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Transfer Planning in 2021, Including Transfers in Anticipation of Legislative Proposals and Possible Retroactive Transfer Tax Legislation

July 2021

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July 22, 2021

Introduction

After the January 5, 2021 Georgia runoff elections produced a 50-50 split, Democrats have controlled the Senate through the tie-breaking vote of Vice President Harris. Almost as important is that Democrat Senator Schumer is the Senate Majority leader controlling what legislative proposals are advanced in the Senate for floor votes. Democrats control the House, the Senate and the Administration, increasing the likelihood of income and transfer tax legislative changes in 2021 or 2022, including the possibility of accelerating the sunset of the gift, estate, and GST exemptions from $10 million (indexed) to $5 million (indexed), or even to $3.5 million (not indexed).

Many clients engaged in significant transfer planning in 2020, but many more clients will be encouraged to take advantage of the large $10 million (indexed--$11.7 million in 2021) exclusions while they exist. While this encourages transfers before changes occur, the possibility exists of retroactive changes, theoretically effective prior to the transfer, thus triggering the payment of gift taxes currently. What planning alternatives should clients be pursuing in taking advantage of a window of opportunity but also avoiding what some clients might view as a potential crisis of triggering a possibly significant gift tax payment

On top of that uncertainty, the Biden administration proposes in the FY 2022 Greenbook, mirroring in some respects several legislative proposals, a deemed realization regime upon making gifts or at death, which would generally result in a deemed realization of gains upon making contributions to trusts following the effective date of enactment (if enacted). These proposals would have a dramatic impact on trust planning in the future.

Tax Legislative Hurdles and Opportunities in 2021

1. Budget Reconciliation Legislative Process for Passage in Senate with Mere Majority Vote

The 50-50 split in the Senate makes passing far-reaching legislation (including tax legislation) difficult with the general 60-vote requirement in the Senate. While the budget reconciliation process offers the opportunity of passing certain types of legislation with only a majority vote in the Senate, it has various limitations and can be quite cumbersome.

For a general summary of the reconciliation process including the statutory authority, the two-step process of a budget resolution and reconciliation act, examples of the use of reconciliation, and the Byrd rule (which limits reconciliations measures that would produce additional deficits outside the "budget window" set in the budget resolution), see Item 2.d. of Estate Planning Current Developments and Hot Topics (May 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

a. **Statutory Authority.** The process for getting tax reform legislation in 2017 was using the budget reconciliation act. The Congressional Budget Act of 1974 (Titles I – IX of the Congressional Budget and Impoundment Control Act of 1974) modified and clarified the role of Congress in the federal budgetary process. It governs the process of annual budget resolutions and budget reconciliations. Title II created the Congressional Budget Office (CBO) to give Congress independent economic analysis; previously the Executive Branch controlled budgetary information. Standing budget committees in the House and Senate were created and additional staffing was authorized for committees involved with budget decisions. The Act includes a reconciliation process that allows expedited consideration of legislation related to spending, taxing, and the federal debt limit.

   For an excellent summary of the budget reconciliation process, see Congressional Research Service, The Budget Reconciliation Process: Stages of Consideration (January 7, 2021), available at **https://fas.org/sgp/crs/misc/R44058.pdf**.

b. **Budget Resolution.** Title III specifies procedures for the adoption of an annual budget resolution, which is a concurrent resolution that is not signed by the President, that sets out fiscal policy guidelines for Congress (but Congress does not adopt a budget resolution in all years). (The budget resolution cannot be filibustered in the Senate.) The budget resolution does not enact spending or tax law, but sets targets of overall receipts and expenditures, based on CBO estimates, for other committees that can propose legislation changing spending or taxes. The limits on revenue and spending that it establishes may be enforced in Congress under "points of order" procedural objections (which requires 60 votes in the Senate to waive). Budget resolutions set spending and revenue levels for a "budget window." The budget resolution also sets the "budget window," which must be at least five years but is usually (but not always) ten years. The budget resolution typically is rather straightforward, primarily stating how much should be spent in each of 19 broad spending categories, and specifying how much total revenue the government will collect for each year in the budget window.

The 2017 Tax Act was passed without any Democratic votes using the reconciliation process. The budget resolution, passed by the House in October 2017, and further limited by the Senate, ended up having a big impact on the final Act, because to get Senator Corker's essential vote, the budget authorized a maximum $1.5 trillion reduction of federal revenues over the ten-year budget window.

c. **Reconciliation Act.** The budget resolution can specify that a budget reconciliation bill will be considered to "reconcile" the work by various committees working on budget issues and to enforce budget resolution targets. Like the budget resolution, it cannot be filibustered in the Senate and only requires a majority vote. The reconciliation directive directs committees to produce legislation by a certain date that meets specified spending or tax targets. The various bills are packaged into a single bill with very limited opportunity for amendment. Only one reconciliation act is allowed for each fiscal year, which allows the possibility of two reconciliation acts in a calendar year, as happened in 2017 and conceivably could happen again in 2021. The reconciliation bill, when ultimately approved by the House and Senate, goes to the President for approval or veto.

d. **Examples of the Use of Reconciliation.** The reconciliation process has proved instrumental in being able to pass measures connected with the budget process without the necessity of garnering 60 votes in the Senate. More than 20 reconciliation bills have been enacted since 1980. For example, reconciliation was instrumental in the passage of deficit-reduction packages during the 1980s and 1990s, welfare reform in 1996, the 2001 and 2003 tax cuts (the 2001 Act passed with Vice President Cheney casting the deciding vote), parts of the Affordable Care Act in 2010, and the 2017 Tax Act. A reconciliation bill in 2017 to repeal and replace the Affordable Care Act failed when three Republican senators voted against it (the last being Senator John McCain's dramatic "thumbs down"). The American Rescue Plan Act of 2021 was enacted on March 11, 2021 with a variety of coronavirus pandemic relief measures; it passed the Senate on March 6, 2021 by a vote of 50-49 (Senator Sullivan (R-AK) did not vote).

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

> a provision shall be considered to be extraneous if it increases, or would increase, net outlays, or if it decreases, or would decrease, revenues during a fiscal year after the fiscal years covered by such reconciliation bill or reconciliation resolution, and such increases or decreases are greater than outlay reductions or revenue increases resulting from other provisions in such title in such year. 2 U.S. Code §644(b)(1)(E).)

The offending provision is automatically stripped from the bill unless at least 60 Senators waive the rule. (In congressional vernacular, reviewing a reconciliation act to determine if any extraneous provisions exist is referred to as giving the proposed legislation a "Byrd bath," and any items that are dropped to avoid having extraneous provisions are called "Byrd droppings.") The Senate parliamentarian makes the decision as to what provisions violate the Byrd rule. The Vice President, as the presiding officer of the Senate, can override the parliamentarian's decision, but "the long-standing Senate precedent is to defer to the parliamentarian's rulings." Steven Dennis & Laura Litvan, *Senate GOP to Snub House Obamacare Repeal Fill, Write Its Own*, BLOOMBERG DAILY TAX REPORT (May 5, 2017). As an example, the Republicans' preferred title for the 2017 tax cut legislation, the "Tax Cuts and Jobs Act," had to be removed because jobs are not directly related to revenue, spending, or deficits, but that unofficial name is often used in referring to the 2017 Tax Act, and a minimum wage provision was dropped from the American Rescue Plan in February 2021. The Senate parliamentarian has been Elizabeth MacDonough since 2012. Kristina Peterson, *Meet the Senate Parliamentarian, Key Figure in Minimum-Wage Debate*, WALL STREET J. (Feb. 25, 2021).

The process used by parliamentarian in a Byrd bath follows a disciplined process, including a consideration of similar precedents.

> The "Byrd bath" is purely a creature of the budget process — the parliamentarians generally don't have to review a regular-order bill. But unlike in an appellate court, there's typically no public record of why a parliamentary ruling went one way or what factors were considered in giving the advice.
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> However, the deliberations are far from cursory or arbitrary, according to former Senate staff members who have participated in them in the past. The vetting process when a Byrd rule point of order is anticipated is extensive and often begins before the bill's markup. Senators' staffs explain the policies in the proposed reconciliation bill to the parliamentarians. The staff members then work through the bill text with them, and the parliamentarians ask questions and sometimes give assignments to provide further explanations.
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> Sometimes senators offer insights into the deliberations behind the rulings. For example, on the Senate floor on March 25, 2010, then-Sen. Kent Conrad explained that the parliamentarian had advised that two provisions in the **Healthcare and Education Reconciliation Act of 2010** violated the Byrd rule, and found it persuasive that the Congressional Budget Office concluded that they didn't score for budgetary purposes (**156 Cong. Rec. S2085**). But that level of transparency is rare.
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> The parliamentarian is hired by the majority leadership, which means they can also be terminated by the party in control. But historically, the parliamentarian has generally continued to hold office through changes in party control. There have been six parliamentarians since the role was established in 1935. Two were fired by the majority leader and then rehired later.
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> …
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> For the budget process, the Office of the Parliamentarian assembles a collection of electronic Senate precedents that is available only to senators and their staffs. Those documents are unofficial and include precedents created after the publication of [*Riddick's Senate Procedure*] in 1992. The precedents are created by the Senate through a vote or a ruling by the presiding officer.
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> Similar provisions in enacted reconciliation bills provide perhaps the most persuasive precedent, especially if they are relatively recent and survived a challenge from the Senate floor.
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> Sometimes the precedents regarding consideration of potential Byrd rule violations are made publicly available, but usually not in their entirety. The Byrd bath process, in which the parliamentarians meet with both Democratic and Republican Senate staffers, is closed to the public, and the underlying rationale for the decision is made public only if a senator chooses to talk about it publicly. Only the ruling on whether a Byrd rule violation exists is usually announced. Although senators frequently announce when they have secured a favorable opinion from the Senate parliamentarian, they rarely explain the grounds for it. Marie Sapirie, *How the Senate's Rules and Precedents Shape the Tax Law*, TAX NOTES (March 15, 2021).

If the legislation does not result in revenue neutrality after the budget window, the classic approach is to sunset the offending measures at the end of the budget window, thus resulting in tax reform measure or tax cuts that would not violate the Byrd rule and that could be passed with a mere majority in the Senate. The "Bush tax cuts" in 2001 lasted only ten years for that reason. The 2017 Tax Act generally sunsets most of the individual and transfer tax provisions (not including, among other things, the chained CPI approach for indexing) after 2025 to avoid having a 60-vote requirement in the Senate under the Byrd Rule.

Tax reform will not necessarily have to be subject to a 10-year sunset provision (what some planners refer to as a "sunrise" provision) if 60 votes cannot be secured in the Senate if the overall package does not add to the deficit outside the budget window of the act. Some significant tax acts have been passed under the reconciliation process without the sunset provision by finding other "pay-fors" so that net tax revenue decreases do not exceed net outlay decreases outside the budget window. (That was accomplished with the 1997 tax act, but that was in a time of budget surpluses.)

The Biden tax proposals are generally to increase taxes, but with some targeted tax relief for middle class Americans. The tax measures would result in overall increased, not decreased, revenues outside the budget window, so the Byrd rule might not play a significant role in efforts to enact a reconciliation package of tax measures by the Biden administration.

For an excellent detailed description of the Byrd Rule and its history, see Congressional Research Service, The Budget Reconciliation Process: The Senate's "Byrd Rule" (updated December 1, 2020) available at **https://fas.org/sgp/crs/misc/RL30862.pdf**.

f. **What Elements of Biden Proposals Could Fit Within Reconciliation Limitations?** The American Rescue Plan legislation, which was enacted on March 11, 2021 under the reconciliation process, dropped the federal minimum wage increase after it was determined by the Senate parliamentarian, Elizabeth MacDonough, to be an extraneous provision under the Byrd rule after a variety of meetings of legislative staff members who had the opportunity to present their respective positions. Many of the other Biden priorities would likely not be appropriate for the reconciliation process (for example, immigration reform, voting rights, and social justice issues).

g. **Two Reconciliation Acts Possible in 2021.** Reconciliation can be used only once for each fiscal budget cycle, but reconciliation could be used in 2021 for both the fiscal 2021 and 2022 years. (Republicans used two reconciliation acts in 2017, one of which was the 2017 tax reform measure.) Democrats used reconciliation for passage of the American Rescue Plan Act of 2021 for the 2021 fiscal budget cycle, but a subsequent reconciliation act could be used later in 2021 for the fiscal 2022 budget. The act for the 2022 fiscal year generally would not be effective until October 1, 2021 or later, the beginning of the 2022 fiscal year, but there is precedent for rate changes effective as of an earlier date. The Omnibus Budget Reconciliation Act of 1993, pursuant to the concurrent resolution on the budget for fiscal year 1994, was enacted August 10, 1993 (Vice President Al Gore cast the deciding 51st vote in the Senate on the Conference Report); OBRA 1993 included retroactive individual and business income tax rate changes retroactive to January 1, 1993.

Furthermore, the Senate parliamentarian on April 5, 2021 construed §304 of the Congressional Budget Act to mean that a **revised** budget resolution with reconciliation instructions could be adopted, which in effect would allow an additional reconciliation measure to be added to the reconciliation act that was passed in March 2021. Effectively, this would permit three or more reconciliation measures to be passed in a single calendar year. However, she later clarified that revising the earlier 2021 budget resolution must go through committee and floor amendment votes, and a legitimate reason – such as a new economic downturn – would be required for a revision. Therefore, Democrats are more likely to attempt a fresh fiscal 2022 budget resolution and reconciliation approach if reconciliation is needed for some of the infrastructure measures, but the budgeting process requires debate and votes on the relevant Congressional panels, which "could allow Republicans to bottle up the budget in committee by denying a quorum." Erik Wasson, *Schumer's Infrastructure Path May Get Trickier After Ruling*, BLOOMBERG DAILY TAX REPORT (June 2, 2021). Under the parliamentarian's clarification, using the fiscal year 2022 budget for a reconciliation act dealing with infrastructure plans would preclude using it later for other purposes, such as Obamacare expansion or cutting drug prices. *Id.*

2. President Biden's Tax Measures and Proposals (Including Deemed Realization Upon Gift and at Death Proposals)

a. **American Rescue Plan.** The American Rescue Plan is a $1.9 trillion coronavirus rescue package passed under the reconciliation legislative process, signed by the President on March 11, 2021. The legislation includes a wide variety of relief measures, including stimulus checks, vaccinations and testing funding, state and local aid, unemployment insurance, minimum wage, and paid leave provisions. It also includes expanding the child tax credit (for 2021 only, a refundable credit of $3,000 for each child ages 6 – 17 and $3,600 for each child under age 6 for couples who make $150,000 or less and single parents who make $112,500 or less) and the earned income tax credit (some provisions apply for 2021 only but other modifications of the EITC are permanent). *See* Rev. Proc. 2021-23 adjusted tables for those credits and the premium tax credit.

b. **American Jobs Plan and Made in America Tax Plan Proposal.** The centerpiece of an expansive infrastructure proposal is The American Jobs Plan, released March 31, 2021. Alongside the infrastructure plan is The Made in America Tax Plan with proposed changes to the corporate tax code. Among other things, the corporate tax plan would increase the corporate tax rate from 21% to

28% (still less than the 35% rate that applied before the 2017 Tax Act), adopt various provisions to discourage shifting jobs and profits offshore, and enact a minimum tax on large corporations' book income (anticipated to apply to 45 very large publicly traded companies). Detailed descriptions of these proposals are included in the Biden administration's "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (popularly called the "Greenbook").

c. **American Families Plan Proposal.** Alongside The American Jobs Plan's proposed investment in infrastructure, The American Families Plan is proposed as an investment in the nation's children and families. It includes various education investments, various measures to support for families (such as child care, family and medical leave program, and nutrition assistance), and tax relief measures for families, including extending key tax cuts in the American Rescue Plan benefitting lower- and middle-income families (such as the child tax credit, the earned income tax credit, the child and dependent care tax credit, and health insurance tax credits). The American Families Plan also includes various tax increases (many of which reverse the tax decreases in the 2017 Tax Act). The FY 2022 Greenbook includes detailed descriptions of the tax proposals in The American Families Plan. Those proposal include:

- Raising the top income rate from 37% to 39.6%;
- Taxing capital gains and qualified dividends as ordinary income (top rate of 39.6% plus the 3.8% "Medicare" tax) for taxpayers having adjusted gross income over $1 million, but only to the extent the taxpayer's income exceeds $1 million ($500,000 for married filing separately), indexed for inflation after 2022, effective "for gains required to be recognized after the date of announcement" (presumably the date the White House released the Fact Sheet about The American Families Plan); the combined federal and state rate in high-tax states could exceed 50%, for example, as high as 52.22% in New York and 56.7% in California); *see* Laura Davison & Allyson Versprille, *Biden Aims at Top 0.3% With Bid to Tax Capital Gains Like Wages*, BLOOMBERG DAILY TAX REPT. (April 23, 2021);
- Providing for deemed realization of gains at the time of gifts and at death for capital gains exceeding $1 million (increased from $100,000 during the Presidential campaign); the Fact Sheet for The American Families Plan referred to "ending the practice of 'stepping-up' the basis for gains in excess of $1 million … and making sure the gains are taxed if the property is not donated to charity," but the FY 2022 Greenbook allows for "stepping-up" the basis of assets passing from a decedent, even for the amount of gains covered by the deemed realization exclusion; the deemed realization proposal for gifts and at death is discussed in more detail in Item 2.g below;
- Taxing "carried interests" as ordinary income;
- Eliminating real estate like-kind exchanges for gains in excess of $500,000, or $1 million for married individuals filing a joint return (the like-kind exchange provision was enacted 100 years ago in 1921 and has been relied on since; repeal could be a huge change for real estate owners, who often have invested using repeated like-kind exchanges and planning on a stepped up basis at death, see Martin Sullivan, *Can Biden Upset the Swap, Swap, and Drop Approach to Commercial Real Estate?*, TAX NOTES (Jan. 19, 2021));
- Permanently extending the current limitation that restricts large excess business losses;
- Applying the 3.8% tax to business income from pass through entities for taxpayers with adjusted gross income over $400,000 who materially participate in the business; and
- Adding $80 billion to the IRS with the goal of raising an additional $700 billion of revenue over ten years.

Overall, the tax increases proposed by the Greenbook are estimated to raise revenue over the next 10 fiscal years by about $3.6 trillion.

Transfer taxes are not included in the tax measures that are in the American Families Plan or in the FY 2022 Greenbook, but the plan will be the subject of intense negotiations – some commentators have noted that the Joint Committee on Taxation in scoring tax proposals often refuses to credit much anticipated revenue to increased compliance efforts that are not tied to specific policy changes, and the administration may end up needing more revenue generators to offset the costs of the infrastructure provisions in the plan, see Jonathan Curry, *Biden's Next Plan Targets Like-Kind Exchanges and Stepped-Up Basis*, TAX NOTES (May 3, 2021).

d. **President Biden's Other General Tax Proposals.** The administration has repeatedly said that it will not increase income taxes on families with income less than $400,000, but a White House official has reported that the threshold is actually higher than that in keeping with the tax brackets before the 2017 Tax Cuts and Jobs Act; the taxable income threshold in 2022 is anticipated to be $452,700 (individuals)/$509,300 (married filing jointly). *See* Jonathan Curry, *Biden's NII Tax Fix Destined to Be the Bane of Practitioners,* TAX NOTES (May 3, 2021).

Some of the other income tax proposals by President Biden that are not included in the FY 2022 Greenbook include the following, many of which are to roll back the 2017 Trump tax cuts:

- Applying the payroll tax to earnings over $400,000;
- Limiting reduction in tax liability from itemized deductions to no more than 28% of deductions;
- Restoring the Pease limitation on itemized deductions for taxable incomes above $400,000;
- Phasing out the §199A deduction for qualified business income above $400,000; and
- Eliminating fossil fuel subsidies.

e. **Transfer Taxes.** As mentioned above, transfer taxes are not addressed in The American Families Plan. Biden's position on transfer tax rates and exclusions was unclear through much of the Presidential campaign. The Obama administration's budget "Greenbook" proposals, beginning in 2013, had included returning to the 2009 estate, gift, GST, and gift tax parameters (45% rate, $3.5 million exclusion for estate and GST taxes, and $1 million exclusion for gift taxes). The exclusion amounts were not indexed.

A rather obtuse reference on the Biden campaign website suggests that President Biden supports a return to the 2009 parameters ($3.5 million/$1 million exclusions, not indexed, and 45% rate). The Biden campaign website (**https://joebiden.com/plans-to-support-women-duringcovid19/**), under the topic of "Highlights of Joe Biden's Plans to Support Women During the COVID-19 Crisis," stated:

> Permanently provide family, medical, and safe leave as well as sick and safe days. As President, Biden will work to provide the type of comprehensive 12 weeks of paid family and medical leave envisioned in the FAMILY Act sponsored by Senator Kristen Gillibrand and Representative Rosa DeLauro. Biden will pay for this proposal by returning the estate tax to 2009 levels.

Dr. Yellen's written responses to questions in her Senate confirmation process also pointed to a $3.5 million exemption level. See Item 6.d below.

The Biden administration may also support various transfer tax reforms, for example, regarding GRATs, valuation discounts, and family limited partnerships. A paper previously written by current key Biden administration officials makes clear their disdain for these planning alternatives:

> Furthermore (and relevant to debates about how much a wealth tax would raise), estate taxes are inherently more prone to avoidance than wealth taxes because they apply only at one point in time per generation. A variety of estate tax avoidance strategies involve **temporarily and artificially deflating the value** of transferred assets at the point in time that the wealth transfer is deemed to occur—and therefore valued—for tax purposes [citation omitted].
>
> For example, **family limited partnerships (FLPs)** are used to temporarily hold investment assets in order to obtain non-liquidity discounts. Once the moment for valuing and taxing the transfer has passed, owners often dissolve the FLP so they can sell the underlying assets at will. The IRS estimates the valuation discounts for FLPs range from 30 to 65 percent [citations omitted].
>
> As another example, donors use "string" or "hybrid" transfers, where the donor retains the ability to receive some portion of the property back, in order to deflate the value of the transferred assets. In these cases, the donor inflates the value of their retained interest at the time of the taxable gift by gaming assumed interest rates,

mortality tables, and other factors. Then, their retained interest is valued at its correct (and much lower) value when it is later included in their taxable estate. In the process, a large portion of the value of the transferred assets can simply disappear for wealth transfer tax purposes. Such "string" transfers include **grantor retained annuity trusts (GRATs)** which, according to one estimate, have reduced the amount of revenue raised by estate and gift taxes by one-third [citation omitted].

…. Sheldon Adelson contributed $31 million of stock to a **GRAT** that enabled him to give **$519 million** to his heirs over two years that was entirely excluded from the estate and gift tax bases [citation omitted]. Under a wealth tax, his heirs would immediately be subject to tax on the $519 million they received. But under the estate and gift tax, that $519 million was not taxed at all. The only time it could be tax [sic] was much later—if and when his heirs later transferred their inheritance to their children. Lily Batchelder & David Kamin, *Taxing the Rich: Issues and Options*, at 23 (Sept. 11, 2019) available at **https://ssrn.com/abstract=3452274** (emphasis added).

f. **Controversial Proposals for Deemed Realization on Making Gifts or at Death.** The Biden administration proposes a deemed realization of gain on making gifts or at death. For a discussion of the realization at death proposals by the Obama administration in 2015 and 2016, see Aucutt, Estate Tax Changes Past, Present, and Future, §17.i. (June 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**).

The Biden administration proposal, House and Senate legislative proposals, and current planning implications of these proposals are discussed in Items 2.g, 2.h, 2.i, and 2.j below.

For an interesting discussion of various collateral tax effects and open questions regarding the deemed realization proposals, see Monte Jackel, *No Escape: Proposals for Taxing Gains at Death*, TAX NOTES (July 5, 2021). For a discussion of potential planning implications of the basis step-up proposals, and the possible extension to include realization at death, see Joan Crain & Justin T. Miller, *Stepping Away from the Step-Up in Basis at Death, A Global Perspective*, LEIMBERG EST. PL. NEWSLETTER #2825 (Sept. 17, 2020). For a detailed discussion of how a realization at death approach might work, see Harry L. Gutman, *Taxing Gains at Death*, TAX NOTES (January 28, 2021).

The deemed realization proposals are bold new taxing approaches in the U.S. that are quite controversial. In an unusual move, all 50 Republican senators signed a letter to President Biden on July 21, 2021 urging the President to drop the realization at death proposal. The letter includes that

… many businesses would be forced to pay tax on appreciated gains, including simple inflation, from prior generations of family owners—despite not receiving a penny of actual gain. These taxes would be added to any existing estate tax liability, creating a new backdoor death tax on Americans.

