BESSEMER TRUST

Heckerling Musings 2021 and Estate Planning Current Developments

July 2021

Steve R. Akers
Senior Fiduciary Counsel
Bessemer Trust
300 Crescent Court
Suite 800
Dallas, TX 75201
214-981-9407
akers@bessemer.com
www.bessemer.com

Ronald D. Aucutt
Senior Fiduciary Counsel
Bessemer Trust
703-408-3996
aucutt@bessemer.com

Kerri G. Nipp
Fiduciary Counsel
Bessemer Trust
300 Crescent Court
Suite 800
Dallas, TX 75201
214-245-1423
nipp@bessemer.com

Table of Contents

July 22, 2021

Important Information Regarding This Summary

This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information and disclaims any liability in connection with the use of this information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Introduction

The 54th Annual Heckerling Institute on Estate Planning was held virtually May 3-6, 2021. This summary includes observations from that seminar, as well as other observations about various current developments and interesting estate planning issues. The goal of this summary is not to provide a general summary of the presentations. Rather, this is a summary of observations of selected items during the week as well as a discussion of other items. This summary sometimes identifies speakers, but often does not (some topics are discussed by various speakers). This summary takes no credit for any of the outstanding ideas discussed at the Institute — it is simply relaying the ideas of others that were discussed during the week.

1. Summary of Top Developments in 2020

Ron Aucutt (Lakewood Ranch, Florida) lists the following as his top ten developments in 2020 in his report, "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:

(1) Social disruption and refocus: Health and racial justice;

(2) The 2020 election;

(3) Increasing confirmation of solutions to defined value clause dilemmas;

(4) Valuation of interests in entities (*Grieve*, *Nelson*)(see Item 31 below);

(5) Deductibility of estate and trust administration expenses (Reg. §§1.67-4, 1.642(h)-(2)) (see Item 5.b.–c below);

(6) Crunch time for syndicated conservation easements (see Item 40 below);

(7) Section 2703 substantial modification rules applied (PLR 202014006);

(8) Revenue Ruling 85-13 applied to transfers between trusts (PLR 202022002) (see Item 26.d below);

(9) Assignment of income avoided on charitable donation of stock (*Dickinson*) (see Item 32 below); and

(10) Hazards of death-bed planning and of post-opinion analysis (*Moore*) (see Item 29 below).

2. Legislative Developments

a. **CARES Act.** The Coronavirus Aid, Relief and Economic Security (CARES) Act (P.L. 116-136, 3/27/2020) provided for direct stimulus payments for taxpayers with adjusted gross income up to $99,000 ($198,000 for joint return taxpayers) and also included a number of tax-related provisions for 2020, including:

- Extension of the deadline in 2020 for making contributions to a traditional or Roth IRA to July 15, 2020;
- Waiver of required minimum distributions (RMDs) for all retirement accounts except defined benefit accounts in 2020 (this included IRAs, even inherited IRAs) and for deferred 2019 RMDs due April 1, 2020;
- Qualified taxpayers could take a "coronavirus-related distribution" of up to $100,000 in 2020 and avoid the 10% penalty for early distributions;
- Relaxed borrowing provisions from 401(k) or retirement plans (but not IRAs);
- $300 Above-The-Line charitable deduction (the staff of the Joint Committee on Taxation interpreted this provision as being $300 for both individuals and joint return filers); Increased limit for deducting cash contributions to public charities in 2020 from 60% to 100% of the individual's "contribution base" (but not applicable to contributions to donor advised funds, supporting organizations, or private foundations other than operating foundations or "flow-through" foundations); and
- Increased corporate charitable deduction limit from 10% to 25% of taxable income for 2020.

For a discussion of these provisions, see Item 2.l. of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

b. **Consolidated Appropriations Act, 2021.** The Consolidated Appropriations Act, 2021 was enacted on December 27, 2020. It includes the COVID-related Tax Relief Act of 2020, which (among many other things) clarifies the tax treatment of PPP loans, and the Taxpayer Certainty and Disaster Tax Relief Act of 2020 that extends or makes permanent numerous tax provisions. At 5,593 pages, it is the longest legislation ever passed by Congress.

Tax provisions include:

(i) an extension (and expansion) of the $300 non-itemizer charitable deduction ($600 for joint returns) for 2021; Professor Sam Donaldson says this is an additional itemized deduction in addition to the standard deduction rather than an adjustment in arriving at adjusted gross income (as it was in 2020);

(ii) an extension of the 100% of AGI limit for cash contributions to public charities (but not donor advised funds, supporting organizations, or private non-operating foundations) for 2021 (for both 2020 and 2021, an individual must make an affirmative election on Form 1040, Schedule A, Line 11 by entering the amount of qualified contributions on the dotted line next to the Line 11 entry space) (in computing the charitable deduction, apply the AGI limits first to current year charitable contributions that do not qualify for the 100% of AGI and then to carryover contributions within each category);

(iii) an extension of the increase of the corporate charitable deduction to 25% of taxable income for 2021;

(iv) a permanent increase of the §6662 penalty for overstating qualified charitable contributions from 20% to 50%;

(v) a permanent extension of the reduction of the medical expense deduction floor from 10% to 7.5%; and

(vi) the addition of a 100% deduction for business meals, including delivery and carryout meals, provided by a restaurant for amounts paid or incurred in 2021 or 2022.

For further discussion of the Consolidated Appropriations Act of 2021, see Item 2.m. of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

c. **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.

d. **Democratic Sweep.** The sweep of the White House, Senate and House of Representative by Democrats in the 2020 elections (and the Georgia Senate run-off elections) has changed the calculus of anticipated tax legislation, including legislation relating to the transfer tax. Tax legislation including some of the tax proposals from the Biden campaign appears much more likely than if Republicans controlled the House or Senate, but significant tax increases will likely have to be enacted through the reconciliation process so that only a majority of the Senate is required (see Item 2.o below). Sweeping changes will likely still be difficult, even using reconciliation, considering the 50-50 division of the Senate and the practical requirement that every (or perhaps almost every) Democratic senator agree to the change (see Item 2.p(2)-(3) below).

e. **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").

f. 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.j 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.

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).

g. **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.

h. **Transfer Taxes.** As mentioned above, transfer taxes are not addressed in The American Families Plan. President 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 suggested that Presidential candidate Biden supported 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. Janet Yellen's written responses to questions in her Senate confirmation process also pointed to a $3.5 million exemption level. Her testimony suggested that tax reform is not the Administration's initial highest priority, but she 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.

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 (David Kamin, current deputy director of the National Economic

Council, and Professor Lily Batchelder, nominated as Assistant Secretary of the Treasury for Tax Policy) makes clear their disdain for these planning alternatives. Lily Batchelder & David Kamin, *Taxing the Rich: Issues and Options*, at 23 (Sept. 11, 2019) available at https://ssrn.com/abstract=3452274. For further discussion of their views about these transfer tax items and other measures for taxing the wealthy, see Items 2.c.(.2) and 2.c.(4) of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

i. **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.j, 2.k, 2.l 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).

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.

j. **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 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.k 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 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.

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

(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 2.n 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).

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.)

m. 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.i 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.j 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.l(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). See Item 9 below regarding planning considerations for using trust protectors.

n. **"For the 99.8 Percent Act"(2019) and "For the 99.5 Percent Act" (2021).** 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% 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. The 2021 bill is available here.

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);
- Increasing 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);
- Increasing the potential estate tax deduction for conservation easements from $500,000 to $2 million (but not exceeding 60% of the net value of the property); 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** (under new §2901) –
  - §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 this bill 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).

o. **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.

(1) **Generally.** 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.

(2) **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 (i.e., the October 1, 2020 – September 30, 2021 budget year), 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 individual and business income tax rate changes retroactive to January 1, 1993.

(3) **Additional Reconciliation Measure Available by Amending Current Budget Resolution.** 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*.

p. **2021 Priorities and Likelihood and Timing of Tax Legislation.**

(1) **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).

(2) **Evenly Divided Congress.** The Congress is very evenly divided, with a 220-211 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 tax proposals would seem unlikely to be successful in such an evenly divided Congress.

(3) **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 (Jan. 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).

(4) **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.

Lee A. Sheppard, a frequent commentator with Tax Notes, predicts that many of the Biden tax proposals will not be enacted, but 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." Lee A. Sheppard, *Will There Be a Tax Bill?*, TAX NOTES (Jan. 19, 2021).

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.
>
> …
>
> 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. …
>
> **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).

q. **Possibility of Retroactive Tax Changes.**

(1) **Democratic Sweep; Transfer Tax Changes?** The sweep of the White House, Senate and House of Representative by Democrats in the 2020 elections (and the Georgia Senate run-off elections) has changed the calculus of anticipated tax legislation, including legislation relating to the transfer tax. A variety of transfer tax proposals have been submitted, ranging from repealing the estate tax or substantially reducing the rate to accelerating the sunset of the doubling of the $5 million (indexed) basic exclusion amount or even reducing the exclusion amount to $3.5 million (and possibly reducing the gift exclusion amount to $1 million). At a minimum, the possibility of accelerating the sunset of the gift, estate and GST exclusion amount to $5 million (indexed) before 2026 has been heightened.

(2) **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 "For the 99.5 Percent Act" proposal would reduce it to $1.0 million, not indexed) and increasing the maximum gift tax rate from 40% to 65% (the Biden Administration has suggested increasing the rate 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").

In the very evenly divided Congress (discussed in Item p(2)-(3) 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.k above.

(3) **Retroactive Tax Legislation Generally and Constitutionality.** 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). For various examples, see Item 2.b.(3) of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights).

(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 (Oct. 25, 2012) (includes a detailed analysis of possible constitutional attacks, including Fifth Amendment Due Process, takings 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). One example of retroactive tax legislation that went "too far" was the retroactive introduction of the federal gift tax. *Untermyer v. Anderson*, 276 U.S. 440 (1928).

(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" (emphasis in original). 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) 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.

(4) 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), retroactive changes in the transfer tax are extremely unlikely in this Congress, due to the evenly divided nature of the Congress (see Item p(2)-(3) and Item 2.q(2) above and the extreme unlikelihood that all 50 Democratic senators would go along, especially with a retroactive reduction in the gift exclusion amount that would be so particularly egregious.

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). The Administration so far has not even hinted at any retroactive tax proposals.

(5) **Planning in Light of Possible Retroactive Legislation.** The possibility of retroactive legislation in some ways encourages current transfers but in other ways raises concerns about making current transfers. In late 2020, before it was known whether the Democrats would have a Senate majority in 2021, some clients made transfers in late 2020 for fear that legislation in 2021 rolling back transfer tax exclusions or enacting other transfer tax reforms conceivably might be made retroactive to sometime in early 2021. Similarly, in 2021, planners may want 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. (But realistically – how likely is it that Congress would pass a retroactive decrease in the gift exclusion amount, catching prior gifts?)

In other ways though, the possibility of retroactive legislation raises risks of triggering unexpected gift taxes. Considering the possibility of retroactive changes, some planners have examined ways of making gifts that could be limited 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 changed circumstances. See Items 10-18 below for a more detailed discussion of these alternative approaches.

r. **Wealth Tax and Mark-to-Market Proposals.** 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 Economics Professors Emmanuel Saez and Gabriel Zucman. 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.

Senator Wyden (Chair of the Senate Finance Committee) proposes taxing long-term capital gains at applicable ordinary income rates and applying an annual mark-to-market regime. For a summary of the Wyden mark-to-market proposal see Item 2.j. of Estate Planning Current Development and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

s. **Accelerating Charitable Efforts (ACE) Act Proposal.** Sen. Angus King (I-ME) and Sen Chuck Grassley (R-IA) on June 9, 2021, introduced bipartisan legislation, the Accelerating Charitable Efforts (ACE) Act, to cause philanthropic funds to be made available to working charities within a reasonable time period by tightening restrictions on donor advised funds (DAFs) and private foundations.

These changes are introduced in response to coalitions of philanthropic and nonprofit leaders and academics urging reforms to unlock hundreds of billions of dollars in DAFs and foundation endowments. A statement from Senator King's office observes that DAFs currently have more than $140 billion set aside for future charitable gifts with no requirement to ever distribute these resources to working charities. However, the proposal is strongly opposed by the Council of

Foundations and others in the charitable sector. If the proposal advances to a committee or Senate floor vote, Council on Foundations president and chief executive officer Kathleen Enright has said "we expect a big, pitched battle over it." *Philanthropy Divided Over Legislation to Accelerate DAF Grants*, Philanthropy News Digest website (posted June 11, 2021).

(1) **Additional Restrictions on DAFs.** Four restrictions would apply to contributions to "nonqualified" DAFs in order to receive an income tax charitable deduction: (i) no deduction would be allowed for non-cash contributions unless the fund sells the asset for cash; (ii) no deduction would be allowed until the fund makes a qualifying distribution of the contribution (or the sale proceeds of the contribution); (iii) the deduction would be limited to the qualifying distribution amount; and (iv) contribution must be distributed within 50 years to avoid the imposition of a 50% excise tax on the undistributed portion of the contribution and attributable earnings.

For contributions to a "qualified" DAF, the no income tax charitable deduction is allowed for the contribution of a "non-publicly traded" asset until the year the asset is sold, and the deduction would not exceed the gross proceeds received from the sale and credited to the fund. A "qualified" DAF is one that requires the donor's advisory privilege to end before the last day of the 14th taxable year beginning the year after the year in which the contribution is made, and in which the donor identifies at the time of contribution a preferred charitable organization to receive any assets that remain in the fund at the end of the time limit. That limitation does not apply, however, to a "qualified community foundation donor advised fund," meaning that (i) no individual with advisory privileges has advisory privileges with respect to more than $1,000,000 (indexed) in DAFs with that sponsoring organization, (ii) the DAF must make qualifying distributions of at least 5% of the fund value each year, and (iii) the community foundation must serve the needs of a particular geographic community that is no larger than four states and that holds at least 25% of the organization's total assets outside of DAFs.

The new rules would apply to contributions after the date of enactment.

(2) **Changes to Private Foundation Minimum Distribution Requirements.** The following would not count toward the 5% minimum distribution requirement for private foundations: (i) administrative expenses paid to substantial contributors or family members and (ii) distributions to a DAF. These two new rules would apply, respectively, to (i) taxable years beginning after and (ii) to returns required to be filed after December 31, 2021.

(3) **Exemptions From Investment Income Excise Tax.** The investment income excise tax would not apply to private foundations meeting either of two requirements: (i) the foundation makes qualifying distributions in excess of 7% of the foundation's asset value (other than direct use assets); or (ii) the foundation has a specified duration of not more than 25 years and does not make distributions to other private foundations having a common disqualified person. These provisions would apply to taxable years beginning after the date of enactment.

(4) **Public Support Test Changes.** To determine whether a charity meets the public support test to be classified as a public charity rather than a private foundation, contributions from a DAF to the charity will be treated as coming from the original donor, or if the original donor is not identified, all contributions from DAFs for which the donor is not identified will be treated as coming from a single donor. This provision would apply to contributions made after the date of enactment.

t. **Proposal to Cap the Section 199A Benefit and to Extend the Section 199A Deduction to Additional Professions.** Senator Ron Wyden (D-Ore.), chairman of the Senate Finance Committee, has introduced the Small Business Tax Fairness Act (which he hopes to include in the larger $3.5 trillion reconciliation bill being planned by congressional Democrats) to cap the eligibility for the 20 percent passthrough deduction under §199A to taxpayers with taxable income of $500,000 or less (the deduction is phased out for taxpayers with taxable income between $400,000 and $500,000). Under current law, certain professions (including the legal and accounting professions) are not eligible for the deduction, but the proposal would extend the eligibility for the deduction to "any trade or business other than the trade or business of performing services as an employee." Senator Wyden estimates that the proposal would raise $147 billion of revenue (but that has not been verified by any official estimates). The Biden campaign had proposed phasing out the deduction for qualified business income above $400,000, but that proposal was not included in the Biden Administration's FY 2022 budget proposal. *See generally Senator's Pass-Through Plan Could Raise $147B to Offset Spending*, BLOOMBERG DAILY TAX REPORT (July 20, 2021); Frederic Lee, *Wyden Passthrough Bill Pitched as Remedy to GOP Tax 'Giveaways,'* TAX NOTES (July 21, 2021).

3. Corporate Transparency Act Overview

a. **Brief Summary.** The Corporate Transparency Act (CTA) was enacted on January 1, 2021 as part of the National Defense Authorization Act. It effectively will create a national beneficial ownership registry. This is an outgrowth of the efforts of the international community, through the Financial Action Task Force (FATF), to combat the use of anonymous entities for money laundering, tax evasion, and the financing of terrorism. Regulations in the U.S., adopted in 2016 and 2018 (the "CDD Regulations"), require financial institutions to obtain identifying information when opening bank accounts for entities and require title insurance companies to provide beneficial ownership information for legal entities used to make high-end cash and wire purchases of real estate in various metropolitan areas. Still, the U.S. has been viewed internationally as being vulnerable to money laundering and tax evasion because of a perceived lack of corporate transparency and reporting of beneficial ownership.

The CTA requires that certain entities must disclose to the Financial Crimes Enforcement Network ("FinCEN") identifying information about individual owners and those who control the entity ("Beneficial Owners") and "Applicants" applying to form an entity. A national registry of entities and their applicants and owners will be created.

At this point, private trusts apparently are not included among the entities that must report, and charitable organizations, including private foundations, are specifically exempt from the reporting requirements.

b. **Reporting Companies.** Companies that must report are corporations, LLCs, and other "similar entities" that are created by filing a document with a secretary of state or similar office or foreign entities registered to do business in the U.S. Trusts would seem not to be included as a Reporting Company because they are not created by filing a document with a secretary of state, but some question exists as to whether they might be considered a "similar entity." Future study of partnerships, trusts, and other legal entities is called for under the CTA, so these rules may evolve in time.

Companies that are exempt from reporting include (1) certain specified companies already under close federal regulation (*e.g.*, banks, bank holding companies, SEC registered entities, insurance companies, charitable organizations exempt from tax under §501(c)(3), 501(a), 527(a) or 4947(a), etc.), (2) companies with a physical presence in the U.S. that employ more than 20 people and that have gross receipts exceeding $5 million, and (3) certain entities with no active trade or business (a number of requirements apply to this dormant company exception).

c. **Beneficial Owner.** A "Beneficial Owner" (who must be reported) is any individual who directly or indirectly (i) exercises substantial control over a Reporting Company or (ii) owns or controls at least 25% of the Reporting Company. Certain individuals are excluded as Beneficial Owners: (i) minors (provided the parent or guardian's information is reported); (ii) nominees or agents; (iii) an employee whose control or economic benefits from the Reporting Company come solely from employment; (iv) an owner solely through a right of inheritance; and (v) a creditor of a Reporting Company (who is not otherwise a Beneficial Owner directly).

For a trust that is a Beneficial Owner of 25% or more of an entity, regulations may adopt an approach, like the approach of the CDD Regulations, that the trustee is the deemed beneficial owner (and not the individual beneficiaries). *See* John A. Terrill & Michael Breslow, *Congress Passes Corporate Transparency Act to Require Disclosure of Beneficial Owners of Entities and the Creation of a National Registry of Entities*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #218 (Jan. 21, 2021).

d. **Regulations and Effective Date.** The Treasury Secretary has broad regulatory authority and must promulgate regulations by January 1, 2022. The CDD Regulations must be conformed with the CTA to eliminate duplicative burdens. The regulations will "use risk-based principles for requiring reports of beneficial ownership information." The reporting requirements take effect on the effective date of the regulations.

e. **Filing Due Dates.** Existing companies when the regulations become effective must file the required information within two years of the effective date of the regulations. Any company formed subsequently must file the report on the formation of the entity. Every Reporting Company must also file a report within one year of certain specified changes of Beneficial Ownership (including any Beneficial Owner exceeding or falling below 25%).

f. **Penalties.** Failure to file a timely required report with FinCEN will result in civil and criminal fines (penalties of $500/day the report is outstanding, up to $10,000) and up to two years imprisonment. Any person who willfully provides false ownership information is subject to similar penalties.

Penalties will also be imposed on anyone who makes an unauthorized disclosure of information about Applicants or Beneficial Owners.

4. Planning for IRA and Retirement Plan Distributions Under the SECURE Act

a. **Overview.** The SECURE Act made various changes regarding retirement benefits including (i) changing the required beginning date for minimum distributions (April 1 of the following year) from age 70½ to 72, (ii) eliminating the prohibition on contributions to an IRA after age 70½ (but if an individual both contributes to an IRA and takes a qualified charitable deduction (QCD) between ages 70½ and 72, the IRA contribution will reduce the portion of the QCD that would otherwise be treated as tax-free), and (most important) (iii) substantially limiting "stretch" planning for distributions from defined contribution plans and IRAs over a "designated beneficiary's"(DB's) lifetime (with several exceptions). The SECURE Act mandates that distributions to a designated beneficiary be made within 10 years following the death of the participant, with exceptions for five categories of "eligible designated beneficiaries" (EDBs).

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

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

c. **Trust Beneficiaries.** A big change for planners comes into play if the owner wants to use a trust as a beneficiary of a qualified plan or IRA.

(1) **Conduit Trusts Generally No Longer Desirable.** A "conduit trust" is a trust that must immediately pay any distribution from a qualified plan or IRA to the trust beneficiary. They were often used because they do not have many complexities that apply to "accumulation trusts" (that permit plan or IRA distributions to be "accumulated" in the trust). They worked fine when plan or IRA distributions were made were distributed over the beneficiary's lifetime, because the distribution each year was relatively small. But when the entire plan must be distributed within 10 years, when the bulk of the plan benefits are distributed to the trust, they would have to be distributed to the beneficiary, and therefore would not serve the purposes for which the owner wanted to use a trust in the first place. Natalie Choate summarizes, "Almost invariably, conduit trusts will not work the way the client anticipated or wants."

(2) **Conduit Trusts Still Appropriate for Surviving Spouse (and Perhaps for Minors).** A distribution to a trust for a surviving spouse probably has to be made to a conduit trust, rather than an accumulation trust, to qualify as an EDB. For example, a standard QTIP trust does not qualify as

an EDB and the 10-year rule would apply after the participant's death. A QTIP trust that also requires such distributions to the spouse of all plan distributions would constitute a conduit trust that is an EDB and would qualify for the spousal special treatment.

Conduit trusts can be helpful if they result in EDB treatment for the beneficiary with a payout over the beneficiary's life expectancy until the EDB status ends. But the owner must understand that the trust protection will end within 10 years after EDB status ends for a beneficiary if a conduit trust is used.

A trust for a minor would probably have to be a conduit trust in order to qualify for the minor child exception. Some people might choose to use a conduit trust for a minor child, to be able to make very slow distributions (life expectancy distributions, which would be very small each year for a minor child) until the child reaches the "age of majority" (defined as having completed a specified course of education, but no later than age 25), but when the child reaches the age of majority, all of the plan or IRA would have to be distributed within the next 10 years, and if it is paid to a conduit trust, the distribution would immediately be paid out from the trust to the beneficiary, thus avoiding any further protections afforded by the trust.

(3) Accumulation Trusts Generally Used. Other than for surviving spouses, accumulation trusts will probably be used if the owner wants a trust to receive plan distributions. Accumulation trusts for disabled or chronically ill individuals will qualify for the lifetime payout exception.

d. New Life Expectancy Tables for Retirement Plan Required Minimum Distributions. The Single Life and Uniform Life tables for calculating required minimum distributions are in Reg. §1.401(a)(9)-9(b)-(c). (The Uniform Life table, which is based on the life expectancy of an individual and someone 10 years younger, may be used only while the account owner is living or for a spousal rollover IRA. Otherwise the Single Life (or Joint Lives) Table must be used. The Uniform Life table allows taking withdrawals at a substantially slower rate. For example, the life expectancy of a 72-year old person under the Single Life table is 17.2 years, and under the Uniform Life table is 27.4 years.) Proposed regulations containing revised tables were issued in November 2019, and the revised tables would have applied to distribution calendar years beginning on or after January 1, 2021. The preamble to the proposed regulations stated that the "life expectancy tables and applicable distribution period tables in the proposed regulations reflect longer life expectancies than the tables in the existing regulations that are generally between one and two years longer than under the existing regulations." Professor Chris Hoyt (Kansas City, Missouri) concludes that "[m]ost individuals will experience reduced RMD amounts of between 0.3% and 0.5% of what they would have had to receive under the prior tables." Christopher Hoyt, *Reduced RMDs From Retirement Accounts*, TRUSTS & ESTATES at 46 (June 2021). Final regulations were issued November 4, 2020 (T.D. 9930, published in the Federal Register on November 12, 2020), and the effective date was moved back to plan years beginning on or after January 1, 2022.

e. ACTEC Comments; Waiting on IRS Guidance; Preview from 2021 IRS Publication 590-B. These provisions of the SECURE Act create many uncertainties. ACTEC filed comments with the IRS on July 14, 2020 and July 29, 2020 identifying various uncertainties and making various recommendations for IRS guidance. American College of Trust & Estate Counsel, Letters to Department of Treasury and IRS titled "Request for Guidance from Treasury on Section 401 of the SECURE Act, Part 1 (July 14, 2020) and Part 2 (July 29, 2020)." These extremely detailed comments include recommendations regarding various issues about the 10-year rule and the effective date in Part 1, and regarding trusts for DBs other than EDBs, trusts for spouses, EDB issues generally, minor child beneficiary and age of majority, disabled and chronically ill EDBs, applicable multi-beneficiary trusts, and the "not more than 10 years younger" EDB category in Part 2. The comments are available from the "Legislative and Regulatory Comments by ACTEC" webpage of the ACTEC website, found here.

The IRS is expected to provide guidance on many issues regarding the SECURE Act. Stephen Tackney, of the IRS Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes) has confirmed that regulations addressing required minimum distributions under the SECURE Act "will come out in a lengthy but complete package" but the timing is not imminent. "I always say it's in the 'soon' category; that means later than imminent but before eventually." The regulations will address not only issues arising under the SECURE Act but will also address "long-standing questions about trusts named as beneficiaries of IRAs." He noted that "[t]he trust and estate bar has asked for lots of flexibility, and the IRS and Treasury hope to accommodate those requests., [but] … flexibility brings with it very complex rules." *See* Nathan Richman, *Proposed SECURE Act Regs Far Along but Not Imminent,* TAX NOTES (June 1, 2021). Hopefully, the IRS will address many of the uncertainties raised in the ACTEC comment letters. For example, the IRS may relax restrictions that no longer serve a purpose for accumulation trusts.

A preview of some positions that the IRS might take in proposed regulations can be gleaned from this year's annual edition of IRS Publication 590-B, Distribution from Individual Retirement Arrangements (IRAs) (March 25, 2021). An example on page 12 in the initial 2021 publication suggests that payments would have to be made each year (based on a life expectancy payout) during the general 10-year period for making distributions from qualified plans and IRAs following the participant's death, but the example was simply a mistake; the only requirement is that the entire account must be distributed by December 31 of the tenth year. *See* Natalie Choate, *IRS Publication 590-B Offers Preview of Treasury Guidance on Post-SECURE RMD Rules … and Some Bloopers*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #757 (April 26, 2021). The IRS issued a statement revising that example on May 13, 2021; a revised version of Publication 590-B dated May 13, 2021 is available for download.

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

Roth conversions may still make sense for taxpayers who are in considerably lower income tax brackets (because of lower income, NOLs, loss carryovers, etc.) than the beneficiaries. (If an accumulation trust is the beneficiary, the trust reaches the maximum 37% bracket at a mere $13,050 of taxable income in 2021, so the participant might be in a significantly lower bracket. However, the time period for the tax-free growth would generally be limited to 10 years following the person's death because of the 10-year rule.)

For a discussion of considerations for making Roth conversions in 2020, see Bernard Kent, *Roth IRA Conversions in 2020*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #737 (June 9, 2020).

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

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

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

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

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

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

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

The plan benefits could be paid to the CRT immediately following the participant's death, thus satisfying the RMD requirements for the plan. The CRT is a tax-exempt entity and does not pay income tax on receipt of the plan benefits. Plan benefits generally must be paid out within 10 years, but if the plan benefits are paid to a CRT, the distributions from the CRT could be made over the lifetime of the individual beneficiary of the trust, thus assuring distributions over the lifetime of the individual and deferring the time that income tax must be paid on the distributions to the beneficiary. If a CRT is used, the best approach will generally be to use a charitable remainder unitrust (CRUT) payable over the lifetime of the beneficiary (not a term-of-years CRT, which must be no more than 20 years—which is only 10 years longer than the payout allowed under the SECURE Act if benefits are paid directly to the beneficiary).

Can the deferral advantage mean that the family member receives more with a CRT than if the plan benefit is left outright to family member? Generally, not. The use of the CRT is **not** primarily a way to beat the SECURE Act and save income taxes. Reasons that that family members generally do not receive more benefits with a CRT than having payment made directly to the beneficiary include the following.

- The payout to the individual must be set so that the present value of the charitable remainder when the CRT is created is at least 10% of the amount contributed to the trust.
- When distributions are made to the individual beneficiary, a "four-tier system" applies to carry out the income tax attributes of the CRT's assets to the individual beneficiary – ordinary income is deemed distributed first. As payments are made over the life of the beneficiary, all or almost all the amounts paid to the individual likely will represent the plan benefits and will be taxed as ordinary income. (After the aggregate CRT distributions have carried out all the plan benefits, the distributions will next represent capital gains of the trust. The CRT should not invest in tax-exempt bonds; as a practical matter the distributions to the beneficiary will never be the tax-exempt income.)
- Do not use a CRT if the decedent is paying federal estate taxes. The §691(c)(1)(A) deduction of the estate tax attributable to the IRD (i.e., the plan benefit paid to the trust) is netted from the first tier ordinary income but is not directly made available to the income beneficiary. PLR 199901023. In effect, the §691(c) deduction amount becomes "tier four" corpus (distributions of which would not be taxable income to the beneficiary).The income beneficiary benefits from the §691(c) deduction only after the trust shrinks to an amount less than the original plan benefits paid to the trust minus the §691(c) deduction.

The "sweet spot" when the CRT may result in a better financial result for the beneficiary than an outright distribution to the beneficiary is (i) if the decedent does not pay federal estate tax, (ii) if the plan benefits will be taxed at a high income tax rate (i.e., the beneficiary is in a high tax bracket), and (iii) a lifetime CRUT is used and the beneficiary lives for at least **30 years** after the CRT is created (outcomes vary with investment returns and tax rates). Otherwise, a CRT should be used to receive plan benefits only if the client has significant philanthropic goals.

For a discussion of other resources about using CRTs to receive plan benefits or of leaving an IRA to charity for a gift annuity, see Item 3.j. of Estate Planning Current Development and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

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

j. **More Detailed Discussion.** For a much more detailed discussion of planning issues in light of the SECURE Act, see Item 3 of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

5. Administrative Guidance Regarding 2017 Tax Act Changes

a. **Anti-Clawback Regulation.** The anti-clawback regulation was issued in November 2019 in response to §2001(g)(2) added by the 2017 Tax Act. The regulation allows the estate to compute its estate tax credit using the higher of the basic exclusion amount (BEA) applicable to gifts made during life or the BEA applicable on the date of death. Notable planning aspects of the anti-clawback regulation include the following.

