IRS (Mark Mitchell)	
Rabbit ($9,067,074)	$5,903,769 (35.0%*)	$9,048,866 (0.4%*)	$5,884,000 (35.0%)	$8,918,940 (1.4%)	$5,880,626 (35.0%)
Angus ($31,970,683)	$20,890,934 (34.5%)	$31,884,403 (0.1%)	$19,854,000 (37.8%)	$31,456,742 (1.4%)	$20,890,934 (34.5%)

* Based on the $9,102,757 estimated value of Rabbit's assets before the stipulated correction.

As noted above, the taxable gift in the case of Angus was the excess of this amount over the $8,043,675 value of the annuity Mr. Grieve took back, in other words $20,890,934 minus $8,043,675, or $12,847,259. Because Mr. Grieve's wife died in 2012, it is possible that he had a DSUE amount from a portability election to apply against that gift. (According to the opinion, the IRS's notice of deficiency would have increased the value of the Angus interest transferred to the irrevocable trust by $10,993,469 (from $20,890,934 to $31,884,403), but, without explanation, would have increased the net value of the resulting gift by only $7,852,480 (from $9,966,659 to $17,819,139).

e. **Analysis**.

(1) **Apparently No Challenge of the LLCs Themselves.** The valuation discounts reflected in the IRS Notice of Deficiency – 0.4% for Rabbit and 0.1% for Angus – are tantamount to simply ignoring the LLCs altogether and simply treating the underlying assets of the LLCs as the subjects of the gifts. Yet there is no indication in the court's opinion that the IRS had encouraged the court to disregard the LLCs or to question, for example, whether the LLCs were formed for a "legitimate and significant nontax reason," which is the standard the Tax Court used in *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005) (reviewed by the Court) in the context of section 2036 (which does not necessarily apply in a gift tax context). Nor is there any indication that the IRS had asked the court to apply section 2703 or 2704.

(2) **Apparently No Section 2036(a)(2) Exposure Under *Powell* and *Cahill*.** *Grieve* is a gift tax case, and Mr. Grieve was alive when the Tax Court decided the case. Therefore there was no occasion for the IRS or the court to raise or address the issue that the 99.8% nonvoting interests might have "the right, … in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom," under section 2036(a)(2) as applied in *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017) (reviewed by the Court), and *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84. In light of *Powell* and *Cahill*, however, it may be noted in passing that neither Mr. Grieve nor his revocable trust retained any interest in Rabbit and Angus, and that in any event the Rabbit and Angus nonvoting units, as the opinion notes, "could not vote on or participate in any proceedings in which the entity or its members took action."

(3) **Concurrent Testimony of Experts.** In a footnote to her opinion, Judge Kerrigan stated that "[w]ith agreement of the parties we directed the expert witnesses to testify concurrently. The procedure was implemented in substantially the same way as in Rovakat, LLC v. Commissioner, T.C. Memo. 2011-225 [affirmed, 529 Fed. Appx. 124 (3d Cir. 2013)]."

In *Rovakat*, Judge Laro had explained:

> To implement the concurrent testimony, the Court sat at a large table in the middle of the courtroom with all three experts, each of whom was under oath. The parties' counsel sat a few feet away. The Court then engaged the experts in a three-way conversation about ultimate issues of fact. Counsel could, but did not, object to any of the experts' testimony. When necessary, the Court directed the discussion and focused on matters that the Court considered important to resolve. By engaging in this conversational testimony, the experts were able and allowed to speak to each other, to ask questions, and to probe weaknesses in any other expert's testimony. The discussion that followed was highly focused, highly structured, and directed by the Court.

The engagement of expert witnesses around a table like this has been referred to colloquially as "hot tubbing," and Judge Laro actually cited an article titled "Experts in the Tub" (21 Antitrust 95, 97 (2007)).

(4) **Formula Clause for GRAT Annuity Payments.** As noted above, for the GRAT to which Mr. Grieve's revocable trust contributed the nonvoting Rabbit units, the annuity payments were defined as percentages of what the opinion describes as "the fair market value of assets transferred to the trust for Federal gift tax purposes." As the court noted in a footnote:

> The parties stipulated that petitioner will not owe additional gift tax if we determine that he understated the initial fair market value of assets transferred to the GRAT if, within a reasonable time, the GRAT pays to petitioner, or to his personal representative in the event of his passing, an amount equal to the difference of the properly payable annuity and the annuity actually paid.