These changes are a significant tax increase that would hit family-owned businesses, farms, and ranches hard, particularly in rural communities. These businesses consist largely of illiquid assets that will in many cases need to be sold or leveraged in order to pay the new tax burden. Making these changes could force business operators to sell property, lay off employees, or close their doors just to cover these new tax obligations. The complexity and administrative difficulty of tracking basis over multiple generations and of valuing assets that are not up for sale will lead to colossal implementation problems and could also lead to huge tax bills that do not accurately reflect any gains that might have accumulated over time. As you will recall, a proposal to reach a similar outcome by requiring an heir to "carry-over" the decedent's tax basis was tried before in 1976—and failed so spectacularly it never came into effect. It was postponed in 1978 and repealed in 1980.

All 50 Democratic senators would likely have to vote for such measures in order to pass them in a reconciliation act, and some Democratic Congressmen have already expressed skepticism. For example, House Agriculture Committee Chairman David Scott has sent a letter to President Biden expressing "serious concerns" about how the proposed tax increases could affect farmers, ranchers and other small businesses and stating that even with exemptions in the proposals, "the provisions could still result in significant tax burdens on many family farming operations." Senator Jon Tester (D-MT) has also expressed concern about the impact of the deemed realization approach on farmers and ranchers.

g. **Deemed Realization Proposals in Treasury's Explanation of Fiscal Year 2022 Budget Proposals ("Greenbook").** Whether the American Families Plan calls for a deemed realization at death system was unclear based on the Fact Sheet that the White House released on April 28, 2021, but the FY 2022 Greenbook provides a detailed description of the deemed realization taxing regime.

The following summary of Deemed Realization Upon Gift or Death Proposals is by Ronald D. Aucutt (Bessemer Trust) and is included with his permission.

The Treasury Department released its "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (popularly called the "Greenbook") on May 28, 2021, available at **https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf**. It proposes no changes to the estate and gift taxes.

Following up proposals announced in the Administration's "American Families Plan" on April 28, 2021, and citing the need to "reduce economic disparities among Americans," the Greenbook (at pages 60-62) includes proposals to increase the top marginal individual income tax rate to 39.6 percent (as it was before the 2017 Tax Act), effective January 1, 2022, and to tax capital gains at the same rate as ordinary income for taxpayers with adjusted gross income greater than $1 million, effective "for gains required to be recognized after the date of announcement" (presumably April 28, 2021).

The Greenbook (at pages 62-64) also provides details focusing and clarifying the proposal for the "deemed realization" of capital gains foreshadowed by the Obama Administration's Greenbooks for Fiscal Years 2016 (Feb. 2, 2015, pages 156-57) and 2017 (Feb. 9, 2016, pages 155-56), by President Biden's campaign, and by Representative Bill Pascrell's H.R. 2286 and Senator Van Hollen's "discussion draft" of the Sensible Taxation and Equity Promotion ("STEP") Act of 2021 discussed in Item 2.h below. That Greenbook proposal is summarized as follows:

(1) **Effective Date.** The proposal would take effect on January 1, 2022, like H.R. 2286. But it would apply to pre-2022 appreciation; there would be no "fresh start" as, for example, in the 1976 carryover basis legislation.

(2) **Realization Events.** Gain would be explicitly recognized on transfers by gift or at death, equal to the excess of an asset's fair market value on the date of the gift or death over the donor's or decedent's basis in that asset. Losses obviously would also be recognized if basis exceeds fair market value because the Greenbook refers to "the use of capital losses … from transfers at death" as an offset. The Greenbook does not mention holding periods or distinguish short-term and long-term gain. The Greenbook also does not specifically incorporate the alternate valuation date for transfers at death, although it does state generally that a transfer "would be valued using the methodologies used for gift or estate tax purposes."

(3) **Taxpayer, Return, and Deductibility.** The Greenbook states that the gain would be reported "on the Federal gift or estate tax return or on a separate capital gains return." Reassuringly, however, the Greenbook confirms that the gain "would be taxable income to the decedent" and, consistently with that characterization, explicitly adds that "the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any)."

(4) **Exclusion for Tangible Personal Property.** "[T]angible personal property such as household furnishings and personal effects (excluding collectibles, such as art)" would be exempt. There is no mention of explicit application to property held for investment as in H.R. 2286 or property related to the production of income as in the STEP Act.

(5) **Exclusion for Transfers to Spouses.** The Greenbook would exempt "[t]ransfers by a decedent to a U.S. spouse," without explicitly exempting lifetime gifts to a spouse as both H.R. 2286 and the STEP Act do. There is no elaboration of the term "U.S. spouse" (for example, citizen or resident), and there are no special provisions targeted to spousal trusts. Typically, the effect of exempting transfers to spouses will be simply to defer the application of the deemed realization rules until the spouse's disposition of the asset or the spouse's death.

(6) **Exclusion for Transfers to Charity.** The Greenbook would exempt transfers to charity. But it adds that "[t]he transfer of appreciated assets to a split-interest trust would generate a taxable capital gain, with an exclusion allowed for the charity's share of the gain based on the charity's share of the value transferred as determined for gift or estate tax purposes." This will require further elaboration.

(7) **Other Exclusions.** The Greenbook proposes a single unified exclusion of capital gains for transfers both by gift and at death of $1 million per person, indexed for inflation after 2022 and "portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes." The Greenbook adds that this would "mak[e] the exclusion effectively $2 million per married couple," without explaining exactly how that would be accomplished for lifetime gifts when there has been no "decedent" or "surviving spouse." The Greenbook does not address whether the use of the exclusion for lifetime gifts is mandatory or elective.

To the extent that exclusion applies, the Greenbook proposes to retain the current basis rules under sections 1014 and 1015. Thus, to that extent, "[t]he recipient's basis in property received by reason of the decedent's death would be the property's fair market value at the decedent's death" (presumably subject to the consistent basis rules of section 1014(f) added in 2015), and the basis of property received by gift would be the donor's basis in that property at the time of the gift. To the extent the exclusion does not apply, the recipient, whether of a gift or at death, will receive a basis equal to the fair market value used to determine the gain. The Greenbook leaves for further elaboration the manner in which those adjustments to basis would be allocated among multiple assets in a case of a lifetime gift or gifts where some but not all of the gain realized under this proposal is sheltered by the exclusion.

In addition, the Greenbook confirms that the exclusion of $250,000 per person of gain from the sale or exchange of a taxpayer's principal residence under section 121 would apply to the gain realized under this proposal with respect to all residences, and it adds that that exclusion would be made "portable to the decedent's surviving spouse." In this case the application to lifetime gifts may be less of an issue, because section 121(b)(2) itself doubles the exclusion to $500,000 for joint returns involving jointly used residences. The Greenbook also confirms that the exclusion under current law for capital gain on certain small business stock under section 1202 would apply.

(8) **Netting of Gains and Losses.** For transfers at death, capital losses and carry-forwards would be allowed as offsets against capital gains and up to $3,000 of ordinary income, mirroring the current income tax rules in sections 1211 and 1212. There is no mention of relaxing the related-party loss rules of section 267 as there is in both H.R. 2286 and the STEP Act, but it seems very unlikely that it would be omitted from any provision for taking losses into account at death, where transfers to related parties are the norm.

(9) **Valuation.** As noted above, the Greenbook contemplates that a transfer generally "would be valued using the methodologies used for gift or estate tax purposes." But the Greenbook adds that "a transferred partial interest would be its proportional share of the fair market value of the entire property." In other words, no discounts. The Greenbook does not indicate whether "partial interest" is meant to be limited to undivided interests such as in tenancies-in-common, or whether it might include nonmarketable interests in entities like partnerships, limited liability companies, and corporations. Surely it would not include, for example, publicly traded stock, but attention in drafting might be required to confirm that.

(10) **Special Rules for Trusts and Entities.** Generally mirroring H.R. 2286 and the STEP Act, the Greenbook provides that transfers into, and distributions in kind from, a trust would be recognition events, unless the trust is a grantor trust deemed wholly owned and revocable by what the Greenbook calls "the donor." There is no mention of "grandfathering" irrevocable trusts in existence on the date of enactment, and therefore this Greenbook feature would apparently apply to distributions of appreciated assets to both current and successive or remainder beneficiaries of preexisting trusts, including, for example, both the grantor and the remainder beneficiaries of a pre-2022 GRAT. With regard to revocable trusts, the deemed owner would recognize gain on the unrealized appreciation in any asset distributed (unless in discharge of the deemed owner's obligation) to anyone other than the deemed owner or the deemed owner's "U.S. spouse" (again undefined), and on the unrealized appreciation in all the assets in the trust when the deemed owner dies or the trust otherwise becomes irrevocable.

But the Greenbook goes a lot farther. The rules about transfers into and distributions in kind from a trust also apply to a "partnership" or "other non-corporate entity." This looks like a far reach, but the Greenbook does not explain further.

The Greenbook also states:

> Gain on unrealized appreciation also would be recognized by a trust, partnership, or other noncorporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. The first possible recognition event for any taxpayer under this provision would thus be December 31, 2030.

Ninety years for periodic "mark-to-market" treatment of trust assets is a surprising departure from the somewhat similar rules in H.R. 2286 (30 years) and the STEP Act (21 years), but it again would apply to assets of partnerships and other entities. And again the Greenbook does not explain further. Because 90 years from January 1, 1940, is January 1 (not December 31), 2030, it appears that the Greenbook contemplates recognition only at the end of the year, but the Greenbook does not clarify that.

(11) **Deferral of Tax.** The Greenbook reprises the Obama Administration's Fiscal Year 2016 and 2017 proposals that "[p]ayment of tax on the appreciation of certain family-owned and -operated businesses would not be due until the interest in the business is sold or the business ceases to be family-owned and operated." Providing that the payment of tax is not "due" (rather than merely providing for a section 6166-like "extension of time for payment") implies at a minimum that there would be no interest charged (which can otherwise be a big problem, even for the no-more-than-14-year deferral of section 6166). The implementing statutory language might also provide that the realization event itself is deferred until ownership or operation of the business passes outside the family. That could increase the amount of tax if there is more appreciation, but it could also prevent the payment of tax to the extent the value of the business declines (which sometimes happens after the death of a key owner). That approach would apparently also tax the realization event at whatever the tax rates happen to be at the time. But if the cessation of family ownership results from the family's sale of the business, that postponed realization approach would be the same as current law in subjecting any sale like that to tax, except apparently for the loss of a stepped-up basis at intervening deaths.

The enactment of this proposal or any close variation of it in a tightly divided Congress is by no means certain, and the long-term durability of such a provision enacted in such a political climate would not be guaranteed. That could create special challenges in cases where a tax on the succession of the family businesses is nominally imposed, but is suspended for many years, decades, or even generations.

And of course the statutory language implementing this Greenbook proposal should be expected to include definitions of a "business," "family-owned," and "family-operated," as well as rules for the identification of assets that should be excluded from the deferral because they are not used in the business, and such rules might also create or aggravate challenges over a long-term suspension.

In addition, like the STEP Act and the Obama Administration Greenbooks (and broader than H.R. 2286), the Greenbook proposal would allow "a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made." Details about start dates and interest rates are not provided, but the proposal might resemble the STEP Act's proposed section 6168, which in turn resembles section 6166 without the 35-percent-of-gross-estate requirement to qualify, with an interest rate equal to 45 percent of the normal annual rate as in section 6601(j)(1)(B), but without the "2-percent portion" as in section 6601(j)(1)(A).

As in H.R. 2286 and the STEP Act, the IRS would be authorized to require reasonable security at any time from any person and in any form acceptable to the IRS.

(12) **Administrative Provisions.** Following the Obama Administration Greenbooks, with a few additions, the Greenbook envisions (but without details) a number of other legislation features,

covering topics such as a deduction for the full cost of related appraisals, the imposition of liens, the waiver of penalties for underpayment of estimated tax attributable to deemed realization of gains at death (which, of course, could not have been foreseeable), a right of recovery of the tax on unrealized gains, rules to determine who selects the return to be filed, consistency in valuation for transfer and income tax purposes, and coordination of the changes to reflect that the recipient would have a basis in the property equal to the value on which the capital gains tax is computed.

(13) **Regulations.** Treasury would be granted authority to issue any regulations necessary or appropriate to implement the proposal, including reporting requirements that could permit reporting on the decedent's final income tax return, which would be especially useful if an estate tax return is not otherwise required to be filed. In a tacit acknowledgment of the harshness of proceeding with such a proposal without a "fresh start" for basis as in 1976, the Greenbook explicitly contemplates that the regulations will include "rules and safe harbors for determining the basis of assets in cases where complete records are unavailable."

(14) **Revenue Estimate.** Taxing capital gains at the same rate as ordinary income for taxpayers with adjusted gross income greater than $1 million and the proposed "deemed realization" of capital gains together are estimated to raise $322.485 billion over the next 10 fiscal years. This includes $1.241 billion estimated for Fiscal Year 2021, which ends September 30, 2021. That presumably results from the proposed retroactive effective date for taxing capital gains at the same rates as ordinary income, but evidently also contemplates increased estimated income tax payments by September 30. (This is the only proposal in the Greenbook that is estimated to have an effect on revenues in Fiscal Year 2021.)

Overall, the tax increases proposed by the Greenbook are estimated to raise revenue over the next 10 fiscal years by about $3.6 trillion.

h. **House and Senate Deemed Realization Proposals Under Consideration.**

The following summary of Deemed Realization Upon Gift or Death Proposals is by Ronald D. Aucutt (Bessemer Trust) and is included with his permission.

(1) **Legislation Introduced and Under Discussion.** On March 29, 2021, Ways and Means Committee Member Bill Pascrell, Jr. (D-New Jersey) introduced H.R. 2286, described as a bill "to amend the Internal Revenue Code of 1986 to treat property transferred by gift or at death as sold for fair market value, and for other purposes." On the same day, Senator Chris Van Hollen (D-Maryland), joined by Senators Cory Booker (D-New Jersey), Bernie Sanders (I-Vermont), Sheldon Whitehouse (D-Rhode Island), and Elizabeth Warren (D-Massachusetts), issued a statement calling "the Stepped-Up Basis Loophole" "one of the biggest loopholes in the U.S. tax code, which subsidizes America's wealthiest heirs," citing a Joint Committee on Taxation estimate that it will cause a loss of $41.9 billion of tax revenue in 2021 alone. The statement was accompanied by 32 pages of statutory language titled the "Sensible Taxation and Equity Promotion ("STEP") Act of 2021," with the acronym of "STEP" evidently designed to recall the "step-up" in basis that it attacks.

(2) **Effective Dates.** A conspicuous and significant difference between Congressman Pascrell's H.R. 2286 and Senator Van Hollen's "discussion draft" of the "STEP Act" is their effective dates.

H.R. 2286 would apply to gifts and transfers made, including transfers from decedents dying, after December 31, 2021. Consistent with the exclusion amount and rate changes in Senator Sanders' "For the 99.5 Percent Act" discussed in Item 3 below that is the typical effective date for broad changes in the taxation of transfers by gift and at death, although other provisions of the Sanders bill itself show how the date of enactment can be a typical effective date for changes to the tax treatment of particular transactions or structures.

For the Senate discussion draft, the corresponding date would be December 31, 2020. In other words, it would be uncharacteristically retroactive to the beginning of 2021. This could be a portent of less deference to conventional effective-date norms in the political climate of the current Congress. Or it could mean only that Congressman Pascrell, as a member of the Ways and Means Committee, has received more technical assistance from staff members who understand the historical and practical preferences for avoiding retroactivity. Or it could mean that a "discussion draft" is only that.

Both proposals would tax past appreciation, not just appreciation following enactment. This contrasts with the 1969 proposed "Taxation of Appreciation of Assets Transferred at Death or by Gift," which stated that "[o]nly appreciation occurring after the date of enactment would be subject to tax." "Tax Reform Studies and Proposals, U.S. Treasury Department," Joint Publication of the House Committee on Ways and Means and Senate Committee on Finance, at 335 (91st Cong., 1st Sess., Feb. 5, 1969). It also contrasts with the 1976 enactment (which proved to be temporary) of carryover basis, which provided a "fresh start" valuation on December 31, 1976, and a proration of appreciation over the entire holding period of nonmarketable assets acquired before that date. Section 1023(h), added by section 2005(a)(2) of the Tax Reform Act of 1976, Public Law 94-455 (94th Cong., 2d Sess., Oct. 4, 1976). Interestingly, it does not contrast as sharply with the "aggregate basis increase" and "spousal property basis increase" provided by the second (also temporary) enactment of carryover basis in 2001, taking effect in 2010, which was not as clearly tailored to sheltering pre-enactment appreciation. Section 1022(b) and (c), added by section 542(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16 (107th Cong., 1st Sess., June 7, 2001).

(3) **Deemed Sale Rule of New Section 1261.** The proposals would add a new section 1261 to the Code, generally treating any property transferred by gift or at death as sold for its fair market value on the date of the gift or death. Both proposals appear to contemplate that the gain on deemed sales at death would be reported on the decedent's final income tax return (Form 1040), or a supplement to it, but they do not say that.

(4) **Exception for Tangible Personal Property.** The deemed sale rules would not apply to transfers of tangible personal property other than collectibles (including coins and bullion) and property held in connection with a trade or business. H.R. 2286 adds property held for investment, and the STEP Act adds property related to the production of income under section 212, to the coverage of the deemed sale rules.

(5) **Exception for Transfers to Spouses.** A transfer to the spouse of a transferor or surviving spouse of a decedent would be exempt from this deemed sale treatment if the spouse is a U.S. citizen (or long-term resident under the STEP Act), essentially deferring sale treatment until the spouse disposes of the asset.

Under H.R. 2286, this exemption is extended to a "qualifying spousal trust," which is defined as a qualified domestic trust ("QDOT") of which the transferor's spouse or surviving spouse is the sole current income beneficiary and has the power to appoint the entire trust. Under the STEP Act, this exemption is extended to a QTIP trust. Awkwardly, the STEP Act describes a QTIP trust as "qualified terminal [*sic*, not "terminable"] interest property." Also awkwardly, H.R. 2286 incorporates the QDOT definition of section 2056A, even though the spouse must be a U.S. citizen to qualify for the deemed sale exception in H.R. 2286 in the first place. That could conceivably even require any ordinary QTIP trust for a U.S. citizen spouse to mandate the withholding under section 2056A(a)(1)(B) of estate tax payable with respect to distributions, for example (or, channeling it into the deemed sale context, withholding the income tax on unrealized appreciation avoided by the transfer to the trust), although there is no indication that such an odd result is intended or would serve any purpose of this proposed legislation. And a strict application of the "qualifying spousal trust" rules in H.R. 2286 would also require the transferor or the spouse to have the power to appoint the entire trust, which is not normal in an ordinary QTIP trust.

Property transferred in such an exempt transfer to an eligible trust for the benefit of the transferor's spouse or surviving spouse would be subject to the deemed sale rules (1) upon a distribution from the trust to someone other than the spouse, (2) upon the cessation of the trust's status as an eligible trust, or (3) upon the spouse's death.

(6) **Exception for Transfers to Charity.** A transfer to a charity or another organization described in section 170(c) would not be a deemed sale. The STEP Act adds explicit exemptions for (1) a trust in which property is set aside for such an organization (subject to annuity, unitrust, and other valuation rules of section 2702), (2) a qualified disability trust defined in section 642(b)(2)(C)(ii), and (3) a cemetery perpetual care fund described in section 642(i).

(7) **Other Estate-Includible Grantor Trusts.** In the case of a transfer to a trust is that is **both** deemed owned by the transferor under subpart E of part 1 of subchapter J (commonly called generically the "grantor trust rules") **and** includible in the transferor's gross estate, **the deemed sale would occur**, not when the property is transferred to the trust, but when:

(a) a distribution is made to a person other than the deemed owner,

(b) the transferor ceases to be the deemed owner of the trust (including, apparently, upon the transferor's death), or

(c) the trust ceases to be includible in the gross estate of the transferor (oddly, in H.R. 2286, explicitly including upon the transferor's death).

(8) **Other, Non-Includible, Grantor Trusts. Under the STEP Act,** in the case of other deemed-owned trusts (except the spousal, charitable, disability, and cemetery care trusts discussed above) – that is, a deemed-owned trust that is not includible in the transferor's gross estate – **the deemed sale would apparently occur**:

(a) when a transfer is made to the trust,

(b) when a distribution is made to a person other than the deemed owner,

(c) when the transferor ceases to be the deemed owner of the trust, or

(d) upon the death of the transferor.

This type of trust is commonly called a "defective grantor trust." The treatment of a transfer to the trust, a distribution from the trust, the termination of grantor trust status, and the death of the transferor as deemed realization events, in effect overturning Rev. Rul. 85-13, 1985-1 C.B. 184, would likely be viewed as quite harsh.

Under H.R. 2286, for grantor trusts not in the gross estate (as well as nongrantor trusts), a deemed sale would occur when a distribution is made from the trust but would not occur at the grantor's death if no distribution occurs at that time. However, for grantor trusts includible in the gross estate, a deemed sale would occur at the grantor's death, even if the assets remain in the trust.

(9) **Non-Grantor Trusts.** In the case of other trusts – that is, a trust that is not deemed owned by the transferor for income tax purposes – transfers to the trust and distributions from the trust (under the STEP Act, perhaps only if the transfer is to another trust) would be treated as a sale, and property held in a long-term trust would be deemed sold at specified intervals. In H.R. 2286, property that has been held in trust for **30 years** without being subject to section 1261 would be deemed sold, or, if it has been continuously held in trust for more than 30 years on the effective date (January 1, 2022), it is treated as sold on that date. In the STEP Act, **all** property held by such a trust would be treated as sold every **21 years**, with property in a trust created before January 1, 2006, first treated as sold on December 31, 2026. Thus, H.R. 2286 would apparently require tracking the holding period of each individual asset, while the STEP Act would apparently subject all trust assets to tax every 21 years regardless of the asset's holding period.

In addition, H.R. 2286 would treat a modification of the direct or indirect beneficiaries of a trust (or the beneficiaries' rights to trust assets) or the transfer or distribution of trust assets (including to another trust) as a deemed sale, unless Treasury and the IRS determine "that any such transfer or modification is of a type which does not have the potential for tax avoidance." This apparently is intended to include some decantings.

(10) **Other Exclusions.** H.R. 2286 would exclude annual exclusion gifts and up to $1 million of net capital gain at death. The $1 million amount would be indexed for inflation after 2022. Thus, lifetime exclusions would be measured by the total value transferred (and the number of donees), while the exclusion at death would be measured by the net gain. Among other complications, the exclusion of gifts to the extent of the dollar amount of the annual exclusion would present the challenge of allocating that exclusion when gifts to any individual of assets with different bases exceed the annual exclusion amount in any year, as well as the challenge of applying that allocation in the case of gift-splitting by spouses.

The STEP Act would provide what amounts to a "lifetime exclusion" of $100,000 of gain, expressed as "the excess of … $100,000, over … the aggregate amount excluded under this subsection for all preceding taxable years." For transfers at death, the exclusion would be $1 million, less the amount of the $100,000 exclusion applied to lifetime gifts. Both the $100,000 and $1 million amounts would be indexed for inflation.

The proposals would not change the exclusion for sales of a principal residence.

(11) **Netting of Gains and Losses.** In the case of deemed sales occurring upon death, the proposals would exempt the sales from the disallowance of related-party losses under section 267, which would allow losses on deemed sales to offset gains.

(12) **Coordination with Basis Rules.** The basis rules for property acquired from a decedent (section 1014) or upon gift or transfer to a trust (section 1015) would be amended to more or less coordinate with the new deemed sale rules, generally providing a stepped-up (or stepped-down) basis if there is a deemed sale. Apparently, under H.R. 2286, that would mean that even annual exclusion gifts excluded from deemed sale treatment would receive a new basis equal to the fair market value at the time of the gift. Spouses and surviving spouses would receive a carryover basis in all cases.

(13) **Extension of Time for Payment of Tax.** The proposals would add a new section 6168, providing an election to pay the income tax on deemed sales in installments, similar to the rules in section 6166 for estate taxes. Like section 6166, section 6168 would apply only with respect to transfers at death, not during life. In contrast to section 6166, however, section 6168 would apply not only to closely held business interests that exceed 35 percent of the gross estate, but to all assets other than "actively traded" personal property (such as securities traded on an exchange).

The STEP Act would mirror section 6166 by allowing payment of the additional income tax in up to 10 equal annual installments beginning no later than five years after the prescribed due date. H.R. 2286 would allow up to seven equal annual installments, with no deferral of the first installment.

Both proposals would provide for payment of interest (at 45 percent of the normal rate as in section 6601(j)(1)(B) for estate tax extended under section 6166, but with no "2-percent portion" as in section 6601(j)(1)(A)), and the STEP Act would make that interest nondeductible for estate tax purposes. Both proposals, like section 6166, would also include provisions for a special lien (which the STEP Act would allow to be partially replaced by a bond), extensions of the period of limitations on assessment, and proration of deficiencies to installments.