- Clients have a "window of opportunity" to make use of the large $10 million (indexed) gift exclusion amount, before the exclusion amount is reduced to $5 million (indexed) in 2026 (or perhaps by earlier legislation). "[T]he increased BEA is a 'use or lose' benefit that is available to a decedent who survives the increased BEA period only to the extent the decedent 'used it' by making gifts during the increased BEA period." Preamble to Final Regulation at 4.
- Donors cannot use the "bonus" exclusion amount (the excess of the large current exclusion amount over a later reduced exclusion amount) before first using the "base" exclusion amount. Preamble to Final Regulation at 8.
- Think twice about gift-splitting. In order to make use of the bonus exclusion amount before it disappears, a gift by one spouse of $11 million is better than $5.5 million gifts by both spouses. If the parties anticipate that the split gift election will be made, consider having the donor's spouse contractually agree to consent to the election at the time the gift is made (in case a divorce occurs before the gift tax return is filed in which event the donor's spouse might express reluctance to consent to gift splitting).
- DSUE amount elected during the increased BEA period will not be reduced as a result of the sunset of the increased BEA. Reg. §20.2010-1(c)(2)(iii), Exs. 3-4.
- DSUE available to a donor must be utilized before using the bonus exclusion amount. Reg. §20.2010-1(c)(2)(iv), Ex. 4.
- The IRS hinted that the current increased GST exemption amount can be allocated to gifts made before 2018.
- The IRS is still considering an anti-abuse rule that would not apply the anti-clawback rule to gifts that are included in the gross estate, such gifts as with retained life estates or with

retained powers or interests or certain gifts valued at a higher amount under §2701 or §2702, or a gift of a legally enforceable note. See Item 8.f below.

For further discussion of each of these issues, see Item 4 of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights and Item 4 of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

b. **Executor or Trustee Fees and Other Miscellaneous Estate or Trust Expenses.** An amendment to regulation §1.67-4(a) (finalized in October 2020) clarifies that the following deductions allowed to an estate or non-grantor trust (including the S portion of an electing small business trust) are not miscellaneous itemized deductions (which are suspended under §67(g) through 2025):

- Costs paid or incurred in connection with the administration of an estate or non-grantor trust that would not have been incurred if the property were not held in the estate or trust;
- The personal exemption of an estate or non-grantor trust; and
- The distribution deduction for trusts distributing current income or accumulating income.

c. **Excess Deductions or Losses at Termination of Estate or Trust.** Regulation §1.642(h)-2 and §1.642(h)-5 (published in connection with the proposed and final regulation §1.67-4) clarifies the treatment of certain deductions on the termination of an estate or trust, which are available as deductions to the beneficiaries succeeding to the property under §642(h). The regulation stipulates that each deduction comprising the section 642(h)(2) excess deduction retains its separate character in one of three categories reported separately to beneficiaries: (1) an amount allowed in arriving at adjusted gross income (i.e., expenses that that were incurred solely because the property was in an estate or trust, §67(e)); (2) a non-miscellaneous itemized deduction; or (3) a miscellaneous itemized deduction. Furthermore, Example 2 of Reg. §1.642(h)-5 was revised in the final regulation to make it clear that the executor can choose which deductions to allocate against income and which to carry out as excess deductions. Any §67(e) deductions that are carried out to beneficiaries will not be treated as miscellaneous itemized deductions (for which a deduction is suspended until 2026).

In mid-July, 2020, the IRS posted guidance regarding reporting of excess deductions, referencing codes and adjustments to be entered on specific lines of Schedule 1 of Form 1040. Internal Revenue Service, *Reporting Excess Deductions on Termination of an Estate or Trust on Forms 1040, 1040-SR, and 1040-NR for Tax Year 2018 and Tax Year 2019*. The 2020 "Instructions for Schedule K-1 (Form 1041) for a Beneficiary Filing Form 1040 or 1040-SR" (released Oct. 21, 2020), citing the final regulations, clarify and elaborate previous versions in explanations titled "Box 11, Code A—Excess Deductions on Termination - Section 67(e) Expenses" and "Box 11, Code B—Excess Deductions on Termination - Non-Miscellaneous Itemized Deductions."

If §67(e) applies to certain expenses of an estate or trust, and if the estate or trust terminates and passes to another trust, can those expenses be deducted by the recipient trust under §67(e)? The regulations do not address that issue specifically, but treating expenses as having the same "character" under §67(e) for beneficiaries as for the original estate or trust would presumably apply for trusts as beneficiaries as well as for individual beneficiaries.

d. **State and Local Taxes Deduction.** The $10,000 limit on state and local tax (SALT) deductions has led some states to consider implementing laws providing relief from state income tax to the extent of contributions to a specified charitable fund, in hopes that the taxpayer could deduct the full charitable contribution without any $10,000 limitation. The IRS issued final regulations, published in the Federal Register on June 13, 2019, blocking these types of arrangements by disallowing a federal charitable deduction when the donor expects to receive an offsetting credit against state and local taxes.

The IRS recognizes special rules for C corporations and specified pass through entities in light of the fact that the $10,000 SALT limitation was never meant to apply to state and local taxes imposed on businesses and business income. Rev. Proc. 2019-12, 2019-4 I.R.B. 401, issued on December 28, 2018, recognized the effectiveness of a charitable contribution offset for C corporations and specified pass-through entities. Some states went beyond allowing a charitable deduction offset for state and local taxes of the business and enacted laws allowing businesses to pay state and local taxes directly at the entity level. The IRS accepted this approach in Notice 2020-75, issued on November 9, 2020, and acknowledged that such payments would reduce the partner's or shareholder's distributive or pro-rata share of income, and that the $10,000 SALT deduction limitation on deductions by the individual owners would not be applicable to such payments. In order for partners or S corporation shareholders to utilize this approach to avoid the $10,000 limitation for taxes incurred by the entity, the state would have to enact a mandatory or elective entity-level income tax on the entity. States that have such an elective entity-level tax include Louisiana, Oklahoma, Rhode Island, Wisconsin, New Jersey, and Maryland. In addition, Connecticut has a non-elective entity-level tax. Similar proposals are being considered in Colorado, Ohio, and Pennsylvania. *See* McQuillan, *SALT Workarounds Spread to More States as Democrats See Repeal*, BLOOMBERG DAILY TAX REPORT (April 27, 2021).

e. **Life Insurance-Basis of Life Insurance and Annuity Contracts Not Reduced by Mortality Charges, Rev. Rul. 2020-5.** The 2017 Tax Act amended §1016(a) to provide that the basis of life insurance and annuity contracts would not be reduced by mortality expenses, or other reasonable charges under the contracts. This is important for determining the amount of income recognized upon the sale of such contracts. This change is contrary to the announced IRS position in Rev. Rul. 2009-13 (Situations 2 & 3) and Rev. Rul. 2009-14 (Situation 2). Rev. Rul. 2020-5, 2020-9 I.R.B. 454 (Feb. 24, 2020), amends those prior revenue rulings to be consistent with the amendment to §1012(a), and to clarify that the basis is not reduced by the "cost of insurance charges," regardless of why the contract was purchased.

f. **Carried Interest Final Regulations.** Section 1061, enacted as part of the 2017 Tax Act, requires certain investment funds (referred to as "applicable partnership interests" (APIs)) to hold assets for more than three years, rather than just for one year, for managers to receive long-term capital gain treatment. In addition, §1061(d) accelerates capital gain recognition in connection with the "direct or indirect" transfer of an API to a "related person" (defined by reference to §318(a)(1)) and in that situation recharacterizes certain long-term gains as short-term gains. Final regulations were released on January 7, 2021 and are effective January 13, 2021. T.D. 9945 (Jan. 13, 2021). The final regulations (i) confirm that gifts to non-grantor trusts would not invoke the acceleration provisions, (ii) adopt the suggestion that only transfers to related persons that would be a sale or exchange would trigger acceleration of gain, and (iii) eliminate certain definitions that had been used for the family office exclusion, which the IRS continues to study. The preamble to the final regulations clarifies that the §1061(d) acceleration applies only to transfers that would be a sale or exchange.

For a summary of the ACTEC comments and the final regulations reaction to those comments see Kevin Matz, *IRS Issues Final Regulations on Carried Interests*, posted on WealthManagement.com (Jan. 22, 2021).

g. **Miscellaneous Other 2019 Guidance.** For a discussion of other guidance issued in 2019 regarding (i) reportable policy sales and transfer of value issues, (ii) the deduction under §199A for qualified business income, and (iii) qualified opportunity funds, see Item 5.d.-f. of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

h. **More Detailed Discussion.** For a more detailed discussion of the issues discussed in Items 5.b.-f. above, see Item 5 of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

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

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

> "3. Guidance on basis of grantor trust assets at death under §1014.
>
> …

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

…

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

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

The Treasury-IRS Priority Guidance Plans beginning in 2017 adopted a revised format that included projects implementing the 2017 Tax Act and reducing regulatory burdens.

b. **Treasury-IRS Priority Guidance Plan for 2020-2021.** The 2020-2021 Plan, published November 17, 2020, employs the revised format. The burden reduction section (Part 3) includes final regulations regarding (1) basis consistency and (2) discretionary extensions of time to make GST exemption allocations (suggesting a likely relaxation of some of the controversial provisions in the proposed regulations for those matters).

Part 6 contains the traditional General Guidance projects in a variety of subject areas. Five items are in the "Gifts and Estates and Trusts" section. Four of them are the same as in the 2019-2020 Plan, which include projects dealing with (1) the basis of grantor trust assets at death under §1014, (2) alternate valuation date matters under §2032(a), (3) the deductibility of certain estate administration expenses under §2053, and (4) (added in the 2019-2020 Plan) regulations under §7520 revising the actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests. The new fifth project, added in the 2020-2021 Plan is: "Guidance on user fee for estate tax closing letters under §2001."

For a general discussion of and commentary about the 2020-2021 Priority Guidance Plan, see Ronald D. Aucutt, *2020-2021 Treasury-IRS Priority Guidance Plan*, ACTEC CAPITAL LETTER NO. 50 (Nov. 25, 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. For further details about the (i) basis consistency, (ii) basis of grantor trust assets at death, (iii) alternative valuation date, and (iv) §2053 personal guarantees and present value concepts, see Item 6.b.- e. of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(1) **Estate Tax Closing Letter User Fee.** On December 28, 2020 the IRS released a proposed regulation (published in the Federal Register on December 31, 2020) that would impose a new $67 user fee to request an estate tax closing letter (IRS Letter 627). Prop. Reg. §300.13. The new system would apply to requests received by the IRS 30 days after the publication of a final regulation.

At one time, the IRS routinely issued estate closing letters after estate tax examinations had been completed, but for returns filed on or after June 1, 2015, the IRS announced that closing letters would be issued only on request. After receiving many complaints from taxpayers' advisors about long delays in obtaining closing letters, the IRS suggested that estates could obtain an estate tax account "transcript" and that a transcript with code "421" would serve "as the functional equivalent of an estate tax closing letter." That approach was not sufficient, however, because purchasers from estates often wanted the more formal estate tax closing letter for comfort that no estate tax lien was outstanding, and advisors often recommend that executors delay distributing estate assets until a closing letter could be obtained in light of the potential personal liability of executors if assets are distributed before estate taxes are paid. The preamble observes, in a classic understatement, that "the IRS received feedback from taxpayers and practitioners that the procedure for requesting an estate tax closing letter can be inconvenient and burdensome," and summarizes the rationale for the new fee and the process that will ultimately be used.

> In view of the resource constraints and purpose of issuing estate tax closing letters as a convenience to authorized persons, the IRS has identified the provision of estate tax closing letters as an appropriate service

> for which to establish a user fee to recover the costs that the government incurs in providing such letters. Accordingly, the Treasury Department and the IRS propose establishing a user fee for estate tax closing letter requests …. As currently determined, the user fee is $67….
>
> Guidance on the procedure for requesting an estate tax closing letter and paying the associated user fee is not provided in these proposed regulations. The Treasury Department and the IRS expect to implement a procedure that will improve convenience and reduce burden for authorized persons requesting estate tax closing letters by initiating a one-step, web-based procedure to accomplish the request of the estate tax closing letter as well as the payment of the user fee. As presently contemplated, a Federal payment website, such as *http://www.pay.gov,* will be used and multiple requests will not be necessary. The Treasury Department and the IRS believe implementing such a one-step procedure will reduce the current administrative burden on authorized persons in requesting estate tax closing letters and will limit the burden associated with the establishment of a user fee for providing such service.

Planners have expressed relief regarding the new system as compared to the existing system characterized by some planners as "horrendous" because "hours are spent on the phone trying to contact IRS on this at substantial expense to the client" (the IRS replaced the telephone method with a fax method during the pandemic).

> Estate planners might not be thrilled about a newly proposed $67 user fee for estate tax closing letter requests, but they're content to say goodbye to a process that has drawn their ire for years.
>
> …
>
> For Ronald D. Aucutt, Bessemer Trust, the proposed user fee is a means to a better process. The $67 amount "may be a token, but it enables this drama to come to an end," he said. *Proposed Estate Tax Closing Letter Fee Earns Sigh of Relief*, TAX NOTES (Jan. 4, 2021).

But Ron rejects the attempted justification of the user fee in the preamble to the proposed regulations, which views closing letters as a mere "convenience" and "service":

> The practice of issuing estate tax closing letters to authorized persons is not mandated by any provision of the Code or other statutory requirement. Instead, the practice is fundamentally a customer service convenience offered to authorized persons in view of the unique nature of estate tax return filings and the bearing of an estate's Federal estate tax obligations on the obligation to administer and close a probate estate under applicable State and local law.

Ron points out that the "unique nature of estate tax return filings" includes the IRS's benefit from liens, transferee liability, priority over other creditors, and other advantages, and with such power should come some level of responsibility.

Other planners have also been critical of the proposed user fee.

> While the fee amount is not outrageously high, it is always irksome when the government charges members of the public before that government will discharge its duty. In this case, that is particularly so since it is the liability that the government imposes on fiduciaries (both in their fiduciary capacity and their individual capacity) that necessitates a closing letter.
>
> A secondary concern is fee creep. We have all seen modest government fees increase over time to unreasonable amounts. Look no further than the fees charged for private letter rulings – these at one time had no fee, then a small fee, and now bear fees in the many thousands of dollars.
>
> As of now, the fee is only proposed. Chuck Rubin, *IRS Is Proposing a User Fee for Estate Tax Closing Letter*, LEIMBERG ESTATE PLANNING NEWSLETTER #2853 (Jan. 14, 2021).

The American Institute of CPAs, in a letter dated February 25, 2021 commenting on the IRS closing letter user fee proposal, "suggests adding a box to check to the next version of Form 706 and Form 706-NA for the executor to request the closing letter together with submitting the user fee at the time of filing the" return. It suggests that this is the simplest manner for an executor to request a closing letter and would also be simpler for the IRS by providing less opportunity for processing errors and by giving IRS personnel notice in reviewing the estate tax return that the executor requests a closing letter. IRS personnel "would have not have to process and input a separate web-based request into the system" and "would not need to research and follow up on an executor's web-based request months later."

(2) New Actuarial Tables. The actuarial tables project, added in the 2019-2020 Plan, is to update the §7520 actuarial tables based on updated mortality information, which must be done every ten years and was last done effective May 1, 2009. The tables were not updated by May 1, 2019, as was required by §7520, and IRS officials have informally indicated that the IRS has been waiting on data from another agency. That data now appears to be available. On August 7, 2020, the National Center for Health Statistics at the Centers for Disease Control and Prevention issued the decennial life table for 2009-2011, which apparently is the underlying data for the IRS actuarial tables. The new Lx table lists the number of individuals, out of a total of 100,000, who will be alive at each of ages 0-110, based on data from the 2010 census (which obviously is already 10 years old). The new data reflects a somewhat remarkable increase in life expectancies compared to the existing Lx table (based on 2000 census data). For example, at age 84 the number of individuals, out of the 100,000 starting pool, expected to be surviving has increased from 37,837 to 44,809, an 18.4% increase in just 10 years. Larry Katzenstein summarizes:

> The improvements in longevity at older ages is truly remarkable. For example, the probability of survival from age 60 to age 90 went from 21.088% to 26.6021% in just ten years. No wonder the Today show stopped years ago highlighting viewers who attained age 100. There were just too many of them. Larry Katzenstein, *New Actuarial Tables Are Coming*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #303 (Nov. 30, 2020) (includes the new Lx table, compared to the existing Lx table).

The rather dramatic increase in life expectancy from the 2010 census data compared with the 2000 census data interestingly is contrasted with a CDC report in February 2021 that life expectancy declined about one year from 2019 to the first six months of 2020 (and declined 2.7 years for non-Hispanic Black people and 1.9 years for Hispanic individuals). National Center for Health Statistics Vital Statistics Rapid Release, Rept. No. 10 (February 2021).

The new tables will result in a larger charitable deduction for CLATs for the life of an individual, but a lower deduction for a CRAT (and more difficulty in satisfying the 10% remainder test and 5% exhaustion test for a CRAT) and for the remainder in a personal residence after a retained life estate.

Presumably, proposed regulations with the new tables will be coming soon. Larry Katzenstein points out the following questions that remain.

> Questions remain. Will we be allowed to elect to use the new rates for any transaction after April 30, 2019, the date on which the new tables were mandated by section 7520 to be effective? Will there be an effective date transition period? Will the IRS at some point allow use of exact computer- generated factors rather than the almost-exact published factors—almost exact because of rounding and related issues required to make published tables workable? Will the IRS make minor tweaks to the Lx table …? Larry Katzenstein, *New Actuarial Tables Are Coming*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #303 (Nov. 30, 2020).

Because the mortality tables have not been late before, there is no model for such transitional relief. But even the timely promulgation of the 2009 mortality tables provided what the preamble described as "certain transitional rules intended to alleviate any adverse consequences resulting from the proposed regulatory change." T.D. 9448, 74 Fed. Reg. 21438, 21439 (May 7, 2009). The preamble went on to elaborate:

> For gift tax purposes, if the date of a transfer is on or after May 1, 2009, but before July 1, 2009, the donor may choose to determine the value of the gift (and/or any applicable charitable deduction) under tables based on either [the 1990 or 2000 census data]. Similarly, for estate tax purposes, if the decedent dies on or after May 1, 2009, but before July 1, 2009, the value of any interest (and/or any applicable charitable deduction) may be determined in the discretion of the decedent's executor under tables based on either [the 1990 or 2000 census data]. However, the section 7520 interest rate to be utilized is the appropriate rate for the month in which the valuation date occurs, subject to the … special rule [in section 7520(a)] for certain charitable transfers.

In other words, transitional relief may be provided with respect to the actuarial components of calculations based on mortality (life expectancy) tables, but not with respect to merely financial components such as applicable federal rates and the section 7520 rate, which have been published monthly as usual without interruption. For example, such transitional relief would apply to the calculations since May 1, 2019, of the values of an interest for life, an interest for joint lives, an interest for life or a term whichever is shorter or longer, or a remainder following such an interest. But no transitional relief would be necessary for calculations related to promissory notes or GRATs that involve only fixed terms without mortality components, which the new mortality tables would not affect.

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

(4) **Anti-Abuse Exception for Clawback Regulation.** There is no item on the 2020-2021 Plan for the anti-abuse exception to the clawback regulation (discussed in Item 8.f(6) below). Only items expected to be completed within the Plan year are included in the Plan, so the omission does not mean that the IRS is not proceeding with work on the anti-abuse project. But the omission from the Plan does suggest that it is not a front-burner project. The project is important for decedents who should die after the exclusion amount has decreased, so based in the current statute, that is not until 2026. If a greater likelihood exists of an earlier sunset of the exclusion amount (or even a reduction to $3.5 million) under the Biden Administration, perhaps this might become a higher priority project at some point.

c. **Inflation Adjustments.** Inflation adjustments for 2020 and for 2021were announced in Rev. Proc. 2019-44 and Rev. Proc. 2020-45, respectively. Some of the adjusted amounts are as follows:

- Basic exclusion amount and GST exemption-$11,700,000 in 2021, from $11,580,000 in 2020 and $11,400,000 for 2019;
- Estates and trusts taxable income for top (37%) income tax bracket-$13,050 in 2021, from $12,950 in 2020 and $12,750 in 2019;
- Taxable income threshold for §199A qualified business income-$329,800/$164,925 (married filing jointly/single) in 2021, from $326,600/$163,300 in 2020 and $321,400/$160,700 in 2019;
- Standard deduction-$25,100/$12,550 (married filing jointly/single) in 2021, from $24,800/$12,400 in 2020 and $24,400/$12,200 in 2019;
- Non-citizen spouse annual gift tax exclusion-$159,000 in 2021, from $157,000 in 2020 and $155,000 in 2019;
- Section 6166 "two percent amount"-$1,590,000 in 2021, from $1,570,000 in 2020 and $1,550,000 in 2019; and
- Special use valuation reduction limitation-$1,190,000 in 2021, from $1,180,000 in 2020 and $1,160,000 in 2019.

d. **No-Rule List, ING Trusts.** The no-ruling revenue procedure for 2020 includes, as one of the items for which rulings or determination letters will not be issued, certain trusts that are typically structured to be non-grantor trusts as an alternative for saving state income taxes (these types of trusts are often referred to as DINGs or NINGs – Delaware incomplete non-grantor trusts or Nevada incomplete non-grantor trusts. Rev. Proc. 2020-3, §3.01(93). The ruling says that rulings regarding the taxation of the trust under §671 (i.e., whether it is a grantor trust) will not be issued for such trusts that are structured to authorize distributions –

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

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

Accordingly, DING and NING transactions would presumably be structured in the future to avoid the "bad facts" listed. *See* William Lipkind & Tammy Meyer, *Revenue Procedure 2020-3 – IRS Will Not*

Rule on Certain Provisions of Non-Grantor Trusts, LEIMBERG INC. TAX PL. NEWSLETTERS #190 (Feb. 4, 2020).

The 2021 revenue procedure deleted that provision regarding taxation under §671 in the "no rulings" section, but added various other provisions in the "areas under study in which rulings will not be issued" section making clear that ING rulings will not be issued regarding the effects under §§671, 678, 2041 and 2514 (powers of appointment), or 2511 (incomplete gift). Rev. Proc. 2021-3, §5.01(9), (10), (15), & (17).

Various IRS rulings over the last several years have approved ING trusts. *E.g.,* Letter Rulings 202006002-006 (community property in ING trust remains community property at first spouse's death for basis adjustment purposes; no ruling whether trust is grantor trust under §675 because that involves fact issues at death), 201925005-010, 201908002-008, 201852014, 201852009, 201850001-006, 201848009, 201848002, 201832005-009, 201744006-008. For a detailed analysis of the various tax effects of ING trusts and the shifting positions of the IRS in private letter rulings regarding varying structures of INGs, see Grayson M.P. McCouch, *Adversity, Inconsistency, and the Incomplete Nongrantor Trust*, 39 VA. TAX REV. 419 (2020).

The effectiveness of ING trusts to avoid state income taxes has been removed by legislation in New York and a proposal is pending in California to do the same. *See* Eric R. Bardell, *California Admits Incomplete Gift Non-Grantor Trusts Work … For Now*, BLOOMBERG LAW NEWS (Dec. 4, 2020).

e. Administration's Budget Proposals. The Administration releases a budget proposal each year (historically in a report titled "General Explanations of the Administration's Fiscal Year ____ Revenue Proposals" that is often referred to as the "Greenbook"), and during the Obama years, a number of estate and gift tax proposals were included. The budget proposals from the Trump Administration did not include specific tax legislation proposals. The FY 2021 budget, titled "A Budget for America's Future," was published February 10, 2020; it was the Trump Administration final budget proposal. The "adjusted baseline projection" used in the budget assumed permanent extension of the individual income tax provisions in the 2017 Tax Act set to expire on December 31, 2025 and the estate and gift tax parameters and provisions in effect for calendar year 2025.

The Biden Administration published its fiscal year 2022 Greenbook on May 28, 2021. The revenue proposals in the FY 2022 Greenbook provide details about tax proposals in the American Jobs Plan and the American Families Plan, as discussed in Item 2.e-f above but has no provisions about the transfer tax.

f. Using Electronic Signatures on Tax Forms. On August 28, 2020, the IRS announced that it would temporarily accept the use of digital signatures on certain forms that cannot be filed electronically. Additional forms were added to that list on September 10, including Forms 706, 706-NA, 709, 3520, and 3520-A. IR-2020-206. An IRS memorandum dated December 28, 2020 (Control Number: NHQ-10-1220-006) allows using electronic or digital signatures for those forms (and other listed forms) that are signed and postmarked from January 1, 2021 through June 30, 2021, and a memorandum dated April 15, 2021 (Control Number NGQ-10-0421-0002) extends that permission through December 31, 2021. The memorandum observes in a footnote:

> Electronic and digital signatures appear in many forms when printed and may be created by many different technologies. No specific technology is required for this purpose during this temporary deviation.

The forms covered by those notices do not include Form 2848 (which taxpayers use to authorize a professional to represent them before the IRS) or Form 8821 (authorizing others to view tax return information), which are oft-used forms that practitioners would especially like to see covered. Steve Gorin (St. Louis, Missouri) reports that a digital signature with these forms can be used beginning in 2021.

> Sometime in January, instead of having to get wet signatures from clients, you'll be able to get a PDF of their signed Form 2848 and use that.
>
> You will also be able to upload the 2848 through an electronic portal.

A recording of a 12/10/2020 webinar on it is at Uploading Forms 2848/8821 with Electronic Signatures (webcaster4.com).

To be able to do this, you need an e-Services account, which involves significant processing time once submitted to the IRS: e-Services | Internal Revenue Service (irs.gov). So you might consider doing this …, if you don't already have one.

IRS said that using the portal speeds delivery to IRS but does not necessarily speed processing once delivered.

g. **Private Letter Ruling Fee Increase.** Revenue Procedure 2021-1, 2021-1 I.R.B. 1 (Jan. 4, 2021) covers the procedures for obtaining private letter rulings, including in Appendix A the fee schedule for letter rulings. The fee varies for various types of letter rulings, but the fee for ruling requests not otherwise listed with other specific fees has increased from $30,000 (for requests received prior to February 4, 2021) to $38,000 (for requests received after February 3, 2021), representing a 26.7% increase. The fee for extension requests under §301.9100-3 for those same periods has increased from $10,900 to $12,600. (The user fee is significantly less for taxpayers with gross income under $250,000 [$3,000 after February 3, 2021], and for taxpayers with gross income from $250,000 to $1 million [$8,500 after February 3, 2021].)

h. **Re-Emergence of Section 2704 Proposed Regulations Addressing Valuation?** Proposed regulations released August 2, 2016 changed the valuation for transfer tax purposes of interests in a family-controlled entity that are subject to restrictions on redemption or liquidation. If the owner was restricted from being able to compel liquidation or redemption within six months for what the regulations called "minimum value" (the pro rata share of the net fair market value of the assets of the entity) the restriction was to be disregarded. Furthermore, a default federal or state law restriction would be disregarded unless it was absolutely mandatory and unavoidable under federal or state law. Prop. Reg. §25.2704-2(b)(4)(ii) & -3(b)(5)(iii). Other changes were proposed limiting a broad exception in the existing regulations for the lapse of a voting or liquidation right under §2704(a). Prop. Reg. §25.2704-1(c)(1). The proposed regulations were highly controversial, resulting in various bills being introduced in Congress to block the regulations. The Trump Administration issued Executive Order 13789 on April 21, 2017, directing the identification of tax regulations issued on or after January 2016 that impose an undue financial burden on taxpayers or add undue complexity to tax laws. The Treasury identified the proposed §2704 regulations as meeting at least one of those criteria in Notice 2017-38 (dated June 22, 2017) and stated that it would withdrew the proposed regulations in a report dated October 2, 2017 (https://www.treasury.gov/press-center/press-releases/Documents/2018-03004_Tax_EO_report.pdf). The Treasury and the IRS acknowledged that the proposed regulations were unworkable.

> After reviewing these comments, Treasury and the IRS now believe that the proposed regulations' approach to the problem of artificial valuation discounts is unworkable. In particular, Treasury and the IRS currently agree with commenters that taxpayers, their advisors, the IRS, and the courts would not, as a practical matter, be able to determine the value of an entity interest based on the fanciful assumption of a world where no legal authority exists. Given that uncertainty, it is unclear whether the valuation rules of the proposed regulations would have even succeeded in curtailing artificial valuation discounts. Moreover, merely to reach the conclusion that an entity interest should be valued as if restrictions did not exist, the proposed regulations would have compelled taxpayers to master lengthy and difficult rules on family control and the rights of interest holders. The burden of compliance with the proposed regulations would have been excessive, given the uncertainty of any policy gains. Finally, the proposed regulations could have affected valuation discounts even where discount factors, such as lack of control or lack of a market, were not created artificially as a value-depressing device.

The proposed regulations were formally withdrawn, 14½ months after their issuance, on October 20, 2017. For a detailed discussion of the history of the proposed regulations, see Item 18 of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (June 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. For a summary of the proposed regulations and concerns raised by them, see Item 5 of Estate Planning Current Developments and Hot Topics (December 2016) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

Will the IRS re-open the §2704 regulation project in an effort to restrict valuation discounts under the Biden Administration? The October 2017 report recognized that the regulations' "approach to the problem of artificial valuation discounts is unworkable," but left open the door to a re-working of regulations that might in some way address valuation discounts. *See* Jonathan Curry, *A Look Ahead: Estate Planners Fear Return of 'Ghastly' Dead Regs*, TAX NOTES (Jan. 4, 2021). A regulatory approach that focuses on valuation discounts for passive assets in an entity as opposed to operating businesses would likely draw fewer attacks from the business community. In addition, valuation discounts might be addressed in legislation. The "For the 99.5 Percent Act" sponsored by Senator Sanders includes such a provision (as discussed in Item 2.n above).

7. Estate Planning for Moderately Wealthy Clients

a. **Small Percentage of Population Subject to Transfer Taxes; Paradigm Shift for Planners.** About 4,100 estate tax returns are expected to be filed for persons who died in 2020, of which only about 1,900 will be taxable, representing less than 0.1 percent of the 2.8 million people who were expected to die in 2020. Tax Policy Center's Briefing Book, Key Elements of the U.S. Tax System (May 2020).

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

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

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

b. **Important Planning Issues**

- Do not ignore the GST tax. Without proper allocation (either automatically or manually) of the GST exemption (also $10 million indexed), trusts created by clients generally will be subject to the GST tax (currently 40%) at the death of the beneficiary unless the trust assets are included in the beneficiary's gross estate. Consider allocating the increased GST exemption to previously created non-exempt trusts.
- Review formula clauses.
- Many moderately wealthy clients will want to rely on portability and leave assets at the first spouse's death either outright to the surviving spouse (and rely on disclaimers if a trust is desirable) or to a QTIP trust with a Clayton provision (which allows the most flexibility). However, a credit shelter trust approach may be appropriate for some moderately wealthy clients.
- Basis adjustment planning will be appropriate for many clients. They and their family members may not have estate tax concerns in light of the higher exclusion amounts even if trust assets are included in their estates so that the assets may qualify for a stepped-up basis at the person's death under §1014 (assuming that §1014 is not repealed).
- Including provisions to provide flexibility to accommodate changing circumstances or changing tax laws can be very helpful.
- For planning in states with state estate taxes (about a third of the states), using multiple QTIP trusts may be helpful if the state recognizes QTIP trusts that are effective for state purposes only.

c. **Further Discussion.** For further discussion of these issues, see Item 7 of Estate Planning Current Development and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

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

a. **Window of Opportunity; Anti-Clawback Regulation.** The $10 million (indexed) gift tax exclusion amount will sunset back to $5 million (inflation adjusted, say about $6.8 million) in 2026 (unless changed by Congress prior to 2026), so gifts making use of the doubled gift tax exclusion amount are available only through 2025. Future legislation may decrease the large exclusion amount even before 2026.

The anti-clawback regulation clarifies that the donor can benefit from using the increased gift exclusion amount even if the donor should die after the estate tax exclusion amount has been reduced. The anti-clawback regulation provides a special rule that allows the estate to compute its estate tax credit using the higher of the BEA [basic exclusion amount] applicable to gifts made during life or the BEA applicable on the date of death. Reg. §20.2010-1(c)(1). For a discussion of various issues regarding the anti-clawback regulation, see Item 5.a above.

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

c. **Defined Value Transfers.** Because of the substantial cushion effect of the very large gift tax exclusion amount, clients making transfers significantly less than the full exclusion amount will have much less incentive to add the complexity of defined value transfers to gift transactions. However, clients wanting to use most of the $10 million (indexed) exclusion amount are more likely will plan to consider a defined value transfer to minimize the risk of having to pay gift tax.