Thus the formula clause worked, even though the GRAT was designed to produce a taxable gift of zero, which could have made the "final determination" of federal gift tax value less obvious. The formula clause used in *Grieve*, of course, is specifically authorized by Reg. §25.2702-3(b)(1)(ii)(B). Even so, for the IRS to force the formula clause to be respected, in this case by entering into the stipulation with the donor, is somewhat comparable to what we might have observed in the recent settlement of cases involving defined value clauses in the broader gift tax context. *See Estate of Donald Woelbing v. Commissioner* (Tax Court Docket No. 30261-13) and *Estate of Marion Woelbing v. Commissioner* (Tax Court Docket No. 30260-13) (petitions filed Dec. 26, 2013; stipulated decisions entered March 25 and 28, 2016); *Karen S. True v. Commissioner* (Tax Court Docket No. 21896-16) and *H.A. True III v. Commissioner* (Tax Court Docket No. 21897-16) (petitions filed Oct. 11, 2016; stipulated decisions entered July 9 and 6, 2018).

As such, *Grieve*, along with *Woelbing* and *True*, might provide a template for the resolution of cases involving defined value clauses, even as the IRS is probably still searching for a case in which it might successfully challenge the effectiveness of such a clause, standing alone, to prevent, defeat, or diminish a valuation challenge.

It also did not seem to matter in *Grieve* that the annuity payments determined by formula were, as the court put it, "to be paid within 105 days of [the respective anniversaries of the funding of the GRAT]." Specifically, neither the IRS nor the court seemed to be concerned that the explicit reference to the 105-day grace period of Reg. §25.2702-3(b)(3) even though it is not a governing instrument requirement might require valuation of the remainder for gift tax purposes to be based on the later permissible payment dates.

It is also interesting, as in Chief Counsel Advice (CCA) 201939002, discussed in Item 25.b above, that the IRS is auditing GRATs at all, although in this case it is easier to understand in a context where clearly Mr. Grieve's other transfer to an irrevocable trust in 2013 produced a taxable gift. The stipulation described in the court's footnote might provide an explanation of why such audits make sense. If, to settle a case, the IRS requires the grantor of a GRAT to explicitly confirm an increase in the annuity payments, more value presumably will be brought back into the grantor's estate to be taxed in the future, and the IRS is given one more tool to use in tracking and enforcing those annuity payments.

41. Interesting Quotations

a. **Congress**. The estate and gift exclusion amount will return to $5 million (indexed) in 2026 if Congress does nothing. "And that plays right into Congress's wheelhouse." – Sam Donaldson

b. **Marketing Genius**. "A marketing genius came up with the strategy of creating an intentional grantor trust so the grantor pays the federal income tax but structured in such a way that the assets are not included in the gross estate. The term that this guru, this legend within the industry, came up with to describe this is the 'defective grantor trust.'" – Sam Donaldson

c. **Defective**?? "So now you sit across the table from a client and you say 'I propose that you create a defective trust.' The client says "Really. How much does this cost?" You say 'Interestingly, it costs more than a non-defective trust.' Somehow to make the client feel letter, some of you call it an "intentionally" defective trust, as if you don't remember that intentional torts are worse than negligence.

But there's nothing defective about the 'intentionally defective grantor trust.' This is the most EE-ffective vehicle you can use because it gets you income tax grantor trust status and does not cause inclusion in the grantor's gross estate."

– Sam Donaldson

d. **The Rich and the Wealthy**. "Not many people use giving a nonadverse party the power to deal with the trust for less than full consideration as a grantor trust trigger. For practical reasons you can see why not a whole lot of people use this. You have to trust this nonadverse party to hold that power and use that power well. And most of your wealthy clients don't trust people. That's why they're wealthy." – Sam Donaldson

e. **Successful Authors**. Actual borrowing from the trust with a loan outstanding at the beginning of the year makes the trust a grantor trust. "The CODE says that. Not a regulation, not a private ruling, not some wacko in a sweater vest writing an article that no one will read now that both of his parents are dead." – Sam Donaldson

f. **Not Tax Avoidance**. Actual borrowing from the trust with a loan outstanding on the first day of the year makes the trust a grantor trust, even if that loan is repaid early in the year. "What if I actually borrow the trust assets for a promissory note on December 29? Why not December 30 or December 31? Well that looks like tax avoidance. On January 5, not January 1, or 2, or 3. That looks like tax avoidance. But on January 5 I repay the loan with 5-8 days of interest. The short term interest rate is what .0000something – some ridiculously low rate. For just a few days of interest, that trust is a grantor trust for all of the year even if the loan is repaid on January 5." – Sam Donaldson