The STEP Act, but apparently not H.R. 2286, would provide for acceleration of the payment of deferred tax if the subject property is disposed of or is used in whole or in part to secure nonrecourse indebtedness.

(14) **Information Reporting.** H.R. 2286 would add a new section 6050Z requiring that, except in the case of securities transactions reported by brokers under section 6045(g), the donor or executor must report to the IRS the name and taxpayer identification number of the recipient of each transfer and information describing the property and stating its fair market value and basis. The donor or executor must also report that fair market value and basis to the recipient of the property. These requirements are similar to the rules currently in section 6035 regarding the consistent basis of property transferred at death, except that section 6050Z would require this

information reported to the IRS to be shared only with "the person to whom such transfer was made" (not, for example, to all beneficiaries who might receive an asset, as with Schedule A of Form 8971) and only "at such time and in such form and manner as the Secretary shall by regulations prescribe."

The STEP Act omits such a reporting requirement, but, seeming to step off-topic somewhat, it would add a new section 6048A requiring any trust (not already reporting under section 6034(b) or 6048(b)) with assets of more than $1 million or gross income for the year of more than $20,000 to report annually to the IRS "(1) a full and complete accounting of all trust activities and operations for the year, (2) the name, address, and TIN of the trustee, (3) the name, address, and TIN of the grantor, (4) the name, address, and TIN of each beneficiary of the trust, and (5) such other information as the Secretary may prescribe."

(15) **Miscellaneous Matters.** In addition, the STEP Act would provide that the costs of appraising property deemed sold under new section 1261 would be deductible for income tax purposes and would not be a "miscellaneous itemized deduction" subject to section 67.

The STEP Act also would waive penalties for underpayment of estimated tax related to income tax on deemed realized gains at death (which, of course, would not have been foreseeable).

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i. **Overview Summary of** Treatment **of Trusts at the Settlor's Death Under the Deemed Realization Proposals.** The following discussion is all VERY complicated, and subject to interpretation of the Code language (and the description in the Greenbook).

(1) **House Bill, H.R. 2286.**

(a) **Grantor Trusts Not in Estate and Nongrantor Trusts.** Under H.R. 2286, there would be **no** deemed realization for assets in a grantor trust not includible in the grantor's gross estate or any nongrantor trust at the death of the grantor unless there is a "distribution of trust assets (including to another trust)." Proposed §1261(c)(3). Therefore, if the trust continues in the same trust for the grantor's descendants, there would be no deemed realization at death. But if trust assets pass to new separate trusts for the grantor's descendants, there would be deemed realization at the grantor's death.

If a transfer triggering a deemed sale of a trust asset under §1261(a) has not occurred within 30 years, a deemed realization event would occur for specific assets in the trust every 30 years (or on January 1, 2022 if the asset has been held continuously in trust for more than 30 years on that date). Apparently, this provision applies for each individual trust asset, thus requiring tracking of the holding periods of all trust assets.

(b) **Grantor Trusts Includible in Gross Estate.** For assets in a grantor trust that is includible in the grantor's gross estate, there **would be** a deemed realization event at the grantor's death, even if the assets remain in the same trust. Proposed §1261(c)(1)(B). It seems ironic that assets in a grantor trust includible in the estate would have a deemed realization at the grantor's death, but assets in a grantor trust not includible in the gross estate would not necessarily have a deemed realization event at the grantor's death.

(2) **Senate Proposal, STEP Act.** Under the STEP Act draft, there **would be** a deemed realization of assets in a **grantor trust** (whether or not includible in the grantor's gross estate) at the grantor's death. Proposed §1261(b)(1)(B). For **nongrantor trusts**, there would **not** be deemed realization at the death of the grantor, but a deemed realization event might occur if the asset is "transferred … in trust" to another trust at the grantor's death. *See* Proposed §1261(a). In any event, a deemed realization event would occur every 21 years (with property in a trust created before January 1, 2006 being first treated as sold on December 31, 2026).

(3) **Greenbook Proposal.** Under the Greenbook description, **grantor trusts and nongrantor trusts** are treated the same (except for revocable grantor trusts). There is **no** automatic deemed realization at the grantor's death, but there would be a deemed realization if a trust asset is

"distributed." So, if the assets remain in the same trust for the grantor's descendants (i.e., a pot trust for multiple beneficiaries), there would be no deemed realization, but if the assets pass to new separate trusts for the grantor's descendants, there would be a deemed realization.

A deemed sale of assets in a trust would occur every 90 years if there has been no deemed sale of those particular assets within the prior 90 years (the testing period begins on January 1, 1940 and the first such "90-year deemed sale" would be December 31, 2030). This apparently applies on an asset-by-asset basis.

(4) **Increased Use of Pot Trusts or Separate Trusts for Grandchildren.** The various proposals have varying rules for when the death of the settlor will result in a deemed sale of trust assets in different trust situations. For those situations in which a deemed sale does not occur unless assets are transferred from the trust (including to a new trust), using "pot trusts" for multiple generations may avoid having trusts terminate at the death of the settlor or for a trust beneficiary to avoid a deemed sale.

An alternative approach for a client with grandchildren who is creating a new trust is to use a separate trust for each grandchild (of which the grandchild's parent and the grandchild would be discretionary beneficiaries) so that at the death of the client or of the client's child who is the parent of the client's grandchildren there would be no distribution to a new trust, but the assets could simply remain in each separate grandchild's trust for each respective grandchild. (That would be a very unusual plan structured to anticipate provisions that we don't know will ever be enacted. Complications would arise in providing equitable treatment for any grandchildren born after the grandchildren's trusts are created.)

j. **Impact of Deemed Realization Proposals on Traditional Trust Planning.** The deemed realization proposals are controversial and adoption of a deemed realization approach seems unlikely considering the ultra-thin Democratic voting margin in the Senate. See Item 2.f above. Even so, planners are considering whether current trust planning should be adjusted to address the rather substantial income tax impact that the proposals could have on trusts being planned currently. For example, as discussed in Item 2.g above, under the FY 2022 Greenbook proposal, transfers to or distributions in kind from trusts (including grantor trusts other than "revocable" grantor trusts) would be deemed realization events. The income tax ramifications of the proposal may gut many of the traditional transfer planning techniques planners have used – even though the administration's proposal does not directly address estate and gift taxes. The following are examples of issues that planners are considering currently in light of these proposals.

- Perhaps place more emphasis on longer-term pot trusts rather than traditional trusts that terminate and split into separate trusts for descendants with the death of each generation (though each of the assets in the long-term pot trust would be deemed to be sold 90 years after the date the respective asset was acquired by the grantor under the Greenbrook proposal, 30 years after the trust acquired the asset under the House proposal, or 21 years after the establishment of the trust (but no earlier than December 31, 2026) under the Senate proposal). Query whether pot trusts with separate shares could be used to avoid the deemed realization that would otherwise occur when trusts split into separate trusts for descendants?
- Another approach may be to create separate trusts for each grandchild, as described in Item 2.i(4) above, to avoid having a deemed sale at the death of the settlor or of the child of the settlor who is the parent of the grandchild.
- An advantage of creating trusts now is that appreciated assets going into the trust would not trigger gain on the funding of the trust (whereas funding trusts with appreciated property next year might be very expensive from an income tax standpoint).
- Sales to grantor trusts or the exercise of substitution powers after 2021 would appear to be realization events as to the grantor for assets going **into** the trust. It is not clear whether there would also be a deemed sale of assets passing **from** the trust in the sale or substitution transaction. (Under the Greenbook proposal and the Senate proposal, a deemed sale occurs upon "distributions" from the trust, and a purchase by the trust would not seem

to be the same as a trust distribution. In contrast, under the House proposal, a deemed sale occurs upon a "transfer" from the trust.)

- GRATs would likely be a thing of the past; contributions of appreciated assets to the trust would trigger gain and distribution of in kind assets in satisfaction of annuity payments and the distribution of in kind assets at the end of the GRAT term to remainder trusts or remainder beneficiaries would also trigger gain.
- Decantings to new trusts may be realization events.
- Be careful about including formula general powers of appointment in trusts – they might also result in deemed realization events upon the exercise or lapse of the general power.
- Building in as much flexibility as possible into irrevocable trusts may be more important than ever (for example, using trust protectors with very broad amendment powers).

k. **Biden Administration Focus on Tax Increases for the Wealthy.** Lily Batchelder, a tax professor at the New York University School of Law and previously deputy director of the White House National Economic Council during the Obama administration, has been nominated as the Treasury assistant secretary for tax policy, which is Treasury's top tax job. David Kamin is the current deputy director of the National Economic Council. Prof. Batchelder and David Kamin have a history of supporting increased taxes on the wealthy, and have co-authored a detailed paper exploring policy options for several structural reforms for increasing taxes on the wealthy including (1) dramatically increasing the top tax rates on labor and other ordinary income, (2) taxing the wealthy on accrued gains as they arise and at ordinary rates, (3) a wealth tax on high-net-worth individuals, and (4) a financial transactions tax. Lily Batchelder & David Kamin, *Taxing the Rich: Issues and Options*, (September 11, 2019) available at **https://ssrn.com/abstract=3452274**.

The Batchelder-Kamin paper observes that inherited wealth is taxed at very low rates (because of the large estate tax exemption), and that financial inheritances are a significant predictor of a child's future earnings.

> [W]hile a large share of the income of the wealthy is derived from labor income, a substantial share is also the product of inheritances. Inherited income is entirely excluded from both the income tax and payroll tax bases. The estate tax and related wealth transfer taxes were meant to partially address this omission. But the exemptions are so large ($22.8 million per couple in 2019) and the base so porous that income in the form of inheritances was taxed at an average rate of less than 4 percent in 2009, and is taxed at even lower rates today [citation omitted]. These exceptionally low rates apply despite the large impact inherited income has on economic mobility. By some estimates, financial inheritances are a more important predictor of a child's earnings than IQ, personality, and education combined [citation omitted]. *Id.* at 6.

The paper views estate tax reforms and taxing accrued gains at death (which may merely refer to eliminating stepped-up basis at death) as "incremental" rather than "structural" reforms. It notes that among the 400 wealthiest American who died during a particular period, the wealth reported on estate tax returns was only about half their wealth as estimated by Forbes. The paper comments briefly about basis step-up at death and the estate tax.

> Repeal of stepped-up basis would eliminate one major incentive to defer realizing gains. But large incentives to defer realizing gains would remain, including those due to the time value of money, potential future rate decreases, and the tax exemption for gains on property donated to charity.
>
> A more robust estate tax would better address the direct effects of inherited advantage. But it would have smaller effects on many of the indirect advantages associated with wealth, such as social connections with other wealthy individuals, access to the best educational opportunities, and the like. *Id.* at 11.

The paper also observes that merely increasing the rate on capital gains may not raise substantial revenue, because of the ability to defer recognition of capital gains that would be taxed at high rates, but that combining an increased capital gains rate with eliminating the basis step-up at death and taxing gains (and allowing losses) as they accrue, rather than waiting until they are realized (but with measures for taxing illiquid assets only when they are sold), would raise substantial revenue. *Id.* at 14-15.

An interview with David Kamin reiterates these goals. In the interview, Mr. Kamin signaled that the following options are among those under discussion:

- Removing "step up in basis" for estates, which revalues assets such as stocks and real estate at market prices, rather than their original purchase cost -- reducing tax liabilities
- Taxing capital gains for wealthy Americans at income-tax rates, which are higher
- A minimum tax for large companies

"The idea of finally eliminating what is a massive loophole, in that the highest income Americans escape tax on their wealth by addressing step up in basis and then taxing capital gains as ordinary income, is a major reform of our system, which I think is needed," Kamin said.

"These would be major accomplishments, which would pretty fundamentally shift how our tax system treats the richest Americans and the largest corporations so they can't escape tax in the ways they now can," he said. Nancy Cook, *Biden Determined to Tax Rich After Windfalls From Covid Crisis*, BLOOMBERG TAX DAILY TAX REPORT (March 22, 2021).

l. **Wealth Tax Not Supported by Biden Administration, But Legislative Proposal Has Been Filed in 2021.** The proposed Ultra-Millionaire Tax Act, co-sponsored by Senators Sanders, Warren and various others, provides a 2% annual tax on the net worth of households and trusts ranging from $50 million to $1 billion and an additional 1% annual tax (for a 3% total tax) on assets above $1 billion. Estimates are that about 100,000 Americans (or fewer than 1 in 1,000 families) would be subject to the wealth tax in 2023, and that it would raise about $3 trillion over a decade, according to an analysis by University of California Berkeley Professors Emmanuel Saez and Gabriel Zucman. Senators Sanders and Warren had both proposed an annual wealth tax in the 2019-2020 Presidential campaign. (The Sanders campaign proposal was much more intense than the 2021 proposal, with rates starting at 1% on net worth above $32 million and increasing in increments to 8% for net worth over $10 billion, applying to about 180,000 households and raising an estimated $4.35 trillion over a decade.)

Treasury Secretary Janet Yellen has confirmed that President Biden does not favor a wealth tax, and that a wealth tax would have significant implementation problems. *See Yellen Favors Higher Company Tax, Capital Gains Worth a Look*, BLOOMBERG DAILY TAX REPORT (Feb. 22, 2021).

For a more detailed discussion of the wealth tax concept, including constitutionality issues and administrative complexities, see Item 2.d of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

3. "For the 99.8 Percent Act" (2019) and "For the 99.5 Percent Act" (2021) Proposals

Senator Sanders on January 31, 2019 introduced S. 309, titled "For the 99.8 Percent Act," and on March 25, 2021 introduced S. 994, titled "For the 99.5 Percent Act." The 2019 and 2021 proposals are very similar (identical in most respects); the differences are described below. A companion bill (H.R. 2576) was introduced in the House on April 15, 2021, by Congressman Jimmy Gomez (D-California), and a similar bill was introduced in the House in 2019. Senator Sanders has introduced similar bills since 2010.

These proposals 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% (2019 proposal)/65% (2021 proposal) over $1 billion. (The GST tax rate is not specifically addressed, so presumably it would be the highest marginal estate tax rate of 77/65% under §2641(a)(1), with a $3.5 million GST exemption.) These amendments apply to estates of decedents dying, and generation-skipping transfers and gifts made, after December 31, 2021.

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 (included in the 2019 proposal, removed from the 2021 proposal);
- Quadrupling the potential reduction of the value for family farm and business property under the §2032A special use valuation rules from $1.19 million currently to $3 million (indexed for inflation

going forward); applicable to estates of decedents dying, and gifts made, after December 31, 2021 (in the 2021 proposal);

- Quadrupling 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); applicable to estates of decedents dying, and gifts made, after December 31, 2021 (in the 2021 proposal);
- Extending basis consistency provisions (and accompanying reporting requirements) to gifts (included in the 2019 proposal, removed from the 2021 proposal);
- Disallowing a step-up in basis for property held in a grantor trust of which the transferor is considered the owner "if, after the transfer of … property to the trust, such property is not includible in the gross estate of the transferor…" (added in the 2021 proposal); this provision applies to transfers after the date of enactment; (observe that the provision is not clear whether it applies to sales or exchanges with grantor trusts, this provision does not appear to apply to §678 deemed owner trusts, and the provision does not appear to apply to sales from one spouse to a grantor trust that is a grantor trust as to the other spouse);
- 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; applicable to transfers after the date of enactment;
- Eliminating **minority discounts** and (in the 2021 proposal) **lack of marketability 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); applicable to transfers after the date of enactment;
- 10-year minimum term for **GRATs** and maximum term of life expectancy of the annuitant plus ten years, 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); applicable to transfers after the date of enactment;
- Major changes for **grantor trusts** –
  - §2901(a)(1), Estate inclusion in grantor's gross estate;
  - §2901(a)(2), Distributions are treated as gifts from the grantor;
  - §2901(a)(3), Gift of entire trust if it ceases to be a grantor trust during the grantor's life;
  - Those three 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;
  - Any estate tax imposed by new §2901 would be a liability of the trust (but the bill has no details about how the amount of estate tax attributable to §2901 would be determined);
  - The 2021 proposal eliminates an exception for trusts that do not have as a significant purpose the avoidance of transfer taxes, as determined by regulations or other guidance from the Treasury;
  - 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" (which does not explicitly include sales) to the trust and attributable to post-date-of-enactment sales in nonrecognition transactions with a deemed owner trust under §678;

  - Observe that this may result in estate inclusion of ILITs (unless the trust is structured as a non-grantor trust) created after the date of enactment, or the portion of an ILIT attributable to post-date-of-enactment contributions to the trust (for example, to make premium payments). *See* Michael Geeraerts & Jim Magner, *Alternative Life Insurance Ownership Structures if Congress Takes a Swing at ILITs Using New Code Section 2901*, LEIMBERG ESTATE PLANNING NEWSLETTER #2865 (Feb. 22, 2021).

- 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 an annual 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).

The Joint Committee on Taxation estimates that the 2021 proposed Act would raise $429.6 billion of revenue over 10 years.

This bill is significant; 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. If any of these provisions are included in an infrastructure/tax reform reconciliation bill later this year, a significant possibility exists of adoption of such provisions (with a date of enactment effective date for most of the provisions other than the rate and exemption amount changes). These proposals are far-reaching. Remember 2012? The mad rush could be even more chaotic if a similar bill is filed in this year's Congress and starts getting serious consideration.

For a much more detailed discussion of the specific provisions in the 2019 proposal, see Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2019 (January 2020), with detailed analysis, (found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**). *See also* Reed Easton, *For the 99.5% Act: End of Traditional Planning Techniques*, ESTATE PLANNING (July 2021).

4. Mark-to-Market Proposal

Several Presidential candidates in 2020 proposed wealth taxes, which would have questionable constitutionality. (Despite the constitutionality concerns, the proposed Ultra-Millionaire Tax Act introduced March 1, 2021, co-sponsored by Senators Sanders, Warren and various others, provides a 2% annual tax on the net worth of households and trusts ranging from $50 million to $1 billion and an additional 1% annual tax (for a 3% total tax) on assets above $1 billion. Estimates are that about 100,000 Americans (or fewer than 1 in 1,000 families) would be subject to the wealth tax in 2023, and that it would raise about $3 trillion over a decade, according to an analysis by University of California Berkeley Professors Emmanuel Saez and Gabriel Zucman.)

Senator Wyden (Chair of the Senate Finance Committee) instead is pushing a mark-to-market system. The Wyden proposal would eliminate the preferential rates for long-term capital gains so that all income would be taxed at applicable ordinary income rates. In addition, new "anti-deferral accounting rules" would apply to high-income taxpayers, providing (i) mark-to-market annual taxation of income from tradable property (such as stocks and bonds), and (ii) lookback taxation of income from nontradable property (a lookback charge [perhaps an interest charge on the deferred tax] would be applied to reduce incentives for the taxpayer to defer the sale of the assets). The anti-deferral accounting rules would apply to taxpayers (including individuals, estates, or trusts) that meet certain income or asset thresholds. A taxpayer would be subject to the rules if she has either $1 million of income OR $10 million of "applicable assets" in each of the prior three years (the income threshold could be satisfied in some years and the asset threshold could be satisfied for other years in the three-year test period). This threshold means that the rules would apply to "only a fraction of the richest 1 percent of Americans." For a detailed description of the proposal, see *Treat Wealth Like Wages*, by Senate Finance Committee Ranking Member Ron Wyden, available at **https://www.finance.senate.gov/imo/media/doc/Treat%20Wealth%20Like%20Wages%20RM%20Wyden.pdf.**

One commentator, though, predicts that Senator Wyden will not be successful in pushing this very bold proposal.

> Wyden's bill would mark traded assets to market for the highest earners. There would be a lookback taxation of non-traded assets. "There are two tax codes in the United States" one for workers who pay taxes out of every paycheck and the other for high fliers who use games and tricks to avoid their taxes. They pay what they want, when they want and sometimes nothing at all," Wyden said at the time.
>
> Wyden has lots of big ideas to reform the taxation of capital assets in individual hands. They are not going to see the light of day, even after he becomes Senate Finance Chair. As chair of an important committee, he will have to be responsible to his business backers. He is up for reelection in the most leftward-leaning state in the country in 2022. Lee A. Sheppard, *Will There Be a Tax Bill?*, TAX NOTES (January 19, 2021).

5. Obama Years "Greenbook" Budget Proposals

The "Greenbook" budget proposals from the Obama years may provide some idea of what the Biden administration may eventually consider for its legislative wish list. A summary of some of the proposals in the Obama administration's last Greenbook (its Fiscal Year 2016 proposals, but many of these were continued from prior years) follows.

a. **Treating Gifts and Bequests as Realization Events.** See a reference to the Obama proposal in Item 2.f above.

b. **Increased Capital Gains Rates.** The top rate on capital gains and qualified dividends would be increased to 28% for couples with income over about $500,000.

c. **Section 529 Plans.** The proposal would have eliminated the advantages of 529 plans for new contributions, but the proposal was dropped in the face of strong opposition.

d. **Overall Limitation on Deductions for Individuals.** The proposal would (1) limit the benefit of most individual deductions to a maximum of 28% (with similar limitations of the tax benefits of tax-exempt bonds and retirement plan contributions), and (2) enact a "Buffet Rule" requiring that the income tax be at least 30% of an individual's income for wealthy individuals.

e. **Restore 2009 Estate, Gift and GST Tax Parameters.** The proposal would restore the 45% rate/$3.5 million estate and GST exemption/$1 million gift exemption (not indexed).

f. **New GRAT Requirements.** New GRAT requirements would include (i) a 10-year minimum term, (ii) a maximum term of life expectancy plus 10 years, (iii) no decrease in the annuity amount in any year, (iv) a remainder interest at the time the GRAT is created that has a minimum value equal to the *greater* of 25% of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed), and (v) a prohibition "from engaging in a tax-free exchange of any asset held in the trust."

g. **Limit Duration of GST Exemption to 90 Years.** The proposal to limit the duration of the GST exemption to 90 years would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date (subject to rules substantially similar to the GST grandfather rules).

h. **Sales to Grantor Trusts.** If sales to grantor trusts occur, the portion in the trust attributable to the sale (net of the amount of consideration received by the grantor in the transaction) would be included in the grantor's gross estate (or would be a gift from the grantor if grantor trust status of the trust terminated during his lifetime). The proposal generally would not apply to irrevocable life insurance trusts. The proposal applies to trusts that engage in a "sale, exchange or similar transaction" on or after the date of enactment.

i. **Section 6166 Estate Tax Lien***.* The special estate tax lien under §6324(a)(1) would last for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after the date of death.

j. **Health and Education Exclusion Trusts.** "HEET" trusts are a seldom-used strategy to create a long-term trust out of which tuition and medical payments could be made for future generations without any GST tax. The proposal would eliminate the current exclusion under §2503(e) for payments from a trust for the health or tuition payments for second generation (and more remote) beneficiaries (which is a rather Draconian approach to the issue).

k. **Simplify Gift Tax Annual Exclusion.** Referencing the complexity of administering *Crummey* trusts and the potential abuses, the proposal would delete the present interest requirement for annual exclusion gifts, allow the $14,000 [now $15,000] per donee exclusion for most outright transfers, and add a new category of gifts to which a $50,000 *per donor* annual limit would apply (but the new $50,000 per-donor limit would not provide an exclusion in addition to the annual per-donee exclusion).

6. Priorities for 2021 Legislative Activities and Likelihood of Tax Reform in 2021

a. **Administration's General Priorities.** Top priorities of the administration at this point appear to be COVID, infrastructure, immigration reform, voting rights, and social justice issues. These stated priorities of the administration suggest that tax legislation (other than tax measures directly related to paying for those measures) will be a low priority at least during the beginning of the administration, and that the likelihood of allocating significant political capital to "tax reform" in 2021 would seem low until late in the year (or even into 2022).

b. **Evenly Divided Congress.** The Congress is very evenly divided, with a 221-211 split in the House and 50-50 split in the Senate (with Vice-President Harris breaking a tie vote). The close margins may require more deliberation and negotiation and would seem to result in more moderate results. Moderation may be required, even using the reconciliation process, because a single Democratic defection may preclude passage.

> With narrow majorities, Democrats don't necessarily get to do everything they say they want … Even though offsets are required, it looks bad to moderates if the net spending number is too big. There are moderates, like Democratic Sens. Joe Manchin III from West Virginia, Krysten Sinema of Arizona, and Jon Tester of Montana. Even new Democratic Sen. Raphael Warnock of Georgia may suddenly become a moderate because he is up for reelection in 2022. Lee A. Sheppard, *Will There Be a Tax Bill?*, TAX NOTES (Jan. 19, 2021).