One possible defined value alternative is a "two-tiered Wandry arrangement." The client would make a traditional *Wandry* transfer of that number of units that is anticipated to be worth the desired transfer amount (which could either be a gift or a sale), but with a provision that if those units are finally determined for federal gift tax purposes to be worth a higher value, a note would be given for the excess amount. That approach was used in *True v. Commissioner* (Tax Court Docket Nos. 21896-16 & No. 21897-16), which cases were settled on a basis that, as reported in Tax Court filings, appears favorable for the taxpayer.

For a more detailed discussion of defined value clauses, see Item 14 of the Current Developments and Hot Topics Summary (October 2017) found here and Item 8.c. of Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts (July 2020) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

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

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

For a detailed discussion of SLATs and "non-reciprocal" SLATs, including a discussion of the §§2036 and 2038 issues and creditor issues, see Items 78 and 80 of the ACTEC 2020 Annual Meeting Musings (March 2020) found here, Item 10.i. of Estate Planning Current Developments and Hot Topics (December 2019) found here, and Item 16 of the Current Developments and Hot Topics Summary (December 2013) found here, all available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(1) **Potential Conflict of Interest Between Spouses.** 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? For discussions of planning considerations for the donor-spouse raised by the repeal of §682, see Item 25 of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. Aside from those tax issues, the client may be very unhappy with the planner if the planner has not discussed the potential for such an event following the creation of the SLAT.

(2) **Creditor Issues.** One of the toughest issues that arises with SLAT planning is the potential creditor issue under the relation-back doctrine. If the donee spouse were to predecease the donor spouse, the donee spouse could have the ability to appoint the assets into a trust of which the original donor spouse is a discretionary beneficiary.

Under the traditional "relation-back doctrine," when a power of appointment is exercised it is deemed to be exercised on behalf of the settlor, so the settlor is treated as the settlor of the recipient trust for state property law purposes. For state law purposes, the donor spouse made the original contribution to the trust. The assets are now in a trust of which donor spouse is a discretionary beneficiary. The classic rule, unless the laws of a domestic asset protection trust state apply, would be that creditors of the donor could reach the trust assets.

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).

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.

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.

f. **Gifts to "Lock In" Use of Increased Gift Exclusion.** Exercise caution before using any of the alternatives described in subparagraphs (1)-(6) below. The IRS is considering whether to adopt an anti-abuse exception to the anti-clawback regulation that would remove the effectiveness of these planning alternatives, as discussed in subparagraph (6) below.

(1) **Enhanced Grantor Retained Income Trust.** For the client that is reluctant to relinquish substantial value, but wants to make a large gift to "lock in" use of the increased gift exclusion to take advantage of the window of opportunity, consider making a gift of an asset while retaining the income from or use of the asset (in a manner that does not satisfy §2702). The asset will be included at its date of death value in the gross estate under §2036(a)(1), but the date of gift value will not also be included in the estate tax calculation as an adjusted taxable gift. §2001(b) (last sentence). The effect is that the asset has been given to someone else, the date of death asset value is included in the gross estate, but at least the date of gift value is offset by the estate tax unified credit, which is increased by the amount of exclusion applied against lifetime gifts under the anti-clawback regulation if that amount exceeds the exclusion amount available at death (for example, because of a decrease in the basic exclusion amount in 2026). The post-gift appreciation in the asset is all that is effectively subject to estate tax. For a detailed discussion of this approach, see R. Eric Viehman, *Using an Enhanced Grantor Retained Income Trust (E-GRIT) to Preserve the Basic Exclusion Amount*, STATE BAR OF TEXAS 25TH ANNUAL ADVANCED ESTATE PLANNING STRATEGIES COURSE, ch. 4.7 (April 2019).

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

The mere gift of a promissory note typically is not legally binding, but the recipient could in principle give some form of consideration (such as agreeing to visit on Mother's Day), which might cause the note to be enforceable.

If the IRS were to pass a regulatory anti-abuse rule under the anti-clawback regulation for gifts that are included in the gross estate, the gift by promise would likely not get the benefit of the anti-clawback rule because the assets that will be needed to pay the liability are still in the gross estate. A planning alternative, if that were to occur, would be for the donor to pay the promised gift amount before death. *See* Katie Lynagh, *Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion*, BNA ESTATES, GIFTS & TRUSTS J. (May 14, 2020).

(3) **Transaction That Does Not Satisfy §2701.** Another approach is making a transfer that intentionally fails to satisfy §2701. A donor would make a gift of a common interest in a partnership/LLC while retaining a preferred interest that does not meet the requirements of §2701. The effect under §2701 is that the preferred interest is treated as having a zero value (for example, because it is noncumulative). The donor would be treated under §2701 as making a gift equal to the donor's entire interest in the entity. (The donor would need to have remaining gift exemption equal to the value of the interest in the entity to avoid having to pay gift tax.) At the donor's death, the mitigation rule in Reg. §25.2701-5(a)(3) will reduce the donor's estate value by the same amount by which the gift value was increased because of the zero value rule.

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

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

(6) **Possible Anti-Abuse Exception to Anti-Clawback Regulation; New York State Bar Association Tax Section Recommendation to IRS.** Planners should be cautious in using the planning approaches described in subparagraphs (1)-(5) above as a way of making use of the increased gift exclusion amount until we know whether the IRS adopts the recommendation not to extend the anti-clawback adjustment to gifts that are included in the gross estate or to situations in which assets have been valued under Chapter 14 (reserved in the November 2019 final regulation).

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

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

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

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

> We recommend that Treasury and the Service consider proposing rules that would create exceptions to the favorable rule of the Proposed Regulations in the case of gifts that are included in the gross estate. Under this approach, if a decedent made a gift of property before 2026 and the gift is included in the gross estate,

any increased basic exclusion amount used by the gift is not preserved at death. As the gift would be purged from the estate tax computation base under Section 2001(b), there is no concern about claw back of tax. Further, the property would be subject to the estate tax lien and the decedent's executor would normally have a right to recover the share of estate taxes attributable to the property.

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

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

For an excellent discussion of planning alternatives that might be impacted by the anti-abuse rule, and planning considerations in light of the possibility of a future anti-abuse proposed regulation, see Katie Lynagh, *Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion*, BNA ESTATES, GIFTS & TRUSTS J. (May 14, 2020). For example, to guard against the possible issuance of such an anti-abuse rule, a possible planning alternative with a retained §2036 interest is to give a protector the ability to remove the grantor's retained income interest (which arguably would not be subject to the three-year rule of §2035 because the donor would not be voluntarily releasing the retained interest, *see* PLRs 9032002 & 9109033, although a regulatory anti-abuse rule could conceivably address deathbed planning).

(7) **Locking in Use of GST Exemption.** Clients might also lock in use of the "bonus GST exemption" before the GST exemption sunsets to $5 million (indexed) by making a transfer to a grantor retained income trust. The estate tax inclusion period (ETIP) during the period of the retained interest prevents the inclusion ratio from being determined during the ETIP, but does not appear to prevent GST exemption from being allocated. The GST tax regulations address the effect of allocating GST exemption prior to the end of the ETIP. Reg. §26.2632-1(c)(5) Exs. (1)-(2); §26.2642-1(b)(2)(i). However, the regulations do not specifically address the effect of a decline of the GST exemption during the ETIP. Also, if an anti-abuse rule is adopted regarding clawback of the estate and gift exclusion amount, will it also address similar alternatives making use of the GST exemption?

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

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 (see the discussion in Item 9 below regarding trust protectors).

h. **Transfers With Flexibility to "Undo" the Transfer.** While the likelihood of retroactively reducing the gift exclusion amount in 2021 is very unlikely (see Items 2.p and 2.q(2) above), the possibility of retroactive legislation exists and some planners have examined ways of making gifts that could be limited not to trigger gift tax or that could be "undone" in the event of subsequent legislation making the gift inadvisable. Alternatives are discussed in Items 10-18 below.

i. **Lifetime Gifts of Low Basis Assets; "Appreciation Hurdle."** The estate tax savings of gifts are offset by the loss of a basis step-up if the client dies no longer owning the donated property (unless §1014 should be repealed by future legislation). Be wary of making gifts of low-basis assets, particularly if the donor is in old age or near death. For a discussion of David Handler's "appreciation hurdle" chart, see Item 10.k. of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

j. **Report Transactions on Gift Tax Returns with Adequate Disclosure.** Many planners encourage clients to file gift tax returns to report gift or non-gift transactions to start the statute of limitations. Otherwise, the possibility of owing gift tax on an old transaction is always present. In order to start the statute of limitations, the return must meet the adequate disclosure requirements of Reg. §301.6501(c)-1(f).

k. **Further Discussion.** For further discussion of each of these alternatives, see Item 8 of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

9. Using Trust Protectors for Flexibility Considering Legislative Uncertainty

a. **General Description; Provides Flexibility.** Offshore trusts have historically used trust protectors, leading to growing use in the United States. A "trust protector" may be given "grantor-like" powers that can be very limited or very broad to make changes regarding the trust. The trust protector is a third party (not the settlor, trustee, or a beneficiary) who is given powers in the trust instrument designed to assist in carrying out the settlor's intent. A wide variety of powers is possible—but the powers must be specifically described and granted in the trust instrument.

A trust protector can provide flexibility to address unforeseen circumstances. One of those unforeseen circumstances might be the impact of tax law changes on the trust. For example, the Biden Greenbook proposal would treat distributions in kind from a trust as deemed realization events. If that were to be enacted, terminating distributions from a trust might be subject to huge capital gains taxes. A trust protector with broad authority to amend the trust (or with authority to amend the trust for tax-savings purposes) might amend the trust to provide that it would not terminate into separate trusts for the primary beneficiary's descendants but would continue as a single "pot trust" for all of the descendants in order to delay the capital gains tax until distributions to beneficiaries were made of in kind assets.

b. **Trust Protector Statutory Authority.** Section 808 of the Uniform Trust Code is entitled "Powers to Direct." Section 808(d) provides that "a person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interest of the beneficiaries." Comments to §808 provide that the section ratifies the "use of trust protectors and advisers." It explains that "Advisers" have been used for certain trustee functions and distinguishes trust protectors:

> "Trust protector," a term largely associated with offshore trust practice, is more recent and usually connotes the grant of greater powers, sometimes including the power to amend or terminate the trust. Subsection (c) ratifies the recent trend to grant third person such broader powers.

The Uniform Trust Code has been adopted in a majority of states; some of them adopted §808 verbatim and others made slight changes. Some states also have separate statutes governing trust advisors and trust protectors, or sometimes just trust protectors.

The authority and specific powers held by a trust protector are as described in the trust instrument, but statutes developed in various states in recent years provide clarity regarding the role or actions of trust protectors. A variety of the state directed trust statutes have language broad enough to apply to trust protectors as well. Some states have enacted statutes addressing the powers of trust protectors specifically (including, among various others, Alaska, Delaware, Idaho, Illinois, Nevada, New Hampshire, South Dakota, Tennessee, and Wyoming) that list sample powers that trust protectors could hold.

Almost all the state statutes are default statutes—providing a list of possible powers but stating specifically it is not an exclusive list. Most of the statutes make clear that trust protectors only have powers that are specifically granted in the trust instrument.

c. **Common Powers of a Trust Protector.** Trust protector powers related to the trustee may include the power to remove and replace trustees, to appoint additional trustees, to act as a tiebreaker, to provide advice or direction regarding discretionary distributions or regarding management actions, or to veto trustee decisions. Powers unrelated to the trustee include the power to change the trust situs or governing law, to terminate the trust under specified conditions, to amend the trust for any valid purpose such as to respond to changes in tax laws, or to alter the beneficial interests such as adding or removing beneficiaries.

d. **Should the Trust Protector be a Fiduciary?** Statutes sometime address whether a trust protector acts in a fiduciary capacity. Most of the statutes addressing trust protectors provide that they are considered to act as a fiduciary unless the trust instrument provides otherwise (Delaware is an example of that approach). Taking the opposite approach, the South Dakota and Alaska statutes provide that the trust protector is not a fiduciary unless the trust instrument provides otherwise. The Wyoming statute provides that trust protectors "are fiduciaries" to the extent of the powers, duties, and discretions granted to them in the trust instrument.

Considering the variety in state law regarding whether protectors act as fiduciaries, the trust instrument should specify explicitly whether the protector acts in a fiduciary capacity.

If the trust protector has the power to direct the trustee to take specified actions, the protector should act in a fiduciary capacity as to such powers.

(1) **Impact on Potential Liability of the Protector.** A protector acting as a fiduciary will be held to a higher standard than a nonfiduciary. Indeed, a third person may be less willing to agree to act as trust protector if the person acts as a fiduciary. The planner might consider the settlor's intent as to potential liability of the protector in determining whether to specify that the protector acts as a fiduciary. Settlors will typically want to minimize the risk for trust protectors.

Even if the protector acts as a fiduciary, a very broad exculpatory provision could be included (to the extent allowed under state law). But whether the exculpatory clause will actually result in protecting the fiduciary will always be subject to some degree of uncertainty.

Planners have varying views about this issue. Some would generally provide that trust protectors are not fiduciaries in order to reduce the risk to them. Others would generally provide that protectors are fiduciaries and rely on exoneration in a trust instrument to exonerate the protector from liability except in the case of willful misconduct. Some planners believe that a protector should be particularly careful with holding a fiduciary power to direct the trustee regarding investments and investment concentrations, even with broad exoneration in the trust instrument.

(2) **Standard for Protector Liability.** In any event, the trust protector's standard of liability should be clearly stated in the trust agreement to avoid uncertainty.

(3) **Power of Appointment Alternative.** As an alternative to naming a trust protector to add flexibility for revising beneficial interests, the settlor could give an individual a limited power to appoint assets to a trust with differing beneficial interests or different beneficiaries because a limited power of appointment is a personal power, not a fiduciary power.

e. **Potential Tax Attacks If Facts Reflect That Settlor Retains Tax-Sensitive Powers Indirectly Through Actions of a Trust Protector.** Long ago, the IRS tried to make a "de facto trustee" argument, treating a settlor as holding the powers of the trustee if the settlor exercised persuasive control over the trustee. Courts (including a U.S. Supreme Court case) rejected that "de facto trustee" argument. However, *SEC v. Wyly* raises concerns for estate planning advisors by treating settlors as the de facto trustee of a trust (albeit in an extreme fact situation in which the trustees always followed the settlors' directions for over a decade).

SEC v. Wyly, 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014) (Judge Scheindlin), is the determination of the "disgorgement" remedy in a securities law violation case by the billionaire Wyly brothers. The court based the amount of disgorgement largely on the amount of federal income taxes that the defendants avoided from the use of offshore trusts, after finding that the trusts were grantor trusts and that the defendants should have paid federal income taxes on all the income from those trusts. The court determined in particular that the "independent trustee" exception in §674(c) did not apply even though the trustees were various Isle of Man professional management companies. Three close associates of the Wylys (the family attorney, the family office CFO, and the CFO of one of the Wyly entities) were trust protectors who had the power to replace the trustees. Throughout the trust administration, the Wylys expressed their requests to the trust protectors, who relayed them to the trustees, who always complied.

There is a growing trend toward naming trust protectors with very broad powers, including the broad ability to amend trusts, change beneficial interests, veto or direct distributions, modify powers of appointment, change trustees, or terminate the trust—all in the name of providing flexibility to address changing circumstances, particularly for long-term trusts. The *Wyly* case points out how that could backfire if a pattern of "string-pulling" by the settlor occurs in practice with respect to the exercise of those very broad powers. Planners will not stop using trust protectors in the future because of *Wyly* but should be aware of potential tax risks that can arise if the broad trust protector powers are abused by overbearing settlors.

f. **Structuring and Drafting Considerations.**

(1) Use a trust protector only if necessary or desirable for particular purposes.

(2) Never rely on state law but spell out in detail what powers are included. Do not just adopt a list of powers that may be included in a state statute because some of those powers are likely not appropriate for a particular situation.

(3) Make clear in the trust instrument whether the trust protector acts in a fiduciary capacity.

(4) Clearly and specifically describe the powers, duties, and compensation of the protector.

- State whether the protector has a duty to monitor the trust situation continually or whether the protector is just in a stand-by mode until requested to act or until some event described in the instrument occurs.
- If the protector has a duty to monitor, provide that the protector has the right to receive information from the trustee that is appropriate to the monitoring function.
- Provide for compensation appropriate to the protector's functions.
- Provide for appropriate exoneration of the trustee, the protector, or both with respect to actions taken or not taken by the protector.
- Describe the manner in which the protector's powers are exercised. For example, if a protector has the power to remove and replace trustees, clarify whether the protector must monitor the trustee's performance or just exercise its discretion when requested by a beneficiary.
- Provide that the protector has standing to enforce its powers in a court action.

(5) Do not mandate that the protector exercise its power (unless that is the settlor's intent) but provide that the protector may exercise its powers in its sole and absolute discretion and that its decisions will be binding on all persons.

(6) Specify the duty and liability of the protectors—for example that there is no liability absent bad faith or willful misconduct. In providing for the protection of the protector, specify who will pay the protector's attorney fees if the protector is sued.

(7) Clarify whether the protector has the right to receive information from the trustee and what information is intended.

(8) Make clear that the term "protector" is just the name given to the person and that the protector does not have the function of "protecting" the trust generally.

g. **Further Resources.** See Item 3.h.(8)-(11) of the Current Developments and Hot Topics Summary (November 2017) found here, Item 3.j.(13) of the Estate Planning Current Developments Summary (December 2018) found here, and Items 34-47 of ACTEC 2021 Annual Meeting Musings (May 2021) found here, all available at www.bessemertrust.com/for-professional-partners/advisor-insights for a more detailed discussion of powers and limitations that can be added for trust protectors to provide flexibility.

Items 10-18 Discuss Transfer Planning Alternatives to Minimize Risk of Gift Taxes Due to Retroactive Gift Tax Legislation.

10. 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 as 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 was no discussion in *Procter* 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 2021-2420 (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." For a discussion of *TOT Property Holdings* and other similar conservation easement cases, see Item 40 below.

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. **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.

11. 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 200314012). 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 11.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 11.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 11.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 11.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 11.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 11.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, a spouse 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.'").

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 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 an ascertainable standard. *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.) 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 11.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 (unless an adverse party must approve the distribution to the spouse). §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, and 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.

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 11.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. For a discussion of possible distinctions to avoid the reciprocal trust doctrine, see Item 25.c. of Transfer Planning in 2021, Including Transfers in Anticipation of Possible Retroactive Transfer Tax Legislation (April 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

12. 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. **Gift 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. See Item 19.f(2) below for a discussion of the claim of right doctrine. 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, some planners recommend 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 11.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 11 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).

13. 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.

14. 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, 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 the appreciation can be in a GST exempt format. Almost all 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 later, 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).

15. 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.

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 15.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.

16. 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.)

17. 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.

18. 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.

19. Fixing Mistakes; Retroactive Revisions and Reversals

The following discussion is a summary of comments by Carol Harrington (Chicago, Illinois). This is a summary of her outstanding paper (which, of course, includes authorities to support the conclusions in the summary).

a. **Significance; Situations in Which "Fixes" May be Desirable.** Actions that someone might want to reverse at a later time include irrevocable trusts, gifts, transfers by deed or assignment, notes, trustee distributions, and tax returns and tax elections. The reasons for needing a fix may be the result of mistakes by the client or advisor (such as scrivener's error or mistakes about underlying facts or law), trustee mistakes (such as improper distributions or sales), changed circumstances, tax mistakes (such as missed elections, failure to qualify for a deduction or other favorable treatment, or mistake about the donor's remaining gift exclusion), or wrongful conduct (such as fiduciary breaches, undue influence, or fraud).

   Analysis of a fix involves whether it is recognized for state law purposes and, separately, whether it will be respected for tax purposes as a retroactive revision. Many actions can be changed by agreement of the parties for state law purposes, but those changes would typically just operate prospectively. Revisions that are recognized under property law concepts may be given retroactive effect for state law purposes and the retroactive effect *may* also be respected for tax purposes.

b. **Property Law Remedies and Grounds for Reversal.**

   (1) ***Bosch* Doctrine.** Remedies vary state to state, and the IRS generally does not respect an outcome not authorized by state law. A state court decision is not necessarily binding on the IRS for federal tax purposes. The federal government is not bound to give effect to a state court decision to which it is not a party unless it is a decision of the highest state court, but the government must give "proper regard" to rulings of other courts of the state. *Estate of Bosch v. Commissioner*, 387 U.S. 456 (1967).

   (2) **Rescission.** Rescission is an action that reverses an agreement or other action and restores the parties to their original positions. Grounds for rescission may be negotiated in the initial contract or agreement and can result from an agreement of the parties after the fact. Also, a person may unilaterally rescind transactions under certain circumstances such as fraud, misrepresentation, mutual mistake, or in some states, unilateral mistake.

   (3) **Reformation.** Reformation conforms a document to reflect the parties' true intentions. Reformation traditionally was a remedy for a *mutual* mistake of fact (not law), but in many states, now any mistake can be a ground for reformation. UNIF. TRUST CODE §415 (reformation allowed if settlor's intent and trust terms were affected by a mistake of fact or law if proved by clear and

convincing evidence). Typical grounds are scrivener's error, mistake of law, or changed circumstances.

Reformation to conform instruments to the original intent of the parties is retroactive to the date of execution. But a reformation for changed circumstances is generally prospective.

Gifts are unilateral actions so a mistake regarding a gift would necessarily be unilateral, and a unilateral mistake is typically a ground for reformation. However, proving the mistake by clear and convincing evidence may be difficult.

Some cases (though not all) have allowed reformations to avoid a bad tax result.

(4) **Constructive Trust; Disgorgement.** Constructive trust or disgorgement of unjust enrichment may have the effect of restoring the wronged person to her original status. They may be a remedy for wrongdoing but may also be remedies for mistake or other situations when one party is treated as holding property for someone else.

(5) **Defenses to Restitution.** The most common defense to restitution is that an innocent party has so changed its position that restitution of the entire amount is inequitable. The defense is not available to wrongdoers.

c. **Trustee Errors and Breach of Trust.** Remedies for trustee errors or breach of trust include money damages, voiding the improper act of the trustee, or applying a constructive trust.

(1) **Distribution Errors.** Distribution errors may be corrected through adjusting subsequent distributions in some circumstances. If that is not possible, the trustee can recover the amounts incorrectly distributed (but defenses may apply based on changed position that would make returning the entire amount of the improper distribution inequitable).

(2) **Wrongful Sale.** A constructive trust is the usual remedy for a wrongful sale, but a bona fide purchaser for value may not be subject to that remedy.

(3) **Wrongful Conduct.** Wrongful conduct can arise from invalid agreements (for example, due to lack of capacity, breach of a confidential relationship, or a violation of public policy) or from fraud, misrepresentation, theft or other improper conduct. In these circumstances, the wrongful party may not be able to restore the property and legal remedies may be inadequate.

d. **Methods for Obtaining Remedies.** Methods of obtaining one of the various remedies include

(1) court action (which carries more weight despite the *Bosch* doctrine but is public, expensive, and unpredictable),

(2) non-judicial settlement agreement (depending on state law and the availability of virtual representation if no conflict exists avoids the appointment of guardians ad litem),

(3) disclaimer (which is a recognized property law measure and, unlike a release, generally relates back to the creation of the interest),

(4) agreements by friendly parties (but the agreement may not avoid bad tax consequences if no property rights to reverse the transaction exist; this could include correcting clear mistakes by amending the original agreement to reflect the mistake but make clear that the revised agreement is a restatement rather than the original).

Another possible approach is to **backdate** documents in an attempt to give an action retroactive effect. However, if there is no disclosure that the intent is that the parties will merely treat the agreement as retroactive, backdating documents may be misleading or fraudulent. The backdated document should make clear that it memorializes an actual prior agreement. Some cases have held that the use of "as of" language in the date constituted disclosure of the backdating. Proving the terms of the prior agreement may be difficult, however, without contemporaneous written evidence. Backdating that avoids tax effects or that affects another third party can be a criminal act.

e. **Transfer Tax Effects.**

(1) **Disclaimers.** The tax effects of disclaimers are governed by §2518; the disclaimant is treated as never having received the interest, so the effect of a disclaimer is retroactive to the date of the original transfer. It has a hard deadline of nine months from the date creating the interest, but a "big loophole" is that a person under age 21 has until nine months after reaching age 21 to disclaim. State law may recognize disclaimers by an executor or guardian or behalf of a decedent or minor. If the instrument does not dictate what happens in the event of a disclaimer, consider the effect of any "anti-lapse" statutes.

Examples of where a disclaimer could be useful include gifts that dramatically depreciate within nine months after the gift, donor remorse (together with a cooperative donee), repairing gifts that do not qualify for a marital or charitable deduction, and an unexpected death shortly after the gift (a disclaimer could result in causing the predeceased ancestor exception to the GST tax to apply to avoid a taxable termination from a testamentary transfer or a direct skip from a gift, Treas. Reg. §26.2651-1(a)(2)(iii).

The income tax effects of disclaimers are not addressed in §2518. Income should not be recognized by the disclaimant if the disclaimer occurs in the same taxable year as the transfer, but if it occurs in a subsequent year, the disclaimant may have to recognize income for the period prior to the disclaimer (and possibly could use the "claim of right" doctrine to deduct that amount in the subsequent year when the disclaimer is made). To avoid that income tax uncertainty, the best practice is to disclaim in the same taxable year in which the gift is made. For a good resource about the income tax effects of disclaimers, see Cline, 848-3rd T.M., Disclaimers—Federal Estate, Gift and Generation-Skipping Transfer Tax Considerations, IV, L. See Item 19.f(2) below regarding the claim of right doctrine.

(2) **Agreement of Parties.** The agreement of unrelated parties to modify transactions probably has no transfer tax consequences because the gift tax does not apply to ordinary business transactions, but gift tax consequences may arise for agreements among family members that do not reflect enforceable rights.

(3) **Reformation for Scrivener's Error.** For transfer tax purposes, cases and PLRs generally have respected retroactive reformations to correct a scrivener's error.

(4) **Reformation for Other Mistakes.** Cases have not consistently respected retroactive reformations to correct other mistakes for transfer tax purposes, but various private letter rulings have respected the retroactive effect of reformations where the instrument is reformed to conform to the settlor's original intent (even if the mistake is not a scrivener's error). See Item 15.e-g above for a summary of several cases dealing with a reformation resulting from a mistake of law as a result of a retroactive tax law change.

f. **Income Tax Effects.**

(1) **Rescission "Same Year" Doctrine.** A rescission in the same taxable year results in ignoring the transaction for income tax purposes, even if the rescission has no underlying legal basis. *See* Rev. Rul. 80-58. The rationale for this doctrine is the "annual accounting concept" "that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. " *Id.* A rescission in the subsequent year is treated as a separate independent transaction. The IRS announced in 2021 that it is studying issues with rescissions and since that time the IRS currently has had a no-rule policy about whether a completed transaction may be rescinded for federal income tax purposes.

(2) **Claim of Right Doctrine.** A taxpayer who receives income under a "claim of right" must recognize the income as taxable income in that year even if the validity of the claim is disputed and even if the taxpayer must repay the income in later year if three conditions exist: (1) the taxpayer receives the income (2) under a claim of right and (3) no restrictions exist on the taxpayer's economic use of the income. This concept applies even if the transaction is later determined to be void ab initio.

Even if the disputed income is eventually returned, the taxpayer cannot claim a refund for the year of receipt even if the statute of limitations is still open for that year, but generally will be entitled to a deduction in the year of repayment. *See generally* Maule, 502-4th T.M., Gross Income: Tax Benefit, Claim of Right and Assignment of Income.

Section 1341 provides that if

(1) an item of income was included in a prior year because the taxpayer appeared to have had an unrestricted right (the claim of right doctrine),

(2) after the close of the prior year it was established that the taxpayer did not have an unrestricted right to the income, and

(3) the amount of the repayment exceeds $3,000, then

the tax liability for the year of repayment is the lesser of (a) the tax computed after deducting the repayment and (b) a hypothetical tax for the repayment year, computed without a deduction, less the decrease in tax that would have resulted for the earlier year if the repaid amount had been excluded from the prior year's gross income. The taxpayer does not receive interest on the "overpaid" tax amount from the original year of receipt.

No deduction is allowed under §1341, however, if the repayment is voluntary (to avoid reversing a receipt of income that is not based on enforceable property law rights).

The IRS regularly objects to relief under §1341 and the cases have been very fact specific.

(3) **Tax Benefit Rule.** A taxpayer must include in income in a current year any previously deducted amount that otherwise produced a tax benefit in a prior year that is recovered in the current year, whether or not the prior year is closed for limitations purposes. The inclusion in the current year is not required, though, if the deduction in the prior year produced no tax benefit. §111. The taxpayer does not have the choice to amend a prior open year to eliminate the benefit of the earlier deduction but must recognize the income in the year received.

Letter Ruling 9236003 in effect concluded that there is no estate tax analogy to the income tax benefit rule (though without using that term). In that ruling an estate tax charitable deduction was allowed for a restricted gift to a university. Eventually the university had to refund the gift for failure to satisfy the restrictions. The executor initially reported the amount that had been allowed as an estate tax charitable deduction on the estate's income tax return for the year that the gift was returned. Several years later the estate filed for a refund of the additional income taxes paid because "there was no support for including the value of the property in the estate's gross income following the transfer from the university." The IRS agreed that the amount is not required to be included in gross income for the year the property was returned. It reasoned that the regulations under §2055 allow an estate tax charitable as long as any conditions that would defeat the charitable transfer are "so remote as to be negligible." The amount returned to the estate for ultimate disposition to the beneficiaries under the will are treated as a devise under §102 and are excluded from gross income.

g. **9100 Relief for Mixed Tax Elections.** Regulations §§301.9100-1 through 301.9100-3 provide procedures for obtaining extensions to make certain elections and applications for relief. "9100 relief" is not in the Internal Revenue Code. It is a creature of IRS regulations. The number 9100 was selected because it was a number so far beyond any Code provisions that it would be a safe number to use for the regulation that would not be confused with regulations for any Code section.

(1) **Automatic Relief under Reg. §301.9100-2.** Reg. §301.9100-2(a) provides an automatic 12-month extension from the extended due date of a return on which an election was required for certain specifically identified regulatory elections, including the §754 election and the election for special use valuation, if the examination of the estate tax return has not commenced.

Reg. §301.9100-2(b) grants an automatic extension of 6 months from the due date of the return, *excluding* extensions, for making regulatory *or statutory* elections having deadlines prescribed as the due date of the return or the due date of the return including extensions, but not including elections that by their terms must be made by the due date of the return, excluding extensions. To qualify for the automatic 6-month extension, the taxpayer must have timely filed the return and taken the corrective action prescribed in the regulation within the 6-month extension period. The 6-month extension apparently is available for a late inter vivos QTIP election, which the IRS views as having a statutory deadline. If the donor filed a timely gift tax return, the donor would have until October 15 of the year following the year in which the gift was made to file an amended Form 709 to make the corrective action for the automatic 6-month extension.

(2) **Non-Automatic Extensions for Relief, Reg. §301.9100-3.** Reg. §301.9100-3 authorizes non-automatic extensions if (1) the taxpayer acted reasonably and in good faith (request relief before the IRS discovers the failure or show the taxpayer relied on a qualified tax professional who failed to make or to advise the taxpayer to make the election), and (2) granting relief will not prejudice the interests of the government. Reg. §301.9100-3(a). (Prejudicing the interests of the government refers to putting the taxpayer in a better position than if the taxpayer had made the election timely.) The specific procedures under Reg. §301.9100-3 are the exclusive method of obtaining an extension of time to make an election that does not qualify for automatic extensions under Reg. §301.9100-2. Relief is not available for any election the time for which is prescribed by statute.