g. **Nonfiduciary is Best**. "I call it a swap power because I went to a public school. The Code calls it a power to reacquire trust assets. Section 675(4)(C) says a trust is a grantor trust if anyone, grantor or otherwise, holds a substitution power exercisable in a nonfiduciary capacity – and I have to confess, that's my favorite way in which to

be able to exercise a power, to hold it in a nonfiduciary capacity. Holding powers in a fiduciary capacity is just a hornet's nest of troubles. But if it's exercisable in a nonfiduciary capacity – who's the only person with two thumbs I have to look out for – This Guy [pointing two thumbs at himself]." – Sam Donaldson

h. **Funerals and Basis**. "Why do people cry at funerals? They cry because of the lost opportunity for that step up in basis if low basis assets were in a grantor trust. Sure, we use little terms, little nomenclature to signal like 'he was gone too soon,' or 'he had more work left, he was called home early.' That's code for – the family did not get a complete step up in basis at the decedent's death and the tears are flowing. How could we have avoided all of this? The moment you see that the client's breathing is labored, put $10 million of cash into the grantor trust and take out $10 million of low basis assets. When the decedent dies, the low basis assets get a step up in basis for the mere cost of forgoing a step up in basis in the cash. ... You go to that funeral and what do they call it? They call it a Celebration of Life." – Sam Donaldson

i. **85-13**. Revenue Ruling 85-13 is the one revenue ruling everyone knows by name. Everyone gets up in the morning, faces east, gets down on a mat, and prays to Revenue Ruling 85-13." – Sam Donaldson

j. **Best Intro**. "It's my pleasure to introduce our next speaker. He's my favorite. I've never missed a single one of his presentations. Although I've heard all the jokes they seem ceaselessly funny to me the whole time. Please welcome back Sam Donaldson." – Sam Donaldson

k. **QPRTs**. "With QPRTs, you should be a little bit alarmed. QPRTs are under the regs, so when you're doing a QPRT according to the regs, you're doing something the IRS wants you to do. Usually we get paid for coming up with things other than what they say 'Here's what we want you to do.'" – Sam Donaldson

l. **Grantor Trust Toggling**. The first time I went to a talk on this, somebody talked about how can I turn on the grantor trust. I thought buy it flowers, take it out, really listen to it in conversation, make eye contact, that sort of thing. (I just have a problem with where propositions get placed in sentences sometimes.)" – Sam Donaldson

m. **SECURE**. On the effect of the SECURE Act to refocus retirement planning on actual retirement, including provisions for minor and disabled children, but not including the legacy planning we do for competent adult children, "They're on to us." – Carol Harrington

n. **Disproportionate Wealth**. "Whatever your views are on the growing disproportionate wealth in this country, charts show that we are back to the disproportion of wealth, they think, that existed around the time of the 1929 market crash." – Carol Harrington

o. **One of Three**. In *In re Watkins*, 209 A.3d 135 (Md. Ct. Spec. App. 2019) the court refused to allow the decedent's third wife (Emeline) to receive an elective share. Under the doctrine of unclean hands, the court found that Emeline had exercised undue influence to cause the decedent to marry her for financial gain.

The decedent met Emeline at a cosmetics counter when he took his dying prior wife to buy makeup shortly before she died. In a deposition, the decedent's daughter said that her father had said that when he told Emeline that he did not want to marry her, she "beat him up, she jumped on his chest and was beating him and was scratching him . . . ." In her deposition testimony, Emeline was asked about this incident and said that she "didn't jump on him." – Carol Harrington

p. **Can't Foretell the Future**. Carol Harrington's mentor told her: "A fool on the spot is worth a genius two generations ago." Carol emphasizes that while drafters want to state clearly the settlor's intent, providing flexibility for the trust is important. "Imagine trusts written 120 years ago that might have restricted trust investments to companies that produce buggy whips." – Carol Harrington

q. **Show Me the Money**. "Who's going to pay taxes? Wealthy people. They have the money. It's really hard to tax poor people. They don't have any money. There are a lot of them. But they don't have any money. We represent people with the money. So, there'll always be death and taxes." – Carol Harrington

r. **Not Acronyms**. In the terms "GST trust" and "GST exemption," "GST" is not an acronym. Those are the legal terms as used in the Code. There's no need to call it "generation-skipping transfer exemption." (See §2631 and §2632(c)(3)(B).) – Carol Harrington