The bolder proposals would seem unlikely to be successful in such an evenly divided Congress.

c. **2022 Midterms.** While tax reform may not be among the highest priorities, Democrats in Congress may feel that they are facing time pressures. Midterms are historically tough on the president's party. Losing just one net Senate seat to Republicans would result in loss of control of the Senate for Democrats. Therefore, while the split Congress may make sweeping changes harder to achieve, the possibility of a shift of control in the House or Senate in the 2022 midterms adds urgency for Democrats to do what they can now regarding tax legislation. But Democrats may sense even more urgency to pass measures that Americans feel directly rather than haggling over tax negotiations.

> In all this, Democrats face a ticking clock. Midterms are typically rough on the president's party, and losing even one Senate seat would end Democrats' control of Congress and thus their ability to govern. That gives Democrats much less room for error than they had in 2009 [with the upcoming 2010 midterms in the first term of the Obama administration]. Then, their congressional majorities reached 60 in the Senate and 257 in the House. They will start this session with 50 senators and 222 House members. If they are to avoid a midterm wipeout -- and a possible rehabilitation of the Trump brand -- they need to govern well, and they need Americans to feel the benefits of their governance fast. Ezra Klein, *Opinion Today*, NEW YORK TIMES (January 21, 2021).

On the other hand, Democrats may feel more comfortable about holding the Senate in 2022, despite the history of traditional midterm losses by the president's party, "as Republicans will be defending

20 of the 34 open seats, including two seats in states (Pennsylvania and Wisconsin) won by President Biden, while Democrats will not be defending any seat in a state won by President Trump. All of this makes confident predictions very difficult." Ronald D. Aucutt, The Top Ten Estate Planning and Estate Tax Developments of 2020 (January 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)**.

Securing votes for politically sensitive transfer tax provisions may be especially difficult (as discussed further immediately below). Three Democratic senators up for re-election in 2022 won their last race by less than 6% (Senators Hassan [NH], Mastro [NV], and Bennett [Colo]), and three more Democratic senators up for re-election in 2024 are from states won by President Trump in 2020 (Senators Manchin [WV], Tester [MT], and Brown (OH]). Also Senators Warnock and Ossof in Georgia won their 2020 races by less than 1% of the vote. Securing votes for estate tax increases from any of these **eight** Democratic senators seemingly would be very difficult (but anything can happen as packaging of proposals and legislative negotiations proceed). *See* Bruce Givner, *The Federal Estate Tax Will Not Increase in 2021*, LEIMBERG ESTATE PL. NEWSLETTER #2882 (April 27, 2021).

d. **Predictions of Scope and Timing of Tax Reform and Transfer Tax Measures.** Various commentators have been predicting that passing sweeping tax reform measures will be difficult and likely not to be front-burner priorities; however, several of the bold tax reform measures are included in the American Families Plan and in the FY 2022 Greenbook.

Testimony from Janet Yellen in her Senate confirmation emphasized economic recovery and pro-growth measures providing relief for middle-class families rather than tax reform. For example, she committed to working with the administration in evaluating the impact of the removal of the cap on SALT deductions and the impact of the §199A deduction on small businesses. See Finance Committee Questions For the Record, United States Senate Committee on Finance, Responses by Dr. Janet Yellen (January 21, 2021). However, Dr. Yellen was more positive in affirming the proposal to reduce the estate tax exemption to $3.5 million and increase the estate tax rate to 45%. When Senator Grassley stated that the proposal would "disproportionately affect farmers and small business owners in Iowa and across the nation through wasteful compliance costs and increased taxes, Dr. Yellen responded:

> If confirmed, I look forward to working with you to advance a range of policies that the President has proposed to strengthen rural America and small businesses.
>
> On the President's estate tax proposal in particular, it may be helpful to note that only about the wealthiest six out of every thousand estates would face any tax – less than 1% -- and every couple with assets under $7 million would be fully exempt from the estate tax. Id.

As indicated by Dr. Yellen, a $3.5 million estate exclusion amount would mean that about 0.6% of estates would be subject to estate tax.

Howard Gleckman, with the Urban-Brookings Tax Policy Center observes that "Reconciliation is a powerful tool, but it's also hard to wield," so Biden will have to decide where tax policy fits on a long list of priorities, ranging from healthcare to immigration, concluding that "There will probably be a little bit of room for tax legislation on there, but I'm not sure how much," and that the $3 trillion of tax increases for corporations and wealthy Americans is "really ambitious, and I don't think he's going to get anything close to that." Alexis Gravely, *Democratic Control of Senate Still Spells Challenges for Tax*, TAX NOTES (January 7, 2021).

Lee A. Sheppard, a frequent commentator with Tax Notes, predicts that many of the Biden tax proposals will not be enacted, including an increase in the corporate tax rate, a corporate minimum tax on book income, the elimination of tax benefits for partnership profits interests, the elimination of like-kind exchanges, or increased capital gains rates. She predicts difficulty in undoing the Trump tax cuts, observing that "the Obama administration, which enjoyed two years of both chambers controlled by the same party, vowed to undo the Bush tax cuts and did not." Lee A. Sheppard, *Will There Be a Tax Bill?*, TAX NOTES (Jan. 19, 2021). She concludes that "[t]here could be stealth tax increases instead of an overt rate increase, like deduction cutbacks." *Id*. Interestingly though, despite her pessimism about the Biden administration's chances of success on many of its tax proposals, she thinks that "[t]he reduction of the transfer tax exemption could well happen."

> It's a political football, and estate planners were scrambling to have clients make gifts last year. It's a quick and dirty way for Democrats to take progressive action without getting blue-state constituents riled up about income taxes. And it would raise nearly $300 billion over 10 years." *Id.*

Ron Aucutt, though, concludes as to future transfer tax increases – "not much and not soon."

> The legislative process in 2021 will be affected by the close margins in Congress. It will also be affected by some obvious priorities – COVID relief and prevention, social justice, environmental concerns, and infrastructure. But another priority is raising revenue, particularly after the 2020 surge of spending in response to the COVID pandemic on an emergency basis that postponed the issue of paying for it (appropriately so in an emergency). Even in 2021, raising revenue to make up for 2020's spending will probably proceed with caution, to avoid undoing some of the 2020 relief or jeopardizing the recipients of that relief. But sooner or later both Democrats and Republicans will have a keen interest in raising revenue again, although very likely with different reasons and different ideas how to do it and how to allocate the burden.
>
> …
>
> In any event, there may be less interest and urgency for estate tax changes (compared to income tax changes with wider and more immediate effect), less likelihood of making income tax changes (other than changes offering COVID relief) effective January 1, 2021, and even less likelihood of a January 1, 2021, effective date for transfer tax changes, for which the calendar year is less relevant**.**
>
> Putting all this together, while there may be little likelihood of sufficient support even among Democrats for comprehensive tax repurposing and restructuring, almost any change [among the provisions in the Biden tax proposals and the "for the 99.8 Percent Act"] could be supported, even by Republicans, (1) if it happens in a hurry and someone who doesn't like it is simply busy with other things, (2) if it happens partially or moderately, (3) if it is given the right "curb appeal" (like "consistency" or "simplification"), or (4) if it is combined with something else that is supported or has the right revenue estimate to pay for something else that is supported. That last cited scenario is exactly what happened, for example, when "Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent" was added to the Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41) by a Republican-controlled Congress in July 2015. It raised just the right amount of revenue to fund a desired extension of the Highway Trust Fund that was scheduled to expire on the day President Obama signed the Act into law. Significantly, the first version of introduced statutory wording for that consistent basis provision had been section 6 of the "Responsible Estate Tax Act" (S. 3533), introduced on June 24, 2010, by Senator Sanders – the original predecessor of what most recently is his "For the 99.8 Percent Act".
>
> And perhaps dominating all of this is the recollection of Vice President Biden's role in negotiating, for example, the estate tax provisions of the 2012 Tax Act with a Republican House and Democratic Senate. As President, he will probably be just as inclined to such a role, particularly at the beginning of his term, subject to how much members of both parties will permit that, and subject of course to the increase in his other responsibilities as President.
>
> **Bottom Line.** So – bottom line prediction – not much and not soon? But it is never possible to be sure. Ronald D. Aucutt, The Top Ten Estate Planning and Estate Tax Developments of 2020 (January 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)**.

Retroactive Tax Legislation (Significance, Examples, Constitutionality, And In Particular, Retroactive Gift Tax Change Unlikely)

7. Significance of Possibility of Retroactive Gift Tax Changes

Throughout 2020, some planners were concerned that clients should make transfers in 2020 in case legislation in 2021 reducing exclusions or increasing rates would be made retroactive to January 1, 2021. In 2021, there is concern that legislation might reduce the gift exclusion amount (the Biden administration proposes reducing it to $1.0 million, not indexed) and increasing the maximum gift tax rate from 40% to 45%. If the effective date should be some date before the date of enactment (for example, January 1, 2021, the date of introduction of the bill, or the date the bill is approved by the House Ways & Means Committee), clients might have made gifts of $11.7 million (the existing gift exclusion amount) thinking that no gift taxes would be due, only to find out that the excess $10.7 million times 45% equals a resulting gift tax of **$4,815,000.** If a married couple each made $11.7 million gifts and the gift exclusion amount were reduced to $1 million retroactively, the couple would owe **almost $10 million** of gift tax!! This would be a rude (to put it mildly) surprise. More to the point, it would be **outrageously unfair.**

The operation of the unified credit for federal gift tax purposes creates the possibility of an inadvertent retroactive gift tax change. Section 2505 describes the unified credit for gift tax purposes, and §2505(a)(1) says the gift tax unified credit is the unified credit under §2010(c) (the estate tax unified credit) "which would apply if the donor died as of the end of the calendar year" [with another adjustment not relevant]. Therefore, if a donor made an $11 million gift on April 1, and the Congress reduces the exclusion amount to $5 million (indexed) effective December 31, the exclusion amount for gift tax purposes for the April 1 gift would be only $5 million (indexed). That is a scary possibility—but transfer tax changes are typically made effective on January 1 of the year following the date of enactment; therefore, the exclusion amount would not be changed as of the date of the gift. Indeed, changes to the exclusion amount in §2010 and §2505 over the last four decades have generally followed the approach of having the revision apply "after December 31" (in 2017, 2013, 2010, 2001, 1997, 1981, and 1976).

The possibility of retroactive legislation has two countering effects. One is a push toward making gifts as soon as possible, to beat what may end up being the retroactive effective date. The other is a fear of making any gifts over $1.0 million for fear of missing the effective date (and getting the "rude surprise").

8. Retroactive Tax Legislation – Generally and Examples

A long history exists of examples of retroactive legislation. Indeed, the Supreme Court has gone so far as to state that Congress "almost without exception" has given general revenue statutes effective dates prior to the dates of actual enactment. *United States v. Darusmont*, 449 U.S. 292, 296 (1981). The 1980 Superfund Law retroactively imposed strict, joint, and several liability on firms that disposed of waste assets long before the bill was passed. Changes in tax rates and other tax changes are often prospective, effective sometime after the enactment of the legislation. But various examples of retroactive tax legislation exist. The first was the 1913 Revenue Act, which had an effective date before its date of enactment. The Revenue Acts in 1918 and 1926 were applied to the entire calendar year that preceded the date of enactment. Some more recent examples of retroactive tax legislation are President Clinton's retroactive tax increase in 1993 (OBRA retroactively increased tax rates to the beginning of 1993 even though the law was enacted in August 1993), the retroactive repeal in 1987 of the estate tax deduction for contributions to ESOPs that had been passed in 1986 (addressed by the Supreme Court in the *Carlton* case discussed below), and the retroactive increase of the minimum tax in the Tax Reform Act of 1976. *See* Daniel Troy, *Retroactive Tax Increases and The Constitution*, HERITAGE FOUNDATION (May 16, 1998).

A number of recent examples of retroactive tax *decreases* include changes in tax legislation in 1997, 1998, 2001, 2003 (included a complicated transition rule that split the year 2003 into two periods for purposes of computing the capital gains tax), and 2012, often applying the rate changes for the full calendar year in which the legislation was signed. See Clark, Starin, Tejeda, Baker & Poorman, *The Capital Gains Rate – Historical Perspectives on "Retroactive" Changes*, XI THE NATIONAL L. REV. No. 21 (January 2021).

9. Constitutionality of Retroactive Tax Legislation (Transfer Tax Legislation in Particular)

a. **General Constitutionality of Retroactive Tax Legislation.** Retroactive tax legislation is not absolutely barred by the U.S. Constitution, and is almost always upheld by the Supreme Court. *See, e.g., United States v. Carlton*, 512 U.S. 26 (1994); *United States v. Hemme*, 476 U.S. 558 (1986); *United States v. Darusmont*, 449 U.S. 292 (1981); *Welch v. Henry*, 305 U.S. 134 (1938); *United States v. Hudson*, 299 U.S. 498 (1937); *Milliken v. United States*, 283 U.S. 15 (1931). It has been viewed by the Supreme Court as "customary congressional practice" that is "generally confined to short and limited periods required by the practicalities of producing national legislation." *Carlton* (quoting *Darusmont*). Indeed, there are few examples of retroactive tax legislation being declared unconstitutional, but it is not out of the question that retroactive legislation could go too far and violate the Constitution (for example if it has an extended period of retroactivity or targets certain taxpayers or penalizes past conduct). *See* Erika Lunder, Robert Meltz, & Kenneth Thomas, *Constitutionality of Retroactive Tax Legislation,* CONGRESSIONAL RESEARCH SERVICE REPORT (October

25, 2012)(includes a detailed analysis of possible constitutional attacks, including Fifth Amendment Due Process, taking for purposes of the Fifth Amendment, unconstitutional ex post facto legislation [but that just applies for criminal laws], unconstitutional bill of attainder, or Fifth Amendment equal protection guarantees).

b. ***United States v. Carlton* – Retroactive "Corrective" Estate Tax Legislation Upheld.** *Carlton* upheld an amendment enacted in December 1987 that retroactively limited the availability of a 50% deduction under §2057 that had been enacted in October 1986 for stock that is sold by the estate to an ESOP, so that the deduction would apply only to stock owned immediately prior to death, as if the amendment were incorporated in the 1986 law. The Carlton estate on December 10, 1986 purchased stock after the decedent's death, sold the stock two days later to an ESOP for $10,575,000 (which was $631,000 less than the purchase price), and claimed an estate tax deduction equal to 50% of the sale price that reduced the estate tax by $2,501,161. The estate argued that the retroactive law change violated the Due Process Clause of the Fifth Amendment. The Court disagreed, primarily because the amendment "is rationally related to a legitimate legislative purpose, giving several specific reasons. (1) The amendment was curative to prevent the deduction from applying to what some called "essentially sham transactions," and the retroactive application was supported by a legitimate purpose furthered by rational means. The change, which prevented an anticipated revenue loss of up to $7 billion by denying the deduction to those who made purely tax-motivated stock transfers, was not unreasonable. (2) The change involved "only a modest period of retroactivity" having been proposed by the IRS in January 1987 and Congress in February 1987 within a few months of the deduction's original enactment. (3) The estate's detrimental reliance was insufficient to establish a constitutional violation because "[t]ax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code." (4) The estate's lack of notice of the change before engaging in the purchase transaction is not dispositive because prior cases (*Welch v. Henry* and *Milliken*) had upheld retroactive taxes despite the absence of advance notice.

Concurring opinions in *Carlton* observed that some limits should apply. Justice O'Connor reasoned that Congress does not have "unlimited power to 'readjust rights and burdens … and upset otherwise settled expectations;'" for example "a 'wholly new tax' cannot be imposed retroactively." She observed that the retroactive change in this case applied "for only a short period prior to enactment," and that "a period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions." Justice Scalia (in a concurring opinion joined by Justice Thomas) believed that the "rationally related to a legitimate legislative purpose" standard announced by the Court was very broad because "[r]evenue raising is certainly a legitimate legislative purpose …, and any law that retroactively adds a tax, removes a deduction, or increases a rate rationally furthers that goal." In Justice Scalia's hyperbolic manner, he observed that "the reasoning the Court applies to uphold the statute guarantees that all retroactive tax laws will henceforth be valid." He welcomed the Court's effective recognition (in his view of the Court's standard) that the Due Process Clause does not prevent retroactive taxes, "since I believe that the Due Process Clause guarantees no substantive rights, but only (as it says) due process." However, he did state his belief that the refusal to reimburse the estate's economic loss for acting in reliance on a tax-incentive provision was harsher and more oppressive than merely imposing a new tax on past actions.

Query whether the Supreme Court would have reacted similarly for a retroactive change in the gift tax, particularly a substantial decrease in the gift exclusion amount?

c. ***Untermyer v. Anderson* – Retroactive Introduction of Gift Tax Not Upheld.** The initial 1924 introduction of the federal gift tax on a retroactive basis for gifts made at any time during the calendar year was not upheld. *Untermyer v. Anderson*, 276 U.S. 440 (1928). The Court ruled that the application of the new gift tax to bona fide gifts not made in anticipation of death that were fully consummated prior to June 24, 1924 (the date of enactment) was arbitrary and invalid under the Due Process Clause of the Fifth Amendment. This case from nearly a century ago has never been overruled by the U.S. Supreme Court, but it has been distinguished in situations that did not involve the introduction of a new tax regime.

10. Retroactive Transfer Tax Legislation Seems Unlikely

While tax legislation is sometimes retroactive to a date prior to the date of enactment (though that is more likely to happen with the income tax than the transfer tax), some commentators have predicted that retroactive tax hikes in 2021 are unlikely. Jonathan Curry, *Retroactive Tax Hikes Seen as Unlikely Under Biden Administration*, TAX NOTES (Nov. 16, 2020).

Treasury Department deputy assistant secretary for tax policy, Mark Mazur, has confirmed that the Biden administration is not actively considering retroactive tax increases. Laura Davison, *Retroactive Tax Hikes Aren't the 'First Choice,' Biden Aide Says*, BLOOMBERG DAILY TAX REPORT (January 26, 2021).

In the very evenly divided Congress (discussed in Items 6.b and 6.c above), the likelihood of a retroactive reduction of the gift exclusion amount is extremely low in light of the extreme unfairness of such a change, In addition, the administration has never hinted at retroactive transfer tax changes. The specter of retroactive tax legislation has appeared most recently with the release of a Discussion Draft of the "Sensible Taxation and Equity Promotion ("STEP") Act of 2021," which would impose a new deemed realization on transfers by gift or at death with a proposed effective date of January 1, 2021. See Item 2.h above.

Planning in Light of Possible Retroactive Gift Tax Changes

11. General Planning Concerns Raised by Possible Retroactivity of Decreased Gift Exclusion Amount

The possibility of retroactive legislation in some ways encourages current transfers but in other ways raises concerns about making current transfers. Clients may be encouraged to act sooner rather than later in taking advantage of the large $11.7 million gift exclusion amount in case the exclusion amount is reduced retroactively to a time earlier than date of enactment of legislation. In other ways though, clients may be discouraged from making gifts in excess of $1 million (President Biden's proposed gift exclusion amount) for fear that retroactive legislation might trigger substantial unexpected gift taxes ($10.7 million x 45% = **$4,815,000**).

Bear in mind though -- how likely is it that Congress would pass a retroactive decrease in the gift exclusion amount, catching prior gifts? Especially if the legislation is not enacted until very late in the year, when tax legislation is typically made effective as of the beginning of the following year.

While the likelihood of retroactively reducing the gift exclusion amount in 2021 is very unlikely (see Item 10 above), the possibility of retroactive legislation exists and some planners have examined ways of making gifts that could be designed not to trigger gift tax or that could be "undone" in the event of subsequent legislation making the gift inadvisable. Alternatives include (1) formula gifts up to the available exclusion amount, (2) gifts to QTIPable trusts, (3) gifts to QTIPable trusts with a disclaimer provision that would pass assets to a trust for descendants (or possibly a SLAT although that is not clearly allowed) if the spouse disclaimed, (4) gifts to trusts providing that disclaimed assets would revert to the donor, (5) combinations of the above, (6) selling assets to delay the decision to make a gift by forgiving the note but shifting future appreciation beginning immediately, and (7) attempting to rescind the gift later based on a mistake of law resulting from a retroactive tax increase. These and other possible alternatives are discussed in Items 12-20 below.

12. Formula Gifts Up to the Exclusion Amount

a. **Description.** The donor might make a gift that does not exceed the applicable gift exclusion amount similar to standard "A/B formula" testamentary bequests. The assignment might be a *transfer* of an amount (or a fractional share of an asset) equal to the remaining gift exclusion amount, taking into consideration any subsequent legislation that might *reduce* the exclusion amount effective as of the date of the gift, but not legislation increasing the exclusion amount as of that date. This would operate somewhat like a *Wandry* clause, transferring only the amount equal to the available exclusion, but the uncertainty about how much is being transferred currently is based on the vagaries of Congress might do, not based on a subsequent gift tax audit or gift tax court decision as with a *Wandry* clause. The clause would not have the effect of "undoing" the effect of any distant gift tax audit or court decision but would be based very objectively merely on what Congress does in the relatively short term.

To be even more analogous to a standard testamentary marital deduction bequest, the clause could merely be a formula *allocation* of a block of assets, partly to a taxable gift portion (such a trust for descendants or for descendants and the donor's spouse) and partly to a nontaxable portion (such as to charity, a spouse, a QTIPable trust, a general power of appointment marital deduction trust, an estate marital trust, an "almost zeroed out" GRAT, or an incomplete gift trust).

b. **Possible *Procter* Attack.** The IRS might conceivably argue that the assignment with a condition subsequent would not be recognized under the reasoning of *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944), which rejected the claim that the following "savings clause" avoided a court determination that a $10,566.07 gift tax applied to a transfer:

> Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property *hereby transferred* which is decreed by such court to be subject to gift tax, shall automatically be *deemed* not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created. (Emphasis added.)

The literal language of the transfer document in *Procter* contemplated that there was a present transfer that counsel believed was not subject to gift tax, and that any property "*hereby transferred*" that would be subject to gift tax was "*deemed*" not to be included in the conveyance. This is different from the contemplated formula assignment that purports only to transfer a specified amount and nothing else.

The full Fourth Circuit Court of Appeals concluded that the provision imposed a condition subsequent to the transfer, and that the condition subsequent violated public policy for three reasons: (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. Observe that none of those three reasons applies to a formula assignment that merely takes into account retroactive gift tax law changes.

Much of the attention in *Procter* about the effect of this clause was about a procedural defect—that the clause would change what had previously been transferred automatically based on what the court decreed and that the clause would automatically undo whatever the court decided.

> The court's holding speaks to a procedural defect with the provision, namely, that the clause created a condition subsequent that could not become operative until a final judgment had been rendered, but once a judgment had been rendered it could not become operative because the matter involved had already been concluded by such final judgment…. "[T]he court in *Procter* [held] that because the adjustment was intended to take effect subsequent to the court's judgment, it cannot avoid the imposition of gift tax, because the tax is imposed on the judgment, and is then final." Diana S.C. Zeydel and Norman J. Benford, *A Walk Through the Authorities on Formula Clauses*, Estate Planning, December 2010, at 4.
>
> Tiffany Carmona and Tye Klooster, *Wandry v. Commissioner-The 'Secret Sauce' Estate Planners Have Been Waiting For?* 26 Prob. & Prop. 10, 11 (Nov./Dec. 2012).

The focus in *Procter* regarding the effectiveness of the formula clause was that the formula was designed to counteract any determination by the IRS or a court that would otherwise result in additional gift tax. The court was unwilling to accept the "Catch-22" effect that its own determination that a gift tax applied caused the gift tax not to apply. That is not the case with an assignment of the gift exclusion amount that could be decreased because of a retroactive law that the Congress might pass. The three reasons given by the Fourth Circuit that the clause violated public policy are not applicable to a formula that merely considered retroactive gift tax law changes.

While *Procter* is often considered as presenting concerns for actions subject to a "condition subsequent," that term was only used **once** in the opinion in the following sentence: "This is clearly a condition subsequent and void because contrary to public policy." The court then discusses in some detail the three reasons that the clause violates public policy (all related to the issue that enforcement attempts by the IRS or courts to find the existence of additional gifts would automatically defeat the additional gifts). There is no discussion that "conditions subsequent" per se are not respected. Indeed, tax policy does not generally reject all "conditions subsequent." For example, the marital deduction regulations specifically recognize the validity of a formula QTIP election "even though the executor's determinations to claim administration expenses as estate or income tax deductions and the final estate tax values will affect the size of the fractional share." Reg. §20.2056(b)-7(h), Ex.7. As another example, a transfer of a specified dollar value of units of an LLC, to be determined by a specific appraiser within several months of the transfer, is a transfer subject to a condition subsequent (the appraised value), but is not viewed as abusive or contrary to public policy. *Cf. Nelson v. Commissioner*, T.C. Memo. 2020-81 (IRS raised no policy objections to the assignment). The *Procter* court reasoned that the condition subsequent violated public policy because of its effect of automatically undoing a determination by the court, **not merely because it depended on some future events**.