Some examples are (1) QTIP elections for estate tax purposes (but not for gift tax purposes because the QTIP election deadline for a lifetime gift is set by statute), (2) reverse QTIP elections for GST tax purposes, (3) splitting trusts for GST tax purposes as of the date of death but after the due date has passed for filing Form 706, (4) allocations of GST exemption (considering all relevant circumstances including evidence of intent to be exempt from the GST tax in the trust instrument), and (5) portability elections if the estate was not required to file Form 706.

9100 relief cannot be used to "unmake" an election, such as unmaking an election in or out of automatic allocation of GST exemption or revoking an actual allocation of GST exemption. Carol Harrington and Julie Kwon believe that an election out of automatic allocation of GST exemption should not preclude relief to affirmatively allocate GST exemption late as if made timely. (A taxpayer can always allocate GST exemption to a trust that is not a "GST trust," which is what the election out of automatic allocation makes the trust.) Because of this position of the IRS, if the return preparer does not know what GST exemption allocation election to make, the safest approach (other than actually finding out what to do) is to make no election. At least in that case, 9100 relief could be granted if other requirements for relief exist.

Fees for 9100 relief private letter rulings for requests filed after February 3, 2021 range from $3,000 to $12,600 depending on the level of gross income of the requesting taxpayer. Rev. Proc. 2021-1, Appendix A.

(3) **Resource.** For further discussion about the details of 9100 relief, see Items 14-22 of ACTEC 2018 Annual Meeting Musings (March 2018) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights).

h. **Amended Returns.** If a return is filed before its due date or extended due date, the taxpayer can file an amended return before the due date, and it will be the "return" for all purposes. Rev. Rul. 83-36. But the IRS can treat an amended return filed after the due date as a return or as something else, in its discretion. Amended returns filed after the due date often have no effect. Even if an amended return is accepted, the original return generally determines the date of filing for limitations purposes.

A special exception exists to recognize an amended return filed to make adequate disclosure of a previously undisclosed or inadequately disclosed gift. *See* Rev. Proc. 2000-34.

i. **Late Elections.** Late elections may sometimes qualify retroactively to the date of transfer if made on the first return filed (such as the split gift election and the QTIP election for a testamentary transfer).

j. **Liability Issues in Connection With Fixing Mistakes.** A planner who makes a mistake should get independent help in fixing the mistake for various reasons (impaired judgment by guilt or fear, conflict of interest, failure to fully inform client of risks and options, and actions taken may look bad even if motives are good).

In assisting to correct the mistakes of others, advise the client of malpractice claim deadlines, which vary from state to state. Damages can be speculative and hard to prove, so fixing the problem is usually better than trying to enforce a claim. Best practices include (1) give advice in writing, (2) recommend that the client consult a malpractice expert, and (3) immediately seek a tolling agreement with the professional involved.

20. Tax Effects of Settlements and Modifications; Early Termination of Trust; Commutation of Spouse's Interest in QTIP Trust

The tax effects of court modifications, other trust modifications, decanting, and settlements are summarized in Items 42-51 of the ACTEC 2015 Annual Meeting Musings (April 2015) summary found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. Item 15 above addresses the tax effects of rescission actions and Item 19 above addresses various ways for making retroactive revisions and reversals, including rescissions and reformations. This Item includes several brief miscellaneous comments.

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

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

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

b. **Revenue Ruling 73-142—Pre-Transaction Actions Can Avoid *Bosch* Analysis.** In Rev. Rul. 73-142, a settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The settlor obtained a local court construction that the settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the settlor removed the trustee and appointed another, so the settlor no longer had the removal power.

   In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred before the taxing event, which would have been the settlor's death. The IRS agreed that it was bound by the court's ruling as well, **"regardless of how erroneous the court's application of the state law may have been."**

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

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

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

d. **Income Tax Consequences of Early Termination of Trusts.** Letter Rulings 201932001-201932010 ruled that the early termination of a trust (under a nonjudicial settlement agreement with court approval), with all of the beneficiaries being paid the actuarial value of their interests in the trust, had very significant income tax consequences. That is contrasted with the fact that trust distributions, even at the normal termination of a trust, are not typically treated as sale or exchange events. The remainder beneficiaries in the 2019 PLRs were treated as having purchased the interests of the life beneficiary and the contingent remainder beneficiaries (and the life beneficiary had a zero basis in his interest under the uniform basis rules of §1001(e) so the total amount paid to the life beneficiary was capital gain). The remainder beneficiaries, as the deemed purchasers, do not pay tax on amounts **received** in the commutation (as the fictional purchasers, they are just receiving what is left in the trust after they have bought out everyone else), but they "realize gain or loss on the property exchanged." So they recognize gain on the assets **paid out** to others less the amount of their uniform basis attributable to those assets. Massive income taxation can result, which could be totally avoided by not terminating the trust early.

Various commutation PLRs have reached similar results, and some case law supports the rationale, including *Cottage Savings Association v. Commissioner*, 499 U.S. 554, 559 (1991) (exchange of participation interests in a group of mortgages for participation interests in another group of mortgages constituted an exchange of property for other property differing materially either in kind or in extent and therefore loss on the exchange could be recognized). *Cf.* Letter Ruling 202047005 (gift of annuity interest in charitable remainder trust to the private foundation remainder beneficiary resulted in termination of the trust, but was treated as a charitable gift rather than as a sale or exchange of a capital asset that would have resulted in taxable income to the taxpayer).

For a detailed discussion of planning implications of these rulings, see Item 16 of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. See also *id.* Item 15.h., which states:

e. **Commutation of Spouse's Interest in QTIP Trusts With Charitable Trust as Remainder Beneficiary, PLR 202016002.** The commutation of a spouse's qualifying income interest in a QTIP trust in return for the actuarial value of the income interest not only has potential income tax effects, as discussed immediately above, but also is treated as a transfer under §2519 of all interests in the trust other than the qualifying income interest. Letter Ruling 202016002 addresses the tax effects of a settlement agreement terminating QTIP trusts by paying to the spouse-beneficiary the actuarial value of her income interest and distributing the remaining assets to the charitable trust that is the remainder beneficiary of the QTIP trust. The transfer of the qualifying income interest itself is subject to potential treatment as a gift under §2511, but the transfer is not a gift if the spouse receives the present value of the qualifying income interest. The transfer of the remaining assets to the remainderman is a gift by the spouse under §2519, but the spouse is entitled to a gift tax charitable deduction where the assets pass to a charitable trust.

f. **Commutation of Spouse's Interest in QTIP Trusts With Individuals as Remaindermen, CCA 202118008.** Chief Counsel Advice 202118008 also involves the commutation of a QTIP trust, but with individuals as remaindermen rather than a charitable trust (so the deemed gift of the remainder interest under §2519 could not be offset by the gift tax charitable deduction). The CCA is an excellent illustration of the difficulty and complexity of planning with QTIP interests. The spouse-beneficiary ("Spouse") held a testamentary limited power of appointment. The Spouse, and the children as remaindermen ("Children") and a virtual representative of the contingent remaindermen entered into an agreement to have all of the property distributed to the Spouse. On the same day, the Spouse transferred the trust assets to trusts for the Children and their descendants, partly as a gift and partly as a sale in return for a promissory note (the "Gift/Sale Transactions"). The CCA addressed various issues.

(1) **Transaction Viewed as Commutation.** The transaction is viewed as a commutation (though the CCA acknowledged that a commutation is typically the distribution of trust assets to all holders of beneficial interests equal to the actuarial value of their interests). The commutation "constitutes

a disposition by Spouse of Spouse's qualifying income interest within the meaning of §2519" and therefore as a "gift of all interests in Trust 1 other than the qualifying income interest."

(2) **Children Treated as Making Gifts to Spouse of Remainder Interest.** The Children were also treated as making gifts to the Spouse of their interests as remaindermen. The Children argued that they should not be treated as making a gift but that the transaction was a reciprocal exchange for consideration. The IRS disagreed, reasoning that the Spouse was treated as not receiving any consideration for the deemed transfer to the children, because transferring all of the QTIP assets to the Spouse did not augment the Spouse's estate beyond the amount that would be included in the gross estate under §2044 if the transaction had not occurred. But the fact that the Spouse was treated as receiving no consideration did not nullify the Children's transfers of their remainder interests. The IRS viewed the transaction as a two-step process. First, "the remainder interest vested outright, equally, in Children, the then remaindermen." Second, "Children then transferred their valuable property interest to Spouse and received nothing in exchange." (Thus, the Children were treated as making a gift of their remainder interests even though the Spouse held a testamentary power of appointment and the Children were not assured of receiving anything. Apparently, the IRS got around that hurdle by reasoning that the transaction was viewed as first "vesting" the remainder interest in the Children.) The IRS looked to Revenue Ruling 98-8 and *Kite II* as supporting its position that the deemed transfer of the remainder interest by Spouse to the Children and the deemed transfer of trust property from the Children to the Spouse do not offset each other.

(a) **Revenue Ruling 98-8 Analysis.** The CCA's conclusion that Rev. Rul. 98-8 supports its conclusion that the two deemed transfers do not offset each other is off base. Rev. Rul. 98-8 merely addresses an indirect commutation of a QTIP trust. (The factual scenario considered in Rev. Rul. 98-8 was (i) the purchase of the remainder interest by the spouse for a note, (ii) the distribution of all trust assets to the surviving spouse, followed by (iii) the spouse paying off the note with a portion of the trust assets. The net result was that the spouse ended up with assets equal to the value of the income interest.) The key result of the transaction considered in Rev. Rul. 98-8 was that the value of the remainder interest was not owned by the spouse and was no longer in a QTIP trust subject to taxation at the spouse's subsequent death under §2044. Therefore, the remainder value would **escape** gift and estate taxation. That is not the case under the facts of the CCA – the Spouse utilized unified credit and received a promissory note that will be included in the Spouse's gross estate.

(b) **IRS Reasoning That *Kite II* Supported Its Conclusion.** The IRS also argued that the *Kite* case supported its conclusion. The Rule 155 order in *Kite* (sometimes referred to as *Kite II*) concluded that the spouse in that case was treated as making a gift of the entire remainder interest value even though the spouse received an annuity interest having an actuarial value equal to the value of the remainder interest. No. 6772-08 (T.C. Oct. 25, 2013) (order and decision under Tax Court Rule 155). (The *Kite* decision on which the Rule 155 Order was based is T.C. Memo. 2013-43, sometimes referred to as *Kite I*.) The CCA reasoned that under the *Kite* analysis, the QTIP statutory scheme and legislative history support the view that

> the separate transfers by Spouse and Children cannot be offset by consideration for gift tax purposes.
>
> …
>
> Eliminating the taxable transfer by Spouse based on a deemed reciprocal gift transfer by the remaindermen would allow the value of the remainder of Trust 1 to escape transfer tax under both §§ 2519 and 2044, which would be contrary to the **QTIP statutory scheme** and **legislative history**. (emphasis added; emphasized words are addressed below)

(c) **Strong Criticism of *Kite II* Reasoning.** The conclusion in *Kite II* that the amount of the *gift* resulting from the deemed *transfer* of the remainder interest was not offset by any payments made to the spouse has been strongly criticized. *See Recent Developments*, 48th ANN. HECKERLING INST. ON EST. PL. (2014) (Ronald Aucutt ed.). Most planners and commentators had believed following *Kite I* that a zero gift would result from the deemed transfer of the remainder interest in light of the court's determination that the wife received full value (an annuity) when she transferred the assets of the QTIP trust. *See e.g.,* Jeffrey Pennell, *Jeff Pennell on Estate of Kite: Will It Fly?* LEIMBERG EST. PL. EMAIL NEWSLETTER, Archive Message #2062 (February 11, 2013).

(d) QTIP Statutory Scheme. The CCA's reasoning that the "QTIP statutory scheme" supports its conclusion is quite ironic. The CCA correctly observes that the purpose of the marital deduction is merely to defer the transfer tax until a subsequent lifetime transfer or the death of the donee-spouse. But in this case the Spouse received back assets (the promissory note), directly owned by the Spouse, and made use of the Spouse's unified credit amount with a combined value equal to the full value of assets that had been in the QTIP trust. Those assets would later be subject to gift or estate tax (or already made use of unified credit amount). The policy and intent of the marital deduction seems to support (indeed to require) that replenishment of the value to the surviving spouse must be considered in determining the amount of gift that is made under §2519. Otherwise, as discussed immediately below, there is a double inclusion of assets subject to the gift and estate tax.

(e) Double Inclusion. The CCA does not address the distinct possibility of taxing the same value twice as a result of its conclusion—once as a gift equal to the value of the deemed transfer of the remainder interest under §2519 and the second time at the spouse's death when the assets that the spouse received as consideration are subject to estate tax and when the spouse made use of unified credit in making a gift of assets to trusts for descendants in the combined Gift/Sale Transaction. The CCA interprets §2519 as resulting in a taxable gift of the full actuarial value of the remainder interest, even though that value is replenished in the wife's direct ownership of assets (or utilization of unified credit).

Would the double inclusion would be avoided by the provision in §2001(b) that any gifts that are also included in the decedent's gross estate will not be added back into the estate tax calculation as adjusted taxable gifts. Apparently not under the CCA's reasoning that the Spouse did not merely make a deemed gift and retain the remainder interest, but the spouse received back assets as the result of an independent gift from the Children.

(f) Legislative History. The CCA reasons that the legislative history to §2519 makes clear that an unlimited deduction is allowed under §2056(b)(7) for QTIP property and

> §§ 2044 and 2519 were added to ensure that the transfer tax deferred by § 2056(b)(7) becomes subject to tax, either on the surviving spouse's death or after a lifetime disposition of spouse's qualifying income interest. *See* H. REP. NO. 97-201, at 161-62.

That legislative history would be satisfied by the inclusion of the promissory note in Spouse's estate and the utilization of Spouse's unified credit, both resulting from the Gift/Sale Transaction. The estate tax on the value in the original decedent's estate was deferred at the decedent's death and will be subject to the transfer tax by the Spouse.

(g) Comparison to Outright Transfer to Spouse. Observe the dramatically different result under this reasoning than if the original transfer had been made outright to the Spouse instead of into a QTIP trust for the Spouse. In that case, the estate tax otherwise payable at the first spouse's death would have still have been deferred, but the Spouse could have made the gifts and sales of those interests to trusts for the descendants without any interim deemed gift from the Spouse to Children and an immediate return gift from Children to Spouse. What is the policy reason behind treating outright transfers to spouses and QTIP transfers so radically differently? In any event, this difference illustrates the wisdom of including liberal distribution standards in QTIP trusts for future planning flexibility. If the trustee simply transfers all the assets to the spouse, that is merely a distribution from the QTIP and is not a deemed transfer of the remainder interest under §2519, at least if the spouse does not make an immediate transfer of those assets in an integrated transaction. *Cf*. Reg. §25.2519-1(e) (the exercise of a power to appoint QTIP property "to the donee spouse is not treated as a disposition under section 2519, even though the donee spouse subsequently disposes of the appointed property").

(3) **Value of Spouse's Gift Is Full Actuarial Value of Remainder Interest.** The value of the Spouse's gift of the remainder interest under §2519 is the full actuarial value of the remainder interest, because [without citing any authority] possible "[d]iscretionary principal distributions and the testamentary limited power of appointment are not taken into account."

In its discussion of the value of the Spouse's gift, the CCA does not directly address why the gift amount is not reduced by the value of the promissory notes received and the use of the Spouse's unified credit amount in the Gift/Sale Transaction when the Spouse gave and sold assets to the trusts for descendants. But in its "reciprocal exchange analysis, the CCA quoted *Kite II* for its conclusion that the gift by the spouse is the full value of the remainder interest, not reduced by the consideration received when spouse transferred the remainder interest. In *Kite I*, the court treated the distribution of assets to the spouse (not authorized in the trust instrument) and the sale of the remainder interest in return for an annuity as an integrated transaction that triggered §2519. As discussed above, the result of not allowing a reduction in the amount of the deemed gift under §2519 is that the value of the remainder interest is subject to transfer tax **twice** – first in the §2519 deemed gift of the remainder interest and second in the use of unified credit and transfer tax that will ultimately be applied on the promissory notes resulting from the Gift/Sale Transaction. For a detailed criticism of the reasoning and effect of the *Kite II* analysis see Akers, Kite v. Commissioner, Rule 155 Order and Decisions (Cause No. 6772-08, unpublished opinion October 25, 2013) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights).

(4) **Value of Gift by Children Is Full Actuarial Value of Remainder Interest.** The value of the gift by the children of the remainder interest to the Spouse (following the deemed transfer of the remainder interest from the Spouse to the Children) does take into account restrictions on the beneficial interests, but the CCA reasons that the possibility of principal invasion for the Spouse was negligible given that the annual income from the QTIP trust would have been sufficient for the Spouse's support needs. The CCA also concludes that "the testamentary limited power of appointment would be appropriately treated as having no measurable effect on the value of these interests." Why not? The CCA merely says that conclusion is "based on all the facts and circumstances" – even though the Spouse *in fact on the same day* made a transfer other than outright to the Children who were the remaindermen.

(5) **Planning For Surviving Spouses' Interests in QTIP Trusts.** Planning for surviving spouses who are beneficiaries of substantial QTIP trusts is complicated. This CCA is an example of clients entering into complicated transactions in planning with QTIP trusts. For an outstanding detailed discussion of planning alternatives for a surviving spouse who is the beneficiary of a QTIP trust, see Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 1202.3 (2010). Some of the alternatives are summarized in Item 8 of the Observations in Akers, Kite v. Commissioner, Rule 155 Order and Decisions (Cause No. 6772-08, unpublished opinion October 25, 2013) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights). Transfer planning utilizing a §2519 deemed transfer is discussed in Item 3.j.(8) of the Estate Planning Current Developments Summary (December 2018) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. *See also* 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).

21. GST Tax Planning Issues—Queries and Conundrums

The GST tax planning issues discussed below are based in large part on a presentation by Julie Kwon at the 55th Annual Heckerling Institute on Estate Planning.

a. **Split Gift Election Issues.**

(1) **Split Gift Election Applies for Gift and GST Tax Purposes (But Not For Estate Tax Purposes).** Section 2513 permits spouses to elect to treat gifts made by either spouse during the year as being made one-half by each spouse for gift tax purposes. In addition, §2652(a) provides that the split gift is treated being made one-half by each spouse for determining who is the transferor for GST tax purposes. Each spouse may either allocate or not allocate GST exemption to his or her one-half deemed part of the gift.

There is no analogous provision in the estate tax statutes, so the consenting spouse who did not actually make the gift is not treated as a grantor of the gift for purposes of applying the estate tax string statutes (§§2036, 2038, 2042). *See* Rev. Rul. 74-556 (no inclusion under §2038). That is very helpful; the consenting spouse can have powers or interests over the gifted property that would otherwise cause estate inclusion in the consenting spouse's gross estate. If the consenting spouse retains powers that would cause the gift to be incomplete if actually made by that spouse (such as a power to shift benefits to other donees), the gift is probably still treated as a completed gift by the consenting spouse, but there is no clear authority to confirm that logical result. *See* Diana Zeydel, *Gift Splitting—A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules*, 106 J. TAX'N 334 (June 2007).

(2) **SPLIT Gift Election for Gifts to a SLAT.** Under §2513, the split gift election applies to gifts to any person other than the donor's spouse; if the interest of the beneficiaries other than the spouse can be ascertained and severed from the interest of the spouse, the election is effective for the transfer to the severed interest for other beneficiaries. *See* Reg. §25.2513-1(a)(4); Rev. Rul. 56-439. To assist in structuring a SLAT so that the consenting spouse's portion can be severed (and hopefully will be de minimis), include a "HEMS" (or more restrictive) distribution standard considering the spouse's other available resources, and hopefully the other resources are substantial enough that the likelihood of having a distribution to the spouse from the trust is very remote. Another alternative is to provide that the consenting spouse is not a beneficiary at all of the trust receiving the gift, but a third party has a power of appointment broad enough to appoint assets to the spouse. In *Nelson v. Commissioner*, (discussed in Item 31 below 29 below) the IRS allowed split gift treatment for a gift to a SLAT, but the terms of the recipient trust are unknown. For a more detailed discussion of this issue, see Item 15.e. of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights).

(3) **Consenting Spouse is Transferor of a Full One-Half of the Transfer for GST Tax Purposes If *Any Part* of Gift Qualifies for Split Gift Treatment.** The GST tax regulations state that the consenting spouse "is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the electing spouse is actually deemed to have transferred under section 2513." Reg. §26.2652-1(a)(4). Various private letter rulings have taken the position that the actual donor spouse is treated as the sole transferor of the transfer if the entire transfer is ineligible for split gift treatment because the spouse's interest is not ascertainable and severable. *E.g*. PLR 201125016.

(4) **Timing of Split Gift Election.** The election to split gifts can be made on a late gift tax return if no return was filed for that year by either spouse and if a notice of deficiency for the gift tax for that year has not been sent to either spouse. §2513(b)(2). For example, if T makes a gift in 2019 of $2 million to a trust and fails to file a timely gift tax return, if GST exemption automatic allocation applies, T is treated as having allocated $2 million of GST exemption. However, if the spouses in 2021 file a late gift tax return reporting the 2019 gift in 2021 and make the split gift election, it is effective (as long as neither spouse had previously filed a 2019 gift tax return), and apparently relates back to the original 2019 transfer, so each spouse is treated as having allocated $1 million of GST exemption, rather than the actual donor-spouse being treated as allocating $2 million of GST exemption.

(5) **ETIPs and Split Gift Election.** The estate tax inclusion period (ETIP) is the period during which the value of transferred property would be included in the gross estate (other than under §2035) of the transferor or transferor's spouse if either of them died during that period. Reg. §26.2632-

1(c)(2)(i). The inclusion ratio of the trust is determined at the end of the ETIP (generally speaking, at the transferor's death or when no portion of the transfer would be included in the gross estate).

If a split gift election is made for a transfer to a trust subject to an ETIP, the ETIP applies to the entire transfer, not just one-half attributable to the donor's deemed gift. The time of termination of the ETIP is determined with respect to the actual donor whose interest caused the ETIP, even though each of the spouses can allocate GST exemption to one-half of the transfer. The split gift election does not change the actual donor for purposes of determining if an ETIP applies (and when it terminates). Stated differently, the split gift election does not create an ETIP if none exists without the election.

(6) **Consent Agreement.** If the parties anticipate that the split gift election will be made, consider having the donor's spouse contractually agree to consent to the election at the time the gift is made (in case a divorce occurs before the gift tax return is filed in which event the donor's spouse might express reluctance to consent to gift splitting).

b. **Calculation of Applicable Fraction/Inclusion Ratio.** The applicable fraction is a fraction, the numerator of which is the transferor's GST exemption allocated to the trust (or direct skip property) and the denominator of which is the value of the property transferred to the trust (subject to certain reductions). §2642(a)(2). The inclusion ratio is 1 minus the applicable fraction. The regulations state that the inclusion ratio is determined "by rounding to the nearest one-thousandth (.001)." Reg. §26.2642-1. For large trusts, rounding to the right decimal place can be significant. Do not just use a spreadsheet that calculates the ratio to many decimal points but just displays the result to the next-lowest thousandth.

c. **Late and Retroactive Allocation of GST Exemption—Death Out of Order.** A special late allocation rule applies for situations in which a death out of order occurs. An example is when the transferor creates a nonexempt trust for the benefit of a child who would receive the assets at age 30, but with assets going to the child's issue if the child dies before age 30. If the child dies before the transferor's death and before age 30 with surviving issue, that would result in an unexpected taxable termination (which could trigger payment of a 40% GST tax). Under §2632(d)(1), the transferor in such a situation (or the transferor's personal representative, if the transferor died in the same year as the child) can make a late allocation of GST exemption to previous transfers with retroactive effect. The retroactive allocation might also apply even if the non-skip person's death does not produce an immediate taxable termination (for example if the trust would last for the life of the grantor and grantor's spouse and then pass to the grantor's descendants, and a child of the grantor predeceases the grantor.) The transferor allocates GST exemption on the basis of the value of the assets one the date of the original gift, regardless of what the assets are worth at the date of the generation-skipping transfer. The allocation is effective immediately before the child's death, which can negate any GST tax due as a result of the taxable termination at the child's death. However, it would not negate any GST tax that was paid on prior generation-skipping transfers from the trust. Possibly the biggest benefit of this type of retroactive allocation is that the transferor can allocate his or her exemption amount as of the date of the generation-skipping transfer, regardless of the amount of exemption he or she had on the date of the original gift.

The retroactive allocation applies beyond just predeceasing children of a transferor. It can apply if the predeceasing person is a lineal descendant of a grandparent of the transferor or of the transferor's spouse or former spouse. In effect, it can apply to predeceasing collateral relatives as well as lineal descendants.

The retroactive allocation must be made on a timely filed gift tax return for gifts made in the year of the death of non-skip person (i.e., the child in the above example). Rapid planning may be required if a non-skip person dies late in a calendar year. The election must be made on the gift tax return by the next April 15 (or October 15 if the return is extended, but the extension only extends the date of filing, not the date for payment of any GST tax in case the election ultimately is not made).

There have been no regulations or private letter rulings under §2632(d). No guidance is available regarding the application of the retroactive exemption allocation if additional allocations or trust divisions or qualified severances have occurred. A literal interpretation of the statute suggests that the retroactive exemption allocation would be to the entire original transfer (or transfers on a chronological basis). (The retroactive allocation under §2632(d) is to transfers to "the trust" in which the predeceasing non-skip person "has an interest or future interest.") The effect of the transferor's prior allocations of GST exemption to the trust or whether the retroactive allocation can be targeted to a particular trust if the original trust has been divided into separate trusts (either by the trust terms or pursuant to a discretionary trustee power) or by a qualified severance is unknown. The purpose of the statute seems to be to provide a way to avoid the unexpected taxable termination, and requiring that the exemption be allocated to the original entire transfer to the trust (which would likely be wasted as to the interests of other children who do not predecease the termination of the trust) seems unfair. Because of the uncertainty regarding the ability to target the retroactive allocation to specific subtrusts that have been created from the original trust, consider making serial allocations, first to the targeted specific trust, and if that is not permitted describe a waterfall of allocations to the extent that exemption is still available.

A retroactive allocation may be combined with a qualified severance to optimize the benefit of the allocation. For example, assume that a trust was created in 2000 with $1,000,000 providing for discretionary distributions to the grantor's spouse, and following the deaths of the grantor and grantor's spouse, the trust would pass to the grantor's issue, per stirpes. Assume the grantor has four children and one of them dies in 2007 survived by children when the trust has a value of $2,000,000. If nothing is done, at the termination of the trust, assets will pass in part to the deceased child's children, causing GST tax from a taxable termination. A combination of (1) the retroactive allocation rule, and (2) a qualified severance can be quite helpful in this situation.

In the example, a two-step process would be used. First, allocate GST exemption under the retroactive allocation rule of §2632(d). The transferor would file a timely filed gift return for the year of the child's death (§2632(d)(2)) allocating GST exemption equal to ¼ of the original $1,000,000 gift amount, or $250,000. This would create an inclusion ratio of 75% (and the "non-taxable" portion, or the applicable fraction, would be 25%). Second, make a qualified severance under §2642(a)(3), to create a trust with $500,000 (i.e., one-fourth of the trust) for the predeceased child's family and another trust with the remaining $1,500,000 for the remaining descendants. Bottom line: Only $250,000 of exemption had to be allocated to protect a $500,000 trust (and subsequent appreciation) that will eventually pass to the predeceased child's family. (A regular late allocation may be preferable if the assets are worth less than the gift amounts when the GST exemption allocation is made; for example, this may be the case with ILITs. Also, if the original gift was a split gift, each spouse is treated as a transferor of half of the trust, and if the child predeceases just one of the parents, the retroactive allocation would only work for one-half of the trust.)

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

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

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

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

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

(2) **If the ETIP Rule Does Not Apply to GRATs, How Much GST Exemption Would Have to Be Allocated To Achieve an Inclusion Ratio of Zero?** The answer is not totally clear, but the denominator of the inclusion ratio is probably based on the full value transferred to the GRAT, not just the nominal value of the remainder interest. *See* §2642(a)(2)(B) (denominator of the applicable fraction is "the value of the property transferred to the trust"). Some planners have suggested, however, allocating GST exemption to the GRAT when it is created just in case the ETIP rule does not apply and in case allocating exemption equal to the nominal remainder value is sufficient to cause the trust to be fully exempt. For example, a formula allocation could be made of "so much as is necessary to achieve a zero inclusion ratio, but not more than the value of the remainder." In light of the uncertainty over the amount of GST exemption needed in this circumstance, if GST exemption is allocated at the creation of a GRAT, it is essential to put a cap on the amount allocated.

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

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

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

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

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

trusts). The retroactive allocation rules do not seem to help; they apply if the child unexpectedly dies "out of order."

22. Maintaining Client Confidentiality and Other Ethical Challenges While Working Remotely

This summary is based, in part, on comments by John Bergner, Jeff Chadwick, and Lauren Wolven at the 55th Annual Heckerling Institute.

a. **Ethical Issues While Working Remotely.** The American Bar Association Model Rules of Professional Conduct (the "Model Rules") have various provisions with special application for attorneys working remotely.

(1) **Rule 1.1 – Competence.** "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." A new addition to comment 8 provides that lawyers should "keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology…."

The duty of competence includes overseeing the execution of documents in a manner that they will be enforced and carry out the client's wishes. For remote witnessing, the attorney not only must make sure that the state authorizes the remote notarization but should also take additional steps such as asking who is present including those outside the range of the camera, asking questions to assure that all signers are aware of what they are doing, and making an appropriate record.

In addition, the attorney must keep up to date on changing laws and procedures and must keep current regarding technology issues.

(2) **Rule 1.3 – Diligence.** Comment 5 requires that lawyers must have a plan for their own incapacity or demise. Attorneys working from home are somewhat like sole practitioners. Make sure that staff personnel know where things are located and what is going on. Have a plan for internet outage during meetings.

(3) **Rule 1.6 – Confidentiality.** "A lawyer shall make reasonable efforts to prevent the inadvertent or unknown unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client."

Comment 18 states that Rule 1.6(c) requires lawyers to act competently to safeguard information. Furthermore, comment 18 provides that a client may require the lawyer to implement special security measures not required by Rule 1.6(c) or may give informed consent to forego security measures that would otherwise be required.

Comment 18 clarifies that "reasonable efforts" factors include sensitivity of the information, likelihood of disclosure if additional safeguards are not employed, cost of employing additional safeguards, difficulty of implementing the safeguards, and the extent to which safeguards adversely affect the lawyer's ability to represent clients (for example, because of their difficulty of use).

The attorney must know who is within earshot of a client when talking with a client in Zoom sessions. Avoid discussing sensitive information during Zoom conferences, but use a telephone for discussing those issues.

(4) **Model Rule 1.18 – Duties to Prospective Client.** Model Rule 1.18 provides that "[a] person who consults with a lawyer about the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client." While exceptions exist, an attorney generally cannot use or reveal information learned from a prospective client (Model Rule 1.18(b)) and cannot represent anyone with interests materially adverse to those of the prospective client if the information received from the prospective client could be significantly harmful to that prospective client. Model Rule 1.18(c). There is a fine line between confidential communications with a prospective client and informal communications that do not create a duty of confidentiality.

(5) **Rule 4.3 – Communicating With Unrepresented Parties.** Model Rule 4.3 requires an attorney to correct any possible misunderstanding with unrepresented persons about the lawyer's role in a matter. It also prohibits a lawyer from giving legal advice to an unpresented person "other than the advice to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonable possibility of being in conflict with the interests of [a client of the attorney]." If the attorney is representing a fiduciary and communicating with beneficiaries, the attorney should constantly remind the beneficiaries that they are not represented by the attorney. Communicating that clearly is more difficult in remote sessions.

(6) **Rule 5.1 – Supervising Subordinate Lawyers and Staff.** Supervising subordinate employees is more difficult when all are working from home. Assure that staff and any outsourcing resources are using secure communication procedures.