s. **Unmarried Cohabitants**. "We know how to get married. If we had wanted to get married, we would have gotten married because we want the presents." – Turney Berry, commenting on the viewpoint of unmarried cohabitants in light of the larger picture of determining the economic rights of unmarried cohabitants

t. **Adapt**. "We are all born ignorant, but one must work hard to remain stupid." Benjamin Franklin, as quoted by Lauren Wolven

u. **Quality Appraisals**. In *Estate of Jones v. Commissioner* (the important 2019 tax-affecting decision), the court observed that the taxpayer's expert's report was 182 pages and the government's expert's response report was 12 pages. "Tax-affecting is here to stay. Get yourself a good appraiser. The 182-page report is probably going to trump the 12-page report." – Carol Cantrell

v. **They'll Turn on Me**. "The nuclear family changes over time. Growing up, my parents and siblings were my 'family.' Now, my wife and children are my family, and my parents and siblings are now 'my parents and siblings.' When my daughters marry and have their own children, I will face a similar betrayal." – David Handler

w. **I've Gotta Know More**. On being asked how much it would cost to prepare "disclaimer trusts" and otherwise generally update potential new clients' wills and revocable trusts, and responding that he of course would first need to learn about the clients' objectives and assets in order to determine whether disclaimer trusts are the appropriate structure, David concludes -- "That's like removing someone's tooth without personally assessing the condition of the tooth and determining the best course of action." – David Handler

x. **No Magic Wand**. On being asked to include provisions in trusts to reward good behavior and punish bad behavior, "What you couldn't accomplish raising your kids 24/7 for 20 years isn't going to be solved with a 50-page trust agreement." – David Handler

y. **Dividing the Jewelry**. After daughters squabble for years about how jewelry was divided, it's not unusual that a one will eventually complain about how bad her mother's taste was in jewelry. What's important is the personal sentimental significance of the pieces and the history in the family. "It's not about the stuff. It's about the story." – Courtney Booth Christensen

z. **Sleep Problems**. After discussing at least the tenth issue among a number of trust administration matters that present difficult problems for trustees –

Phil Hayes: "That's another one that keeps me up at night."

Stacy Singer: "You don't get much sleep, do you?"

aa. **Speed Kills**. "Before hitting 'send,' ask yourself whether you would be comfortable if your text of email ended up as an exhibit in a lawsuit." – Presentation by David Blickenstaff, Lorraine Cavataio, and Lauren Wolven

bb. **Football Tickets**. One of the changes in the 2017 Tax Act is to eliminate the 80% deduction for contributions to colleges or universities in order to obtain priority for seating or parking at college or university events. "That is Greek to me. I would make a charitable contribution NOT to have to go to a football game." – Natalie Choate

cc. **Purpose and Values**. "With the increased exclusion, a lot of clients think they don't need to update their estate plans. Before there were estate taxes there was estate planning, but it was about the people, the process, and purpose –the purpose of the wealth. A lot of times imbedded right in the documents were the values of the family and the intention for what was to come. It's time to get back to some of that again." – Thomas Rogerson

dd. **Shirtsleeves to Shirtsleeves**. "The Shirtsleeves to Shirtsleeves phenomenon is that the first generation creates the wealth, the second generation gets used to the wealth, the third generation enjoys the heck out of the wealth, and then the next generation laments the facts that it's gone. My family's in that fourth generation, in the lamentation phase." – Thomas Rogerson

ee. **Generations to Generations-John Adams Advice**. "John Adams wrote 'I must study and or engage in politics or wars [kind of the entrepreneurs of his day], that my sons may have the liberty to study and engage in mathematics, commerce and agriculture [kind of the professional careers of the day], in order to give their children the right to study painting, poetry, and music.'"

Going from necessity to culture. Families that have been multi-generationally successful, with an entrepreneurial bent to them, will tell you that very often it is those artistic out-of-the box thinkers that are some of the ones that help the family grow into the next generation and come up with new ideas and new ventures going forward." – Thomas Rogerson

ff. **Connectedness and Family Inter-Connectedness**. "People that feel connected are more resilient. There are studies showing this, yet families are feeling less connectedness within the family. We're feeling it within our culture too. David Brooks' book, *The Second Mountain*, focuses on this this issue. He says that in our country we have gotten to the point of hyper-individualism, and it's causing people to feel lonely and anxious and stressed and having depression and angst. He says the solution is – Join. Join community, join AA if you've got a substance problem, join Kiwanis Club, join something – because then you'll be connected and you'll be more healthy and more resilient.