Conservation easement cases that have rejected various types of "savings clauses" on the basis of *Procter* have also pointed out that the subsequent event is a finding that a problematic clause is "conditioned on a subsequent IRS or court determination." *TOT Property Holdings, LLC v. Commissioner,* 127 AFTR 2d 2021-XXXX (11th Cir. June 23, 2021). Similarly, *Belk v. Commissioner*, 774 F.3d 221, 230 (4th Cir. 2014), emphasized that a savings clause purported to alter contract rights triggered by "a determination that [could] only be made by either the IRS or a court."

The formula *allocation* approach rather than a formula *transfer*, with the excess amount attributable to the retroactive decrease in the gift exclusion amount passing to a nontaxable portion, seems to be less susceptible to a *Procter* attack, which has sometimes been referred to by the IRS as rejecting a formula that "retransfers" assets to a donor. For example, in Technical Advice Memorandum 200337012 the IRS rejected a formula transfer of "that fraction of Assignor's Limited Partnership Interest in Partnership which has a fair market value on the date hereof of $A" because "a certain percentage of the Partnership interest held by Trust would be retransferred to Taxpayer. This is the type of clause that the courts in *Procter* and *Ward* conclude are void as contrary to public policy."

c. **Possible "Current Value Completed Gift" Argument.** An assignment of an amount equal to the exclusion amount, taking into consideration retroactive legislation, is a completed gift because any adjustments in the amount being assigned is out of the donor's control. The assignment document no doubt would control for state law purposes and a retroactive reduction in the gift exclusion amount would reduce the amount transferred, but whether such amount would be subtracted from the taxable gift is uncertain. The IRS might take the position that the assignment must be valued at the time of the gift because that is when the gift is complete. The value of the assignment would take into consideration the likelihood of the gift exclusion amount being reduced and by what amounts. (That likelihood would be difficult to value; perhaps the likelihood is so remote that the IRS would take the position that it should be ignored altogether in valuing the gift as of the time of the assignment.)

An analogy might be the assignment of a derivative based on the performance of some particular asset (such as the value of a specified number of shares of Apple stock after 12 months). The gift would be valued based on the current value of that contractual right, not the actual amount transferred 12 months later based on the value of Apple stock at that time. *See* David Handler, *Naked Derivatives and Other Exotic Wealth Transfers*, 50th HECKERLING INST. ON EST. PL. ch. 8 (2016).

d. **Formula Part Gift Part Sale.** The transfer might be structured as a sale with a purchase price equal to the fair market value of the asset (perhaps as finally determined for gift tax purposes) minus the transferor's finally determined gift tax exclusion amount remaining at the date of the sale, taking into consideration all facts and laws that apply as of the date of the sale.

e. **Drafting Issues.**

- The assignment could include a "purpose" provision making clear that the purpose is to assign as large amount as possible without generating federal gift tax based on federal gift tax law as it is finally determined to exist as to the assignment by the time the federal gift tax return is filed and to eliminate any possible unintended gift tax due to retroactive tax law changes between the date of the assignment and the date the gift tax return is filed reporting the gift (or perhaps to the due date of such gift tax return).

- The assignment might state the amount initially allocated to the assignment but make clear that the donor still owns any excess amount represented by any subsequent retroactive decreases in the gift exclusion amount and that titles will be adjusted accordingly to implement the formula transfer.
- If a formula allocation approach is used, with the excess passing to a nontaxable portion, the clause might provide that the taxable portion amount will be placed in escrow until the federal gift tax return reporting the gift is filed, and if a retroactive tax law change reduces the exclusion amount, the excess amount initially allocated to the taxable gift portion will be moved to the nontaxable portion, including all income and appreciation attributable to that portion of the escrowed funds.
- The formula might include an ordering provision, specifying what particular assets would first be used as adjustments are made under the formula.

13. Transfer to Inter Vivos QTIPable Trust

a. **General Description.** A donor might make a transfer to a QTIPable trust if the donor is comfortable with the spouse being the sole beneficiary of the trust. The donor can defer the decision of whether the transfer is a taxable gift until the donor decides whether to make the QTIP election on the gift tax return reporting the transfer. Making a QTIP election would mean that the gift to the trust would be covered by the gift tax marital deduction thus avoiding any taxable gift. If the gift exclusion amount is not decreased retroactively, the QTIP election would not be made. The decision of whether the donor would make the election on the Form 709 could be delayed until October 15 of the following calendar year if the gift tax return is extended.

For *outstanding* resources discussing a wide variety of planning considerations for inter vivos QTIP trusts, see Richard S. Franklin, *Lifetime QTIPs—Why They Should Be Ubiquitous in Estate Planning*, 50th HECKERLING INST. ON EST. PL. ch. 16 (2016); Richard S. Franklin & George Karibjanian, *The Lifetime QTIP Trust – the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exemption*, 44 BLOOMBERG TAX MGMT. ESTATES, GIFTS & TR. J. 1 (March 14, 2019).

b. **Features and Special Tax Considerations.**

(1) **SLAT-Like Advantages.** The QTIPable trust approach works well for the married donor who wants to take advantage of the "window of opportunity" to utilize the large gift exclusion amount but wants to keep some ability for the couple to have access to the gift assets if needed for lifestyle reasons. The QTIPable trust is a type of a spousal lifetime access trust (SLAT) that includes the donor's spouse as a beneficiary.

(2) **Donor in Control of Decision to "Undo" the Taxable Gift.** The donor is in control of the decision of whether to cause the transfer not to be a taxable gift (by making the QTIP election on the donor's gift tax return).

(3) **Mandatory Income Interest.** While all trust income must be paid to the spouse at least annually, the trust is not automatically disqualified merely because the trust permits non-income producing assets to be retained or because the trust invests in non-income producing assets, as long as the spouse has the power to require the trust to produce a reasonable amount of income. *See* Reg. §25.2523(f)-1(f), Ex. 2.

(4) **No Power of Appointment During Spouse's Lifetime.** No person (including the spouse) may have a lifetime power to appoint any of the trust assets to any person other than the spouse. §§2056(b)(7)(B)(ii)(II), 2523(f)(3). The spouse can be given a testamentary limited power of appointment.

(5) **Principal Distributions.** The trust cannot allow any distributions to anyone other than the spouse during the spouse's lifetime. The trust can prohibit principal distributions to the spouse or may allow principal distributions according to a standard or (if the spouse is not the trustee) within the discretion of the trustee or under other broad non-ascertainable standards (such as a "best interests" standard).

(6) **Make QTIP Election on Timely Filed Form 709.** The QTIP election ***must*** be made on a timely filed gift tax return (§2523(f)(4)(A)), and there is no possibility of getting 9100 relief to make a late election (*e.g.*, PLR 200314102). If the donor spouse dies before the end of the year of the gift, the gift tax return must be filed by the estate tax filing date, if sooner. §6075(b)(3).

(7) **Formula QTIP Election Permitted.** The QTIP election may be made by a formula, for example based on the donor's gift exclusion amount. See Item 13.c below.

(8) ***Clayton* Provision Probably Not Available.** A "*Clayton*" provision, to allow beneficiaries other than just the spouse if the QTIP election is not made, likely cannot be used for inter vivos QTIP trusts. See Item 13.d below.

(9) **"Clayton Flexibility" Available to Some Extent With Disclaimer Provision.** Although a *Clayton* provision cannot safely be used to add other beneficiaries if the QTIP election is not made, the flexibility to add other trust beneficiaries could be available by using a disclaimer provision, specifying where assets will pass if the donee spouse disclaims his or her interest in the trust. See Item 13.e below.

(10) **Remainder Alternatives.** The trust must last for the spouse's lifetime. As mentioned above, the spouse (or anyone else) could have a testamentary limited power of appointment following the spouse's death. In default of exercise of any such power of appointment, the trust could continue as a trust for the benefit of the original donor spouse. The continuing trust could be a QTIPable trust or could be a "bypass trust" that would not be includable in the donor-spouse's gross estate (see Item 13.f below). The assets could be divided by a formula between a QTIPable trust and a bypass trust for the original donor spouse. Reg. §§20.2056(b)-7(b)(2)(i) & 20.2056(b)-7(h), Exs. (7-8).

(11) **Deferral of Decision to Apply Donor's or Donee's GST Exemption; "Reverse QTIP Election."** The donor's decision of whether to make the QTIP election can be deferred until the filing date of the gift tax return reporting the transfer (October 15 of the year following the gift if the original April 15 gift tax return due date is extended). Assume a husband makes a gift to a QTIPable trust for his wife. Upon filing the gift tax return reporting the transfer, if the QTIP election is not made, the donor can allocate his GST exemption if desired. If the QTIP election is made, the donee wife is generally treated as the transferor to the trust (and she could allocate her GST exemption to the transfer), but §2652(a)(3) allows the donor to elect for the donor to be treated as the transferor for GST tax purposes only, meaning that the donor could allocate his GST exemption to the QTIP trust if desired. The ETIP rule does not apply to a QTIP trust if the "reverse" QTIP election has been made. Reg. §26.2632-1(c)(2)(ii)(C).

(12) **Divorce Provisions.** A special consideration in creating any inter vivos QTIP trust is that it must provide an income interest to the donee spouse for life, even in the event of divorce. The donor spouse must be comfortable with that possibility. If a divorce were to occur, the trust could provide that any right to receive discretionary principal distributions or a testamentary limited power of appointment for the spouse would terminate.

Troublesome income tax issues with respect to the QTIP trust would also arise following a divorce. See Item 13.g below.

(13) **Grantor Trust.** The trust is a grantor trust (with the donor spouse as the deemed owner) as to income because of the spouse's mandatory income interest and it would also be a grantor trust as to principal if the trust authorizes discretionary principal distributions to the spouse. The trust can also be designed so that it would continue as a grantor trust as to the original donor even following the donee spouse's death and even if the trust effectively continues as a "bypass

trust" for the benefit of the original donor spouse. Reg. §1.671-2(e)(5) (if a trust transfers to another trust, the grantor of the original trust is also treated as grantor of the transferee trust unless a person with a general power of appointment over the original trust exercises that power in favor of another trust). *See generally* Gans, Blattmachr & Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP. 52, at 56 (July/August 2007).

(14) **Gifts by Donee Spouse; Release.** The donee spouse can have the flexibility, in effect, to make a gift of the trust assets. If the trust does not have a spendthrift clause, the donee spouse could assign her interest in the trust, which would cause the spouse to be treated as having made a gift of the entire trust, of the income interest under §2511 and of the remainder interest under §2519. Even if the trust has a spendthrift clause, the trust might provide that a "release" by the donee spouse of her interest would not be treated as a prohibited alienation. *See* RESTATEMENT (THIRD) OF TRUSTS, §58 cmt. c; Richard S. Franklin, *Lifetime QTIPs—Why They Should Be Ubiquitous in Estate Planning*, 50th HECKERLING INST. ON EST. PL. ¶1602.4 (2016).

(15) **Disclaimer Flexibility.** The donee spouse could trigger a taxable gift by disclaiming the gift within the 9-month disclaimer period if the spouse had not received any distributions from the trust. The disclaimer could be made by a formula. See Item 13.e below.

(16) **Minority Interests.** Even if the QTIP election is made for the trust, assets in the trust are not subject to being aggregated to determine voting control with interests owned by either the donor or donee spouse. *See Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999), *acq*. 1999-35 I.R.B. 314, *as corrected by* Ann. 99-116, 1999-52 I.R.B. 763.

(17) **Must be U.S. Citizen.** No marital deduction is allowed for a gift to a non-citizen spouse made on or after July 14, 1988. A modified annual exclusion is allowed for the first $100,000 (indexed from 1997) of annual gifts, but a gift to a lifetime QTIP does not qualify for that modified annual exclusion. Reg. §25.2523(i)-1(d) Ex.4.

c. **Formula QTIP Election.** Furthermore, this strategy may allow limiting the amount of the taxable gift if the donor wishes to put a cap on the amount of gift tax owed as a result of the transfer. Various examples in the regulations reiterate that formula QTIP elections may be used. *See* Reg. §§20.2056(b)-7(b)(2)(i) & 20.2056(b)-7(h), Exs. (7-8). For a discussion of the mechanics of making a formula election, *see* Tech. Adv. Memo. 9116003 (discussing validity of QTIP election of "an amount from the assets... equal to the minimum amount necessary to reduce the federal estate tax payable as a result of my death to the least amount possible …"). By using a formula QTIP election, the planner can provide that the QTIP election is made over a sufficient portion of the transferred property so that no gift tax or only a maximum set amount of gift tax is payable on the transfer. In this manner, making a formula QTIP election operates much like using a defined value clause — except that the formula QTIP election approach is clearly sanctioned in the regulations and existing rulings.

For example, Wife may transfer to an inter vivos QTIP trust an amount equal to the unused gift exclusion amount and make a formula QTIP election sufficient to reduce the federal gift tax to zero, taking into consideration the available gift exclusion amount at the time of the election and considering finally determined gift tax values (which would cause the formula election to operate like a defined value clause) . The regulations provide that a taxpayer may make the gift tax QTIP election by means of a formula that relates to a fraction or percentage of the QTIP trust. Reg. §25.2523(f)-1(b)(3). The estate tax QTIP regulations contemplate formula elections, §20.2056(b)-7(b)(2)(i) and have an example of such a formula partial election. Reg. §20.2056(b)-7(h), Exs. 7-8; *see* Tech. Adv. Memo. 9116003 (discussing validity of QTIP election of "an amount from the assets... equal to the minimum amount necessary to reduce the federal estate tax payable as a result of my death to the least amount possible …"). Richard Franklin suggests the following formula election as an example:

> I elect to treat as qualified terminable interest property that portion of the gift, up to 100%, necessary to reduce the Federal gift tax to zero after taking into account the available gift tax exclusion amount and final gift tax values. Richard S. Franklin, *Lifetime QTIPs—Why They Should Be Ubiquitous in Estate Planning*, 50th HECKERLING INST. ON EST. PL. ¶1601.4[B] (2016).

(This tracks the language in the example in the regulation cited above.)

d. ***Clayton* Uncertainty.** The non-elected portion of an inter vivos QTIP should continue to give the spouse a mandatory income interest and permit distributions to no one other than the spouse during his or her lifetime. The *Clayton* regulation (based on the result in *Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992)) provides that the portion of the assets for which the QTIP election is not made may pass to a trust having different terms than the required terms for a QTIP trust — including a trust that would be similar to a standard "bypass trust" for the spouse that would not be in the spouse's estate for estate tax purposes. Reg. §20.2056(b)-7(d)(3). However, that provision, is only in an estate tax regulation and is not in the similar gift tax regulation, Reg. §25.2523(f)-1(b). The gift tax regulation is not a model of clarity, and there would seem to be some uncertainty about this result. Section 25.2523(f)-1(a)(1) of the gift tax regulations states as follows:

> (c) *Qualifying income interest for life* — (1) *In general*. For purposes of this section, the term *qualifying income interest for life* is defined as provided in section 2056(b)(7)(B)(ii) and §20.2056(b)-7(d)(1).

On the one hand, this statement would seem to incorporate the "*Clayton* regulation," because this statement provides that for *gift* tax purposes, the term "qualifying income interest for life" is defined as provided in §2056(b)(7)B)(ii). The *Clayton* regulation is in the section of the regulations describing a "qualifying income interest for life." Therefore, the interpretation of that estate tax statutory term, as including an income interest that is contingent on the existence of a QTIP election, would seem to control for gift tax purposes also. More importantly, the gift tax QTIP statute itself provides that "rules similar to the rules of clauses (ii)… of section 2056(b)(7)(B) shall apply." Section 2056(b)(7)(B)(ii) defines the term "qualifying income interest for life." If the gift tax statute simply makes reference to the statutory definition of "qualifying income interest for life," an interpretation of that statute to include an income interest that is contingent on the existence of a QTIP election would seem to be controlling for gift tax purposes also.

On the other hand, the general statement in the gift tax regulation, quoted above, refers not only to §2056(b)(7)(B)(ii) of the statute, it also refers specifically to Reg. §20.2056(b)-7(d)(1). However, the "*Clayton* regulation" is in §20.2056(b)-7(d)(3). Furthermore, the gift tax regulation specifically restates (as a very similar mirror provision) what is in §20.2056(b)-7(d)(2), (4), (5), and (6), thus suggesting that the omission of 7(d)(3) has particular significance, raising the question of whether an income interest that is contingent on whether a QTIP election is made would qualify for the gift tax marital deduction.

If a *Clayton* provision added other beneficiaries if the QTIP election is not made, it would seem that the gift would not be complete in the year of the original transfer — because the donor would retain the power to shift benefits among beneficiaries until the gift tax return filing date has passed. (Conceivably the gift would never become complete during the donor's lifetime because the return making the election would always be due the following year, thus extending the completion of the gift to the following year, extending the due date of the return to the year after that, etc.)

Even if a *Clayton* provision could be used for inter vivos QTIP trusts, including the provision could be problematic because until the period for making the election had passed, the donor might have retained a §2036(a)(2) power because of the donor's ability to make or not make the election on the Form 709, which could trigger gross estate inclusion for an additional three years under §2035.

e. **Disclaimer Provision to Add "*Clayton* Flexibility."** Although a *Clayton* provision cannot safely be used to provide for other beneficiaries if the QTIP election is not made, the trust could include a disclaimer provision specifying where assets that are disclaimed by the donee spouse will pass. The trust might provide that disclaimed assets would pass to a trust for descendants if the donee spouse disclaimed, as discussed in Richard Franklin, *Lifetime QTIPs – Why They Should be Ubiquitous in Estate Planning*, 50th ANN. HECKERLING INST. ON EST. PL. ¶1601.4[C] (2016)(including a form for a formula disclaimer provision).

(1) **No Acceptance of Benefits.** The donee spouse could not receive benefits from the trust before making a disclaimer. (A QTIP trust includes a mandatory income interest for the donee spouse. The donee spouse would need to disclaim before accepting any income distributions from the trust.)

(2) **No Power of Appointment.** The disclaimant-spouse could not have a power of appointment over disclaimed assets.

(3) **Nine-Month Limit for Disclaimer Allows Consideration of Any Retroactive Decrease in Exclusion Amount.** The disclaimer would have to be made within 9 months of the original transfer rather than by October 15 of the following year, but that is probably long enough to have a good sense of whether a retroactive decrease in the gift exclusion amount is being considered by Congress. If not, the donee spouse may be comfortable disclaiming and allowing the trust to include other beneficiaries. If the gift exclusion amount has been reduced retroactively by Congress, the amount of such reduction would not be disclaimed by the donee spouse, so that the QTIP election could be made for that portion of the trust to avoid gift taxes with respect to the decrease of the exclusion amount. But the balance of the trust might be disclaimed so that the donee spouse would no longer have a mandatory income interest and so that the disclaimed assets could pass to a trust solely for descendants.

(4) **Formula Disclaimer Permitted.** The donee spouse could disclaim by a formula, which could be of the largest amount that could pass free of federal gift tax taking into consideration the donor spouse's remaining gift tax exclusion amount and the values of assets as finally determined for federal gift tax purposes. (In this manner, the formula disclaimer could act as a defined value provision, using a formula approach that is sanctioned by regulations. Such a formula disclaimer approach was specifically approved in *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009).)

(5) **Questionable Whether Disclaimed Assets Could Pass to SLAT With Donee Spouse as Discretionary Beneficiary.** Whether the disclaimed assets from an inter vivos QTIP could pass to a SLAT with the donee spouse as a discretionary beneficiary is not clear. One of the requirements of a valid disclaimer under §2518 is that the interest passes either "(A) to the spouse of the decedent, or (B) to a person other than the person making the disclaimer." §2518(b)(4). In a testamentary context, it is clear that the disclaimed assets could pass to a trust of which the disclaimant spouse is a potential beneficiary. However, it is not clear that applies if the donor spouse has not yet died. Literally, §2518(b)(4)(A) refers to the "spouse of the *decedent*" and Reg. §25.2518-2(e)(2) has references to "decedent" and "surviving spouse," Richard Franklin, *Lifetime QTIPs – Why They Should be Ubiquitous in Estate Planning*, 50th ANN. HECKERLING INST. ON EST. PL. ¶1601.4[C][1] (2016). Despite the literal wording of the statute and regulation, one planner reports having been through a tax audit with the situation in which the disclaiming spouse of a lifetime QTIP was a continuing beneficiary, and the arrangement presented no problems. One commentator has concluded that the spouse of a still-living donor should be able to disclaim and remain a beneficiary of the disclaimed assets, reasoning that "presumably §2518(b)(4)(A) will be read to apply to the 'spouse of the transferor.'" Christopher P Cline, *Disclaimers—Federal Estate, Gift and Generation-Skipping Tax Considerations*, 848-3rd TAX MGMT. (BNA) ESTATES, GIFTS AND TRUSTS, at III.A., n.102 ("Section 2518(b)(4)(A) [and Reg. §25.2518-2(e)(2)] refers to a spouse who disclaims as the 'spouse of the decedent'; however, … in the unusual situation of a donee spouse who disclaims an inter vivos gift from the donor spouse that then passes, without direction on the donee spouse's part, to a trust for the benefit of the donee spouse … presumably §2518(b)(4)(A) will be read to apply to the 'spouse of the transferor.'").

(6) **Transfer to QTIPable Trust Except that Third Person Can Appoint to SLAT; Powerholder Disclaim Power If Desirable to Make QTIP Election.** Another planning alternative to simulate a Clayton election suggested by one creative planner is for the donor to give assets to a trust that would be QTIPable except that someone has the power to appoint the assets to a SLAT. After a period of time, if a gift to the SLAT would be desirable, the powerholder could appoint the assets to a SLAT. If not making a gift would be desirable (for example, because a retroactive tax law would cause a gift tax to be payable), the third party could disclaim the power (within 9 months of the transfer), which would cause the power to be deemed never to have existed, thus protecting the ability to make a QTIP election so that no taxable gift would result.

f. **Remainder to Bypass Trust for Donor Spouse.** If assets remain in trust for the benefit of the original donor spouse after the death of the donee spouse, the regulations make clear that the assets will not be includable in the donor spouse's gross estate under §2036 or §2038 because the donee spouse is treated as the transferor of the continuing trust. §2044(c); Reg. §25.2523(f)-1(f), Exs. 10 & 11; Treasury Decision 8522, 59 FED. REG. 9642 (Mar. 1, 1994) (explaining the regulation examples).

That is not the end of the analysis, however. A totally separate issue is that, despite the tax rules, for state law purposes the donor of the QTIP trust may be treated as the donor of the continuing trust for his or her benefit after the death of the donee spouse. Can a creditor argue that the assets originally came from the original donor, and that when they end up in a trust for her benefit, she should be treated as having created that trust, so that it is a self-settled trust reachable by her creditors? Indeed, that result is a possibility if the assets pass to the trust for the original donor spouse. Under the traditional "relation back" doctrine, the original donor spouse is still treated as the transferor of the trust for state law purposes. Therefore, for state law purposes, the trust may be treated as a "self-settled trust" and subject to claims of the donor's creditors unless the donor resides in a state with a domestic asset protection trust (DAPT) statute. *See generally* Gans, Blattmachr & Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP. 52, at 56 (July/August 2007). If the client does not live in a self-settled trust state with a DAPT statute, an attempt to incorporate the laws of a self-settled trust state may not be effective for creditor purposes. The comments to the new Uniform Voidable Transactions Act (formerly the Uniform Fraudulent Transfer Act) take the position that if the law of the state of the settlor's principal residence does not recognize self-settled trusts, transferring assets to a trust under the laws of another self-settled trust state would be a voidable transfer. UNIF. VOIDABLE TRANSACTIONS ACT §4, Comment 8, (last paragraph) (July 2014).

The ability of a grantor's creditors to reach trust assets generally will trigger inclusion in the gross estate under §2036. *See, e.g.*, *Outwin v. Commissioner*, 76 T.C. 153 (1981), *acq*. 1981-2 C.B. 1; Rev. Rul. 77-378, 1977-1 C.B. 348. But, as described above, Reg. §25.2523(f)-1(f) indicates that the trust will not be includible in the donor's gross estate under §2036. Could the ability of a grantor's creditors to reach trust assets trigger estate inclusion under §2041 as well?

Section 2041 should not apply if trust distributions to the original donor spouse are subject to ascertainable standards. *See generally* Gans, Blattmachr & Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?*, 42 REAL PROP. PROB. & TR. J. 413, 436-437 (2007). Using ascertainable distribution standards avoids the §2041 issue, at least under the laws of most states providing that creditors cannot reach more than the trustee could distribute under a maximum exercise of discretion. *See* RESTATEMENT (THIRD) OF TRUSTS §60 cmt. f; Tech. Adv. Mem. 199917001 (ascertainable standard could limit creditor access under state law and therefore limit IRS's ability to include trust in grantor's estate under §2036).