(7) **Rule 5.5 – Multijurisdictional Practice.** Under Rule 5.5(b) if an attorney is not admitted to practice in the state, the attorney cannot have a presence in the jurisdiction for the practice of law. What if the attorney is out of state at a vacation home and is working from that jurisdiction in representing clients in the home state, even though the attorney is not licensed in the vacation home state? This is probably not a big concern with bar associations. Rule 5.5(c) permits providing "legal services on a temporary basis" in certain cases, including situations "reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice," but some states have not adopted that subsection or have altered it. The District of Columbia Court of Appeals issued an opinion applying the temporary exception to an attorney who is in the District because of the pandemic. Several cases (in Ohio and Oregon) have applied the temporary basis exception to attorneys awaiting acceptance to the bar of a new state under a reciprocal admission arrangement between states.

b. **Engagement Letters; Communications With Non-Clients.** An attorney-client relationship should begin with a written engagement letter that clearly identifies the client (and in some situations, who is not the client) as well as the scope of the representation and other important matters.

c. **Sample Letters.** Written materials at the 55th Heckerling Institute have a number of excellent samples of letters for communicating with persons who are not clients that the attorney may have communications with, but whom the attorney does not represent. Examples include sample letters (i) about assets in a probate estate and about the administration process generally, (ii) forwarding a Receipt, Release, and Refunding Agreement at the conclusion of an estate administration, and (iii) for owners of a business where the attorney represents only the entity. There are also sample letters to a client whose legal fees are being paid by a parent and to the parent in that situation clarifying the attorney's relationship to each party. Sample letters also address disclosing potential conflicts of interest (for example in spousal joint representations, in situations where an attorney represents multiple family members, and in representing co-fiduciaries).

d. **Safeguarding Client Information.** As discussed in Item 22(3) above, Model Rule 1.6(a) requires attorneys to safeguard confidential information.

(1) **ABA Formal Opinions.** ABA Formal Opinion 11-459 states that a lawyer communicating with the client by email "ordinarily must warn the client about the risk of sending or receiving electronic communications … where there is a significant risk that a third party may gain access."

ABA Formal Opinion 477R addresses the requirement that a lawyer use reasonable efforts to prevent inadvertent or unauthorized access. It states that using unencrypted routine email generally constitutes an acceptable method of communication but is not always reasonable. It includes guidelines about reasonable efforts that should be taken with respect to technology and information security issues.

ABA Formal Opinion 480 addresses confidentiality obligations for lawyer blogging and other public commentary.

ABA Formal Opinion 483 discusses lawyers' obligations after an electronic data breach or cyberattack.

ABA Formal Opinions 11-459 and 477R both recommend informing clients about certain risks involved in electronic communications. Lawyers should consider including such a provision in engagement letters.

The general approach of the ABA opinions is that security should be balanced with practicality.

(2) Practical Tips Generally for Safeguarding Client Information.

- Appreciate the significance of the threat; information in client files is a treasure trove of sensitive information.
- Understand how client information is transmitted and stored; it is not enough to "let IT handle it."
- Understand and use reasonable electronic security measures. Potential cybersecurity threats increase dramatically with remote work. Reasonable electronic security measures include using a virtual private network (VPN) on all devices, installing a security and antivirus system for the home network, keeping the home router updated and secure (consider updating it about every five years), changing password periodically, encrypting data, and relying on dual factor authentication.
- Label confidential information.
- Train layers and assistants in technology and information security.
- Conduct due diligence on vendors providing communication technology.

e. Practical Tips for Zoom or Other Remote Meetings.

- Understand the basics of video conferencing technology and how to set up virtual meetings, including protocols to avoid "zoom bombing."
- Use up to date video conferencing software and security software.
- Clearly understand who is present in virtual meetings (including who is within hearing range).
- How secure is the conferencing platform?
- Use a password.
- Use a waiting room.
- Use a random meeting id number.
- Give the id number just to people invited to the meeting.
- All participants should have the Zoom app for Zoom calls (that is more secure).
- A recording of the Zoom meeting should be saved on the attorney's own computer and not posted to the Zoom cloud.
- Weigh the amount of security needed based on the sensitivity of the conversation (and for really sensitive issues, use a landline telephone).
- For multi-party negotiations, do not use the private chat, for fear it may not be hidden from others. Have a telephone handy for private text messages.
- Don't forget the mute button.

f. Practical Tips for Safeguarding Verbal Communications.

- When not in use, cover cameras and disable microphones.
- When working at home, be mindful of who may be within earshot of a family member that might waive the attorney-client privilege.
- Lawyer and clients should be aware of "what" might be listening ("Alexa" and her colleagues); disable self-listening devices altogether when speaking with clients.

- When appearing on video, make sure that confidential files related to other clients are not visible.
- To the extent possible avoid verbally communicating with clients in public places or using unsecured public WIFI networks.
- Stay up to date on current technology and cybersecurity developments.

g. **Practical Tips for Safeguarding Written Communications.**

- Model Rule 1.6(c) requires lawyers to use reasonable efforts to safeguard written communications from inadvertent disclosure.
- Inform clients of potential foreseeable breaches of electronic communications. For example, ABA Formal Opinion 11-459 states that if a client in an employment dispute uses her work computer for communications, the attorney should warn the client that her employer may access and review the client's email communications, resulting in loss of the attorney-client privilege. (For highly sensitive matters, the attorney might advise the client to use a standalone personal email address and not use a work or shared email address.)
- In light of the foregoing comment, consider the email address that a client is communicating from.
- Written communications are virtually impossible to delete.
- Be careful about who is copied on written communications.

h. **Safeguarding Electronic Files.**

- Electronic files are "always there."
- Electronic files are often stored in multiple places (the firm's document management system, each lawyer's individual desktop, in the "cloud," or on flash drives). Each must be safeguarded.
- When providing documents to client electronically, emphasize the importance of storing documents in a safe place.

23. Consideration of Beneficiary's Other Resources in Making Discretionary Distribution Decisions

a. **Great Variance in Default Rules.** If a trust instrument does not address whether a beneficiary's outside resources should be considered in making distribution decisions, the traditional rule has been that a beneficiary's other resources are *not* considered for support trusts, and was the position of the Restatement (Second) of Trusts:

> *e. Trust for support.* … It is a question of interpretation whether the beneficiary is entitled to support out of the trust fund even though he has other resources. The inference is that he is so entitled. It is a question of interpretation whether the trustee is authorized to pay the funeral expenses of the beneficiary. The inference is that he is so authorized. RESTATEMENT (SECOND) OF TRUSTS § 128, cmt. e (1992) (Reporter's notes cite numerous cases holding that a beneficiary is entitled to distributions irrespective of other resources as well as contrary cases).

Eleven years later, the Restatement (Third) of Trusts changed positions, stating as a default rule that a beneficiary's other resources *should* be considered:

> **Significance of beneficiary's other resources.** It is important to ascertain whether a trustee, in determining the distributions to be made to a beneficiary under an objective standard (such as a support standard), (i) is required to take account of the beneficiary's other resources, (ii) is prohibited from doing so, or (iii) is to consider the other resources but has some discretion in the matter. If the trust provisions do not address the question, the general rule of construction presumes the last of these. RESTATEMENT (THIRD) OF TRUSTS § 50, cmt. e (2003).

The Restatement (Third) also states in §60 that there should be no difference between a support trust and a discretionary trust as to this issue.

Further statements in that comment of the Restatement (Third) are somewhat schizophrenic:

> Specifically, with several qualifications (below), the presumption is that the trustee is to take the beneficiary's other resources into account in determining whether and in what amounts distributions are to be made, except insofar as, in the trustee's discretionary judgment, the settlor's intended treatment of the beneficiary or the purposes of the trust will in some respect be better accomplished by not doing so.
>
> …
>
> Another qualification is that, to the extent and for as long as the discretionary interest is intended to provide for the support, education, or health care of a beneficiary (or group of beneficiaries, Comment f) for periods during which a beneficiary probably was not expected to be self-supporting, the usual inference is that the trustee is *not* to deny or reduce payments for these purposes because of a beneficiary's personal resources. (But contrast the effect of *another's* duty to support the beneficiary, Comment e(3)).

Extensive comments and Reporter's notes to section 50 of the Restatement (Third) of Trusts make clear that states have adopted varying default rules, and trust agreements should make the settlor's intent clear as to this issue. *See* Michael J. Cenatiempo and Caroline S. Marciano, *Discretionary Trusts Primer*, TRUSTS & ESTATES, at 42 (Feb. 2008).

Cases in 2019 and 2020 in Missouri and Nevada take opposite positions regarding the issue. The Missouri court in *In re Potter Exempt Trust*, 593 S.W.3d 556 (Mo. Ct. App. 2019), interpreted a provision directing the trustee to "use and apply so much of the net income of [the trust] as they may deem necessary or advisable to or for [the beneficiary's] benefit" as creating a "need" trust. The court relied heavily on the Restatement (Third) position and concluded (somewhat inconsistently) that "the trustees have authority to examine [the beneficiary's] other financial resources in making their decision regarding what is 'necessary and advisable' … [but] broad discretion granted to the trustees does not require them to do so." In stark contrast, the Nevada Supreme Court held that a trustee was *not* required to consider other resources in light of the applicable Nevada statute and a provision in another part of the trust instrument that other income or resources should be considered for other beneficiaries. *In re Raggio Family Trust*, 460 P.3d 969 (Nev. 2020).

b. **Other Issues Even if Other Resources Should be Considered.** Once a determination is made whether outside resources should be considered under the applicable state law, various other issues arise:

- What impact should the beneficiary's other resources have on the distribution decision (for example, the trustee might be more liberal in making distributions in some situations if the trustee knows that the beneficiary will not have to rely on the trust for support, but if the beneficiary has no resources, the trustee might be more restrictive in making distributions so the trust will not be exhausted during the beneficiary's lifetime);
- Should principal as well as income resources be considered; beneficiaries generally do not have to become impoverished before distributions may be made to them, *see, e.g.*, *Keisling v. Landrum*, 218 S.W.3d 737 (Tex. App.–Fort Wort, 2007, no writ);
- What evidence of other resources should the trustee seek to document its due diligence in considering outside resources (examples include tax returns, bank and financial statements, or statements of assets prepared by the beneficiary)?

c. **Planning Pointers.**

(1) **Be Explicit.** The drafter cannot be too explicit in stating whether outside resources should be considered.

(2) **Ascertaining Settlor's Intent About Outside Resources Based on Particular Words in Distribution Standard is Unrealistic.** Determining the settlor's intent regarding outside resources from particular words used in the distribution standard ("may vs. shall," "necessary vs. appropriate") is unrealistic; as a practical matter, the wording of the distribution standard may simply be the drafter's routine drafting convention.

(3) **Flexibility.** In many situations, giving the trustee maximum flexibility in deciding whether to consider other resources and abilities will be desirable. For example, the trust agreement could provide that the trustee "may but need not" consider outside resources.

(4) **Discuss With Settlor.** This issue should not just be standard boilerplate in trusts, but the planner should always discuss the issue with the settlor. The settlor must understand that if the trust requires the trustee to consider other resources, a knowledgeable trustee *will* ask for information about income each year (perhaps asking for the beneficiary's Form 1040) and other information. This will likely be irksome to beneficiaries.

24. Planning for Non-U.S. Citizen Spouses

This summary is based on a presentation by Michelle Graham and Michael Rosen-Prinz at the 55th Annual Heckerling Institute.

a. **Marital Deduction.** The default rule is that there is no marital deduction allowed if the surviving spouse is not a U.S. citizen. However, there are some exceptions to this rule.

(1) **Qualified Domestic Trust ("QDOT").** Under §2056(d)(2)(A), if the decedent spouse's assets pass to a QDOT for the benefit of the surviving spouse, the marital deduction will be allowed.

(2) **Reformed Trust.** If the decedent spouse's assets pass to a trust for the benefit of the surviving spouse that otherwise qualifies for the marital deduction but for the provisions of §2056(d)(1)(A), such trust may be reformed after the decedent spouse's death to meet the requirements of a QDOT. Reg. §20.2056A-4(a). Such a reformation may be made pursuant to the terms of the trust agreement or a judicial proceeding. A nonjudicial reformation must be completed by the time prescribed for filing the decedent spouse's estate tax return. For purposes of determining this deadline, returns filed early are deemed to be filed on the due date for the return (including extensions), and late returns are deemed to be filed on the date actually filed. A judicial reformation must be commenced on or before the due date for the decedent spouse's estate tax return (including extensions actually granted), regardless of the date the return is actually filed. Note that the judicial reformation need not be completed by such date, only commenced.

(3) **Transfer or Assignment to QDOT.** Under §2056(d)(2)(B), property that passes from the decedent spouse to the surviving spouse outright may be treated as though it passed to a QDOT if such property is transferred or irrevocably assigned to a QDOT. Such transfer or assignment must be made "before the estate tax return is filed and on or before the last date prescribed by law that the QDOT election may be made." Reg. §20.2056A-4(b)(1).

(4) **Assets That Cannot be Transferred or Assigned.** In the event property is not transferable to a QDOT, such as certain retirement plans or annuities, the property may still be treated as passing in the form of a QDOT if certain requirements are met. Reg. §20.2056A-4(c). The following requirements must be met:

(a) The surviving spouse must agree to pay the deferred tax due on the corpus portion of each payment received on an annual basis;

(b) Form 706-QDT must be filed and tax payments must be made each April 15th following the year in which the surviving spouse receives a payment (with exceptions for the years of the decedent spouse's death and the surviving spouse's death);

(c) The decedent spouse's executor must file the Information Statement with the estate tax return; see Reg. §20.2056A-4(c)(5) for a description of the Information Statement;

(d) The decedent spouse's executor must file the Agreement to Pay Section 2056A Estate Tax with the estate tax return; see Reg. §20.2056A-4(c)(6) for a description of the Agreement; and

(e) The decedent spouse's executor must make an election under Reg. §20.2056A-3 for the property that cannot be transferred or assigned.

In the event the surviving spouse does not wish to receive the payments outright, the surviving spouse may instead agree to roll over the corpus of each payment received to a QDOT within sixty days of receipt. Reg. §20.2056A-4(c)(3).

(5) **Spouse Becomes Citizen.** Under §2056(d)(4) and Reg. §20.2056A-1(b), the marital deduction will be allowed if (i) the surviving spouse becomes a citizen before the estate tax return is filed for the decedent spouse's estate and (ii) the surviving spouse was a U.S. resident at all times after the decedent spouse's death. For purposes of determining this deadline, returns filed early are deemed to be filed on the due date for the return (including extensions), and late returns are deemed to be filed on the date actually filed.

b. **QDOT Requirements and Taxation.**

(1) **Requirements.** Several requirements must be satisfied in order for a trust to qualify as a QDOT: (1) The trust must be an "ordinary trust" as defined in Reg. §301.7701-4(a); (2) the trust must be maintained under and the administration governed by the laws of a state of the United States or the District of Columbia; (3) the trust instrument must require at least one U.S. Trustee (either individual U.S. citizen or domestic corporation); (4) the trust instrument must provide that no corpus distribution may be made unless the U.S. Trustee has the right to withhold for the QDOT tax; (5) an irrevocable election must be made by the decedent spouse's executor; and (6) the trust instrument must contain provisions to ensure collection of the QDOT tax. Reg. §20.2056A-2.

(2) **Taxation.** Under §2056A(b), a deferred estate tax is imposed upon the occurrence of a taxable event. The three main taxable events include: (1) any distribution of principal during the surviving spouse's lifetime; (2) the death of the surviving spouse; and (3) the trust ceasing to qualify as a QDOT. Reg. §20.2056A-5(b).

(3) **Distributions Not Subject to QDOT Tax.** Certain distributions can be made from the QDOT that will not be subject to the QDOT tax.

(a) **Income Distributions.** Distributions of income (as defined in §643(b), except that income does not include capital gains) to the surviving spouse are not subject to the QDOT tax. Distributions made in accordance with local law that permits a right to income to be satisfied by a unitrust amount will be considered distributions of income for these purposes if such unitrust amount meets the requirements of Reg. §1.643(b)-1. Lastly, income does not include IRD under §691, and the method specified in Reg. §20.2056A-4(c) may be used for determining the allocation between income and corpus for such annuity payments.

(b) **Hardship Distributions.** Distributions made to the surviving spouse for a substantial and immediate need relating to the health, education, maintenance, or support of the spouse or any person the spouse is legally obligated to support are not subject to the QDOT tax unless such amount could have been obtained from another reasonably available source. Reg. §20.2056A-5(c)(1).

(c) **Payment of Certain Expenses and Taxes.** Reg. §20.2056A-5(c)(3) lists certain miscellaneous dispositions of trust assets that are exempt from the QDOT tax, including but not limited to the payment for ordinary and necessary expenses of the QDOT, payment of income taxes imposed on the QDOT, and sales of assets for full and adequate consideration.

(d) **Distributions After Spouse Becomes U.S. Citizen.** Under §2056A(b)(12), if the surviving spouse becomes a U.S. citizen and meets other requirements, distributions of corpus from the QDOT will no longer be subject to the QDOT tax.

c. **Hot Topics in International Tax and Estate Planning.**

(1) **Substantial Presence Test.** An individual will be considered a U.S. resident for tax purposes if the individual meets the substantial presence test under §7701(b)(3). To meet this test, the individual must be physically present in the U.S. on at least (1) 31 days during the current year and (2) 183 days during the three-year period that includes the current year and the two prior years, counting (a) all such days in the current year, (b) one-third of such days in the immediately preceding year, and (c) one-sixth of such days in the year before that. For purposes of the substantial presence test, an alien may exclude certain days from the calculation if the individual qualifies for the Medical Condition Exception. Revenue Procedure 2020-20 (released May 11, 2020) expanded the

Medical Condition Exception to account for the pandemic, allowing certain individuals to exclude from the calculation up to sixty consecutive calendar days starting on or after February 1, 2020 and on or before April 1, 2020.

(2) **The Corporate Transparency Act ("CTA").** The CTA was enacted on January 1, 2021 and requires certain reporting companies to report their "beneficial owners" to Financial Crimes Enforcement Network (FinCEN), starting as of the effective date of the regulations, which must be promulgated by January 1, 2022. The goal of CTA is to prevent the use of shell companies to hide illegal activities; it is not directed toward large operating companies. The question remains whether trusts will be required to report under the CTA. Most trusts do not fall under the definition of "Reporting Companies" since they are not created pursuant to a filing with the secretary of state. However, it is possible that statutory trusts will be considered a "similar entity" as described in the definition and therefore covered. See Item 3 above.

(3) **Virtual Currency Reporting**. FinCEN Notice 2020-2 was issued on December 31, 2020, acknowledging that the FBAR regulations do not include foreign accounts holding virtual currency as a type of reportable account under 31 CFR 1010.350(c). However, FinCEN intends to propose an amendment to the regulations to include virtual currency as a type of reportable account. The IRS believes there is rampant underreporting of taxes with virtual currency, and practitioners in this area believe there will soon be a tremendous amount of attention focused on it, similar to the resources dedicated to offshore accounts in the past.

25. "Descendants"—Issues Arising from DNA Testing; Inheritance; Adoption

The discussion in this Item is based on remarks by Sarah Johnson, who has also spoken at length previously at the Heckerling Institute and other courses regarding planning issues surrounding the definition of "descendants" in various contexts. *See* Sarah Moore Johnson, *Sweet Child O'Mine: Planning for Parents of Minors*, 53rd ANN. HECKERLING INST. ON EST. PL. (2019). Much of this summary is verbatim from her comments at the 2021 Heckerling Institute.

a. **One-Set of Parents Rule, *In re Estate of Heater*.** *In re Estate of Heater*, 466 P.3d 728 (Utah Ct. App. 2020), *cert. granted*, addresses the "one-set-of-parents" rule, established by the Uniform Parentage Act (UPA) that reflects the "adopted-treated-as-natural-born principle that also applies under most probate laws. Utah's version is that upon adoption, an individual's parentage becomes that of the adoptive parents and the individual's relationship and entitlements and responsibilities to, from, and through the individual's natural parents is severed. The case involves much family drama, both before and after the death of John Heater. Mr. Heater was a married man, with two children, a son and a daughter. Apparently, John had an affair with one of his employees who was also married and already had a child of her own. During the affair, the employee had a son, whom she named John Carlon, and John Heater sent the young John Carlon $100 every year on his birthday and paid for his nanny. John Carlon was raised by his mother's husband, Mr. Carlon, whom everyone assumed to be his father.

When Mr. Heater died intestate, his son and daughter were appointed co-personal representative, and they apparently fought about various things throughout the estate administration. In the eighth year after Mr. Heater's death, with the probate still open, and the son reached out to John Carlon by social media and told him, I think you're my brother. DNA testing confirms that John Carlon and the son were identified as half-siblings. Ancestry.com also revealed that John Carlon shared DNA with Mr. Heater's mother's relatives. John Carlon asserted his right as beneficiary of the estate, and Mr. Heater's daughter strenuously objected.

Complexities arose because Utah Code's various definitions of children create an infinite loop of cross-reference. The probate code definition says that for purposes of intestate succession, an individual is the child of the individual's natural (i.e., biological) parents, regardless of their marital status. It further states that the parent and child relationship *may* be established as provided in the Utah UPA. The UPA says that a child is the child of the man who was married to the child's mother at the time of the child's birth, and this definition applies unless another statute of the state expressly contravenes it. So, the probate code looks to the UPA, and the UPA looks to the probate code. As a result, John Carlon is either the son of Mr. Heater, his biological father, or he is the son of Mr. Carlon, his presumptive father, or maybe he is the son of both.

The daughter argued that John cannot be the son of both, because Utah case law has developed a "one-set-of-parents" inheritance rule that prohibits a person from inheriting from two different fathers. The court says this one-set-of-parents rule only applies to adopted children, and the UPA is subordinate to the probate code, so using the probate code rule that biology prevails, John Carlon is a beneficiary of Mr. Heater's estate.

How the Utah Supreme Court reacts to this case will be interesting because we all know that the purpose of intestacy laws is to honor the probable intent of the decedent. Mr. Heater very likely would not have wanted his son and daughter to split their inheritance with John Carlon.

b. Pre-2008 Uniform Probate Code Approach.

(1) Right of Child to Inherit From Genetic Parent. The Uniform Probate Code has not caught up to the problem of DNA test kits. For states that rely on the pre-2008 version of the UPC, a "natural parent" or "genetic parent" definition is used to establish the parent-child relationship, and the status of a child born out of wedlock can be proved through genetic testing. A genetic match creates a presumption of parentage that may be rebutted only by clear and convincing evidence. So, in pre-2008 UPC states, children of extramarital affairs and perhaps the biological offspring of sperm or egg donors can inherit from their biological parent. Some years ago, it was pretty common for guys in college to donate their sperm to raise beer money for parties. The news that their previously unknown offspring can easily track them down through DNA test kits and inherit from them is probably pretty shocking.

The DNA test kit market has doubled in sales each year since 2015, and it is predicted that over 90 million kits will be sold in 2021 alone. That's 90 million opportunities a year to find a surprise relative.

Fertility clinics now make all parties sign a contract that terminates the donor's parental rights, including the right of inheritance, but things were not quite as professional in the early days of reproductive science when fertility doctors would sometimes inject their own sperm into the mix without the patient's knowledge to increase her odds of pregnancy.

(2) Right of Genetic Parent to Inherit From Child. One bit of good news for pre-2008 UPC states, is that even though the biological child can inherit from the out of wedlock parent, the out of wedlock parent and his or her kindred cannot inherit "from or through" the biological child unless the parent has openly treated the child as his own and has not refused to support the child.

(3) Rights of "Diblings" to Inherit From Each Other. The requirement that the parent acknowledge and not refuse to provide support in order for the parent or his family to inherit through the out-of-wedlock child means that test-kit discovered half-siblings would not inherit from one another if their common father had either not known of his paternity, or had known but kept it a secret, or had refused support. So that's good. Especially when you hear about the prolific sperm donors who have fathered 100 to 200 children. Those sperm donor siblings, or "diblings" as they are called, would not all be able to inherit from one another as long as donor dad did not hold himself out as their father.

c. 2008 Uniform Probate Code Approach. What about states that have adopted the 2008 and later versions of the UPC? The modern versions of the UPC recognize that the starting point of "natural" or "genetic" parent does not work when applied to children born of reproductive technology. These statutes now have complicated rules meant to *include* non-genetic intended parents and *exclude* genetic donors, surrogate mothers, diblings, and the like. But the modern UPC unfortunately *dropped* the abandonment language of the older statutes. This flaw allows half-siblings who unknowingly shared the same biological parent through extramarital affairs or prior marriages to inherit from one another, even if the parent had no knowledge of his paternity. Some of these states are Colorado, Maine, Montana, New Jersey, New Mexico, and North Dakota.

d. **Drafting Pointers; Additional Resource.** The point here, is that there is an urgent and increased need to make sure the definition of descendants in our wills and trusts have intent-based language that not only brings in children who have been equitably adopted by a family, but also *excludes* unknown descendants. For example, consider defining "descendant" to require that the ancestor designated *openly acknowledged the child as his or her own and did not refuse to support such child*.

For an additional discussion of the inheritance issues arising from DNA testing (including inheritance rights of diblings) and estate planning issues from artificial reproduction technologies see Items 31-35 of the ACTEC 2020 Annual Meeting Musings (March 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

e. **Adopted Child Not Limited to One-Set-of-Parents Rule, *Rogers v. Pratt*.** There have also been some developments in the areas of adoption and inheritance. In *Rogers v. Pratt*, 467 P.3d 651 (Okla. 2020), a mother had reconnected with the son she gave up for adoption as an infant – the son had even lived with her for several months after his adoptive parents had died. The mom stated in her will that she had no children, and then expressly disinherited all other family members. The son asserted his rights as a pretermitted heir, took his case all the way to the Oklahoma Supreme Court, and won.

But doesn't adoption sever the right to inherit? Oklahoma is one of the five states (perhaps there are others as well) that expressly allows an adopted-out child to inherit from his or her biological parent, even though the biological parent cannot adopt through the adopted-out child. Those states are Kansas, Louisiana, Oklahoma, Rhode Island, and Texas. Also, Alaska, Illinois, and Maine provide for a continuation of inheritance rights between the adopted-out child and the genetic parents if it is so stated in the adoption decree. In these states, client questionnaires should ask whether the client has given up a child to adoption; if so, that child needs to be expressly disinherited if that is the client's intent.

f. **Stepchild and Adult Adoption Issues, *Parris v. Ballantine*.** *Parris v. Ballantine*, 2020 WL 5740810 (Ala.), involved a dynasty trust created by a member of the DuPont family in 1971. This was THE DuPont family, so significant dollars were likely at stake. The Trust had divided into shares for children and then grandchildren, and eventually, one of the grandchildren, Aimee, found herself diagnosed with terminal cancer. She had no children but had helped raise her husband's now-adult son. She adopted her stepson on her deathbed so that he would be the beneficiary of her trust, rather than allowing her trust to be added to her siblings' shares. The trust definition of descendants made no reference to adoption, so Alabama law controlled. Like most states, Alabama adopted a statute in 1931 that allowed adopted children to be included as descendants of their adopted parents and ancestors for purposes of inheritance. But the Supreme Court noted that the statute's use of the word "children" had been ruled in prior cases to include only those adopted as minor children. Further, at the time the trust was written in 1971, there was no legal mechanism for adult adoptions in Alabama; therefore, the court concluded that the adopted stepson was not a beneficiary of the trust.

g. **Drafting Pointer for References to Adult Adoptions.** Many planners use definitions of descendants that limit the inclusion of adopted children to those who were adopted prior to age 18, consistent with the Alabama statute. Ben Pruett (Bessemer Trust in Washington, D.C.) recommends increasing the age of adoption to 19 because there are many stepparents who want to adopt their stepchildren as minors, but are prevented from doing so by the biological parent, who could be a real jerk and refuse to terminate their parental rights out of spite. Increasing the age to 19 or 21 gives the family time to accomplish an adult adoption, which can no longer be contested by the biological parent. Since adopting that change, Sarah Johnson has seen this exact scenario play itself out in two different client matters, and she definitely recommends this change.

26. Planning Developments With Deemed Owner Trusts Under Section 678

a. **Grantor Trusts Overview.** For a rather detailed discussion of grantor trusts, including powers and interests that trigger grantor trust treatment under §§674-677, beneficiary deemed owned trusts under §678, dividing partial grantor trusts, portion rules, toggling, sales to grantor trusts, and other uses and benefits of grantor trusts, see Items 11-23 of ACTEC 2016 Summer Meeting Musings

(Including Fiduciary Income Tax "Bootcamp") (September 2016), found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights and Item 23 of Heckerling Musings 2020 and Estate Planning Current Developments (August 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

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

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

For a detailed discussion of the use of BDOTs, see Item 16 of the Estate Planning Current Developments Summary (December 2018) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. *See also* Edwin P. Morrow III, *IRC Section 678(a)(1) and the Beneficiary Deemed Owner Trust (BDOT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2587 (September 5, 2017) (outstanding summary of technical issues; article has been updated various times through 2020; contact author for updated version).

(2) **Beneficiary Defective Inheritor's Trust ("BDIT").** Under §678(a)(2), "a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which . . . such person has previously partially released or otherwise modified [a §678(a)(1)] power and . . . retains such control" that would cause the grantor to be treated as the owner pursuant to §671 to §677. If a gift is made to a trust and the beneficiary is granted a withdrawal right over the entire contribution, such power will cause the beneficiary to be considered the owner pursuant to §678(a)(1). Once the withdrawal right lapses, if income of the trust may be distributed to the beneficiary, the beneficiary will continue to be considered the owner pursuant to §678(a)(2) in conjunction with §677(a). (One of the technical issues surrounding BDITs is that the "partial release or modification" of a withdrawal power arguably is not the same as the mere "lapse" of a withdrawal power; despite this argument, the IRS in a number of private letter rulings has treated the beneficiary as an owner of the trust with respect to lapsed withdrawal rights.) Trusts with such provisions are commonly referred to as BDITs.

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

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

c. **Trust Treated as Deemed Owned Trust Under §678 Despite HEMS Standard; Beneficiaries/Trustees Did Not Pay Attention to HEMS Limitation.** An ERISA case that turned on the ownership of various entities ignored trusts as separate taxpayers but treated them as being owned by the respective beneficiaries under §678 despite the fact that the beneficiaries' power to withdraw income and principal of the trusts was limited by a health, education, maintenance, and support ("HEMS") standard; the court disagreed because the HEMS limitation was not "dutifully followed." *United Food & Commercial Workers Unions v. Magruder Holdings, Inc.*, Case No. GJH-16-2903 (S.D. Md. March 27, 2019).

For a more detailed discussion of this case (and a reference to a case with similar reasoning, *SEC v. Wyly,* 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014)), see Item17.c. of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

d. **Trust Treated as §678 Trust as to Sale Transaction Because Beneficiary Could Withdraw Proceeds of Sale; Sale from §678 Trust to Grantor Trust Afforded Non-Recognition Treatment Under Rev. Rul. 85-13.** PLR 202022002 addressed the sale from a trust (Trust 1) to an irrevocable grantor trust (Trust 2) that is a grantor trust as to A. In the ruling, Trust 1 prohibits a distribution of "Shares," but allows for a distribution of the proceeds from the sale of the Shares, and because the beneficiary had reached age 40, the beneficiary could withdraw the proceeds of the sale. A Subtrust of Trust 1 agreed to sell an LLC that held the Shares (the only asset of the Trust 1 Subtrust) to Trust 2 in return for cash and a promissory note. The IRS reasoned that the Trust 1 Subtrust was treated as owned by A under §678 for purposes of the sale even though A could only withdraw the proceeds of the sale and not the Shares or LLC prior to the sale. (This was somewhat similar to the situation in Rev. Rul. 85-13, in which a trust was treated as a grantor trust with respect to a sale to the grantor for an unsecured promissory note, which was treated as a borrowing by the grantor that triggered §675(3).) No ruling or case has previously addressed whether non-recognition treatment under the reasoning of Rev. Rul. 85-13 would be applied to transactions between a §678 trust and the beneficiary-deemed owner of the §678 trust. This ruling does not directly address that issue, but analogously ruled that "the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A."