The thing he doesn't focus on is joining your family. The first community you are born into is your family. We as advisers within families have the opportunity to really encourage that and help them get back to that – back to the future. That's what family life was before." – Thomas Rogerson

gg. **Family Legacy**. "Leonard Sweet had a quote, slightly adapted. 'What you did is your history, but what you set in motion in your family is your family legacy.'" – Thomas Rogerson

hh. **Family "Communication."** "In one study of families that had, by their own admission, failed at preserving both family unity and wealth, 60% said the reason of the failure was due to lack of communication and trust around group decision making in the family. Some clients say 'I'm glad to hear that because we don't have that problem. We communicate great. When I want to get something across to my kids, I just tell them.'" – Thomas Rogerson

ii. **Family Therapy**. "This is the session on Fiduciary Litigation, otherwise known as luxury priced group therapy for affluent families." – Dana Fitzsimons

jj. **Best Learning Method**. "Our actual goal today is to help us learn lessons as fiduciaries and advisors to fiduciaries and to learn those lessons as always the best possible way, which is through the suffering of other people." – Dana Fitzsimons

kk. **Stealing 101**. "From *Ahern v. Montoya*, 2019 Nev. Unpublished LEXIS 401 (2019) we learn that

when you refuse to give your daughters two million dollars in mandatory trust distributions,

when you steal $1 million from a trust after being removed by the court as trustee,

when you lie under oath that a trust account has $2 million when it has $10,000,

when you use trust assets for private jet transportation and hotels –

you will be surcharged for $2.6 million in actual damages and up to $3.6 million in punitive damages once there's a separate hearing on the amount of damages.

Folks if we have learned anything from 1,000 years of the common law of trusts going back to the Crusades it is this. Write this down.

When you are a trustee and you are planning to steal from the trust, fly commercial!" – Dana Fitzsimons

ll. ***Bleak House* Mets Trust Law**. The *Schwartz v. Wellin* (D. S.C.) fact scenario has resulted in a number of reported decisions over the last five years. Among other things, a grantor sold a limited partnership interest to a grantor trust eventually resulting in a transfer of $100 million to the trust, which the grantor's adult children as trustees distributed to themselves. Lawsuits broke out, including an attempt by the parent-grantor to set aside the sale to the trust and a lawsuit against the estate planning attorney who planned the sale transaction. (The lawsuit against the attorney was dismissed as being barred by the statute of limitations.) The lawsuits have continued for years.

"The 2019 federal district court opinion began by noting that the following quotation from Charles Dickens' *Bleak House* could have been written about this case:

> 'This suit has, in course of time, become so complicated, that no two lawyers can talk about it for five minutes, without coming to a total disagreement as to all the premises. Innumerable children have been born into the cause, innumerable young people have married into it, and sadly, the original party has died out of it. A long procession of judges has come in and gone out during that time, and still the suit drags its weary length before the court.'

And that is how you know you have exhausted the patience of the federal district court in South Carolina." – Dana Fitzsimons

mm. **Mega-Million Dollar Lawsuit Turns on a Capital Letter; or Would YOU Have Caught This in Reviewing the Long Partnership Agreement**? The day after Christmas, the Federal District Court of South Carolina court in *Wellin v. Wellin* did what no party pleaded, what no party wanted, and what no party asked for, and over their objection. The court held that the transfers of partnership interests to a trust were invalid ab initio. The partnership agreement defines a "Person" to include both individuals and *entities*. The partnership agreement, in the same sentence, describes a transferor of partnership interests using the defined term "Person" but uses "person" (not capitalized) when referring to who may be permissible transferees. Because of the distinction of using the term "Person" for a transferor but "person" as a transferee, the court concluded that the agreement must mean that only individuals can be transferees of partnership interests, not trusts.

"The federal court, due to the lack of a capitalized 'P' voided ab initio all transfers to the trusts including partnership interests containing over $150 million of Berkshire Hathaway stock." – Dana Fitzsimons

nn. **Fast Talkers**. "I'm sorry that I am talking so fast, but to get through all of the detailed facts of this case I have to do something Dennis Belcher told me never to do when giving a speech, and that is to 'talk like a Yankee.'" – Dana Fitzsimons