The creditor issue likely will be avoided if the laws of a DAPT state are applicable and the donor spouse is merely a discretionary beneficiary, or if the applicable state law includes a statute that protects lifetime QTIP trusts in this circumstance after the donee spouse's death. (At least 18 states have statutes that address this situation in the context of initial transfers to an inter vivos QTIP trust. Those states are Arizona, Arkansas, Delaware, Florida, Georgia, Kentucky, Maryland, Michigan, New Hampshire, North Carolina, Ohio, Oregon, South Carolina, Tennessee, Texas, Virginia, Wisconsin, and Wyoming.) See Item 23.c(1) below. As discussed above, if the client does not live in a self-settled trust state, an attempt to incorporate the laws of a self-settled trust state may not be effective for creditor purposes. UNIF. VOIDABLE TRANSACTIONS ACT §4, Comment 8, (last paragraph) (July 2014).

Whether the original donor spouse can retain a special power of appointment as part of the backend interest in a lifetime QTIP trust is not clear. Some private letter rulings appear to sanction it, but the regulations suggest that it is not permissible [see Reg. §25.2523(f)-1(a)(1); Jeffrey N. Pennell, *Estate Tax Marital Deduction*, 843-3rd TAX MGMT. (BNA) ESTATES, GIFTS, AND TRUSTS, at VI.F.6, note 518] and cautious planners may want to avoid the concern. A suggested alternative to allow needed flexibility is to grant an independent trustee broad authority to make distributions to the original donor spouse.

If circumstances change, the independent trustee could make outright discretionary distributions to the donor spouse, who could then make adjustments in the ultimate distribution of the property.

The continuing trust for the benefit of the donor spouse continues as a grantor trust as to the original donor. *See* Reg. §1.671-2(e)(5), discussed at Item 13.b(13) above.

g. **Special Tax Concerns Following Divorce.** The trust would continue as a grantor trust, at least as to trust income, because of the donee spouse's right to receive the trust income. §677(a). Section 672(e) treats a grantor as holding any power or interest held by an individual who was the spouse of the grantor at the time of the creation of such power or interest, so the ex-spouse's interest as a beneficiary probably is sufficient to trigger grantor trust status under §677(a) even following the divorce (but see ACTEC comments filed with the IRS on July 2, 2018 suggesting the possibility of a contrary result). Previously, §682 provided that the income of the trust (which must be distributed to the donee spouse) will be taxable to the donee spouse even though the trust would continue as a grantor trust as to the donor spouse as to trust income. Section 682 has been repealed, though, for divorces occurring after 2018. The donor spouse will likely be unhappy having to pay income tax on income that is distributed to his or her ex-spouse from the trust. The donor spouse would want to negotiate in a marital agreement or in the divorce decree that the donee spouse will be responsible for any income tax attributable to trust income even if the trust is a grantor trust as to the donor spouse.

Even prior to the repeal of §682, a similar concern existed as to capital gain income. If the donee spouse is a discretionary beneficiary of principal, §682 may not have applied as to capital gains allocated to principal because it applied to "income of any trust which such wife is *entitled* to receive," and the donee arguably was not "entitled" to receive any principal under a discretionary distribution standard. The problem is that capital gain income would be taxed to the trust, or perhaps to the original donor spouse if the trust continues as a grantor trust as to the trust corpus. For planning considerations, see Nelson & Franklin, *Inter Vivos QTIP Trusts Could Have Unanticipated Income Tax Results to Donor Post-Divorce*, LEIMBERG ESTATE PLANNING NEWSLETTER #2244 (Sept. 15, 2014).

For further discussion of the impact of the repeal of §682 following a divorce, see Item 7 of ACTEC 2020 Fall Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

h. **Approaches for Addressing Reciprocal Trusts Issue.** If both spouses want to make gifts and want to take steps to minimize gift tax in the unlikely event of retroactive gift tax legislation, if each spouse creates a QTIPable trust for the other spouse, the IRS might argue that the trusts are includable in each spouse's gross estate under the reciprocal trust doctrine. See Item 25 below. An alternate approach might be for Spouse A to create a QTIPable trust for Spouse B and for Spouse B to make a gift outright to Spouse A with a provision that if Spouse A disclaims the gift, any disclaimed assets would pass to a trust for descendants. (Whether Spouse A could disclaim and have the assets pass to a trust for the benefit of Spouse A and descendants is not clear because of the reference in §2518(b)(4)(A) to "spouse of the DECEDENT," as discussed in Item 13.e(5) above). That approach would seem to avoid the §2036 reciprocal trust doctrine, but could the IRS argue that the disclaimer would not be a qualified disclaimer under §2518 under the theory that each spouse's gifts were in consideration of the other's gift? *See* Reg. 25.2518-2(d)(1) ("acceptance of any consideration in return for making the disclaimer is an acceptance of the benefits of the entire interest disclaimed"). But in the described transaction, Spouse A would not be receiving any consideration for making the disclaimer.

This approach is not perfect; it does not satisfy the desire to have the combined gifts pass to trusts of which one of spouses is a potential beneficiary, but at least it allows nine-months to make the decision of whether Spouse A would disclaim and have the assets pass to a trust of which neither spouse is a potential beneficiary.

The other approach would be for each spouse to create QTIPable trusts for the other spouse, but make the trust terms as different as possible – different trustees, different trustee removal powers, different principal distribution standards, different remainder beneficiaries, different testamentary powers of appointment, different administrative provisions, etc. (as discussed in Item 25.c below).

14. Transfer to Trust With Disclaimer Provision Causing Reversion to Donor

a. **General Description.** The donor could make a transfer to a trust with a disclaimer provision specifying that if a particular beneficiary or the trustee disclaims, the disclaimed assets would be returned (i.e., "revert") to the donor, which means that the donor would be treated as not having made a gift of the amount that reverts to the donor. This approach leaves nine months after the gift for "wait and see" planning, but in the meantime, beneficiaries could not accept any benefits in order for the disclaimer to be a qualified disclaimer under §2518. Planners commenting on this approach suggest that the disclaimer could be made by (1) a designated primary beneficiary of the trust on behalf of all beneficiaries (which would be particularly helpful if there are various minor or potentially unborn beneficiaries) or (2) the trustee. If the property reverts to the donor, the original transfer is not a completed gift.

For an outstanding discussion of a wide variety of tax issues with this type of planning, see Ed Morrow, *How Donees Can Hit the Undo Button on Taxable Gifts*, LEIMBERG ESTATE PLANNING NEWSLETTER #2831 (Oct. 19, 2020).

b. **Assets Do Not Remain in Trust If Gift is "Undone" By a Disclaimer.** If some or all of the transfer is not treated as a taxable gift as a result of a disclaimer, those assets don't remain in trust but are returned to the donor. Some donors would prefer that they keep assets that are not treated as taxable gifts. In contrast, the QTIPable trust approach results in the assets being maintained in the trust for the balance of the spouse's life.

c. **Donor Must Rely on Disclaimant Rather Than Having Control Over the Decision to "Undo" a Taxable Gift.** An important disadvantage to this approach for some donors is that the donor is not in control of the decision to "undo" a taxable gift (for example if subsequent retroactive gift tax legislation occurs), but the donor must rely on a third party (the beneficiary or perhaps the trustee) to disclaim if making a taxable gift becomes undesirable.

d. **Does Disclaimed Property from an Inter Vivos Gift Revert to the Donor?** Property disclaimed from an inter vivos gift passes by state law, typically according to the terms of the dispositive instrument. UNIFORM DISCLAIMER OF PROPERTY INTERESTS ACT §6(b)(2) (UDPIA); *e.g.,* TEX. PROP. CODE §240.051(d). If the instrument is silent, the property generally passes as if the donee had predeceased the gift. UNIFORM DISCLAIMER OF PROPERTY INTERESTS ACT §6(b)(3)(A). Under many state anti-lapse statutes, the assets would pass to the disclaimant's surviving descendants. *Id*. at §6 Comments.

Nothing in UDPIA (or most state laws) prevents the instrument from specifying a different disposition of the assets upon a disclaimer than upon the death of the disclaimant.

The disclaimer regulations similarly recognize that the disposition of disclaimed assets is controlled by the terms of the governing instrument, or if the governing instrument is silent, by state law. *See e.g.*, Reg. §25.2518-2(e)(5), Ex. 4 ("[t]he provisions of the will specify that any portion of the … trust disclaimed is to be …"); *Id*., Ex. 8 ("[t]he will made no provisions for the distribution of property in the case of a beneficiary's disclaimer. The disclaimer laws of State X provide that …").

Because the first priority is that the assets pass as provided in the transfer instrument and that provision may be different from how the assets would pass if the disclaimant predeceased, there is no reason for the instrument not to specify that any disclaimed asset will revert to the donor. If the instrument does not direct that disclaimed assets will revert to the donor, do not assume that is what would happen under state law. If a reversion to the donor is desired, the instrument should explicitly direct that, for example, "any disclaimed assets shall revert to me."

e. **Tax Effect of Disclaimer of Inter Vivos Gift.** Gift tax regulations make clear that the gift tax does not apply to a donor if, as a result of a qualified disclaimer, a completed transfer of an interest in property is not effected." Reg §25.2511-1(c)(1). The disclaimer regulations provide that the disclaimed property is treated "as passing directly from the transferor to the person entitled to receive the property as a result of the disclaimer." Reg. §25.2518-1(b). If the property is treated as "passing" directly from the donor to the donor (therefore, retained by the donor), obviously, no gift is made.

f. **Income Tax Effect of Disclaimer.** If the disclaimer is made in the same taxable year, the doctrine allowing rescissions made in the same taxable year to be respected for income tax purposes (Rev. Rul. 80-58) should apply to the disclaimer. Any taxable income would be returned to the donor and would be taxed to the donor. If the disclaimer is made in a subsequent taxable year, there is no clear authority that the taxable income arising before the disclaimer would be taxable to the donor and not the disclaimant. The disclaimant may have to include the income and rely on the claim of right doctrine to deduct (under §1341) the amount that reverts to the donor in the subsequent year. The best practice is to avoid that uncertainty by disclaiming in the same taxable year in which the gift is made.

g. **Complexities for Disclaimers from a Trust.** If a deed from A is given to B, and B disclaims, local law will often provide that the property reverts to A. In that simple example, the manner of disclaiming the property is easy. B simply disclaims, and the property reverts to A. Similarly, if a gift is made to a trust with a single beneficiary and on trust termination the assets pass to that beneficiary or his or her estate, the beneficiary can simply disclaim. But the disclaimer process can get much more complicated when the gift is made to a trust with multiple beneficiaries. Each beneficiary could disclaim his or her interest in the trust, including potential remainder beneficiaries. Determining the portion of the trust represented by each beneficiary's interest could be difficult. Obtaining disclaimers from multiple beneficiaries, some of whom may be minors and some of whom may have very small potential interests, can become quite complicated. To avoid such complexities, planners have recommended that the trust instrument specify that the property may be disclaimed (1) by a particular beneficiary (on behalf of all beneficiaries) or (2) by the trustee.

(1) **Disclaimer by Primary Beneficiary.** Even without any prearranged agreement, the donor may be comfortable that the primary beneficiary will be willing to disclaim if doing so can avoid the payment of a significant current gift tax by the donor. The mere expectation of a future benefit in return for executing a disclaimer will not render it unqualified. *See Estate of Monroe v. Commissioner*, 124 F.3d 699 (5th Cir. 1997); *Estate of Lute v. U.S.*, 19 F. Supp.2d 1047 (D. Neb. 1998) (disclaimed property was subsequently transferred to trust with disclaimant as co-trustee).

One commentator takes the position that while a beneficiary may be authorized to disclaim on behalf of other beneficiaries, that disclaimer of the interests of other beneficiaries may not be recognized as a qualified disclaimer under §2518 based on the theory that a person "cannot disclaim more than what she receives." Ed Morrow, *How Donees Can Hit the Undo Button on Taxable Gifts*, LEIMBERG ESTATE PLANNING NEWSLETTER #2831 (Oct. 19, 2020). Even if the disclaimed asset passes to another person pursuant to the terms of the document, he reasons that for purposes of §2518, only the disclaiming person's interest in the trust would be treated as having been disclaimed.

> [W]hen someone disclaims only a portion of an asset, it is logical to conclude that only the portion disclaimed negates the gift, even if the entire gift reverts to the donor pursuant to the donative instrument.
>
> This does not mean that the entire gift in trust cannot be "undone" by disclaimer, similar to outright gifts. It merely means that all the owners of all the interests must disclaim (such as both current and remainder beneficiaries), or the trust must be designed to reduce or eliminate such other interests (such as by naming a child's estate to take upon the child's death). *Id.*

In order to allow an administratively convenient disclaimer by all beneficiaries, one alternative might be to draft a trust with a single beneficiary (or minimal beneficiaries, all of whom could disclaim) but include a limited power of appointment allowing the addition of more beneficiaries (including remainder beneficiaries) or allowing appointment to another multi-beneficiary trust at a later time.

Another alternative might be to provide in the trust agreement that the primary beneficiary would have the authority to direct the trustee to disclaim. A concern with that approach is that while the beneficiary could deliver a qualified disclaimer without being treated as making a gift under §2518, a direction that someone else disclaim might not be entitled to that same protection, and the primary beneficiary might be treated as making a gift of her interest in the trust. To address that potential problem, Christine Quigley (Chicago, Illinois) suggests that the trust agreement might provide that if the primary beneficiary disclaims her interest in the trust, the trustee is directed to disclaim the trust.

(2) **Disclaimer by Trustee.** The difficulty of obtaining disclaimers by all beneficiaries could be avoided by giving the trustee the authority to disclaim the transfer of assets to the trust.

(a) **Does Local Law Permit Trustee to Disclaim If Authorized in Trust Agreement?** If a disclaimer by a trustee is not effective under state law, it is not a qualified disclaimer for purposes of §2518. Rev. Rul. 90-110, 1990-2 C.B. 209. The planner should confirm that local law allows a trustee to disclaim if authorized to do so in the trust agreement. Trustees did not have the authority to disclaim under traditional common law principles. *See* RESTATEMENT (SECOND) OF TRUSTS §102 ("[i]f a trustee has accepted the trust, whether the acceptance is indicated by words or by conduct, he cannot thereafter disclaim"). Many state statutes now authorize trustees to disclaim, particularly if authorized to do so in the trust agreement. *See* RESTATEMENT (THIRD) OF TRUSTS §86, cmt. f (2007) (authority to disclaim property or a fiduciary power if in the interest of beneficiaries and consistent with other fiduciary duties; disclaimer cannot be made merely for convenience of trustee or to lessen trustee responsibilities; trustee must exercise reasonable care and skill in exercising power to disclaim, with the assistance of competent financial, tax, and legal advice as needed).

The UDPIA authorizes a trustee to disclaim even without express authorization in the trust agreement.

> Except to the extent a fiduciary's right to disclaim is expressly restricted or limited by another statute of this State or by the instrument creating the fiduciary relationship, a fiduciary may disclaim, in whole or part, any interest in or power over property, including a power of appointment, whether acting in a personal or representative capacity. A fiduciary may disclaim the interest or power even if its creator imposed a spendthrift provision or similar restriction on transfer or a restriction or limitation on the right to disclaim, or an instrument other than the instrument that created the fiduciary relationship imposed a restriction or limitation on the right to disclaim. UDPIA §5(b).

Some states (such as Texas, discussed below) impose requirements before a trustee may disclaim, such as obtaining a court order or giving notice to all trust beneficiaries.

If the trustee must accept the trust, to assure that the trustee is the trustee of the trust before disclaiming certain property contributed to the trust, an initial small "seed gift" might be made to the trust. A subsequent large transfer could then be disclaimed by the trustee.

(b) **Texas Statutes.** Texas statutes permit trustee disclaimers unless the instrument restricts the right to disclaim. TEX. PROP. CODE §240.008(a). The effect of the disclaimer is that the property never becomes trust property. TEX. PROP. CODE §240.053(a)(1). Trustees must either get court approval of the disclaimer or give notice to all current and presumptive remainder beneficiaries of the trust before making the disclaimer. TEX. PROP. CODE §§240.008(d), 240.0081(a).

(c) **Trustee's Fiduciary Duty.** Even though the trustee may be authorized to disclaim, the trustee must consider whether doing so would be a breach of fiduciary duty. Some of the disclaimer statutes specifically acknowledge that a trustee disclaimer could potentially be a breach of trust. UDPIA §8 cmt ("Every disclaimer by a trustee must be compatible with the trustee's fiduciary obligations").

The Texas disclaimer statute very explicitly addresses the trustee's fiduciary duties. The disclaimer must be compatible with the trustee's fiduciary obligations unless a court approves it, but a disclaimer by a trustee is not a per se breach of the trustee's obligations. TEX. PROP. CODE 240.008(f). However, the statute makes clear that a possible remedy for breach of fiduciary obligations does not include voiding or otherwise making ineffective an otherwise effective disclaimer. TEX. PROP. CODE §240.008(g).

(d) **Gift by Beneficiary Who Fails to Object?** A qualified disclaimer by a beneficiary clearly means that the beneficiary is not treated as having made a gift. However, if the trustee disclaims and the beneficiary fails to object or take steps to prevent a breach of trust by the trustee, has the beneficiary made a gift by not taking steps to protect and enforce his or her rights as a beneficiary?

(e) **Drafting Issues.** The trust instrument should not only authorize the trustee to disclaim all or any portion (including a fractional portion) of any property contributed to the trust and provide that the property will revert to the donor but should also address fiduciary duty concerns. The agreement can provide specifically that a disclaimer by the trustee will not be considered a breach of fiduciary duty, even though the result is that the property reverts to donor. The trust agreement or particular assignment can make the donor's intention clear that an amount is being contributed that is not anticipated to cause the payment of gift tax, the trustee is authorized to take actions in order to carry out that settlor intent, and the trustee will incur no liability for disclaiming any portion in excess of the intended amount that would not trigger payment of gift tax. This provision may also provide a reasonable basis for the trustee to execute a defined value formula disclaimer of an amount, as finally determined for gift tax purposes, that does not exceed a specified value or that will not cause the payment of gift taxes.

(3) **General Disclaimer Considerations.** The general disclaimer considerations summarized in Item 13.e above also apply to this planning approach, including that there can be no acceptance of benefits prior to the disclaimer.

(a) **Nine-Month Limit.** The disclaimer must generally be made within nine months of the transfer to the trust. If the disclaimer is by a young beneficiary of the trust, the time period for making the disclaimer is extended until the beneficiary is age 21. For a good discussion of concerns that arise from such a delayed disclaimer period for a trust with minor beneficiaries, see Ed Morrow, *How Donees Can Hit the Undo Button on Taxable Gifts*, LEIMBERG ESTATE PLANNING NEWSLETTER #2831 (Oct. 19, 2020). The nine-month limit is probably long enough to know if a retroactive decrease in the gift exclusion amount would otherwise result in a taxable gift (just the amount of the decrease would be disclaimed to revert to the donor), but the nine-month limit is shorter than the period allowed for making the QTIP election under the QTIPable trust alternative described in Item 13 above.

(b) **No Acceptance of Benefits.** The donee cannot receive benefits from the trust before making a disclaimer. For a beneficiary disclaimer, this means that the beneficiary could not receive any trust distributions prior to the disclaimer (or would have to establish that the benefits accepted were not out of the severable portion being disclaimed, *e.g.*, PLR 9036028). For a trustee disclaimer, does this require that the trustee not accept the contribution until the decision is made whether or not to disclaim the contribution? The regulations state that "merely taking delivery of an instrument of title, without more, does not constitute acceptance," Reg. §25.2518-2(d)(1), and actions by a fiduciary "in the exercise of fiduciary powers to preserve or maintain the disclaimed property shall not be treated as an acceptance of such property," Reg. §25.2518-2(d)(2). But the regulations provide no details about acceptance of benefits in the context of a disclaimer by a trustee that causes property to revert to the donor.

(c) **Formula Disclaimer Permitted.** Formula disclaimers are permitted, which allows the possibility of a defined value formula disclaimer considering values as finally determined for gift tax purposes. *See Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009).

15. Combinations of Alternatives

Combinations of the above alternatives could be used, such as a formula gift with a disclaimer provision reverting assets to the donor, a formula gift with a pourover to a QTIP trust including a disclaimer provision, a gift to a QTIPable trust with a disclaimer provision with disclaimed assets passing to a trust for descendants, or a similar gift to an "estate-type" marital trust with a disclaimer provision.

16. Sale for Note, Leaving Ability Later to Forgive Part of Note

a. **Description.** A donor might make a gift to a grantor trust of an amount that the client feels comfortable would not exceed an amount to which the gift exclusion amount that might retroactively be reduced. The individual might then sell assets to the grantor trust for a note in a traditional sale to grantor trust transaction. After the dust has cleared on transfer tax legislation in 2021, and the gift exclusion amount is known, the individual would have the flexibility to make an additional gift by forgiving part of the note.

b. **Advantage – Subsequent Appreciation Is (Mostly) Transferred; GST Exempt.** Even though the large gift is not completed initially, the effect of this transaction is that all appreciation after the sale is transferred to the trust (other than the very nominal interest amount on the note if an AFR note is used). Furthermore, all of the appreciation can be in a GST exempt format. Almost all of the advantages of making an initial large gift will be realized without taking any risk on a retroactive decrease in the gift exclusion amount.

c. **Disadvantage – Risk of Losing Large Exclusion Amount.** The risk of not making a large completed gift currently is the possibility that the exclusion amount is not reduced retroactively to the date of the initial transfer, but that legislation decreasing the gift exclusion amount is enacted suddenly or with some retroactive date subsequent to the date of the initial transfer (for example, the date that the legislation is approved by the House Ways and Means Committee) before there is an opportunity for the seller to forgive some of the note. The ability to take advantage of the "window of opportunity" that exists with the large exclusion amount would have been lost.

d. **Upfront Gift If Intend to Forgive Note?** If a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, the IRS position is that the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan. Rev. Rul. 77-299, 1977-2 C.B. 343. However, if there is no prearranged plan and the intent to forgive the debt arises at a later time, the donor will have made a gift only at the time of the forgiveness. Rev. Rul. 81-264, 1081-2 C.B. 186. The IRS has subsequently reiterated its position. *See, e.g.,* Field Service Advice 1999-837 (donor makes gift of full amount of loan initially if donor intends to forgive the loan as part of a prearranged plan); Letter Rul. 200603002 (transfer of life insurance policies to trust in return for note in the amount of the difference between the combined value of the policies and the amount sheltered by gift tax annual exclusions; several months later the donors canceled the note and forgave the debt; taxpayer did not request a ruling on this issue, but IRS stated that it viewed the donors as having made a gift at the outset in the amount of the note where there was a prearranged plan that it would be canceled). The IRS position is contrary to several Tax Court cases (to which the IRS non-acquiesced in Rev. Rul. 77-299).

   In any event, the donor in the proposed planning alternative does not have any prearranged plan to forgive the note. Depending on what Congress does, the seller may forgive some of the note, but the seller may very intentionally *not* forgive any of the note if Congress retroactively reduces the gift exclusion amount.

e. **Discounting Note Value.** Depending on the specific fact situation, a valuation discount may possibly apply in valuing the note. Even though §7520 provides that no gift is considered to have been made when a loan is made in return for a note bearing interest at the AFR, that does not mean the note is necessarily worth its face amount. *See* Michael S. Strauss & Jerome M. Hesch, *A Noteworthy Dichotomy: Valuation of Intra-family Notes for Transfer Tax Purposes*, 45 BLOOMBERG TAX MGMT. ESTATES, GIFTS & TR. J. 4 (Jan. 9, 2020). Planners may consider applying a valuation discount if a subsequent gift is made of part of the note. *See* Alan S. Gassman, Jerome B. Hesch & Martin B.

Shenkman, *Biden 2-Step for Wealthy Families: Why Affluent Families Should Immediately Sell Assets to Irrevocable Trusts for Promissory Notes Before Year-End and Forgive the Notes If Joe Biden Is Elected, A/K/A What You May Not Know About Valuing Promissory Notes and Using Lifetime Q-Tip Trusts*, LEIMBERG EST. PL. NEWSLETTER #2813 (Aug. 10, 2020).

17. Rescission of Part of Gift After Gift Exclusion Amount is Decreased Retroactively

a. **General Description.** If a taxpayer makes a gift by mistake, rescission may be an available state law remedy. Various cases have allowed rescission of transfers under state law, often based on scrivener's error or mistake. That's the easy part. This issue is then whether the rescission will be recognized for federal tax purposes.