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

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

This reasoning does not necessarily extend to BDOTs, in which another party has the right to withdraw all income (including capital gains) from a trust, rather than having the ability to withdraw all trust assets (as was the case under the facts of Letter Ruling 202022002). In that situation, the party would not necessarily be treated as the owner of the **entire** trust, and the IRS might take the position that Rev. Rul. 85-13 applies only if the deemed owner is treated as the deemed owner of the entire trust.

27. Electronic Wills and Uniform Electronic Wills Act

Traditionally, wills must be on paper, either typed (or printed) or handwritten. Nevada was the first state to adopt a statute recognizing electronic wills. NEV. REV. STAT. §133.085(1) (2017). Electronic will statutes now exist in Nevada, Indiana, Arizona, and Florida (effective July 1, 2020). (Remote on-line notarization became effective in Florida on January 1, 2020, and electronic wills, including remote witnessing and electronic signing, becomes effective on July 1, 2020.) In addition, the Uniform Electronic Wills Act has been enacted in Utah (in 2020) and in Colorado (in 2021). The Uniform Act has been introduced and is being considered in 2021 in Idaho, North Dakota, Virginia, and Washington.

For more discussion of and references to resources about electronic wills, see Item 26 of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

28. Family Limited Partnership and LLC Planning Developments; Planning in Light of *Estate of Powell v. Commissioner* and *Estate of Cahill v. Commissioner*

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

(1) **Bona Fide Sale for Full Consideration Defense.** The bona fide sale for full consideration defense is the key for defending both §2036(a)(1) and §2036(a)(2) cases. Almost every one of these cases that the taxpayer has won was based on the bona fide sale for full consideration exception to §2036. The three exceptions are *Kelly, Mirowski,* and *Kimbell* (at least as to some assets). See Item 28.f below.

(a) **Bona Fide Sale Test – Legitimate and Significant Nontax Reason.** The key is whether "legitimate and significant nontax reasons" existed for using the entity, as announced in *Bongard v. Commissioner*, 124 T.C. 95 (2005). Having tax reasons for creating entities is fine; the test is whether "**a**" legitimate and significant nontax reason applied as well. The tax purposes are not weighed against the nontax purposes. For a listing (with case citations) of factors that have been recognized in particular situations as constituting such a legitimate nontax reason, see Item 8.g. of the Current Developments and Hot Topics Summary (December 2016) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

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

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

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

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

(3) **Section 2036(a)(2).** In a few cases, the IRS has also made a §2036(a)(2) argument, that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the income or property contributed to the entity. Two cases have applied §2036(a)(2) where the decedent had some interest as a general partner (*Strangi* and *Turner*), and one case applied §2036(a)(2) when the decedent held merely a limited partnership interest (*Powell*, as discussed in Item 28.c.(1) below).

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

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

(b) **Overview of *Powell* and *Cahill*.** *Powell* (discussed in Item 28.c.(1) below) and *Cahill* (discussed in Item 28.c.(2) below) add a significant additional risk under §2036(a)(2), based on whether the decedent could act with third parties to undo whatever is causing a discount. The focus seems to be on the ability to join with others to cause a liquidation of an entity (or termination of an agreement, as in *Cahill*), and would seem to extend to the ability to join with others in amending documents to permit liquidation or termination. (The ability to amend the partnership agreement without consent of limited partners was one of the factors that the court mentioned in *Turner I* for applying §2036(a)(2)). One possible response is to provide in the underlying agreements that the decedent owns a class of interest that does not permit joining with others to liquidate the entity or amend the agreement. Query whether the absence of a right to vote on liquidation or amendment would be a §2703 restriction that is ignored under the *Cahill* reasoning?

Other cases have limited the broad application of the "in conjunction with" argument relied on in *Powell* and *Cahill*. (See Item 28.e below for a discussion of the *Helmholz*, *Tully*, and *Bowgren* cases.) The taxpayer in *Morrissette* made these arguments, but the court determined that §2036 did not apply because of the bona fide sale for full consideration exception, as discussed in Item 39.c-d below.

(c) **IRS Agents Are Making the *Powell* Argument.** John Porter tried *Estate of Wittingham v. Commissioner* in February 2018. The case was ultimately settled, but the IRS made the *Powell* argument with respect to an LLC created by the decedent, in which the decedent and her two sons were the managing members and held the Class A units with voting rights. The case involved the sale of units in return for a private annuity even though the decedent had just found out that she had pancreatic cancer. The case ultimately settled with the taxpayer conceding that some prior purported loans were gifts and conceding about 20% of the private annuity issue because of uncertainty about some medical issues.

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

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

c. **FLP Assets Includable under §2036(a)(2) – *Powell, Cahill,* and *Morrissette.***

(1) **Synopsis of *Estate of Powell*.** *Estate of Powell v. Commissioner*, 148 T.C. 392, is a "reviewed" Tax Court decision that may be the most important Tax Court case addressing FLPs and LLCs since the *Bongard* case 15 years ago. The Tax Court breaks new ground (1) in extending the application of §2036(a)(2) to decedents owning only limited partnership interests, and (2) in raising the risk of double inclusion of assets under §2036 *and* a partnership interest under §2033, which may (in the court's own words) result in "duplicative transfer tax." (The case was decided on cross motions for summary judgement and is not an opinion following a trial.)

The facts involve "aggressive deathbed tax planning," and the fact that the taxpayer lost the case is no surprise. But the court's extension of the application of §2036(a)(2) and the extensive discussion of possible double inclusion for assets contributed to an FLP or LLC were surprising (but whether a majority of the judges would apply the double-inclusion analysis is not clear).

The "plurality" and concurring opinions both agreed that §2036(a)(2) applied (though the concurring opinion did not address the reasoning for applying §2036(a)(2)). The plurality opinion reasoned (1) that the decedent, *in conjunction with* all the other partners, could dissolve the partnership, and (2) that the decedent, through her son as the GP and as her agent, could control the amount and timing of distributions. The opinion adopted the analysis in *Strangi* regarding why the "fiduciary duty" analysis in the Supreme Court *Byrum* case does not apply to avoid inclusion under §2036(a)(2) under the facts of this case. The court held that any such fiduciary duty here is "illusory."

The §2036(a)(2) issue is infrequently addressed by the courts; it had been applied with any significant analysis only in four prior cases (*Kimbell and Mirowski* [holding that §2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that §2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 50% interest in the corporate general partner). *Powell* is the first case to apply §2036(a)(2) when the decedent **owned merely a limited partnership interest**. In this case the decedent owned a 99% LP interest, but the court's analysis drew no distinction between owning a 99% or 1% LP interest; the court reasoned that the limited partner "in conjunction with" all the other partners could dissolve the partnership at any time.

The combination of applying §2036(a)(2) even to retained *limited partnership* interests and the risk of "duplicative transfer tax" on future appreciation in a partnership makes qualification for the **bona fide sale** for full consideration exception to §§2036 and 2038 **especially important**. In one respect, this means that *Powell* does not reflect a significant practical change for planners, because the §2036 exception has been the primary defense for any §2036 claim involving an FLP or LLC.

For excellent discussions of the *Powell* case, see Todd Angkatavanich, James Dougherty & Eric Fisher, Estate of Powell: *Stranger Than Strangi and Partially Fiction*, TR. & ESTS. 30 (Sept. 2017) and Mitchell M. Gans & Jonathan G. Blattmachr, *Family Limited Partnerships and Section 2036: Not Such a Good Fit*, 42 ACTEC L.J. 253 (Winter 2017).

For a detailed discussion of the facts and court analysis in and planning implications of *Powell*, see Item 15.g. of the Current Developments and Hot Topics Summary (December 2017) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(2) **Synopsis of *Estate of Cahill* and Settlement.** In *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (Judge Thornton), the decedent's revocable trust had advanced $10 million to an irrevocable trust under a split dollar agreement for the trust to purchase life insurance policies on the lives of the decedent's son and his wife. The estate valued the estate's right eventually to be reimbursed for its advances at only $183,700, because of the long period of time before the policies would mature at the insureds' deaths. The IRS argued, among other things, that the reimbursement right should have a value equal to the full cash surrender value of the policies (about $9.6 million) in part because of §§2036, 2038, and 2703. The court rejected the estate's motion for a partial summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) did not apply and that Reg. §1.61-22 applied in valuing the decedent's reimbursement rights.

The court reasoned that §§2036(a)(2) and 2038(a)(1) could apply because the decedent, in conjunction with the irrevocable trust, could agree to terminate the split dollar plan and the decedent would have been entitled to the cash surrender value of the policies (without waiting until the insureds' deaths), and because the advance of the premiums in this situation was not a bona fide sale for full and adequate consideration. (The court cited its recent decision in *Powell v. Commissioner*.)

In addition, the court in *Cahill* concluded that §2703(a) applies, to disregard the irrevocable trust's ability to prevent an early termination of the agreement in valuing the reimbursement right, because the provision preventing the decedent from immediately withdrawing his advance was an agreement allowing the third party to acquire or use property at a price less than fair market value (§2703(a)(1)), and because the agreement significantly restricted the decedent's right to use his "termination rights" under the agreement (§2703(a)(2)).

The estate tax audit was settled on August 16, 2018, with the estate conceding all the issues regarding the intergenerational split dollar arrangement (agreeing that the value of the decedent's reimbursement right was the $9.6 million cash surrender value of the policies) and the imposition of a 20% accuracy-related penalty under §6662; the IRS conceded regarding the value of certain notes from family members unrelated to the split dollar transaction.

For a more detailed summary of the *Cahill* case (including ramifications of its §2703 analysis) see Item 13 of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(3) **Tax Court Follows Same Position in *Estate of Morrissette v. Commissioner*.** The initial case in *Estate of Morrissette v. Commissioner,* 146 T.C. 171 (2016), determined that the economic-benefit regime applies to the split dollar arrangement in that case. The IRS made arguments under §§2036, 2038, and 2703, similar to its arguments in *Cahill*.

The taxpayer's Memorandum in support of its motion that §§2036, 2038, and 2703 do not apply emphasized the prior cases that have limited the broad application of the "in conjunction with" clause to rights already provided by state law. The Memorandum made strong arguments regarding (1) cases that applied outer limits in applying the "in conjunction with" phrase in §2038 and (2) that the restriction on the trust's right unilaterally to terminate the split dollar agreements is provided under common law and is not a basis for applying §2703. Excerpts from the Memorandum are quoted at length in Item 13.c.(6) of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

The court entered an Order dated February 19, 2019 denying the taxpayer's motions for summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) do not apply, reasoning merely that *Estate of Cahill* "is directly on point" regarding §§2036(a)(2) and 2038(a)(1).

The court ultimately held that the bona fide sale for full consideration exception to §2036 and 2038 and the §2703(b) safe harbor applied, and the court valued the estate's reimbursement right, T.C. Memo. 2021-60 (May 13, 2021), discussed in Item 39.c-f below. For a much more detailed discussion of the *Morrissette* developments before the 2021 opinion, see Item 13 of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

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

The net effect is that, under the *Powell* reasoning, §2036 conceivably will apply to almost all FLPs/LLCs, whether or not the client retains a general partner or managing member interest, unless the bona fide sale for full consideration exception to §2036 applies. Furthermore, the same reasoning would seem to apply to a contribution to practically any enterprise or investment involving other parties. For example, interests in C corporations, S corporations, or undivided interests in real estate would be subject to the same reasoning that the decedent could join with the other shareholders/co-owners (perhaps even if unrelated?) and dissolve the entity/co-ownership, with all parties receiving their pro rata share of the assets.

d. **What to Do? Planning in Light of Powell.**

(1) **Overview of Planning Alternatives.** Planning alternatives for avoiding inclusion under §2036 (and in particular, §2036(a)(2)) in light of *Powell* and *Cahill* include the following:

- No revocable transfers;
- Avoid transfers under a power of attorney;

- Satisfy the bona fide sale for full consideration exception;
- Transfer all voting rights, including power to amend or revoke the agreement;
- Eliminate unanimous partner approval requirement for dissolution (which was present in *Powell*);
- Avoid having the decedent or decedent's agent as general partner of an FLP;
- Provide for slicing and dicing of voting rights and manager powers (discussed in more detail below);
- No participation in removal of managers unless replacement must be not related or subordinate to the donor;
- Use trusts as owners of entity interests with an independent trustee;
- Transfer all interests during life; and
- "Claim victory" and dissolve the FLP/LLC following prior successful transfers.

For a more detailed discussion of these and other planning steps in light of *Powell*, see Item 19.d. of Estate Planning Current Developments and Hot Topics (December 2020) found here and Item 15.g. of the Current Developments and Hot Topics Summary (December 2017) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(2) **Slicing and Dicing of Voting Rights.** If the donor retains any voting rights, create classes of voting rights. For example Class A limited partners and members would possess full voting rights normally provided to limited partners or members, and Class B limited partners or members (including the donor) could vote on all matters other than (a) the liquidation or dissolution of the entity, (b) distributions from the entity, (c) the right to approve a proposed transfer of an interest in the entity, or (d) the amendment of the entity agreement in a way that would alter any of those restrictions.

(3) **Limiting Donor's Powers as Manager of LLC or as General Partner of Limited Partnership.**

(a) **Distribution Decisions.** If the donor will continue to be a general partner or hold an interest in a general partner or will be the manager of an LLC, limit the donor from having the right to participate in any distribution decisions. For example, use a separate "distribution general partner" or "distribution manager" who has exclusive authority over decisions about when the entity would make distributions to its owners.

If the donor insists on participating in distribution decisions, §2036 and §2038 should not apply if distributions decisions are subject to a definite standard that is specific enough that it can be enforced by a court (based on old cases under §2036 and §2038). Consider providing that Class A limited partners or a "special general partner" or "special manager" (other than the donor) must consent to establishing reasonable reserves (at least for more than a baseline established in a budget that is approved from time to time by all the partners).

(b) **Investment and Management Decisions.** There are strong arguments that investment and administrative powers held by the donor as a general partner (or manager of an LLC) should not trigger estate inclusion under §2036 or §2038. *See, e.g.*, *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) ("the power to invest in 'nonlegals' (i.e., investments not classified under a particular State law or ruling of the pertinent court as legal investments for trust funds) and the power to sell or exchange the trust property do not amount to a right to designate who shall enjoy the trust property or a right to alter, amend, or revoke the terms of the trust"); *United States v. Powell*, 307 F.2d 821 (10th Cir. 1962) (trustee-grantor had power to invest assets as he deemed "most advisable for the benefit of the trust estate"; held that trustee's acts were subject to review by a court of equity and did not invoke the predecessor to §2038); *Estate of Graves v. Commissioner*, 92 T.C. 1294, 1302-03 (1989) ("Even if the decedent had the power to direct the investment of the trust property, this power would not constitute a power to alter, amend or revoke because she would have effectively been a trustee. As a trustee, she would have had to act in good faith, in accordance with her fiduciary responsibility, and safeguard and conserve the trust principal."); *Estate of King v. Commissioner*, 37 T.C. 973 (1962), *nonacq*. 1963-1 C.B. 5 (grantor had the right to direct the trustee regarding investment of trust assets, but the court reasoned that "the grantor had in effect made himself a fiduciary" and held that there was "no retained right or power in the decedent to divert any of the corpus to the income beneficiaries or to divert any income to the remaindermen"). The key under these cases is the existence of a fiduciary duty that a court can supervise and ensure that the fiduciary will act impartially. *See Estate of Bowgren v. Commissioner*, 105 F.3d 1156 (7th Cir. 1997) (absence of fiduciary duty by donor to donee who received an assignment of an interest in a land trust caused §§2036(a)(2) and 2038 to apply).

Despite this strong authority, some planners are reluctant, considering the *Powell* and *Cahill* broad "in conjunction with" reasoning, to allow a donor to serve as manager of an LLC with management authority regarding investment decisions. Conceivably, the IRS might argue that the donor could make investments in non-income-producing assets that would deprive the entity of any cash flow to make distributions to the owners, and therefore retain the ability to designate who shall possess or enjoy the property or the income therefrom (§2036(a)(2)) or alter, amend, revoke, or terminate enjoyment of the property (§2038(a)(1)). Bear in mind that §2038 is triggered by the mere ability to affect the timing of enjoyment of the property even though the identity of the beneficiary is not affected, Reg. §20.2038-1(a), and §2038 is based on powers that exist at death rather than powers that are retained at the time of the transfer.

Even if the transfer is to a trust with an independent trustee that is a member of the entity, if the donor serves as a manager of or in some other management position with the entity, the IRS could possibly argue under *Powell* that the donor's authorities "in conjunction with others" could impact beneficial enjoyment of the transferred assets.

Because of these concerns, if the donor makes a gift of an interest in the entity, some respected planners structure the entity to avoid having the donor as a general partner or manager or limit the donor's authority as manager or other management position to participate in "tax-sensitive" activities. Diana Zeydel (Miami, Florida) has noted the possibility of limiting the donor's authority as manager with respect to decisions, approvals, or consents relating to various potentially tax sensitive activities such as distributions, allocations to reserves, determining the fair market value of interests, making loans to or guarantees of loans of any entity owner, withdrawal or resignation of any owner, dissolution or liquidation of the entity, any incident of ownership in any life insurance policy on the life of any entity owner, voting the stock of any "controlled corporation" as described in §2036(b), or an amendment of the governing instruments with respect to any of those matters.

If the donor merely makes a sale of an interest in an entity (and does not make a gift), planners may still encourage the appointment of a distribution officer and a liquidation officer to be safe and just let the donor manage the assets.

Other respected planners are not as concerned with the donor serving as the manager of an LLC with authority over LLC investments, especially if the owners of the entity are family trusts with independent trustees. They believe that only the independent trustee of the trust can control the beneficiary's enjoyment of the gifted asset, and the LLC manager has a fiduciary duty to the LLC members a la the Supreme Court's fiduciary duty analysis in *United States v. Byrum*; therefore it is the trustee of the trust and not the grantor as manager who controls the income and distribution spigot to the recipients of the gifted property.

e. **Prior Cases That Have Limited the Broad Application of the "in Conjunction with" Phrase in §§2036 and 2038.** Section 2036(a)(2) was enacted with almost identical "in conjunction with" statutory language as in §2038. Several cases have limited the application of the "in conjunction with" provision in determining whether §2038 applied. *E.g.*, *Helvering v. Helmholz*, 296 U.S. 93 (1935), *aff'g* 75 F.2d 245 (D.C. Cir. 1934) (power in a trust agreement to terminate the trust with the consent of all beneficiaries was not a power to revoke, alter, or amend the trust in conjunction with others because state law conferred the right to terminate a trust with the consent of all beneficiaries, and the trust provision "added nothing to the rights which the law conferred"); *Tully Estate v. Commissioner*, 528 F.2d 1401 (Ct. Cl. 1976) ("Congress did not intend the 'in conjunction' language of section 2038(a)(1) to extend to the mere possibility of bilateral contract modification"); *Estate of Bowgren v. Commissioner*, T.C. Memo. 1995-447, *rev'd and remanded on other grounds*, 105 F.3d 1156 (7th Cir. 1997) (ability of decedent to have terminated or modified the beneficial interests of children was with the unanimous consent of the children and "[s]uch a power is not a retained power under section 2036(a)(2), see Stephens, Maxfield, Lind & Calfee, Federal Estate and Gift Taxation 4-148 n.52 (6th ed. 1991), and is a power to which section 2038(a) does not apply, see sec 20.2038-1(a)(2)").

For further discussion of these cases, see Item 19.e. of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

f. **Summary of §2036 FLP/LLC Cases (14-23, with 2 on Both Sides).** Of the various FLP/LLC cases that the IRS has chosen to litigate, 14 have held that at least most of the transfers to an FLP/LLC qualified for the bona fide sale exception —

(1) *Church v. United States,* 2000-1 USTC ¶60,369 (W.D. Tex. 2000) (preserve family ranching enterprise, consolidate undivided ranch interests);

(2) *Estate of Eugene Stone v. Commissioner*, T.C. Memo. 2003-309 (partnerships to settle family hostilities);

(3) *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004), *vacating and rem'g* 244 F. Supp. 2d 700 (N.D. Tex. 2003) ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests);

(4) *Bongard v. Commissioner*, 124 T.C. 95 (2005) (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts);

(5) *Estate of Schutt v. Commissioner*, T.C. Memo. 2005-126 (maintaining buy and hold investment philosophy for family du Pont stock);

(6) *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74 (joint management and keeping a single pool of assets for investment opportunities);

(7) *Estate of Miller v. Commissioner*, T.C. Memo. 2009-119 (continue investment philosophy and special stock charting methodology);

(8) *Keller v. United States*, 2009-2 USTC ¶60,579 (S.D. Tex. 2009) (protect family assets from depletion in divorces);

(9) *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 BL 223971 (W.D. Ark. Oct. 2, 2009) (centralized management and prevent dissipation of family "legacy assets");

(10) *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) (maintaining buy and hold investment philosophy for closely held stock);

(11) *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21 (asset protection and management of timberland following gifts of undivided interests);

(12) *Estate of Joanne Stone v. Commissioner*, T.C. Memo. 2012-48 (desire to have woodland parcels held and managed as a family asset and various other factors mentioned);

(13) *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73 (ensuring equal estate distribution, avoiding potential litigation, and achieving effective asset management); and

(14) *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249 (centralized management and other factors).

(In the context of intergenerational split dollar life insurance scenario rather than an FLP/LLC, situation, *Estate of Morrissette* held that the bona fide sale for full consideration exception applied, and *Estate of Cahill* held that it did not apply on the facts of those cases.)

Three cases (*Kelly*, *Mirowski*, and *Kimbell*) held that §2036 did not apply (at least for some assets) without relying on the bona fide sale for full consideration exception. All the FLP cases resulting in taxpayer successes against a §2036 attack have relied on the bona fide sale exception to §2036 except *Kelly*, *Mirowski*, and *Kimbell*. *Kelly* relied on the bona fide sale exception to avoid treating the contributions to partnerships as transfers triggering §2036, but reasoned that no retained enjoyment existed under §2036(a)(1) regarding gifts of limited partnership interests [that obviously did not qualify for the bona fide sale for full consideration exception]. *Mirowski* similarly relied on the bona fide sale exception with respect to contributions to the partnership, but not as to gifts of partnership interests. *Kimbell* relied on the bona fide sale for full consideration exception for transfers to a partnership, but for other transfers to an LLC, the Fifth Circuit refused to apply §2036 (the particular issue was about §2036(a)(2)) without addressing whether the bona fide sale for full consideration exception applied to those transfers.

Interestingly, six of those 14 cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the *Miller*, *Joanne Stone*, and *Purdue* cases and authored the Tax Court's opinion in *Bongard*. Judge Chiechi decided both *Stone* and *Mirowski*. (Judge Wherry decided *Schutt*, Judge Halpern decided *Black*, Judge Jacobs decided *Shurtz*, Judge Foley decided *Kelly*, and *Church* and *Kimbell* were federal district court opinions ultimately resolved by the Fifth Circuit. *Keller* and *Murphy* are federal district court cases.)

Including the partial inclusion of FLP/LLC assets in *Miller* and *Bongard*, 23 cases have applied §2036 to FLP or LLC situations: *Estate of Schauerhamer v. Commissioner*, T.C. Memo. 1997-242, *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000), *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, *Thompson v. Commissioner*, T.C. Memo. 2002-246, *aff'd*, 382 F.3d 367 (3d Cir. 2004), *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd,* 417 F.3d 468 (5th Cir. 2005)*, Estate of Abraham v. Commissioner*, T.C. Memo. 2004-39, *Estate of Hillgren v. Commissioner*, T.C. Memo. 2004-46, Estate of *Bongard v. Commissioner*, 124 T.C. 95 (2005) (as to an LLC but not as to a separate FLP), *Estate of Bigelow v. Commissioner*, T.C. Memo. 2005-65, *aff'd*, 503 F.3d 955 (9th Cir. 2007), *Estate of Edna Korby v. Commissioner*, T.C. Memo. 2005-102, *aff'd*, 471 F.3d 848 (8th Cir. 2006), *Estate of Austin Korby v. Commissioner*, T.C. Memo. 2005-103, *aff'd*, 471 F.3d 848 (8th Cir. 2006), *Estate of Rosen v. Commissioner*, T.C. Memo. 2006-115, *Estate of Erickson v. Commissioner*, T.C. Memo. 2007-107, *Estate of Gore v. Commissioner*, T.C. Memo. 2007-169, *Estate of Rector v. Commissioner*, T.C. Memo. 2007-367, *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278, *Estate of Jorgensen v. Commissioner*, T.C. Memo. 2009-66, *aff'd*, 431 Fed. Appx. 544 (9th Cir. 2011), *Estate of Mille*r *v. Commissioner*, T.C. Memo. 2009-119 (as to transfers made 13 days before death but not as to prior transfers), *Estate of Malkin v. Commissioner*, T.C. Memo. 2009-212, *Estate of Holliday v. Commissioner*, T.C. Memo. 2016-51, *Estate of Beyer v. Commissioner*, T.C. Memo. 2016-183, *Estate of Powell v. Commissioner,* 148 T.C. 392 (2017), and *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40. In addition, the district court applied §2036 in *Kimbell v. United States* but the Fifth Circuit reversed.

g. **Review of Court Cases Valuing Partnership Interests.** Despite the many cases that have addressed the applicability of §2036 to limited partnership or LLC interests, fewer cases have actually reached the point of valuing partnership interests. John Porter, an attorney in Houston, Texas who has litigated many of the family limited partnership cases, summarizes discounts that have been allowed by the courts in FLP/LLC cases as follows (the *Streightoff*, *Estate of Jones*, *Grieve*, and *Nelson* case results have been added to the table):

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Strangi I	Securities	Tax	31%
Knight	Securities/real estate	Tax	15%
Jones	Real estate	Tax	8%; 44%
Dailey	Securities	Tax	40%
Adams	Securities/real estate/minerals	Fed. Dist.	54%
Church	Securities/real estate	Fed. Dist.	63%
McCord	Securities/real estate	Tax	32%
Lappo	Securities/real estate	Tax	35.4%
Peracchio	Securities	Tax	29.5%
Deputy	Boat company	Tax	30%
Green	Bank stock	Tax	46%
Thompson	Publishing company	Tax	40.5%
Kelley	Cash	Tax	32%
Temple	Marketable securities	Fed. Dist.	21.25%
Temple	Ranch	Fed. Dist.	38%
Temple	Winery	Fed. Dist.	60%
Astleford	Real estate	Tax	30% (GP); 36% (LP)
Holman	Dell stock	Tax	22.5%
Keller	Securities	Fed. Dist.	47.5%
Murphy	Securities/real estate	Fed. Dist.	41%
Pierre II	Securities	Tax	35.6%
Levy	Undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Giustina	Timberland; forestry	Tax	25% with respect to cash flow valuation (75% weighting to cash flow factor and 25% weighting to asset method); BUT reversed by 9th Circuit and remanded to reconsider without giving 25% weight to asset value
Koons	Securities	Tax	7.5%; Estate owned 70.42% of voting interests and could remove limitation on distributions
Gallagher	Publishing company	Tax	47%
Streightoff	Securities	Tax	0% lack of control discount because the 88.99% LP interest could remove the general partner and terminate the partnership; 18% lack of marketability discount
Kress	Manufacturing	Tax	Lack of marketability discounts of 25% for 2007-2008 gifts & 27% for 2009 gifts (those numbers included 3% downward adjustment because family transfer restriction was not taken into account); adjustment also made for minority interest in evaluating non-operating assets
Jones	Sawmill & timber	Tax	35% lack of marketability discount from noncontrolling interest value
Grieve	Securities	Tax	35% for one LLC and 34.5% for another LLC (98.8% non-voting LLC interest)
Nelson	FLP owned 27% of holding company that owned various subsidiaries with operating businesses	Tax	FLP's interest in holding company valued with 15% lack of control discount and 30% lack of marketability discount; transferred limited partner interest in FLP valued with 5% lack of control discount and 28% lack of marketability discount

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

29. FLP Assets Included Under §2036(a)(1); Application of §2043 Consideration Offset; Formula Transfer to Charitable Lead Trust Not Respected; Loans Not Respected; No Deduction for Attorney's Fee, *Estate of Howard V. Moore v. Commissioner*, T.C. Memo. 2020-40

a. **Synopsis.** In a pre-death planning context beginning in late 2004, after contracting to sell a farm for about $16.5 million the decedent transferred a 4/5ths interest in the farm to an FLP in return for a 95% limited partnership interest. A Management Trust (with two children as co-trustees) was the 1% general partner, but the decedent exercised practical control over the FLP and caused transfers of $2 million of the sale proceeds to himself, $2 million to his children (who gave notes for their transfers), and $500,000 to a grandson as a gift.

The decedent subsequently gave $500,000 to an Irrevocable Trust (for his children) and several weeks later transferred his 95% limited partnership interest to the Irrevocable Trust for a $500,000 cash down payment and a $4.8 million note (the gift and sale amount represented a discount of just over 50% for the FLP interest).

The decedent's revocable trust provided a formula bequest to a charitable lead trust in an amount to "result in the least possible federal estate tax." In addition, the Irrevocable Trust provided that the trustee would distribute to the revocable trust "the value of any asset of this trust which is includible in my gross estate."

Following the decedent's death at the end of March 2005, the charitable lead trust apparently was funded with a substantial amount under the revocable trust's formula transfer. An IRS examination resulted in this case alleging additional gift and estate taxes.

Not surprisingly, the court determined that the farm was included in the gross estate under §2036(a)(1). The bona fide sale for full consideration exception in §2036(a) did not apply because no businesses required active management, the children did not actually manage sale proceeds in the FLP, no legitimate creditor concerns existed, and the "whole plan" involving the FLP had a "testamentary essence." The decedent retained enjoyment or possession of the assets transferred to the FLP under §2036(a)(1) (at least by implied agreement) because, although he kept sufficient assets for personal needs, he instead "scooped into FLP assets to pay personal expenses," and his relationship to the assets remained unchanged after the transfer to the FLP.

The court followed up on the discussion of §2043 in *Estate of Powell v. Commissioner* with its own lengthy analysis, but on the facts of the case the application of §2043 had little practical impact.

The court refused to allow any additional charitable deduction under the formula transfer provision in the Irrevocable Trust as a result of the inclusion of the farm in the gross estate because (1) specific wording in the formula limits any transfer, and (2) the charitable amount was not ascertainable at the decedent's death but depended on subsequent events (the IRS audit and tax litigation). The *Christiansen* and *Petter* cases were distinguished because they merely involved valuation issues to determine what passed to charity, but in this case the charity did not know it "would get any additional assets at all."

The court also determined that (1) the $2 million transfers to the children in return for notes were actually gifts (with a detailed review of factors considered in determining whether bona fide debt exists), (2) additional gift taxes resulting from those gifts must be included in the gross estate under §2035(b) because the gifts were made within three years of death, and (3) a flat fee of $475,000 for attorney's fees was not deductible because the evidence did not establish what services were performed for the fee and that it was necessarily incurred in the administration of the estate. The case is being appealed to the Ninth Circuit Federal Court of Appeals. *Estate of Howard V. Moore v. Commissioner,* T.C. Memo. 2020-40 (April 7, 2020, Judge Holmes).

For a detailed discussion of *Estate of Moore*, see Item 20 of Estate Planning Current Developments and Hot Topics (March 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

b. **Very Brief Overview of Facts.** In a very convoluted pre-death planning scenario (this really is a **very** brief and overly simplified overview of the facts), the decedent (knowing he had less than six months to live) transferred 4/5ths of a farm (that he had already contracted to sell) to an FLP in return for a 95% limited partnership interest. He subsequently sold the 95% interest to an Irrevocable Trust for a cash down payment and $4.8 million note at a price representing a discount of about 50%.