oo. **All in a Name**. *Estate of Bond*, 2019 Ark. App. LEXIS 255 (2019) addresses a holographic will signed by Judge Elza Clifton Bond, Jr. "Elza Clifton Bond, Jr. was a respected judge. With a name like, Elza Clifton Bond, Jr. that's what he's going to be. He's not going to be a barista. He's destined for bigger things. He didn't get stuck with Dana Gene Fitzsimons, Jr. I'm having Elza envy here. (That was not in my prepared remarks. It's just my insecurity that comes out when I have a microphone.)" – Dana Fitzsimons

pp. **The Experts**. In *Bitetzakis v. Bitetzakis,* 2019 Fla. App. LEXIS 1328 (2019), George started to sign his will after two witnesses had signed the will. After signing his first name, his wife interrupted him and said (incorrectly) that he needed to sign before a notary. George usually signed his full name for his signature. The next day, George went to a notary without the will but with a self-proving affidavit (listing George as the only witness to his will), and George and the notary signed the affidavit. The court held that the will itself was not signed by George and that the self-proving affidavit did not cure the problem.

"This is the perversion of Google, by which everyone – and by everyone I primarily mean my mother – is now a doctor, a lawyer, and an expert in everything." – Dana Fitzsimons

qq. **All in a Signature**. In *Pena v. Dey,* 2019 Cal. App. LEXIS 825 (2019), a case of first impression, the trustor told his lawyer he wanted to revise his 2004 revocable trust and a 2008 amendment, and the lawyer asked him to send him the trust and amendment with his proposed changes. Robert sent the revocable trust and amendment with interlineations to his lawyer, attaching a Post-it note saying "Hi Scott, Here they are. First one is 2004. Second is 2008. Enjoy!. Best, Bob."

The lawyer called several days later to ask some clarifying questions, but Robert died later that same day before the amended documents could be finalized for signature. The court held that the interlineations did not amend the trust because they were not signed and that the Post-it note did not provide the signature because it was a separate writing despite being attached.

"The court held that the once patented Post-it note low-tack pressure sensitive adhesive was not enough to make the signature "stick" to the instrument. Not clear whether Superglue would have produced a different result." – Dana Fitzsimons

rr. **Vacation Home Disputes**. "According to consistent case law, the best planning advice for leaving a vacation home in trust for your children to peacefully and harmonious share continues to be – Don't!" – Dana Fitzsimons

ss. **2019 Dumbest Probate Criminal**. "This man forged a will to try to collect a $1.24 million unclaimed estate. He listed in the will as the assets the exact assets from the unclaimed estate inventory, to the penny. He acted extremely agitated before the clerks and while he was there to collect over a million dollars, he complained about the cost to *park his car*. And he was caught with a large container of stolen notary seals. Spoiler Alert: He Go To Jail." – Dana Fitzsimons

tt. **Chicago Dispute Resolution**. "Misapplying the law by a court is probably not the most severe thing that's ever happened when somebody stole from a bunch of Chicago cops." – Dana Fitzsimons

uu. **Drawing Inferences**. "The *Estate of DeChellis v. DeChellis* case out of Ohio held that there is no constitutional impediment to drawing an inference against you in a civil suit to recover probate estate assets when you take the Fifth when asked if you stole $750,000 in cash." – Dana Fitzsimons

vv. **Fiduciary Litigation Grief**. "This is my adaption of the Kübler-Ross model to trust law. The first stage of fiduciary litigation grief – you fight outside of court. The second stage – you fight in mediation. The third stage – you fight over discovery. The fourth stage – you fight over the merits in the trial court and through appeals. And now, finally the fifth stage of fiduciary litigation grief – you fight over the attorneys' fees. You never actually get to acceptance. The litigants just run out of money." – Dana Fitzsimons

ww. **New Acronym**. The charitable split-interest trust planning area is full of acronyms. CLAT, CRAT, CRUT, NICRUT, NIMCRUT, FLIP NUMCRUT, etc. In discussing whether a client might be relying on a split-interest trust for any cash flow from the trust in retirement years, Mark Williamson coined an important new acronym, YMNGP —– "You Might Not Get Paid." (The YMNGP Trust may not be very popular.) – Mark Williamson

xx. **A Romantic**. If a nonresident client makes a gift of tangible property while in the United States, the gift is subject to the U.S. gift tax (and no lifetime gift exclusion amount applies for the NRA). If the NRA gives a $30,000 bracelet to his paramour while visiting in New York, that is a gift that qualifies for the annual exclusion, resulting in a $15,000 taxable gift.

"Instead, the NRA should show her the bracelet, and say that as soon as the bracelet is out of the United States he will transfer title to her. In the meantime, would she like to keep it and care for it as his bailee?" – G. Warren Whitaker