> Generally, the "rescission doctrine" is broadly understood as providing that a transaction may be disregarded for federal tax purposes if the parties to the transaction, during the same taxable year in which they undertake the transaction, rescind the transaction and restore themselves to the same position they would have occupied had they not undertaken the transaction (*i.e.*, they return to the *status quo ante*). While the Service has issued a few published rulings and a number of private letter rulings dealing with the application of the rescission doctrine to corporate transactions, the case law in this area is somewhat confusing, and some of the private letter rulings extend the rescission doctrine to areas not covered by existing law or the existing published guidance. NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON THE RESCISSION DOCTRINE (April 11, 2010).

Beth Kaufman summarizes the general factors considered in determining the federal tax consequences of rescissions.

> In determining the consequences of unwinding or rescinding a transaction on federal tax liabilities, courts have considered many factors such as the amount of time between the original transaction and the request to unwind it, the stage of the transaction, the type of the unwinding, the type of the transaction (e.g., sale, gift, payment of compensation or a dividend), the tax motivation for the unwinding, and the relevant operative Code section. [Citing Sheldon I. Banoff, *Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud?,* 62 TAXES 942, 946-7 (1984) (hereinafter Banoff, *Unwinding or Rescinding*).] This broad range of factual situations is outside of the scope of this paper, however, as a general matter, it is important to note that there is no clear unified treatment or policy regarding those situations in which the unwinding is of a transaction that was completed in a prior year. This lack of clear unifying principles leads to a case-by-case evolvement of the case law, complete with contradicting court decisions on the same issues and even on very similar facts.
>
> Footnote Observation: The likelihood for a successful unwinding for tax purposes is the greatest if the unwinding occurs in the same taxable year. For elaboration and references see Banoff, *Unwinding or Rescinding* at 990, 993; *Davis v. United States*, 378 F. Supp. 579 (N.D. Tex. 1974).
>
> Beth Shapiro Kaufman, *Disclaimers and Rescissions: Special Considerations for 2010* (August 2011)(unpublished manuscript).

See generally New York State Bar Association Tax Section Report on the Rescission Doctrine (Report No. 1216) (8/11/2010) citing Sheldon I. Banoff, *Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud*, 62 TAXES 942 (Dec. 1984); David H. Schnabel, *Revisionist History: Retroactive Federal Tax Planning*, 60 TAX LAWYER 685 (2007).

Rescission cases dealing specifically with rescissions of gifts due to a mistake have focused on the kind of mistake.

b. ***"Same-Year Rule."*** A widely held belief is that rescissions must occur in the same year as the underlying transaction to be given effect for tax purposes. However, the notion that rescissions are respected only if they occur in the same taxable year is an income tax concept. *See* Rev. Rul. 80-58, 1980-1 C.B. 181 (rescission occurring in same year as taxable event is respected if parties are returned to their original positions). Even if the "same-year rule" applied to gift transactions, the rescission of an early-year 2021 gift based on a retroactive law change likely could be made in 2021 because the retroactive law change likely would be known in 2021 (it is extremely unlikely that a law change in 2022 would be made retroactive to gifts made early in the prior year).

c. **Scrivener's Error; Mistake of Fact.** A scrivener's error presents the easiest situation for recognizing that a transfer was an unintended transfer for gift tax purposes. *E.g.*, *Dodge v. United States*, 413 F.2d 1239 (5th Cir. 1969) (taxpayer mistakenly transferred all of an asset instead of the intended 20 percent; "[t]hat was simply a technical donation on paper, defective from its inception, immediately subject to recall by the donor, and very likely in fact to be recalled or rendered nugatory"); *Touche v. Commissioner*, 58 T.C. 565 (1972) (donor transferred twice the dollar amount intended).

d. **Mistake of Non-Tax Federal Law.** A rescission was also recognized in a case involving a mistake regarding the government's conflict of interest rules for high level government appointees. After realizing that transferring assets to an irrevocable trust triggered gift tax, the taxpayer reformed the trust in a state court proceeding to make it revocable and subsequently sought a gift tax refund. The gift tax refund was allowed because local law permitted the revocation of a gratuitous transfer into trust that was made as a result of the transferor's mistake of fact or law. *Berger v. United States*, 487 F. Supp. 49 (W.D. Penn. 1980).

e. **Mistake of Tax Law.** A mistake of law may be sufficient grounds for a state law rescission. For example, in *Stone v. Stone*, 29 N.W.2d 271 (Mi. 1947), parents gave a one-half interest in a partnership to their minor children with the understanding that income from that interest would be reported on the children's income tax returns. The IRS determined, based on a subsequent U.S. Supreme Court decision, that the income was still taxed to the parents. The court allowed rescission of the gift as an equitable remedy. While rescission was allowed as a state law remedy, that does not mean that the federal tax consequences are reversed as well.

Recognizing a rescission to disregard a gift for gift tax purposes based on a mistake of law is more problematic than the scrivener's error or mistake of non-tax law situations; cases have gone both ways. A mistake as to the tax effects of making a gift was not sufficient grounds to void the gift for gift tax purposes in *Board v. United States*, 13 T.C. 332 (1950) (gift to reduce future estate tax was rescinded by a state court because of mistake in not knowing the gift triggered payment of gift tax, but the gift was still complete for federal gift tax purposes). *See also* PLR 8205019 (similar situation).

More recently however, a mistake regarding a disclaimer (that was not a qualified disclaimer), was recognized as sufficient grounds for rescinding the disclaimer and no gift resulted from the original disclaimer. *Breakiron v. Gudonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010). The court discussed that one line of cases does not give effect to a rescission for federal tax purposes "because neither party to the state law reformation proceeding has an interest in paying federal tax on the transfer" and "the possibility of 'collusion' to avoid federal liability exists." Another line of cases does give effect to a state law rescission for federal tax purposes. The court acknowledged that the two lines of cases are not easily reconciled but focused on the fact that the IRS was a party to the state law proceeding in giving effect to the rescission for federal law purposes.

> The court in *Van Wymelenberg* required the IRS to be a party to guard against the possibility of "collusion," that is, usurpation of the federal interest in collecting federal taxes, since both parties to a state court proceeding may have a common interest in minimizing federal tax liability. *See Van Den Wymelenberg v. United States*, 397 F.2d 443, 445 [22 AFTR 2d 6008] (7th Cir.1968). A contested proceeding in which the IRS is a party would provide it with the opportunity to cross-examine the plaintiff to ensure that there was a genuine mistake (as in *Dodge* and *Berger*), rather than a post hoc attempt to minimize a federal tax obligation or to avail oneself of a tax advantage unbeknownst to the plaintiff at the time of the original transfer.
>
> … The IRS is a party to the proceeding…. While the mistake was not a mere "scrivener's error," it was a mistake at the time he disclaimed-not a hindsight decision by plaintiff to avail himself of a tax advantage. The IRS had an opportunity during this proceeding to adduce evidence that plaintiff's execution of the disclaimers was something other than a mistake, and did not.

Section §2505(a)(1) provides that the unified gift credit amount applicable to a gift is the estate tax unified credit amount determined as if the donor died as of the end of the calendar year. Therefore, if the gift tax unified credit amount were to be reduced mid-year, without changing the operation of §2505(a)(1), the applicable credit amount for gifts made anytime during the year would be the reduced amount. Claiming a mistake of law is more difficult because the statute specifically provides that a mid-year reduction in the credit amount applies even to prior gifts made in that year, even if the law change is not explicitly made retroactive.

f. **Rescission Because of Mistake Based on Retroactive Law Change Given Effect, *Neal v. U.S.*.** In *Neal v. United States*, 187 F.3d 626 (3rd Cir. 1999), the donor relinquished a retained contingent reversionary interest in a grantor retained income trust (GRIT) to avoid triggering the old §2036(c), which was later repealed retroactively. The taxpayer paid gift tax when the GRIT was created and again when she released the reversionary interest. The next year, Congress repealed the §2036(c) provision retroactively, and the taxpayer obtained a state court order rescinding the release of the reversionary interest. The state court reasoned that

> releases executed in reliance on a statute which, in legal effect, did not exist, is certainly as much of a mistake, if not more, as was Mr. Berger's mistake about the conflicts of interest rules in Berger [discussed in Item 17.d above] which the state court and the district court both found to have been a unilateral mistake of law permitting rescission or reformation of the otherwise irrevocable trust.

In effect, the rescission was allowed because of not knowing that §2036(c) would be repealed retroactively. The taxpayer sued for a refund of the gift tax attributable to the release of the interest that had been rescinded under state law. The **IRS asserted** that there was no mistake of law when the reversionary interest was released, and the **later retroactive change in the law was irrelevant** as to whether the taxpayer was mistaken as to the law at the time of the release. The court disagreed, with emphasis on the retroactive law change:

> For all practical purposes, the retroactive repeal of section 2036(c) made the law at the time Neal released her reversionary interests other than what she understood it to be. A transfer based upon a mistake of law is rescindable under Pennsylvania law, and therefore incomplete for tax purposes. See Berger v. United States, 487 F. Supp. 49, 51-52 (W.D. Pa. 1980). The District Court recognized that the IRS would be quick to assert a claim if the tax laws were changed retroactively to indicate that Neal owed a higher tax. Indeed, taxpayers often are forced to pay higher taxes on past events based on later retroactive changes to the law (without complaint from the IRS).
>
> …
>
> … The only distinction between Berger and this case is that the rules in Berger were contrary to Berger's beliefs at the time he made his transfer of funds, and no retroactive change of the law was involved. We do not find this distinction critical.
>
> We agree with the District Court's analysis. While Neal was under no mistake as to the status of the law at that moment, she was mistaken as to the effect that the law would have on her tax liabilities. The general doctrine of mistake is geared toward freeing persons who were mistaken regarding the effect that a particular law would have on their situation. As a result, the District Court and Orphan's Court properly found that Neal released her interests "under a mistake of law."
>
> The IRS's position is essentially that Neal was under no mistake of law when she released her reversionary interests in the GRIT and that the effects of the retroactive repeal of section 2036(c) should not be considered. **The IRS asserts that the fact that the later change was made retroactive, nunc pro tunc, is irrelevant to the consideration of whether Neal was mistaken as to the law at the time. We disagree.**
>
> The IRS further asserts that Neal suffered no injustice because she released the contingent interests in an attempt to avoid tax liability, as if this were somehow wrongful in and of itself. However, Neal was clearly attempting to abide by the law, and was not illegally seeking to avoid liability. The clause she relied on was written specifically to benefit taxpayers in her position. The government should not now claim that she was abusing the system by following the law.
>
> We conclude that Neal's releases were rescindable under Pennsylvania [law] and that the District Court properly held that she is due a refund of the 1989 gift tax that she paid on the releases. (Emphasis added.)

Technical Advice Memorandum 9408005 provides a more detailed description of the IRS position regarding a rescission based on a retroactive law change. (The facts of this TAM seem remarkably similar to the *Neal* facts, suggesting that it may have been issued with respect to the *Neal* gift tax refund claim.) The IRS reasoned that because the retroactive law change provided no relief for taxpayers whose actions were based on the later repealed statute, the rescission should have no effect for tax purposes.

> When section 2036(c) of the Code was retroactively repealed by the Revenue Reconciliation Act of 1990, **Congress did not provide any relief for taxpayers who had executed instruments in reliance upon the statute.** Chapter 14 (the replacement to section 2036(c)) was enacted by the Revenue Reconciliation Act of 1990, and is effective for transfers after October 8, 1990. Although transactions completed before October 9, 1990, are exempt from Chapter 14, they are not exempt from gift tax law that predated repealed section 2036(c). In 1991, in an attempt to return to the same position that A was in prior to Notice 89-99, A rescinded each release. A contends that, because section 2036(c) was revoked retroactively, the rescissions result in treating the interests as if the reversions were never released. Consequently, A contends that, because the reversions were

not released, there was no transfer of the reversions that was subject to the gift tax and, thus, A is entitled to a refund of the gift tax paid.

…

… A's unconditional release of the reversionary interests were transfers that constituted taxable gifts at the time the releases were executed. The releases resulted in beneficial interests in the trusts passing to the holders of the trusts remainder interests that could not be revoked without the consent of the remaindermen. The subsequent rescission of the releases does not serve to treat the transfers as if they never occurred.

A taxpayer is not entitled to a refund of federal gift taxes paid attributable to the release of a reversionary interest **if the taxpayer later rescinded the release because of the revocation of the underlying section of the Internal Revenue Code.** (Emphasis added.)

g. **Modification of Trust to Ignore Disclaimer Because of Mistake Based on Retroactive Law Change Not Given Effect for Tax Purposes, *Lange v. U.S.*.** An earlier district court case with similar facts had reached an opposite result. *Lange v. U.S.*, 78 AFTR 2d 96-6553 (N.D. In. 1996). Edith Lange created a grantor retained income trust (GRIT) in 1989 in which the grantor retained a reversion and general power of appointment if she died within ten years. Edith's intent was that the trust would avoid the application of §2036(c). Later in 1989 Edith disclaimed the reversionary interest and general power of appointment (apparently in order to avoid §2036(c)) and filed a gift tax return for 1989 and paid gift tax attributable to the value of the disclaimer (apparently the disclaimer was not a qualified disclaimer under §2518). Section 2036(c) was repealed retroactively in 1990, so the disclaimer had been unnecessary. Edith obtained a court order modifying the trust to ignore the disclaimer, and subsequently filed a claim for refund of the gift tax reflected on the 1989 gift tax return as originally filed.

The court's analysis relied on *Van Den Wymelenberg v. United States*, 397 F.2d 443 (7th Cir. 1968), which refused to give effect to a court order modifying a trust to comply with the requirements of §2503(c) two years after the gift to the trust. Even though *Wymelenberg* did not involve a modification based on a mistake of law due to a retroactive law change, the *Lange* court simplistically reasoned "[s]imilarly, the later modification of the trust agreement to disregard the disclaimer does not affect the tax consequences of the disclaimer. The tax consequences attach when the transaction occurs."

h. **Summary.** In early 2010 some taxpayers made gifts because the gift tax rate was only 35% and some believed that rates might increase in future years. Instead, the 2010 Tax Act retained the 35% rate and increased the exemption from $1 million to $5 million. Some taxpayers who had made gifts over $1 million to take advantage of what they believed was a beneficially low rate discovered they could have avoided any gift tax if they had waited to make gifts until the gift exemption amount had risen to $5 million. The subsequent law change (which was not retroactive) would have resulted in more favorable treatment, and some taxpayers may have preferred to have made their gifts in a later year. The general consensus of planners was that rescissions of the gifts made in early 2010 would not undo the fact that a completed gift had been made and gift tax was owed. Similarly, some donors made gifts in 2012 while the $5 million gift exemption was available out of fear that Congress might reduce the gift exemption amount. When Congress did not do so, some donors had "donor-remorse" over having made the gifts and wanted to undo them. Allowing a rescission of the gift because of a mistake in predicting that future laws might be more unfavorable or in making a wrong guess of what the law would be in the following year is generally believed not to be sufficient to apply a mistake of law rescission.

The equities are far different, however, for a subsequent retroactive law change that would impose gift tax on a prior transfer that had been made when the law at that time provided that no gift tax would be due on the transfer. Courts may align with the Third Circuit Court of Appeals' position in *Neal* in allowing a rescission of a gift in that circumstance that seems egregiously unfair.

BUT the case law is widely varied regarding the tax effects of rescissions, and relying on a rescission to unwind a gift that is later retroactively determined to generate gift tax is **ripe with uncertainty**. As Howard Zaritsky puts it, "Mulligans in tax law are few and far between." After all, allowing rescissions to undo the effects of retroactive law changes in all situations would seem inconsistent with the established constitutional authority of Congress to adopt retroactive tax laws.

18. Defined Value Clause

Using a defined value clause may be a way of anticipating future tax law changes (as well as anticipating future IRS or court value determinations). A defined value clause has the effect of adjusting values based on certain types of retroactive law changes (for example that might disallow valuation discounts.)

19. Conditional Gifts

Consider making gifts conditioned on the fact that laws that now apply a certain maximum rate or exclusion amount or that allow discounts remain effective as of the date of the gift. That does not make the gift incomplete because the condition is outside the control of the donor. However, if the law does change, the gift would be reversed. Conditional gifts are generally recognized under the concept of the donor's freedom to the maximum extent allowed by law unless the condition contradicts public policy. *See* RESTATEMENT (THIRD) OF TRUSTS §29 cmts. i-m (2003).

Drafting suggestions for conditional gifts recommended by Prof. Gerry Beyer in his article *Manipulating the Conduct of Beneficiaries With Conditional Gifts* include the following -- clearly state the donor's intent, create a condition precedent, include the consequences of a failed condition, anticipate an attack based on the condition being contrary to public policy, provide objective standards for conditions, and specify who will determine subjective standards.

20. Example Form for Formula Gift Combined With Disclaimer Provision

An example of a formula gift equal to the remaining gift exclusion amount taking into consideration future retroactive law changes combined with a disclaimer provision causing disclaimed assets to revert to the donor is provided by Jonathan Blattmachr. He prepared this clause for his drafting system (with Michael Graham) called Wealth Transfer Planning (the clause is included here with his permission):

[NOTE: This sample form is provided courtesy of InterActive Legal, for informational purposes only. The attorney-draftsperson is responsible for determining whether this document is appropriate for any particular client, and is responsible for editing the document as needed, using the attorney's professional judgment. Provision of this form does not constitute legal advice.]

Assignment

I, [DONOR NAME], in consideration of $10 cash received from [TRUSTEE NAME], as Trustee, of the trust dated [TRUST DATE] (known as [TRUST NAME]) and its successors and assigns, the receipt of which is hereby acknowledged, and $10 cash received from [SPOUSE'S NAME], my spouse who is a United States citizen, the receipt of which is hereby acknowledged, hereby make the following assignments of all of my right, title and interest in [PROPERTY DESCRIPTION] ("the Property") as follows:

1. To the Trustees of [TRUST NAME] that fractional share of the Property (a) the numerator of which is the lesser of (i) the entire fair market value of the Property as finally determined for Federal tax purposes as of the date of this instrument, or (ii) the amount of my Remaining Gift Tax Exemption, and (b) the denominator of which is the fair market value of the Property as finally determined for Federal tax purposes as of the date of this instrument.
2. To [SPOUSE'S NAME] the remaining fractional share, if any, of the Property not assigned above to the Trustees of [TRUST NAME];

I authorize [SPOUSE'S NAME], individually as assignee of any interest in the Property and as the principal beneficiary of [TRUST NAME] to renounce and disclaim any of the Property assigned above and to the extent, if any, my spouse makes any such renunciation and disclaimer the property so renounced and disclaimed that otherwise would pass to my spouse directly or to the trust shall be revested in me.

For purposes of this instrument, the following terms shall have the following meaning:

1. The "Gift Tax Exemption" shall mean an amount equal to the maximum fair market value of property which, if transferred by gift (within the meaning of Section 2501 of Code) as of the date of this instrument, would generate a tax equal to the amount allowable as a credit under Section 2505 of the Code, taking into account any amendments to the Code made by legislation enacted after the date of this instrument but which is applicable to transfers made on the date of this instrument.

2. My "Remaining Gift Tax Exemption" shall mean an amount equal to the Gift Tax Exemption reduced by the amount of such Gift Tax Exemption I have used or been deemed to have used by any prior transfers by me before this transfer including those made earlier this calendar year.

3. The "Code" shall mean the Internal Revenue Code of 1986, as amended.

IN WITNESS WHEREOF I have executed this Assignment as of the ___ day of ___________, 202__.

____
[DONOR'S NAME]

Alternatively, this gift of the amount, if any, in excess of the donor's gift tax exemption, could pass to a trust for the spouse which is designed to qualify for the QTIP election, or to an "incomplete gift" trust created by the donor. The latter may provide a way to use this technique for a client who is not married.

General Transfer Planning Considerations for 2021

21. General Planning Issues

a. **Focus on Client's Goals.** Before getting caught up in all of the sophisticated concerns and details about transfer planning in 2021, the planner must first and foremost focus on the client's goals, concerns, and long-term legacy desires. Estate planning involves family and legacy and tends to be more emotional than other transactions. Focus on the client's philosophy before the client starts to consider transfer planning with questions such as –

- What is your attitude about taxes?
- Do you want to include charity in your plan?
- How much will your lifestyle be affected if you make substantial gifts, and how do you feel about that?
- How much do you want to leave to children and grandchildren, and when do you want to do it?

These are very critical questions that need to be answered before a client starts giving away assets.

b. **Transfer Planning During a Period of Legislative Uncertainty and in Low-Interest Rate Environment.** A great deal of uncertainty exists regarding whether gift/estate exclusion amounts will be reduced, whether rates will be increased, whether other transfer tax reforms might be implemented (for example, attacking valuation discounts, GRATs, and future transfers to grantor trusts). A terrific resource addressing a wide variety of planning alternatives during times of such uncertainty is Carlyn McCaffrey & Jonathan Blattmachr, *The Estate Planning Tsunami of 2020*, ESTATE PLANNING (Nov. 2020).

Of course, a key transfer planning consideration in the current environment is taking advantage of the window of opportunity with the current large gift exclusion amount before it is reduced, whether that is in 2026 (as scheduled) or earlier as a result of legislation that may reduce it to $5 million (indexed), $3.5 million (not indexed), or $1 million. For a general discussion of a wide variety of issues relevant to estate planning for moderately wealthy clients and general transfer planning considerations (including ways to lock in use of the current large gift exclusion amount) see Items 7-8 of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

Adding flexibility to irrevocable trusts can be very helpful considering the existing substantial legislative uncertainty. Some of the ways of adding considerable flexibility are:

- using nontaxable powers of appointment;
- providing broad standards for distributions 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.

22. Transfer Planning with Some Type of Potential Retained Benefit

a. **Significance.** Many mega-wealthy individuals made gifts using their large $10 million (indexed) gift exclusion amount in 2020 or earlier. Individuals in 2021 who are not mega-wealthy clients may be considering using the large gift exclusion while it exists, but may want some kind of potential access to or potential cash flow from the transferred funds.

b. **Specific Planning Alternatives.** Planning alternatives for providing some benefit to the grantor and/or the grantor's spouse include:

- Borrowing of trust funds by grantor;
- Trust with settlor's spouse as a discretionary beneficiary (SLAT) or that might eventually include the settlor as a discretionary beneficiary;
- SLAT that eliminates the spouse as a beneficiary if the spouse's net worth exceeds a specified amount;
- "Non-reciprocal" trusts;
- Self-settled trust with the settlor as a discretionary beneficiary established in domestic asset protection jurisdictions;
- Trust for which a third party has the power to add the settlor as a discretionary beneficiary in the future, *see* Abigail O'Connor, Mitchell Gans & Jonathan Blattmachr, *SPATs: A Flexible Asset Protection Alternative to DAPTs*, 46 ESTATE PLANNING 3 (Feb. 2019);
- Sale for a note or annuity rather than making a gift of the full amount to be transferred;
- Transferring residence to trust or co-tenancies between grantor/spouse of grantor and trust;
- "Reverse defective grantor trust" transaction in which the donor purchases (including through the exercise of a substitution power) or borrows assets gifted to trust;
- Preferred partnership freeze;
- Turning off grantor trust status (to at least minimize the continuing cost to the grantor);
- Payment of management fees to the grantor;
- Inter vivos QTIPable trust; and
- Retained income gift trust.

Each of these alternatives is 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**.

23. Spousal Lifetime Access Trusts (SLATs)

The settlor may wish to make gifts in a way that the settlor's spouse (or the settlor) could retain some use of the assets in case needed as a "rainy day" fund. A popular way of using the increased gift exemption may be for a settlor to make gifts to a "lifetime credit shelter trust" for the benefit of the settlor's spouse (and possibly children). The trust could be designed to give as much control and flexibility as possible to the surviving spouse without creating tax or creditor concerns. The trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the settlor and his or her spouse, but the assets would not be included in the gross estates of the settlor or the settlor's spouse. Such a trust would likely be a grantor trust as to the grantor under §677 (unless the consent of an adverse party were required for distributions to the spouse).

a. **Trust Terms.** The trust would include the settlor's spouse as a discretionary beneficiary, containing very similar terms as a standard credit shelter trust created under a will. The trust may allow very broad control to the spouse but still not be included in the donee spouse's estate for estate tax purposes and hopefully will be protected against claims of both the settlor's and spouse's creditors. In some ways, this is the ideal kind of trust for the spouse.