The decedent's revocable trust provided a formula bequest to a charitable lead trust in an amount to "result in the least possible federal estate tax." In addition, the Irrevocable Trust provided that the trustee would distribute to the revocable trust "the value of any asset of this trust which is includible in my gross estate."

The FLP transferred $500,000 to each of his four children in return for a five-year note bearing interest at a rate of 3.6% from each of the children. (The mid-term applicable federal rate for February 2005 was 3.83%. Rev. Rul. 2005-8, 2005-1 C.B. 466.) The notes had no amortization schedule, no payments were made, no efforts were made to collect the notes, and the court ultimately did not respect the notes. In addition, the FLP transferred $2 million to the decedent's revocable trust, which was used to pay various expenses, including Mr. Moore's income tax attributable to the sale of the farm. Mr. Moore's daughter treated this as a loan from the FLP (the estate claimed a $2 million debt deduction and treated the loan as a receivable of the FLP), but there was no further evidence that it was a loan, the Living Trust never repaid the FLP, and the court did not respect it as a loan.

Mr. Moore died at the end of March 2005, as a resident of Arizona. The case is on appeal to the Ninth Circuit Federal Court of Appeals.

c. **Issues.** The court said that it had to decide the following issues.

   (1) Is the value of the farm included in the gross estate under §2036 despite its sale by the FLP?

   (2) If so, does the subsequent transfer of the Living Trust's interest in the FLP to the Irrevocable Trust remove that value from the gross estate?

   (3) Can the estate deduct the $2 million ostensible debt from the Living Trust to the FLP, "*future* charitable contributions," and $475,000 in attorney's fees?

   (4) Were the $500,000 transfers to each of the children loans or gifts?

   Interestingly, whether the transfer of the limited partnership interests for $5.3 million (reflecting a 53% discount) was a gift (with resulting penalties and interest) was not an issue addressed by the court.

d. **Estate Inclusion Under §2036(a).** Not surprisingly, the court determined (after a lengthy analysis) that the farm was included in the gross estate under §2036(a)(1). The bona fide sale for full consideration exception in §2036(a) did not apply because no businesses required active management, the children did not actually manage sale proceeds in the FLP, no legitimate creditor concerns existed, and the "whole plan" involving the FLP had a "testamentary essence." The decedent retained enjoyment or possession of the assets transferred to the FLP under §2036(a)(1) (at least by implied agreement) because, although he kept sufficient assets for personal needs, he instead "scooped into FLP assets to pay personal expenses," and his relationship to the assets remained unchanged after the transfer to the FLP.

e. **Section 2043 Consideration Offset Discussion.**

   (1) **Court Analysis.** The court followed up on the discussion of §2043 in *Estate of Powell v. Commissioner* with its own lengthy analysis. The court proceeded with an extended discussion of §2043, fortunately avoiding *Powell*'s doughnut and doughnut hole analogies, but applying a formula approach. The court's analysis ended up with the following formula:

      Value in Gross Estate = Value of farm at date of death – money that left the estate between the time of the sale and date of death.

   The court discussed five examples of how §2043 would apply in different circumstances, but on the facts in the *Moore* case the application of §2043 had little practical impact.

(2) **Section 2043 Background.** The §2043 analysis was not actually "discovered" in *Powell*. The plurality opinion's summary of how §2043 applies in the context of §2036 FLP cases is similar to what Professor Jeffrey Pennell has been telling planners for decades. *See*, *e.g.,* Pennell, *Recent Wealth Transfer Developments*, ABA REAL PROP., PROB. & TR. LAW SECTION 14TH ANN. EST. PL. SYMPOSIUM, at 21-23 (2003).

(3) **Double Inclusion Approach Is Often Not Applied in Other Contexts.** In other contexts, the IRS has not used the double inclusion approach where doing so would result in unfair results. The IRS has previously ruled that life insurance proceeds received by a partnership should not be includible in the gross estate *both* under §2042 and under §2033 as to the decedent's partnership interest. For example, in Revenue Ruling 83-147, 1983-2 C.B. 158, the IRS refused to include life insurance proceeds payable to a partnership both as part of a partner's interest in the partnership and under §2042 as a result of incidents of ownership attributed to the decedent as partner of the partnership, because doing so would result in "unwarranted double taxation":

> In *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff'd on another issue* 244 F.2d 436 (4th Cir. Cir), *cert denied*, 355 U.S. 827 (1957), a partnership held 10 policies on the decedent's partner's life, at his death…. The court found that the decedent, in his individual capacity, had no incidents of ownership in the policies, and held that the insurance proceeds were not includible in the gross estate under the predecessor to section 2042(2) of the Code. The Service acquiesces in the result of *Estate of Knipp* on the basis that in that case the insurance proceeds were paid to the partnership and inclusion of the proceeds under the predecessor of section 2042 would have resulted in the **unwarranted double taxation** of a substantial portion of the proceeds, because the decedent's proportionate share of the proceeds of the policy were included in the value of the decedent's partnership interest. See also section 20.2042-1(c)(6) of the regulations (which adopts a similar rule with regard to life insurance proceeds paid to or for the benefit of a corporation). (Emphasis added.)

A distinction regarding life insurance inclusion under §2042, however, is that §2043(a) refers to transfers under §2035-§2038 and §2041, but not transfers under §2042.

Similarly, the regulations regarding GRATs state that if the GRAT assets are included under §2036, the retained annuity interest payments that are payable after the decedent's death are not also included under §2033 "because they are properly reflected under this section." Reg. §20.2036-1(c)(1)(i).

Over the last 24 years preceding the *Moore* decision, 22 cases (listed in the last paragraph of Item 28.f above) had held that the value of assets contributed to a family limited partnership or LLC were included in a decedent's estate under §2036, but *none* of those cases, other than *Powell*, included both the FLP assets and the FLP interest in the gross estate. Despite this long history of FLP/§2036 cases and other examples of avoiding double inclusion described above, the *Moore* opinion responds:

> Excluding the value of the partnership interest from Moore's gross estate might appear to be the right result because it would prevent its inclusion in the value of the estate twice. The problem is that there is nothing in the text of section 2036 that allows us to do this.

(4) **Practical Impact of Applying §2043 in FLP/§2036 Context.** Applying the double inclusion with a §2043 consideration offset analysis (rather than simply including the §2036 amount in the gross estate) has a practical impact on the overall result primarily in situations in which (1) the assets contributed to the entity have appreciated or depreciated by the time of death, or (2) distributions from the entity have been made that are still owned by the decedent at death.

For detailed examples of the effects of subsequent appreciation, subsequent deprecation, or subsequent distributions from an entity, see Summary of *Estate of Moore v. Commissioner* (April 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(5) **Summary: Double Inclusion Analysis Going Forward in FLP Context.** Using the double inclusion §2036 approach with a §2043 consideration offset rather than the single inclusion §2036 approach results in "unfair" double taxation if *appreciation* occurs and still allows the partnership

discount if significant *depreciation* occurs. From a policy standpoint, the single inclusion §2036 approach seems preferable.

The fact that eight (but less than a majority) of the judges in *Powell* and now *Moore* adopted the double inclusion analysis may embolden the IRS to take that position in future cases. But we do not yet know how a majority of the Tax Court judges would rule as to that issue.

In any event, the double inclusion analysis applied in *Powell* and *Moore* raises a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer had merely retained the assets, if the assets appreciate between the time of contribution to the entity and the date of death and if §2036 applies to the transfer of assets to the FLP (or other entity).

(6) **ACTEC Comments to IRS Recommending Adoption of the Position of the *Powell* Concurring Opinion.** The American College of Trust and Estate Counsel (ACTEC) filed comments with the Internal Revenue Service on May 26, 2021, recommending issues for inclusion in the 2021-2022 Treasury Priority Guidance Plan. The comments include a recommendation that if assets contributed to a partnership (or LLC) are included in the contributor's gross estate under §2036, unless what was transferred into the entity has been re-transferred or unless some third party paid consideration for what is included in the estate under §2036, the entity interest itself should not also be included under §2033.

The comments observe that this would be consistent with the treatment of assets transferred to a GRAT if the grantor dies before the end of the GRAT term and value attributable to the GRAT is included in the decedent's gross estate under §2036. Section 2043 is not used; instead the annuity payments that are due after the date of death are not also included in the gross estate under §2033. Reg. §20.2036-1(c)(1)(i).

The comments recommend a proposed solution to the complexities, inconsistencies, and unfairness that results under the double inclusion/§2043 analysis in *Powell* and *Moore*:

> Under the concurring opinion in *Powell*, the entire lifetime transaction should be disregarded and the transferred property should be entirely included in the gross estate at its date of death value and the partnership units ignored for such purposes. This approach would avoid the complicated analysis that results from the application of Section 2043, i.e., the valuation of the retained interest under Section 2036(a) inclusion/Section 2043(a) offset that leads to illogical results which are unfair to either the taxpayer (doubling counting post transaction appreciation) or the Service (doubling counting of post transaction depreciation). The concurring opinion would result in tax on the value of the assets actually transferred.
>
> The solution proposed here is not only the more practical one, but also the outcome that is the most "fair" to the taxpayer and to the government. And it is the most theoretically satisfying. We propose that Section 2043 should not apply where there is no consideration provided by a third party because the taxpayer's estate has received no additional assets or value in a transaction that is essentially with himself or herself. In cases where the consideration received in the transfer is from a third party, the estate is actually enlarged by the consideration received and Section 2043 should apply to exclude the additional value. (If the partnership interest received upon formation of the partnership is sold within three years of a partner's death and the sale does not qualify for the bona fide exception under Section 2035, the amount of the Section 2035 inclusion would need to be reduced by the consideration received from the third party in the sale.) [footnote omitted]
>
> …
>
> Conclusion and Recommendation
>
> Although the Tax Court has eliminated any concern that both the underlying assets contributed to a partnership as well as the partnership interest itself may be subject to full estate tax, Section 2043 is at best a crude tool to avoid double taxation. And its application in *Powell* and *Moore* runs counter to the Section 2036 regulations because it provides for both the assets transferred to be included in Section 2036 as well as the interest received in exchange (such as a partnership interest) to be included under Section 2033. The better result would be simply to include only the assets transferred by the decedent in the pre-death transaction (e.g., to the partnership) where the taxpayer had retained such a power or interest (in the partnership) and to cause Section 2036 to apply.

Accordingly, we respectfully recommend that the Treasury Department and the Internal Revenue Service issue guidance, perhaps in the form of a revenue ruling, adopting the position taken in the concurring opinion in *Estate of Powell*.

f. **Charitable Formula Transfer Provision Not Respected.** The court refused to allow any additional charitable deduction under the formula transfer provision in the Irrevocable Trust as a result of the inclusion of the farm in the gross estate because (1) specific wording in the formula limits any transfer and (2) the charitable amount was not ascertainable at the decedent's death but depended on subsequent events (the IRS audit and tax litigation). The *Christiansen* and *Petter* cases were distinguished because they merely involved valuation issues to determine what passed to charity, but in this case the charity did not know it "would get any additional assets at all."

The *Moore* opinion draws a distinction between estate tax examinations and court determinations of value vs. other issues. A contingency based on ultimate determination of valuation issues is not a "transfer … contingent on the happening of some event." The court reasoned that in *Christiansen,* in which the opinion was also written by Judge Holmes and recognized a formula transfer) and *Petter*, "we *knew* the charity clearly would receive assets, just not how much. Here we *don't know* if the charity would get any additional assets at all." (Emphasis in original.)

Under this approach, formula transfers to charity that depend on IRS or court determinations as to any issues other than values are suspect. The *Moore* opinion, however, offers no support for making a distinction between a court resolution of valuation issues vs. the resolution of other issues (such as §2036 inclusion) that impacts the amount passing to charity under a formula bequest. Both involve significant uncertainties about how the issues will ultimately be resolved, based on a set of facts that existed at the date of death. For example, the opinion cites *Estate of Marine v. Commissioner*, 97 T.C. 368, 378-79 (1991), *aff'd*, 990 F.2d 136 (4th Cir. 1993), in support of its position that charitable deductions must be ascertainable at the decedent's date of death. But in *Marine*, the personal representative could make bequests to compensate individuals chosen by the representative who contributed to the decedent's well-being, with no limit on the number of persons who could receive such bequests, which would reduce the amount that could pass to charity under the residuary estate. That is a contingency based on future events and exercises of discretion involving distributions to an unlimited number of non-charitable beneficiaries, far different from a court determination of the tax effects of facts as they existed at the date of death. A court determination of the tax effects of transactions that had occurred involving the FLP by Mr. Moore is something that "depends only on a settlement or final adjudication of a dispute about the past" (to quote Judge Holmes' reasoning in *Christiansen*). "It should make no difference whether inclusion as of the date of death is the trigger, rather than the value of the gross estate. Both cases turn on resolution of a dispute involving the ultimate size of the gross estate." Larry Katzenstein and Jeff Pennell, Estate of Moore v. Commissioner – *Discount Planning Debacle*, LEIMBERG ESTATE PLANNING NEWSLETTER #2790 (April 20, 2020).

Classic testamentary marital deduction formula clauses traditionally take into account a wide variety of factors, not just valuation issues, to leave enough assets to a surviving spouse in order to avoid or minimize federal estate tax (analogous to the "least possible federal estate tax" formula charitable clause in *Moore*). Adjustments in estate tax examinations or litigation are taken into consideration in applying the formula marital bequest. If the formula transfer in the *Moore* case had been to a surviving spouse or marital trust, presumably the formula bequest would have been respected, assuming sufficient estate assets were available to satisfy the formula bequest. *E.g.*, *Estate of Turner v. Commissioner*, 138 T.C. 306 (2012) (sometimes referred to as "*Turner II*").

The appeal of *Estate of Moore* will be heard by the Ninth Circuit Federal Court of Appeals, which approved the *Petter* defined value clause case involving a formula charitable transfer.

g. **Transfers in Return for Notes Not Respected as Loans but Are Treated as Gifts.** Mr. Moore directed the FLP to transfer $500,000 to each of his four children in return for a five-year note bearing interest at a rate of 3.6% from each of the children. The notes had no amortization schedule, no payments were made, and no efforts were made to collect on the notes. The IRS asserted that these transfers "were gifts and not loans because they lack a legitimate debtor-creditor relationship." Various factors relevant in determining if a transfer creates a bona fide debt were summarized (citing *Estate of Rosen v. Commissioner*, T.C. Memo. 2006-115, as well as other cases). Even though the children signed notes and the debt was not proportionate to the children's ownership in the FLP (both of which weighed in favor of a bona fide debt), the court found it was "more likely than not" that these were gifts based on a variety of other factors:

- The notes had no fixed payment schedule;
- The children never made required interest payments;
- The FLP never demanded repayment of the loans;
- There was no evidence the children had the resources to repay the loans, and thin capitalization weighs against a finding of bona fide debt;
- Repayment depending solely on earnings does not support a finding of bona fide debt;
- The notes were not secured;
- Comparable funding from another lender was unlikely;
- The children did not set aside funds to repay the notes; and
- Most important, Mr. Moore had listed a desire that each of his children *receive* $500,000 as one of his estate planning goals, and the attorney testified that the payments needed to be loans for tax purposes because "having [them] as a gift wouldn't be the best use of the tax laws."

These transfers from the FLP to the children, totaling $2 million, were treated as gifts, and the additional resulting gift tax was included in the gross estate under §2035(b) because the gifts had been made within three years of death.

The loan vs. gift issue was also addressed by the court in *Estate of Bolles v. Commissioner*, T.C. Memo. 2020-71, discussed in Item 30 immediately below.

30. Treatment of Advances to Son as Legitimate Loans vs. Gifts, *Estate of Bolles v. Commissioner*, T.C. Memo. 2020-71

a. **Synopsis.** The Tax Court addressed whether advances from a mother to her children (and particularly, over $1 million of advances to a struggling son) were legitimate loans or were gifts. Although the mother documented the advances, there were no loan agreements, security, or attempts to force repayment. She forgave the "gift tax exemption amount" of the debts each year. Large amounts were advanced to a struggling son ($1,063,333 over 23 years), and at some point, the mother realized that the son would never be able to repay the advances; on October 27, 1989, she prepared her revocable trust to exclude that son from any distribution of her estate at her death. The court treated advances through 1989 as loans but treated subsequent advances as gifts. *Estate of Bolles v. Commissioner*, T.C. Memo. 2020-71 (June 1, 2020, Judge Goeke).

b. **Basic Facts.** A mother generally wanted to treat her five children equally. She made advances to her children, keeping records of the advances and "occasional repayments for each child," but there were no notes, no collateral, and no attempts to force repayment. She treated the advances as loans, but she "forgave the 'debt' account of each child every year on the basis of the gift tax exemption amount." The court observed that "[h]er practice would have been noncontroversial but for the substantial funds she advanced to Peter."

Peter was the oldest of the children. He took over his father's architecture practice. He experienced success in attracting clients but had financial difficulties largely because his expectations exceed realistic results. A family trust became liable for $600,000 of his bank loans. Because of his financial difficulties, the mother advanced substantial funds ($1,063,333) to Peter from 1985 through 2007.

The mother prepared a revocable trust dated October 27, 1989 that "specifically excluded Peter from any distributions of her estate upon her death." She subsequently amended the revocable trust to permit Peter to share in her estate but only after accounting for "loans" made to him plus accrued interest. Peter signed an acknowledgement that $771,628 plus accrued interest using the AFR for short-term debt determined at the end of each calendar year, would be subtracted from Peter's share of the estate at the mother's death.

Presumably, the mother forgave some of the advanced amounts to Peter under her annual gift plan, and Peter apparently made some repayments on the loans through 1988, but the IRS asserted that the entire $1,063,333 amount, plus $1,165,778 of accrued interest, was an asset of the mother's gross estate or that $1,063,333 was an adjusted taxable gift to be included in computing her estate tax liability.

c. **Court Analysis.** Both parties pointed to *Miller v. Commissioner*, T.C. Memo. 1996-3, *aff'd*, 113 F.3d 1241 (9th Cir. 1997), for the traditional factors used to decide whether an advance is a loan or a gift:

> Those factors are explained as follows: (1) there was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) actual repayment was made, (7) the transferee had the ability to repay, (8) records maintained by the transferor and/or the transferee reflect the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax purposes is consistent with a loan.
>
> These factors are not exclusive. See, e.g., Estate of Maxwell v. Commissioner, 98 T.C. 594 (1992), aff'd, 3 F.3d 591 (2d Cir. 1993). In the case of a family loan, it is a longstanding principle that an actual expectation of repayment and an intent to enforce the debt are critical to sustaining the tax characterization of the transaction as a loan. Estate of Van Anda v. Commissioner, 12 T.C. 1158, 1162 (1949), aff'd per curiam, 192 F.2d 391 (2d Cir. 1951).

The court observed that the mother had recorded the advances and kept track of interest, but there were no loan agreements, collateral, or attempts to force repayment. A critical factor to the court was "that the reasonable possibility of repayment is an objective measure of [the mother's] intent." Peter's creative ability as an architect and ability to attract clients likely convinced the mother that he would be successful and "she was slow to lose that expectation." But she must have realized he would be unable to repay her loans by October 27, 1989, when her revocable trust blocked Peter from receiving additional assets from her at her death.

The court concluded that advances to Peter were loans through 1989 but after that were gifts. Also, the court "considered whether she forgave any of the prior loans in 1989, but [found] that she did not forgive the loans but rather accepted they could not be repaid on the basis of Peter's financial distress."

d. **Planning Observations.**

(1) **Significance Generally.** The IRS may treat the transfer as a gift, despite the fact that a note was given in return for the transfer, if the loan is not bona fide or (at least according to the IRS) if there appears to be an intention that the loan would never be repaid. (If the IRS were to be successful in that argument, the note should not be treated as an asset in the lender's estate.)

A similar issue arises with sales to grantor trust transactions in return for notes. The IRS has made the argument in some audits that the "economic realities" do not support a part sale and that a gift occurred equal to the full amount transferred unreduced by the promissory note received in return. Another possible argument is that the seller has made a transfer and retained an equity interest in the actual transferred property (thus triggering §2036) rather than just receiving a debt instrument.

(2) **Gift Presumption.** A transfer of property in an intra-family situation will be presumed to be a gift unless the transferor can prove the receipt of "an adequate and full consideration in money or money's worth." Reg. §§25.2512-8; 25.2511-1(g)(1)("The gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions ..."). *See Harwood v. Commissioner*, 82 T.C. 239, 258 (1984), *aff'd,* 786 F,2d 1174 (9th Cir. 1986), *cert. den.*, 479 U.S. 1007 (1986).

(3) **Treatment as Bona Fide Loan.** In the context of a transfer in return for a promissory note, the gift presumption can be overcome by an affirmative showing of a bona fide loan with a "real

expectation of repayment and an intention to enforce the collection of indebtedness." *Estate of Van Anda v. Commissioner*, 12 T.C. 1158, 1162 (1949).

The bona fide loan issue has been addressed in various income tax cases, including cases involving bad debt deductions, and whether transfers constituted gross income even though they were made in return for promissory notes. *E.g.*, *Santa Monica Pictures, LLC v. Commissioner*, T.C. Memo. 2005-104 (no basis was established for assumption of debt that was not a bona fide indebtedness); *Todd v. Commissioner*, T.C. Memo. 2011-123, *aff'd*, 110 AFTR 2d ¶ 2012-5205 (5th Cir. 2012) (unpublished decision) (appellate decision emphasized post hoc note execution and that the loan was never repaid as supporting that the note was merely a formalized attempt to achieve a desired tax result despite a lack of substance).

The *Bolles* court cited *Miller v. Commissioner*, which is often cited regarding whether transfers are treated as bona fide loans. It involved transfers made to a son in return for a non-interest-bearing unsecured demand note, and the *Miller* court analyzed in detail the nine factors that it listed. *Miller* cited a number of cases in which those same factors have been noted to determine the existence of a bona fide loan in various contexts, and those nine factors have been listed in various subsequent cases.

A recent case addressing advances from a family limited partnership analyzed eleven factors that were important in determining whether the transfers were gifts or loans. *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40 (discussed in Item 29.g above) *See also Estate of Rosen v. Commissioner*, T.C. Memo. 2006-115 (detailed analysis of eleven bona fide loan factors as applied to transfers from an FLP).

(4) **Other Transfer Tax Related Contexts in Which Loan Issue May Arise.** Whether a loan is respected for federal tax purposes can arise in a variety of estate planning contexts:

- Whether §2036 applies in a sale-leaseback transaction if the sale for a note is not recognized as a bona fide sale;
- Possible estate inclusion under §§2033, 2035 and 2038 for property transferred in return for a note if the note is not respected;
- The treatment of advances from an FLP as distributions (even though notes were given for the advances) may support the inclusion of FLP assets under §2036; and
- Whether a note owed by the estate is valid debt for purposes of qualifying for a §2053 deduction.

Cases involving each of these scenarios are summarized in Item 21.d.(4) of Estate Planning Current Developments and Hot Topics (May 2021) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

(5) **Upfront Gift If Intend to Forgive Loan?** In *Bolles*, the mother made advances and, according to the opinion, "forgave the 'debt' account of each child every year on the basis of the gift tax exemption amount." The court said that "practice would have been noncontroversial but for the substantial funds" the mother advanced to Peter. While the court may have thought that plan was "noncontroversial," the IRS has taken the position that advances made with the intention of forgiving the purported "loans" are treated as upfront gifts, but cases have not always agreed with that position.

(a) **IRS Position.** Revenue Ruling 77-299 announced the IRS position that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, 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. The IRS relied on the reasoning of *Deal v. Commissioner,* 29 T.C. 730 (1958), for its conclusion in Rev. Rul. 77-299. 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.

(b) **Case Law.** The Tax Court reached a contrary result in several cases that were decided before the issuance of Rev. Rul. 77-299 (and the IRS non-acquiesced to those cases in Rev. Rul. 77-299). Those cases reasoned that there would be no gift at the time of the initial loan as long as the notes had substance. The issue is not whether the donor intended to forgive the note, but whether the note was legally enforceable. *See Haygood v. Commissioner*, 42 T.C. 936 (1964) (gift that occurred at the time of the initial transfer was reduced by the full face amount of the secured notes even though the taxpayer had no intention of enforcing payment of the notes and the taxpayer in fact forgave $3,000 per year on the notes from each of the transferees); *Estate of Kelley v. Commissioner*, 63 T.C. 321 (1974) (no upfront gift even though parents extinguished notes without payment as they became due).

The court in *Estate of Maxwell v. Commissioner*, 3 F.3d 591 (2d Cir. 1993), distinguished *Haygood* and *Kelley* in a §2036 case involving a transfer of property subject to a mortgage accompanied with a leaseback of the property. Other cases have criticized the approach taken in *Haygood* and *Kelley* (though in a different context), observing that a mere promise to pay in the future that is accompanied by an implied understanding that the promise will not be enforced should not be given value and is not adequate and full consideration in money or money's worth. *E.g., Miller v. Commissioner*, T.C. Memo. 1996-3, *aff'd without opinion*, 113 F.3d 1241 (9th Cir. 1997); *Estate of Musgrove v. United States*, 33 Fed. Cl. 657, 664 (1995); *Estate of Lockett v. Commissioner*, T.C. Memo. 2012-123.

(c) **Which is the Best Reasoned Approach?** One commentator gives various reasons in concluding that the taxpayers' position is the more reasoned position on this issue.

> The IRS has not done well with this approach, and there are reasons for this. Even if the lender actually intends to gradually forgive the entire loan, (1) he is free to change his mind at any time, (2) his interest in the note can be seized by a creditor or bankruptcy trustee, who will surely enforce it, and (3) if the lender dies, his executor will be under a duty to collect the note. Therefore, if the loan is documented and administered properly, this technique should work, even if there is a periodic forgiveness plan, since the intent to make a gift in the future is not the same as making a gift in the present. However, if the conduct of the parties negates the existence of an actual bona fide debtor-creditor relationship at all, the entire loan may be recharacterized as a gift at the time the loan was made or the property lent may be included in the lender's estate, depending on whether the lender or the borrower is considered to "really" own the property.
>
> …
>
> If the borrower is insolvent (or otherwise clearly will not be able to pay the debt) when the loan is made, the lender may be treated as making a gift at the outset.

KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶28.05[2][a](Warren Gorham & Lamont 1997). Other commentators agree that the Tax Court analysis in *Haygood* and *Kelley* is the preferable approach. *E.g.*, HOWARD M. ZARITSKY & RONALD D. AUCUTT, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS, §12.02 (2d ed. 1997).

(d) **Planning Pointers.** While the cases go both ways on this issue, taxpayers can clearly expect the IRS to take the position that a loan is not bona fide and will not be recognized as an offset to the amount of the gift at the time of the initial transfer if the lender intends to forgive the note payments as they become due. Where the donor intends to forgive the note payments, it is especially important to structure the loan transaction to satisfy as many of the elements as possible in distinguishing debt from equity. In particular, there should be written loan documents, preferably the notes will be secured, and the borrower should have the ability to repay the notes. If palatable, do not forgive all payments, but have the borrowers make some of the annual payments.

31. Gift and Sale of Partnership Interests Expressed as Dollar Amounts Based on Subsequent Appraisals, Lack of Control and Lack of Marketability Discounts, Multi-Tiered Discounts, *Nelson v. Commissioner*, T.C. Memo. 2020-81

a. **Synopsis.** This gift tax case determined the value of gifts and sales of interests in a limited partnership, the primary asset of which was 27% of the common stock of a holding company that owned 100% of eight subsidiaries (six of which were operating businesses). The gifts and sales were of limited partner interests having a specified dollar value on the transfer date "as determined by a qualified appraiser within ninety (90 days) of the effective date of the Assignment" (180 days in the case of the sale). An appraisal was prepared for the holding company, which was then used to prepare an appraisal for the transferred limited partner interests. The percentage limited partner interests that were transferred were based on those appraisals and documented in the partnership's records and used for preparing subsequent income tax returns.

The IRS took the position that the transfers resulted in additional gifts of about $15 million. The taxpayers first argued that the transfers were actually of interests worth a particular dollar value rather than of particular percentage interests. The court disagreed, observing that the clauses in the assignments "hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes."

> **Observation:** This is a practical approach that is often used in structuring assignments of hard-to-value assets. The IRS did not object to this type of assignment (determining the percentage interest transferred based on an appraisal completed relatively soon after the transfer) as abusive, but merely proceeded to enforce the assignment as drafted and then value the interests so transferred.

The court ultimately determined that the 27% interest that the partnership owned in the holding company was valued using a 15% lack of control discount (slightly lower than the taxpayers' expert's position of a 20% discount but higher than the IRS's expert's 0% discount) and 30% for lack of marketability (agreed to by experts for both the taxpayers and the IRS). The holding company value was then used to determine the value of the limited partner interests, which the court determined using a 5% lack of control discount (compared to 15% by the taxpayer's expert and 3% by the IRS's expert) and a 28% lack of marketability discount (compared to 30% by the taxpayers' expert and 25% by the IRS's expert). The values determined by the court resulted in an additional gift value of about $4.5 million. On October 16, 2020, Mr. and Mrs. Nelson filed notices of appeal of the Tax Court's decision to the Court of Appeals for the Fifth Circuit. *Nelson v. Commissioner*, T.C. Memo. 2020-81 (Judge Pugh).

b. **Facts and Court Analysis.** For a detailed summary of the basic facts in the case and of the court's analysis, see Item 24 of Estate Planning Current Developments and Hot Topics (December 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

c. **Observations.**

(1) **Not a Rejection of Defined Value Clauses.** The court's refusal to treat this as a transfer of a dollar amount based on values as finally determined for gift tax purposes might on first blush be viewed as a rejection of a defined value transfer. That is not the case. The transfer was of a defined value of interests not as finally determined for gift tax purposes but as determined by a qualified appraisal that would be completed shortly after the date of the transfer.

The taxpayers argued that the transfers were intended to be dollar amounts of units of the partnership based on values as finally determined for gift tax purposes. But was that really the intent in 2008-2009? In effect, they argued that the assignments were intended to have "*Wandry* clauses," but bear in mind that the *Wandry* case was not decided until 2012. *Wandry v. Commissioner*, T.C. Memo. 2012-88.

(2) **Importance of Using Grantor Trusts With Defined Value Transfers.** The facts of *Nelson* illustrate the importance of using grantor trusts with defined value transfers. If the amount transferred depends on values as finally determined for gift tax purposes, the amounts actually transferred

may not be determined for years. In the meantime, income tax returns are filed, reflecting the anticipated amounts that were transferred. If the defined value transfer is made to a grantor trust, even if the ownership percentages change as a result of a gift tax audit, all the income and deductions will have been reported on the grantor's income tax return in any event, and no corrective returns should be necessary (unless the parties wish to file corrected entity level returns to make clear the appropriate sharing of profits and losses of the entity's owners).

(3) **Potential Disadvantage of Defined Value Clauses.** This case illustrates a potential disadvantage of using defined value clauses. This case did not involve a defined value clause, so the percentage interests transferred did not have to be adjusted to reflect the values determined by the court. Instead, the donors made additional taxable gifts and may have had to pay additional gift taxes. The court ultimately determined that the taxpayers made additional gifts of about $4.5 million, resulting in additional gift taxes of just over $2 million.

As a result of the settlement discussions with IRS Appeals, the taxpayers attempted to adjust the percentage interests transferred from 64.79% (for the gift and sale) to only 38.55%. If that had been the effect of the assignment clauses, the parties would have decreased the Trust's interest in the FLP (with underlying assets of over $60 million) by 26.24%, or a reduction of the Trust's value by about $15.9 million, without counting subsequent appreciation and income. In effect, the taxpayers will pay an additional $2 million of gift tax (if the Tax Court case is upheld on appeal) in order to keep in the Trust an additional $15.9 million, plus untold subsequent appreciation and income (unreduced by income tax because the grantor pays it) that has accumulated in the Trust during the intervening twelve years, which amount could now be multiples of $15.9 million. Even in the face of that seemingly outstanding result compared with the taxpayers' apparent settlement position, however, on October 16, 2020, Mr. and Mrs. Nelson filed notices of appeal of the Tax Court's decision to the Court of Appeals for the Fifth Circuit.