Possible terms could include the following:

- The donor's spouse could be a discretionary beneficiary (perhaps with children as secondary beneficiaries or as the primary beneficiaries).
- The spouse could be the trustee (distributions that the spouse could make to himself or herself would be limited to HEMS).
- Provide that no distributions could be made that would satisfy the settlor's legal obligation of support (and if distributions are made to the donee spouse, preferably the spouse should use those distributions for things other than basic support needs to remove any inference that the funds are actually being used for the settlor's benefit).
- The spouse could have a "5 or 5" annual withdrawal power.
- The spouse could have limited power of appointment (exercisable at death or in life).
- In case the donee spouse predeceases the settlor, the power of appointment could be broad enough to appoint the assets back to a trust for the settlor. Exercising the power of appointment in the donee spouse's will to include the settlor spouse as a discretionary beneficiary should not cause inclusion in the settlor spouse's estate under §2036(a)(1) if there was no pre-arrangement, but that might not prevent the settlor spouse's creditors from being able to reach the trust assets depending on state law, which itself could trigger estate inclusion for the original settlor-spouse. The power of appointment should provide that it cannot be exercised in a manner that would grant the original settlor a power of appointment over the assets to avoid triggering §2038 inclusion in the settlor's estate.
- A "trust protector" or some independent party could be given the discretion to add the settlor of the trust at some time in the future (perhaps after a number of years or after the donor is no longer married to the donee spouse or only if the applicable state law has a DAPT statute). Alternatively, a third party could have a power of appointment broad enough to include the settlor as a discretionary beneficiary (which could similarly be subject to conditions, if desired). *See* Abigail O'Connor, Mitchell Gans & Jonathan Blattmachr, *SPATs: A Flexible Asset Protection Alternative to DAPTs*, 46 ESTATE PLANNING 3 (Feb. 2019). Absolutely no understanding (or even implied agreement) should exist with the protector about how the power would be exercised.
- Another way of addressing the case where the donee spouse predeceases the donor would be to have some life insurance on the donee spouse payable to the settlor or a trust for the settlor that has substantially different terms than this trust.
- Another way still of addressing a divorce or the donee spouse predeceasing the settlor would be to authorize the trustee to make loans to the grantor. Loans to the settlor are more tax efficient than distributions so that the gift exclusion amount that was allocated to the gift is not wasted, and no interest income will result for loans to the grantor if the trust is a grantor trust.
- If the settlor were concerned about how the donee spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the settlor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee spouse to change an exercise of the power of appointment.
- To address the possibility of a divorce, in which event the settlor spouse may not want the donee spouse to continue as a beneficiary, the trust could define the "spouse" to be the person to whom the grantor is married at the time without causing estate inclusion in the settlor's estate (sometimes referred to as a "floating spouse" approach). *See Estate of Tully*

Jr. v. United States, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§2036(a)(2) or 2038). Therefore, the trust could also be available for the benefit of a new spouse. Also, the settlor and donee spouse may enter into an agreement that the gift will be taken into consideration in any property settlement incident to a divorce.

- If the settlor gets to the point that the settlor really needs to be a beneficiary of the trust and wants the spouse to exercise the power of appointment, estate taxes may be the least of the settlor's concerns.
- Consider including a tax reimbursement clause but only if, under state law, such clause will not cause the trust to be available to the settlor's creditors. Non-DAPT states with these statutes include Arizona, Florida, Kentucky, Maryland, New Jersey, North Carolina, Oregon, New York, and Texas. *E.g.*, TEX. PROP. CODE §112.035(d)(1) (a settlor is not considered a beneficiary of a trust solely because a trustee other than the settlor "is authorized under the trust instrument to par or reimburse the settlor for, or pay directly to the taxing authorities, any tax on trust income or principal that is payable by the settlor under the law imposing the tax"); s*ee* Rev. Rul. 2004-64.
- An often-neglected issue with SLAT planning is the potential for conflicts of interest between the spouses. Should the spouses be represented by independent counsel? What if the donee-spouse sues for divorce soon after the mega-SLAT is funded?

b. **Application of §§2036-2038 If Donee Spouse (or Other Beneficiary) Appoints Assets Into Trust for Benefit of Original Settlor Spouse.** This issue is receiving increased attention by planners.

(1) **Potential Application of §2036.** If the donee spouse exercises a testamentary limited power of appointment to appoint the assets into a trust of which the settlor-spouse is a discretionary beneficiary, the IRS might argue that §2036 could apply in the settlor's estate if it could establish an implied agreement that the donee spouse would leave the donated assets back into a trust for the benefit of the settlor spouse. This is analogous to situations in which one spouse makes a gift to the other spouse, and the other spouse bequeaths the property back into a trust for the benefit of the original settlor spouse. For a discussion of various relevant cases see Item 5.k.(1) of the "Estate Planning Current Developments and Hot Topics (December 2012)" located **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

A specific exception in the QTIP regulations provides that the §2036/2038 issue does not apply for gifts to an inter vivos QTIP trust, where the assets are left back into a bypass trust for the benefit of the settlor spouse. Reg. §25.2523(f)-1(d)(1) & (f) Exs. 10-11. See Item 13.f above. However, those examples would not apply because the rationale in them is that the assets are included in the donee spouse's estate under §2044.

The possibility of a beneficiary exercising a power of appointment for the benefit of the grantor (or grantor's spouse) applies beyond just SLATs. Trusts for descendants or other beneficiaries may grant a beneficiary a power of appointment broad enough to allow appointing the assets to a trust that may benefit the grantor or the grantor's spouse; the same general issues apply.

The primary issue regarding inclusion in the settlor spouse's estate under §2036 is whether an implied agreement existed that the power of appointment would be exercised to include the settlor spouse as a discretionary beneficiary. Prof. Jeffrey Pennell once summarized: "I think, frankly, it would be difficult for the government to make that case, but of course you could leave a trail of documents – a smoking gun – that could allow the government to say this was all part of a prearrangement, and that conceivably could get you into §2036."

(2) **Potential Application of §2038.** Section 2038 can apply to an ability to alter, amend, revoke, or terminate that exists in the trust at the death of the decedent – it did not have to be retained at the outset. So, in exercising the non-general power of appointment, the donee spouse must be

careful not to give the settlor spouse anything that would rise to the level of a right to alter, amend, revoke, or terminate. For example, the settlor could not have a testamentary power of appointment by reason of the exercise.

In addition, if creditors can reach the assets in a trust to which assets have been appointed by the donee spouse under the reasoning of the relation back doctrine (discussed below), that could create a §2038 problem, even if no implied agreement regarding how the donee spouse would exercise the power of appointment existed at the time of the original transfer. Although various cases have held that assets in a trust that can be reached by the settlor's creditors are in the settlor's gross estate under §2036 [*e.g.*, *Estate of Paxton v. Commissioner,* 86 T.C. 785 (1986)], some cases have also suggested that inclusion may also result under §2038. *E.g.*, *Outwin v. Commissioner,* 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §2036(a)(1) or §2038(a)(1)).

c. **Creditor Rights Issue.**

(1) **Creditor Concerns If Settlor Becomes Beneficiary of SLAT.** A totally separate issue is that, despite the tax rules, for state law purposes the settlor to the lifetime credit shelter trust may be treated as the settlor of the continuing trust for his or her benefit after the death of the donee spouse if the settlor spouse has been added as a discretionary beneficiary. Therefore, for state law purposes, some possibility exists that the trust may be treated as a "self-settled trust" and subject to claims of the settlor's creditors. This would seem to turn on what has been called the "relation back doctrine." The power of appointment is "conceived to be merely an authority to the power holder to do an act for the creator of the power." *Donative Transfers* vol. 2 §§11.1-24.4, in RESTATEMENT (SECOND) OF PROPERTY 4 (1986). Therefore, the donee spouse, in exercising the power of appointment, is acting for the "creator of the power," so the original settlor spouse is treated as having made the appointment into a trust for the settlor spouse's benefit. Little discussion of this doctrine exists, however, in the context of creditor's claims. Barry Nelson observes that "none of the reported cases regarding the Relation Back Doctrine address its application to the settlor of a QTIP or SLAT who receives trust assets upon the death of the donee spouse through the exercise of a non-general power of appointment."

After discussing the relation back doctrine in this context, one commentator concludes, "Thus, it is not clear that a court would actually hold that it was a transfer from the settlor to a trust for his own benefit through a power holder's discretionary exercise of a power of appointment, but it is a risk." Alexander Bove, *Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined,* 36 ACTEC L.J. 333, 337 (2010). *See also Watterson v. Edgerly,* 40 Md. App. 230, 388 A.2d 934 (1978) (husband gave assets to wife and next day wife signed will leaving assets to trust for husband; held that the trust was protected from husband's creditors under the trust spendthrift clause).

At least 18 states have statutes that address this situation in the context of initial transfers to an inter vivos QTIP trust, as opposed to transfers to a lifetime credit shelter trust. Those states are Arizona, Arkansas, Delaware, Florida, Georgia, Kentucky, Maryland, Michigan, New Hampshire, North Carolina, Ohio, Oregon, South Carolina, Tennessee, Texas, Virginia, Wisconsin, and Wyoming. The Arizona, Maryland, Michigan, Ohio, and Texas statutes also address the issue for all inter vivos trusts initially created for the settlor's spouse (including the lifetime credit shelter trust strategy discussed in this subparagraph) where the assets end up in a trust for the original settlor-spouse. *E.g.*, ARIZ. REV. STAT. §14-10505(E-F); OHIO REV. CODE §5805.06(B)(3)(a); TEX. PROP. CODE §§112.035(d)(2) (settlor becomes beneficiary under exercise of power of appointment by a third party), 112.035(g)(1) (marital trust after death of settlor's spouse), 112.035(g)(2) (any irrevocable trust after death of settlor's spouse), 112.035(g)(3) (reciprocal trusts for spouses). For a discussion of and citations to these statutes, see David Shaftel, *Twelfth*

ACTEC Comparison of the Domestic Asset Protection Trust Statutes, (August 2019)(to access that excellent summary, go to **www.actec.org** and search for "David Shaftel")).

(2) **Gross Estate Inclusion for Settlor In Light of Creditor Access?** The client may not be overly concerned with actual creditor issues, but that could raise tax issues at that point. If there is an implied agreement that the original donee spouse will exercise the power of appointment in this way, that could raise a §2036(a)(1) concern. The implied agreement issue can likely be avoided by allowing some time to elapse before the power of appointment is exercised. But a §2038 issue may also apply, and keep in mind that §2038 does not require retention at the time of the original gift. The issue under §2038 is whether, at death, the donor has the power to "alter, amend, revoke, or terminate" the trust.

As to the §2038 issue, *Outwin v. Commissioner*, 76 T.C. 153 (1981), said that §2038 potentially could apply if the settlor's creditor can reach the trust assets. To avoid §2038 inclusion if the settlor's creditors can reach the trust assets, having an ascertainable standard may satisfy the "definite external standard" exception that has been recognized by the IRS (Rev. Rul. 73-143, 1973-1 C.B. 407) and various courts for avoiding §2038. *E.g.*, *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947); *Estate of Ford v. Commissioner*, 53 T.C. 114 (1969), *nonacq*. 1978-2 C.B. 3, *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971); *Estate of Wier v. Commissioner*, 17 T.C. 409 (1951), *acq*. 1952-1 C.B. 4 (addressing predecessor of §2036(a)(2) and §2038; "the education, maintenance and support" and "in the manner appropriate to her station in life").

How much of a problem is this? Nineteen states are domestic asset protection trust (DAPT) states, (Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming). The creditor issue is not a problem in those states because a settlor's creditors cannot reach assets in a properly structured "self-settled" trust that may be distributed to the settlor under a discretionary standard.

There are at least five states that do not allow the settlor's creditors to reach the assets in a trust that is the recipient of the exercise of a power of appointment by the original donee spouse of a SLAT under the relation-back doctrine. Those states are Arizona, Maryland, Michigan, Ohio, and Texas (three of those are not DAPT states).

Even using a "self-settled trust state" for the new trust provides no absolute protection if the settlor does not reside in that state; the settlor's state of domicile may refuse to recognize the asset protection features of the new trust on public policy grounds. The state of the settlor's residence may assert that public policy prevents using an asset protection trust in another state. Also, see Item 13.f above regarding the Uniform Voidable Transactions Act when attempting to apply the laws of another state that is a self-settled trust state.

Another possible defense is that there are precious few cases applying this relation back doctrine in the creditor situation, so maybe the potential creditor issue is not a problem at all under the relation-back doctrine.

(3) **Planning Considerations in Light of Creditor Concerns.** If the state does not have a DAPT statute or a statute negating the "relation back" doctrine, a planning alternative to minimize the risk of estate inclusion for the donor spouse is for the original donee spouse to appoint the assets to a trust that merely gives a party the power to add the settlor as a discretionary beneficiary or perhaps that gives a third party a power to appoint assets to the settlor. The potential creditor issue will never arise if the settlor is never added as a discretionary beneficiary, and the settlor may never need to be a potential discretionary beneficiary of the trust assets. If the rainy day arises and there really is a need, it may well be that estate tax problems are the least of the settlor's concerns at that point.

d. **Other Advantages of SLATs.** In addition to avoiding estate inclusion, the trust also provides protection against creditors, elder financial abuse, and identity theft. Over time, the trust can accumulate to significant values (because it is a grantor trust, the client will pay income taxes on the trust income out of other assets) and can provide a source of funding for retirement years.

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

e. **Gift From One Spouse to SLAT With Split Gift Treatment.** Instead of having each spouse make $10 million gifts, some planners have suggested that one spouse could give the entire $20 million to a trust having the other spouse as a discretionary beneficiary. The other spouse would make the split gift election, which treats him or her as the transferor for gift and GST tax purposes (meaning that the spouse's gift and GST exemption could be used) but NOT for estate tax purposes. Therefore, the assets would not generally be included in the spouse's gross estate for estate tax purposes even though he or she was a discretionary beneficiary. The problem with this approach is that split gift treatment is not allowed if the consenting spouse is a beneficiary of the trust unless the spouse's interest in the trust is ascertainable, severable, and de minimis. *See* Rev. Rul. 56-439, 1956-2 C.B. 605; *Wang v. Commissioner,* T.C. Memo. 1972-143 (no split gift election allowed where consenting spouse's interest in trust receiving gift assets was not ascertainable); *Robertson v. Commissioner,* 26 T.C. 246 (1956) (gift splitting allowed for full amount transferred); *see generally* Diana Zeydel, *Gift-Splitting -- A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules,* 106 J. TAX'N 334 (June 2007). Interestingly, Letter Ruling 200130030 allowed gift splitting for the full amount of the transfer without discussing the value [in particular, that it had no value] of the donee spouse's severable interest).

While the *amount* that can qualify for gift splitting may be limited for gift purposes, the regulations appear to provide that if *any* portion of the transfer qualifies for gift splitting, a full one-half of the transferred amount shall be treated as having been transferred by the consenting spouse for GST purposes. Reg. §26.2652-1(a)(4).

For a more complete discussion of the relevant cases and letter rulings, see Item 5.k.(3) in the December 2012 "Estate Planning Current Developments and Hot Topics" found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

Gift splitting should be allowed in full if:

- Distributions of both income and principal to the donee spouse are subject to an ascertainable standard of distribution under §2514, preferably a standard based upon the spouse's accustomed standard of living;
- The trustee must consider other resources available to the spouse before exercising its discretion to distribute income or principal to the spouse; and
- The resources that are, and are expected to be, available to the spouse for the remainder of his or her lifetime are sufficient to meet the spouse's living expenses, such that the likelihood that the trustee will need to exercise its discretion to distribute income or principal to the spouse is so remote as to be negligible.

f. **Planning for Complications Arising From Divorce From Spouse-Beneficiary.** The 2017 Tax Act provides that alimony payments will not be deductible and will not be income to the recipient. In addition, §682 is repealed for situations in which the divorce occurred after 2018; that section provided that if one spouse created a grantor trust for the benefit of the other spouse, following the divorce the trust income would not be taxed to the grantor spouse under the grantor trust rules to the extent of any fiduciary accounting income that the donee spouse is "entitled to receive." The repeal of §682 is particularly troublesome, in part because §672(e) treats a grantor as holding any power or interest held by an individual who was the spouse of the grantor at the time of the creation of such power or interest, so the ex-spouse's interest as a beneficiary arguably might be sufficient to trigger grantor trust status under §677 even following the divorce (but see ACTEC comments filed with the IRS on July 2, 2018 suggesting the possibility of a contrary result).

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

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

The repeal of §682 not only suggests changes when drafting SLATs, but also increases the importance of involving estate planning advisers in divorce planning. *See* George Karibjanian, Richard Franklin & Lester Law, *Alimony, Prenuptial Agreements, and Trusts Under the 2017 Tax Act*, BLOOMBERG TAX MGMT. ESTATES, GIFTS & TR. J. (May 10, 2018).

g. **Special Planning Considerations for SLATs.**

- Avoid the reciprocal trust issue by making only one spouse a beneficiary, at least initially.
- Using a SLAT prevents gift splitting if the spouse's interest is not severable, ascertainable, and de minimis (see Item 23.e above)
- The SLAT provides a benefit only while the donee spouse is living and married to the grantor.
- Consider an agreement of the spouses that the gift will be taken into consideration in any property settlement incident to a divorce.
- Consider life insurance on the donee spouse in case the donee spouse dies before the grantor.
- Give the donee spouse a limited testamentary power of appointment exercisable in favor of the grantor (but carefully consider §2036 and creditors' rights against the settlor before the donee spouse exercises the power of appointment).
- The grantor may exercise a power of substitution (e.g., for a long-term AFR note) if the parties divorce so that the settlor would have the ability to re-acquire favored assets in the trust.
- The step transaction doctrine may treat the donee spouse as a grantor if transfers were made by the donee spouse to the grantor shortly before the grantor funded the trust.
- If the SLAT is funded by the grantor with a residence, can the grantor reside in the residence without paying rent? (Presumably yes, under the reasoning of various §2036 cases that a

settlor's continuing to live with his spouse is not considered an implied agreement of retained enjoyment.) If the grantor pays rent, is it a gift? (Presumably not.)

- The various planning considerations discussed for DAPTs also apply with respect to provisions about adding the settlor as a discretionary beneficiary. For example, use the laws of a DAPT state, or at least use the laws of a state with favorable legislation negating the "relation back" doctrine to help resolve the creditor issue (which, in turn, is an estate tax issue if the SLAT assets are appointed to a trust for the settlor's benefit). See Item 23.c(1) above.

24. Trust for Settlor as Discretionary Beneficiary (DAPT); Possible Inclusion of Settlor as Discretionary Beneficiary at Some Later Time

A settlor might create a trust naming the settlor directly as a discretionary beneficiary, with the possibility of it serving as a "rainy day fund" in the unlikely event that financial calamities occur, without necessarily triggering §2036(a)(1) (a transfer with an implied agreement of retained enjoyment). This only works, though, if local law does not allow the settlor's creditors to reach the trust as a result of the settlor's status as a beneficiary (or else the gift would not be a completed gift and the assets would be included in the settlor's gross estate for estate tax purposes). Self-settled trusts (sometimes referred to as domestic asset protection trusts, or DAPTs) may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors. The state law issue about creditor access is vitally important if the settlor is named directly as a discretionary beneficiary.

Important planning issues for DAPTs include (i) conflict of laws issues if a settlor of one state creates a DAPT under another state's DAPT laws, (ii) whether a judgment in one state will be entitled to "full faith and credit" in an enforcement action against a DAPT in another state (a DAPT state), (iii) whether a transfer to a DAPT is a completed gift, and (iv) whether being a discretionary beneficiary will trigger estate inclusion under §2036. These issues, as well as planning considerations to minimize incomplete gift and §2036 concerns, are discussed in Item 79 of ACTEC 2020 Annual Meeting Musings (March 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**).

25. Multiple "Non-Reciprocal" Trusts

a. **Preferable If Only One Spouse Creates SLAT; Other Spouse Creates Trusts for Others.** If clients are concerned about having enough retained assets as a "rainy day" fund in case of unexpected severe financial reverses, hopefully that concern can be accommodated by having only one spouse make a gift to a trust with the other spouse as a discretionary beneficiary. The gift by the other spouse would be to a trust with only descendants as beneficiaries, and that clearly avoids the reciprocal trust doctrine (although an issue could arise if the spouses serve as trustees of each other's trust).

b. **Both Spouses as Beneficiaries of Trust Created by Other Spouse; Reciprocal Trust Concern.** Some clients may want to go further and have each of the spouses create SLATs for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

   If A creates a trust for B and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. *United States v. Grace*, 395 U.S. 316 (1969). In *Grace*, the trust terms were identical, the trusts were created 15 days apart, and the trusts were of equal value. The Court reasoned:

   > Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the *trusts be interrelated,* and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the *same economic position* as they would have been in had they created trusts naming themselves as life beneficiaries. (Emphasis added)

If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Commissioner,* 46 T.C.M. 910 (1983); PLR 200426008; *but see Estate of Green v. United States,* 68 F.3d 151 (6th Cir. 1995) (Jones, J. dissenting).

c. **Possible Distinctions to Avoid Reciprocal Trust Doctrine.** Possible distinctions that could be built into the trusts include the following.

- Create the trusts at different times (separated by months, not 15 days as in *Grace*).
- Fund the trusts with different assets and different values (observe that *Grace* holds that just having different assets is not sufficient to avoid the doctrine, but it applies only to the extent of mutual value, *Estate of Cole v. Commissioner,* 140 F.2d 636 (8th Cir. 1944)).
- One trust allows distributions without any standard but the other trust imposes a HEMS standard.
- One trust might require considering the beneficiary-spouse's outside resources and the other would not.
- One of the spouses would become a discretionary beneficiary only after the lapse of some specified time (say, 5 years) or on the occurrence of some event. For example, Letter Ruling 200426008 addresses trusts under which (i) husband would not become a beneficiary of wife's trust until three years after wife's death and then only if the husband's net worth did not exceed a specified amount and his income from personal services was less than a specified amount, and (ii) wife had a "5 or 5" power of withdrawal from husband's trust after their son's death.
- One trust includes the settlor's spouse as a discretionary beneficiary but the other trust would merely give an independent party, perhaps after the passage of some specified time, the authority (not exercisable as a fiduciary) to add that settlor's spouse as a discretionary beneficiary.
- One trust allows conversion to a 5% unitrust but the other trust prohibits that.
- Provide different termination dates and termination events.
- Provide for different remainder beneficiaries upon termination of the trusts.
- Include an inter vivos power of appointment in one trust and not the other (like in *Levy*).
- Utilize different testamentary powers of appointment (maybe one trust has one and the other does not or perhaps there are different classes of permitted appointees or perhaps in one trust the power is exercisable only with the consent of a non-adverse party).
- Use different trustees.
- Structure different removal powers (one allows the grantor to remove and comply with Rev. Rul. 95-58 but the other puts removal powers in the hands of some third party).

d. **Spouses as Secondary Beneficiaries.** There may be an advantage to making the primary beneficiary the settlors' children and/or grandchildren and including each other only as secondary beneficiaries.

e. **Differences Must be "Real."** In any event the differences need to be "real." Additionally, the structure of the trusts is only part of the equation, and probably not the most important part. How the trusts are *administered after they are created* may be the most critical factor. Clients may want to make gifts to the trusts and then immediately start flowing cash out of the trusts to each other the same as they did before the trusts were created. If that is done, the IRS would likely argue the existence of a pre-arranged plan that the income or other benefits would come right back to the grantor, even if only indirectly through the spouse.

f. **Spouses Not Reciprocal Trustees.** Consider not having each of the spouses serve as trustee of the other's trust. Reciprocal dispositive powers may be sufficient to invoke the reciprocal trust doctrine if the trusts are sufficiently interrelated; reciprocal economic interests may not be required. *See Bischoff v. Commissioner,* 69 T.C. 32 (1977); *Exchange Bank & Trust v. United States*, 694 F.2d 1261 (Fed. Cir. 1982).

For a more complete discussion of the reciprocal trust doctrine, authorities holding that the reciprocal trust doctrine does not apply if there are substantial differences between trusts, authorities for applying the doctrine to reciprocal powers, and related creditors' rights issues see Item 5.I of the December 2012 "Estate Planning Current Developments and Hot Topics" found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

g. **Creditors' Rights Issue?** A possible concern with "non-reciprocal" trusts by each of the spouses for each other is that they may not be respected for state law purposes with respect to claims of creditors against the settlors*. Cf. Security Trust Co. v. Sharp*, 77 A.2d 543 (Del. Ct. Ch. New Castle 1950) (case did not involve a creditor attack on a reciprocal trust, but suggested in dictum that reciprocal trusts would be subject to attack by creditors). The *Security Trust* case was over 60 years ago, and locating any reported case in which creditors have attacked a reciprocal trust under this theory is difficult.

State legislatures may address this issue. For example, Arizona and Texas statutes provide protection from a reciprocal trust attack when spouses create trusts for each other. ARIZ. REV. STAT. §14-10505(E); TEX. PROP. CODE §112.035(g)(3).

The possibility of creditors attacking reciprocal trusts should not be a problem if the trusts are created under the laws of states that have adopted DAPT provisions (as discussed in Item 24 above).

If the settlors' creditors can reach the trust assets, that would cause inclusion in the settlors' estates for estate tax purposes under §2036 (and possibly under §2038).