(4) **Support of Planning Alternative for Transferring Hard-To-Value Assets; 90 vs. 180 Days for Appraisals.** As a practical matter, valuing hard-to-value assets on the date of the transfer is impossible. A formula transfer of a dollar value worth of a particular asset, based on an appraisal to be obtained within a specified term in the near future, is routinely used, and is not viewed by the IRS as abusive. By the time the gift tax return is filed, the appraisal will be at hand, and a specific number of shares or units that have been transferred pursuant to the formula will be known and listed on the gift tax return. *See* Rev. Rul. 86-41, 1986-1 C.B. 300 ("In both cases, the purpose of the adjustment clause was not to preserve or implement the original bona fide intent of the parties, as in the case of a clause requiring a purchase price adjustment based on an appraisal by an independent third party retained for that purpose").

The IRS apparently raised no objections to these assignments based on values as determined by appraisals within a short time after the transfers, and indeed simply proceeded to enforce the terms of the assignments.

Obviously, that approach provides no protection against gift taxes in the event of an audit. The key distinction of a classic defined value type of transfer is that the formula dollar value being transferred is based on values as finally determined for federal gift tax purposes.

(5) **Partnership Respected by IRS Despite Being Created Shortly Before Transfers.** The FLP was created only about three months before the transfers, but the IRS did not argue that the partnership should be ignored as simply an artificial device to produce more valuation discounts.

(6) **Transfer Restrictions Not Addressed in Appraisals, So No Section 2703 Issues Arose.** Both the WEC corporate documents and the FLP agreement contained transfer restrictions, generally just allowing transfers to family members. For the corporation, shareholders could also sell their shares back to the corporation or other shareholders, and for the FLP, the partners could also sell interests with the approval of the general partners (who happened to be Mr. and Mrs. Nelson) or subject to a right of first refusal by the FLP and the other partners. None of the experts applied any valuation discounts because of the transfer restrictions. Therefore, no issues arose as to whether the restrictions should be disregarded in valuing the transfers under §2703.

(7) **Sale for Note Using AFR Was Respected.** The sale in early 2009 in return for a note using the mid-term AFR that was secured by the limited partner interest that was sold was respected by the IRS. The IRS did not attempt to argue that the note's value should be discounted because the interest rate was less than a market interest rate.

Anecdotal indications are that the IRS has recently raised questions in some audits as to whether notes using the AFR in sale transactions should be discounted in value because of the interest rate. So far, there is no case law supporting that position. *But see* PLR 200147028, in which the IRS seemed to embrace a market interest rate standard when it ruled that partitioned and reformed trusts "will retain their GST tax exempt status … [i]f the trustee elects to make one or more loans to the beneficiaries … provided that such loans are adequately secured and subject to a market rate of interest." There is no indication in the ruling whether the taxpayers who had requested the ruling had included that proviso on their own or if perhaps the IRS had required them to add it. (The ruling states that the taxpayers had asked a court to grant that discretion and the court had agreed, but it doesn't indicate whether that request had been made at the suggestion of the IRS after the ruling request had been submitted).

Most planners use the applicable federal rate, under the auspices of §7872, as the interest rate on notes for intra-family installment sales. Section 7872 addresses the gift tax effects of "below-market" loans, and §7872(f)(1) defines "present value" with reference to the "applicable Federal rate." Using §7872 rates would seem to be supported by the position of the IRS in a Tax Court case and in several private rulings.

In *Frazee v. Commissioner*, 98 T.C. 554 (1992), the IRS urged, as its primary position, that the interest rate under §7872 (rather than the interest rate under §483 or any other approach), should apply for purposes of determining the gift tax value of a promissory note in the context of a sale transaction. Whether the §7520 rate or some other market rate should apply was not strictly before the court, because the IRS proposed using the lower §7872 rate. However, the court analyzed §7872 and concluded that it applied for purposes of valuing a note given in a seller financed sale transaction:

> Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply the provision as drafted. 98 T.C. at 588.

The opinion concluded with an acknowledgement that this approach was conceded by the IRS in its position that §7872 applied rather than valuing the note under a market rate approach: "We find it anomalous that respondent urges as her primary position the application of section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept." *Id*. at 590. The concept is welcome, probably because rates under §7872 are objective and do not burden the court with the need for evidence, argument, and judgment.

The use of the §7872 rate for intra-family note transactions was subsequently approved in *True v. Commissioner*, T.C. Memo. 2001-167 ("We concluded in Frazee v. Commissioner, supra at 588-589, that section 7872 does not apply solely to loans of money; it also applies to seller-provided financing for the sale of property. In our view, the fact that the deferred payment arrangement in the case at hand was contained in the buy-sell agreements, rather than in a separate note as in Frazee, does not require a different result."), *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004).

Private letter rulings have also taken the position that using an interest rate that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. *E.g.*, PLRs 9408018; 9535026.

(8) **No Issue of "Equity" in the Sale Transaction.** Although PLR 9535026 (which often is cited as the IRS's first approval of an installment sale to a grantor trust) does not refer to any "equity" in the trusts, such as other property to help secure the debt or property with which to make a down

payment, it is well known that the IRS required the applicants for the ruling to commit to such an equity of at least 10% of the purchase price. *See generally* Michael Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 EST. PLAN. 3, 8 (Jan. 1996). (In PLR 9251004, the IRS had held that a transfer of stock to a trust with no other assets, in exchange for the trust's installment note, "must be considered a retention of the right to receive trust income" for purposes of §2036.)

In *Nelson*, a gift to the Trust believed to be $2,096,000 was followed by a sale of property believed to have a value of $20,000,000. That would have resulted in "equity" of only about 9.5%. No mention was made of that in the opinion, and it cannot be determined whether that was a part of the IRS's concerns about the transactions. Of course, after the gift component had been adjusted by the Tax Court to a total of $6,643,916 ($2,524,983 as the gift made on December 31, 2008, plus $4,118,933 as the additional gift at the time of the sale on January 2, 2009) and the sale component remained $20,000,000, this issue disappeared.

(9) Multi-Tiered Discounts. The IRS did not question applying substantial discounts at both the level of assets owned by the FLP and also of interests in the FLP itself.

Discounts at multiple levels of interests owned by partnerships were allowed in *Astleford v. Commissioner*, T.C. Memo. 2008-128. The court in *Astleford* allowed full lack of control and marketability discounts at both the subsidiary level and the parent level. The cases cited by the court suggest that this is appropriate when there are minority interests being valued at both levels. Footnote 5 of the *Astleford* opinion cites four Tax Court and Tax Court memorandum cases that have allowed multi-level discounts where there were minority interests in both levels. (*Estate of Piper, Janda, Gow,* and *Gallun*.) However, footnote 5 also identifies cases that have refused to apply multi-level discounts where minority interests in subsidiaries were a significant portion of the parent entity's assets (*Martin*) or for a subsidiary that was the parent's "principal operating subsidiary" (*Estate of O'Connell*). Other cases that have addressed multi-tiered discounts include *Kosman* (1996), *Dean* (1960), and *Whittemore v. Fitzpatrick* (D. Conn. 1954). The multi-tiered discounts were not questioned in *Nelson* even though both of those conditions (addressed in *Martin* and *Estate of O'Connell*) were applicable.

Grieve v. Commissioner, T.C. Memo. 2020-28 (March 2, 2020), rejected on procedural and prudential grounds the approach offered by the taxpayer's expert at trial for the taxpayer to apply tiered discounts that would have resulted in a value considerably lower than the value reported on an appraisal attached to the gift tax return. The court explained that it had found no justification for using a net value significantly lower than the value to which the taxpayer had previously admitted on the appraisal attached to the gift tax return (without any specific criticism of the multiple-tiered discounting approach).

(10) Split Gift Election for Gift to SLAT. Mrs. Nelson made a gift to the Trust on December 31, 2008, and Mr. Nelson consented to making the split gift election with respect to that gift. The effect of the split gift election is that the transfer is treated as having been made one-half by each of the spouses for gift and GST tax purposes (meaning that the consenting spouse's gift and GST exemption could be used), but not for estate tax purposes. Because the election does not treat the spouses as making equal transfers to the trust for *estate* tax purposes, Mr. Nelson could be a beneficiary of the trust without causing estate inclusion under §2036(a)(1) and Mr. Nelson could serve as trustee without risking estate inclusion for him under §2036(a)(2) or §2038.

The case has no discussion of any problems with the split gift election (other than to note that any resulting gifts are made one-half by each of the spouses). A potential problem, however, with making the split gift election for a transfer to a SLAT 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 and severable, so that the gift amount by the spouse is the amount of the transfer other than the spouse's severable interest (because one cannot make a gift to himself or herself). The terms of the trust are unknown; perhaps Mr. Nelson's interest is ascertainable, severable, and de minimis based on the terms of the agreement. See Item 21.a above for a discussion of issues regarding the split gift election.

32. Charitable Gift Followed by Redemption Not Treated as Anticipatory Assignment of Income, *Dickinson v. Commissioner*, T.C. Memo. 2020-128

a. **Basic Facts.** A shareholder and chief financial officer of a privately held company desired to donate shares of stock to the Fidelity Investments Charitable Gift Fund (Gift Fund). In 2013, 2014, and 2015, the board of directors authorized donations of shares to the Fidelity Gift Fund because it had a written policy requiring that it immediately liquidate donated shares and would promptly tender the donated stock to the issuer for cash. In each of those years, the taxpayer donated appreciated shares to the Gift Fund. Separate documents were signed by the taxpayer, by the corporation, and by the Gift Fund making clear that the Gift Fund owned and had exclusive control of the shares prior to the redemption and had full discretion over all conditions of subsequent sale and was not under any obligation to sell the shares. The Gift Fund redeemed the shares shortly after each donation, and the IRS ultimately claimed that the redemptions resulted in an assignment of income, as if the shareholder first sold the shares (realizing gain) and then contributed the cash to the Gift Fund. *Dickinson v. Commissioner*, T.C. Memo. 2020-128 (Sept. 3, 2020) (Judge Greaves, summary judgment).

b. **Court Analysis.**

(1) ***Humacid v Commissioner* Analysis.** The court looked to its reasoning from more than 50 years earlier in *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964). In that case the court respected "the form of this kind of transaction [i.e., as a donation of shares followed by the charity's redemption of the shares rather than as a sale of shares by the taxpayer followed by a donation of the cash proceeds] if the donor (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale."

The donor met the first prong because it transferred all rights in the donated property (as confirmed by the various documents signed by the taxpayer, the corporation and the Gift Fund). Even a **preexisting understanding** that the charity "would redeem donated stock does not convert a postdonation redemption into a predonation redemption" or suggest "that the donor failed to transfer all his right in the donated stock."

The second prong, that the donation was made before the "property gives rise to income" implements the assignment of income doctrine, that a taxpayer who has earned income cannot escape taxation by assigning his right to receive payment. A key to the court's analysis is its view that this second prong "ensures that if stock is about to be acquired by the issuing corporation via redemption, the shareholder cannot avoid tax on the transaction by donating the stock before he receives the proceeds."

(2) ***Dickinson* Test.** The court summarized its test in this type of situation as follows: The assignment of income doctrine applies "only if"

(1) "the redemption was practically certain to occur at the time of the gift, and"

(2) "would have occurred whether the shareholder made the gift or not."

The first leg was probably satisfied on these facts, in light of Fidelity's strict written policy that it would immediately sell such donated stock. But the second leg was not satisfied. The taxpayer set out on three occasions to make charitable gifts. There was no indication whatsoever that the taxpayer would have sold shares to the corporation if the shares had not been donated to the Gift Fund.

(3) **Refusal to Apply "Legally Bound" Test of Rev. Rul. 78-197.** The IRS announced in Rev. Rul. 78-197, 1978-1 C.B. 83, that it refuses to treat a redemption in this type of situation as an anticipatory assignment of income as long as the charity is not legally bound to sell the donated shares and cannot be compelled to surrender the shares for redemption. The IRS argued in *Dickinson* that taxpayer's and corporation's reliance on the Fidelity policy of immediately offering donated shares for redemption, "may suggest the donor had a fixed right to redemption income at the time of the donation." The court disagreed, reasoning that it refused to adopt Rev. Rul. 78-

197 as the test for resolving anticipatory assignment of income claims in *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002), and does not do so in this case either.

c. **Observations.**

(1) **"Palmer Issue."** This type of situation is often referred to colloquially as the "Palmer issue," based on *Palmer v. Commissioner*, 62 T.C. 684 (1974) (taxpayer donated stock to foundation and then caused corporation to redeem the stock the following day), *aff'd,* 523 F.2d 1308 (8th Cir. 1975).

(2) **Refusal to Adopt Rev. Rul. 78-197 Bright Line Rule.** Planners and taxpayers have been comforted by a bright line test in Rev. Rul. 78-197, 1978-1 C.B. 83, refusing to treat a redemption in this type of situation as an anticipatory assignment of income as long as the charity is not legally bound to sell the donated shares and cannot be compelled to surrender the shares for redemption. (Ironically, while the court in *Rauenhorst* did not adopt the "legally bound" test in Rev. Rul. 78-197 as the appropriate test, it *strongly* criticized the IRS for taking a position contrary to its own published ruling that it had not withdrawn.)

On one hand, not having the bright line test is concerning for taxpayers and planners. On the other hand, the court's test is for many situations an *even stricter* standard for the IRS to meet. (Indeed, the IRS might have satisfied the "compelled to redeem the shares" test of Rev. Rul. 78-197 in this situation because of Fidelity's written policy that it would sell any such donated shares, but it did not meet the second leg of the court's test – that the redemption would have occurred whether the shareholder made the gift or not.)

(3) **Practical Effect of Court's Approach vs. Rev. Rul. 78-197 Approach.** Ron Aucutt summarizes the practical effect of the court's approach:

> [T]his analysis should leave no cause for concern about a typical, perhaps recurring, donation of stock of an ongoing corporation, when there would have been no redemption in the absence of the gift. *Dickinson* offers less comfort for the case of, for example, a scheduled liquidation, or even a scheduled partial buy-back of shares, which a shareholder tries to beat by making a charitable donation. 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).

(4) **Roadmap for Planners.** The court's emphasis on the documentation of the transaction provides a roadmap to planners.

- The *corporation* confirmed in a letter to the Gift Fund that the corporation's books and records reflected the Gift Fund as the new owner of the shares.
- The *taxpayer* signed a letter of understanding indicating that the stock was "exclusively owned and controlled by Fidelity" and that Fidelity "maintains full discretion over all conditions of any subsequent sale" and "is not and will not be under any obligation to redeem, sell, or otherwise transfer the stock."
- The *Gift Fund* sent confirmation letters explaining that it had "exclusive legal control over the contributed asset."

33. Decanting That Violates Duty of Impartiality, *Hodges v. Johnson*

Decanting has become a popular trust modification alternative, particularly for making administrative adjustments to trusts. Trustees should keep in mind, though, that just because they have the power to take an action does not mean that they cannot be held accountable for exercising that power in an improper manner. Decantings that change the beneficial interests of beneficiaries in particular may raise questions.

Hodges v. Johnson provides a good reminder that even though trustee has the POWER to decant to a trust for some but not all beneficiaries, the trustee must exercise that power consistently with settlor intent and in accordance with the trustee's duties, one of which is the duty of impartiality. In 1997, the New Hampshire Supreme Court upheld a finding that a decanting to eliminate as beneficiaries the settlor's two stepchildren and one child with whom he had become estranged was void, violated the trustee's duty of impartiality, and failed to consider the interests of all beneficiaries, both present and remainder, and upheld the removal of the trustee. 177 A.3d 86 (N.H. 2017). The removed trustees subsequently sought reimbursement of their expenses related to the decanting. The New Hampshire Supreme Court in 2020, upheld a trial court finding that the removed trustees should not have their post-trial fees and costs they incurred personally in defending the decants reimbursed from the trust. The court reasoned that they committed a serious breach of trust and should not be reimbursed, observing that they could have submitted a petition for instruction as to whether the decanting was appropriate. 244 A.3d 245 (N.H. No. 2019-0319, Sept. 23, 2020).

34. Titling of Casualty Insurance Policy, *Jones v. Phillips*

a. **Synopsis.** *Jones v. Phillips*, 859 S.E.2d 646 (Va. 2020) addresses a marital residence that was owned by spouses as tenants by the entireties and that they transferred 99% to wife's revocable trust and 1% to husband's revocable trust. (Virginia law preserves creditor protection even after tenancy by the entireties property is transferred to a trust.) The dwelling was destroyed by a fire and the casualty insurance policy was in the husband's name. The issue was whether the husband's creditor could garnish the casualty insurance proceeds. The couple argued unsuccessfully that the proceeds were tenancy by the entireties property and were therefore immune to claims of the spouses' individual creditors. There is a difference between ownership of underlying property (which may be tenants by the entireties) and of the casualty insurance policy (which was owned just by the husband). Therefore, the husband's creditors could reach the proceeds.

b. **Practical Pointer.** If underlying property is held as joint tenancy with right of survivorship or as tenants by the entireties, considering titling the casualty insurance policy the same way (if the insurance policy can be held by those titles under state law).

35. John Doe Summons Upheld to Determine Identity of Law Firm's Clients Seeking Advice Regarding Particular Issues, *Taylor Lohmeyer Law Firm P.L.L.C. v. United States*

A client of the Taylor Lohmeyer law firm was audited, and the client agreed to pay about $4 million in tax, interest, and penalties regarding the assignment of income to foreign accounts that the law firm had helped him structure. The IRS issued a "John Doe summons" to the law firm to disclose the names of all clients over a 12-year period that had used the law firm's services regarding establishing any foreign account, any foreign legal entity, or any asset in the name of any such foreign entity.

Section 7609 addresses special procedures for third-party summonses, and lists requirements for a John Doe summons, "which does not identify the person with respect to whose liability the summons is issued." One of those requirements is that "there is a reasonable basis for believing that such person or group or class of persons may fail or may have failed to comply with any provision of any internal revenue law." §7609(f)(2).

The law firm acknowledged the general rule that a client's identity is not protected from the attorney-client privilege and is subject to subpoena, but argued that an exception applies when disclosure of the identity necessarily discloses the substance of the legal advice. The Fifth Circuit upheld the subpoena in a three-judge panel decision, relying primarily on a case involving an accounting firm, *U.S. v. BDO Siedman*, 337 F.3d 802 (7th Cir. 2003) (and obviously not involving the *attorney*-client privilege). The court summarized that the summons would not reach

> motive, or other confidential communications of [legal] advice…. Consequently, the Firm's clients' identities are not "connected inextricably with a privileged communication", and therefore, the "narrow exception" to the general rule that client identities are not protected by the attorney-client privilege is inapplicable.

Taylor Lohmeyer Law Firm P.L.L.C. v. United States, 957 F.3d 505, 513 (5th Cir. 2020).

The Fifth Circuit voted 9-8, on a petition seeking an *en banc* rehearing, not to grant the petition without giving any reasons for their decision, despite a strong eight-judge dissenting opinion, which emphasized that "[w]hen the IRS pursues John Doe summonses against law firms, serious tensions with the attorney-client privilege arise." *Taylor Lohmeyer Law Firm P.L.L.C. v. United States*, Cause No. 19-50506 (Dec. 14, 2020).

Concern regarding the erosion of the attorney-client privilege was summarized in an American College of Tax Counsel Amicus Brief:

> [T]he panel's decision could facilitate the issuance of John Doe summons to a law firm seeking documents identifying any companies who retained the firm for legal advice regarding structuring their businesses so that intellectual property assets were located in low tax jurisdictions, or identifying any individuals who engaged the firm for legal advice regarding **structuring a family limited partnership or annuity trust**. Departing from longstanding and established precedent in this and other circuits, the panel's decision subjects the John Doe summons power to abuse by allowing the IRS to make broad requests to law firms to circumvent the privilege. American College of Tax Counsel Amicus Brief at 14-15 (emphasis added).

The case is summarized (and strongly criticized) in James P. Dawson & Kevin E. Packman, *IRS Fishing Expedition Leads to Erosion of Attorney-Client Privilege*, LEIMBERG INC. TAX PLANNING NEWSLETTER #209 (Dec. 29, 2020).

36. Valuation of Majority Interests in LLCs Owning Real Estate; Estate Tax Charitable Deduction Based on Values Passing to Each Separate Charity, *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17

a. **Synopsis.** Ms. Warne made gifts of interests in five LLCs owning real estate investments in 2012 and died owning (actually in a revocable trust) majority interests in the LLCs (all over 70% and three over 80%). The operating agreements all gave significant powers to the majority interest holders (including the power to dissolve the LLCs and to remove and appoint managers). Ms. Warne owned 100% of one LLC at her death, which she left 75% to a family foundation and 25% to a church. The real estate interests were substantial; the remaining LLC interests owned by Ms. Warne at her death were valued on her estate tax return at about $73.7 million. The parties agreed on most of the values, but the court determined the values of three leased fee interests at the date of the gift and at the date of death.

The court also determined appropriate lack of control and lack of marketability discounts for the LLC majority interests owned at death. The court suggested that it might have found zero lack of control discount for the majority interests, but the parties had agreed that some level of lack of control discount should apply. The court generally adopted the approach of the estate's expert, who compared premiums from completely controlling interests in companies (90% - 100% interests) with premiums from interests that lacked full control (50.1% - 89.9% interests) and concluded that the discount should be in the 5% - 8% range (compared to the IRS's expert's 2% lack of control discount). However, in reaching that conclusion the expert took into consideration that strong opposition and potential litigation would arise if the majority holder attempted to dissolve. The court found no evidence of future litigation risks and lowered the lack of control discount to 4%.

Both experts used restricted stock studies to determine the lack of marketability discount (5% - 10% by the estate's expert and 2% by the IRS's expert). The court concluded that a 5% lack of marketability discount was appropriate.

The estate argued that the 100% interest in the LLC that was left to two charities should be completely offset by the estate tax charitable deduction (because the 100% interest was donated entirely to charities), but the court concluded that a charitable deduction was allowed only for the value passing to each charity. The parties had agreed that a 27.385% discount applied for the 25% passing to the church and a 4% discount applied for the 75% passing to the foundation. (Applying discounts to the charitable deduction reduced the charitable deduction by over $2.5 million.)

The failure to file penalty was applied for the late filing of the gift tax return because the estate offered no evidence of reasonable cause for the late filing.

The case is appealable to the Ninth Circuit Court of Appeals if it is appealed. *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (Feb. 18, 2021) (Judge Buch).

b. **Basic Facts.** Mr. and Ms. Warne amassed various real estate properties beginning at least in the early 1970s. Over time, the real estate properties were owned in five separate LLCs. Mr. Warne died in 1999. Ms. Warne made gifts of various minority interests in the LLCs to her two sons in 2012, and

Ms. Warne died in 2014. The 2012 gift tax return was filed (late) at the same time as Ms. Warne's estate tax return (which was timely filed), in May 2015.

At the time of Ms. Warne's death, the Warne Family Trust (the "Family Trust," apparently a revocable trust), the value of the assets of which was included in Ms. Warne's gross estate, owned the following majority interests in the five LLCs: 78%, 72.5%, 86.3%, 87.432%, and 100%. The remaining minority units were owned in various amounts by one of more of the sons, by three granddaughters, and by a sub-trust of the Family Trust. All of the LLC agreements "grant significant power to the majority interest holder, such as the ability to unilaterally dissolve the LLCs and appoint and remove managers."

The LLC of which the Family Trust owned 100% was Royal Gardens, LLC ("Royal Gardens) and the trust agreement provided that following Ms. Warne's death the Royal Gardens units were left 75% to the Warne Family Charitable Foundation and 25% to a church.

The estate tax return listed the values of the Family Trust's majority interest in each of the LLCs at $18,006,000, $8,720,000, $11,325,000, $10,053,000, and $25,600,000 (Royal Gardens), respectively, or a total value of $73,704,000. Those values were determined by first valuing the underlying real property interest in each LLC, and by applying lack of control and lack of marketability discounts to the LLC interests owned by the Family Trust.

The IRS asserted a gift tax deficiency for the 2012 gifts (and before trial increased the deficiency to $368,462) and asserted an estate tax deficiency of $8,351,970.

The unresolved issues addressed at trial were (i) the date of gift value of three leased fee interests (that were owned by two of the LLCs), (ii) the date of death value of those same three leased fee interests, (iii) the appropriate discount for lack of control and lack of marketability of the majority interests in the LLCs held by the Family Trust at Ms. Warne's death, (iv) whether discounts apply to the 25% and 75% interests left to separate charities in the Royal Gardens LLC, and (v) whether a failure to file penalty under §6651(a)(1) applies for the 2012 gift tax return that was filed late. Apparently, the parties came to agreement with respect to the values of the remaining real estate properties and as to the appropriate lack of control and lack of marketability discounts for the gifted LLC interests.

The two sons were co-executors of Ms. Warne's estate, and they both resided in California when the petitions were filed (so the case would be appealable to the Ninth Circuit Court of Appeals).

c. **Analysis.**

(1) **Values of Leased Fee Interests.** Three leased fee interests were valued by appraisers for the estate and for the IRS. The appraisers, in appraiser-speak fashion, referred to various approaches such as the "direct capitalization approach" (which the court determined was inappropriate for the particular property involved), "yield capitalization approach," appropriate discount rates, "discounted cashflow analysis," "sales comparison approach," and "buildup method" (for determining a discount rate).

The court weighed the arguments made by the appraisers, putting more weight on the expert's appraiser as to some issues and on the IRS's expert as to other issues. The court determined which of various comparable properties were most appropriate for valuing the three leased fee interests.

(2) **Lack of Control Discount for Majority LLC Interests.** The estate and IRS each used a different appraiser than the appraiser used to value the underlying leased fee interests in order to determine appropriate lack of control and lack of marketability discounts for the majority percentage interests owned by the Family Trust at Ms. Warne's death.

The court emphasized that majority interests were being valued and that the LLCs all grant significant powers to the majority interest holder (including the power to dissolve and to remove and appoint managers). The court pointed to cases that have held that no lack of control discount applies in similar situations (*Estate of Jones v. Commissioner*, 116 T.C. 121, 135 (2001); *Estate of*

Streightoff v. Commissioner, T.C. Memo. 2018-178) and hinted that it might have concluded that *no* lack of control discount was allowed, but "[b]ecause the parties agree to a discount for lack of control, we will find one; however, given the control retained by the Family Trust, the discount should be slight."

The IRS's expert used data from nine closed-end funds to estimate a lack of control discount of 2%. The estate argued that discounts from closed-end funds are sometimes used to discern minority-interest discounts, but not discounts for lack of control for a majority interest. The court was sympathetic to that position, citing the *Richmond* (T.C. Memo. 2014-26), *Kelley* (T.C. Memo. 2005-235), and *Peracchio* (T.C. Memo. 2003-280) cases as examples of using closed-end funds for valuing *minority*-interest discounts, and noting that while the *Grieve* case (T.C. Memo. 2020-28) used closed-end funds for analyzing the lack of control discount for majority interests in LLCs, the majority interests valued in *Grieve* lacked voting rights, making the interests more similar to minority interests. The court also thought the nine closed-end funds selected as comparables were too dissimilar to the LLCs in the estate, and that a larger sample size should be used when comparables are more dissimilar (citing *Lappo,* T.C. Memo. 2003-258, and *Heck*, T.C. Memo. 2002-34). Because the IRS's expert's database was inappropriate, the court refused to adopt its 2% discount.

The estate's expert compared premiums from completely controlling interests in companies (90% - 100% interests) with premiums from interests that lacked full control (50.1% - 89.9% interests), and after considering qualities specific to the five LLCs (including "strong opposition and potential litigation" if the majority owner attempted to dissolve), concluded that a lack of control discount of 5% - 8% should apply. The court found no evidence that the minority interest holders were litigious or would pursue litigation to contest a dissolution. Citing *Olson v. United States*, 292 U.S. 246, 257 (1934), for its statement that potential occurrences "not fairly shown to be reasonably probable should be excluded from consideration," the court concluded that no adjustment should be made for future litigation risks so the discount should be lower than the 5% - 8% range suggested by the estate and that a **4% lack of control discount** was appropriate.

(3) **Lack of Marketability Discount.** Both experts used restricted stock equivalent discounts to determine the lack of marketability discount. The estate's expert determined that a 5% - 10% discount should apply and the IRS's expert used a 2% discount. The court concluded that the estate's expert "considered additional metrics and provided a more thorough explanation of his process." Furthermore, the IRS's expert reached a 14.5% restricted stock equivalent discount but from that determined a mere 2% discount for lack of marketability "without justifying the substantial decrease in the discount." The court accepted the 5% - 10% range suggested by the estate's expert but believed that the lower end of the range was appropriate, so concluded that a **5% lack of marketability** discount applied.

(4) **Charitable Deduction Discount.** The Family Trust's 100% interest in Royal Gardens passed entirely to charity, but was split between two charities, 25% to a church and 75% to a family foundation. The estate maintained that applying a discount in determining the charitable deduction because each charity received less than 100% was not appropriate:

> The estate insists that discounts are inappropriate and would subvert the public policy of motivating charitable donations. It claims that because 100% of Royal Gardens was included in the estate and the estate donated 100% of Royal Gardens to charities, the estate is entitled to a deduction of 100% of Royal Gardens' value.

The court disagreed, applying a two-step analysis. First, the court reasoned that in valuing the gross estate, "we value the entire interest held by the estate, without regard to the later disposition of that asset." Second, the court noted that a charitable deduction is allowed "for what is actually received by the charity" (quoting *Ahmanson Foundation*, discussed immediately below). "In short, when valuing charitable contributions, we do not value what an estate contributed; we value what the charitable organizations received."

The court cited *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981), in support of both of those steps of the analysis. In *Ahmanson*, the decedent owned the one voting share and all 99 nonvoting shares of a corporation. The voting share was left to the decedent's sons and the 99 nonvoting shares were left to a charitable foundation. The gross estate value of the 100 shares took into consideration that the decedent held full voting control of all the shares, but "the estate's deduction attributable to the donation of the 99 nonvoting shares necessitated a 3% discount to account for the foundation's lack of voting rights." The fact that the asset in *Ahmanson* was split between an individual and a charity rather than between two charities made no difference because that did not affect the value of the church's and foundation's respective interests that they received "and it is the value of the property received by the donee that determines the amount of the deduction available to the donor."

The parties reached agreement regarding the amounts of discounts if the court determined that discounts were appropriate in determining the charitable deduction for the charitable transfers to the church and to the foundation. The parties stipulated a 27.385% discount for the 25% passing to the church and a 4% discount for the 75% passing to the foundation. Discounting the interests passing to the separate charities resulted in a reduction of the charitable deduction of over $2.5 million, a quite significant reduction.

(5) **Failure to Timely File Penalty.** The IRS met its burden of showing that the taxpayer filed late, but the estate did not meet its burden of establishing reasonable cause, offering no evidence in support of that position. Therefore, the failure to timely file penalty under §6651(a)(1) was applicable as to any gift tax deficiency.

d. **Observations.**

(1) **Small Lack of Control and Marketability Discounts Allowed for Controlling Majority Interest in LLCs.** Lack of control and lack of marketability discounts were determined for the estate tax value of the estate's super-majority in five LLCs owning real estate (all over 70% and three over 80%). Several of the LLCs owned multiple real estate investments; one owned multifamily apartment buildings and a retail shopping center and another owned a multifamily apartment complex and another unleased property. The other three LLCs each owned a single real property investment (an operating farm, property surrounding a gas station, and a mobile home park). The LLC operating agreements all "grant significant power to the majority interest holder, such as the ability unilaterally to dissolve the LLCs and to appoint and remove managers." Even so, the 4% lack of control discount and 5% lack of marketability discount, a combined seriatim discount of 8.8% (.04 + [.05 x .96] = .088), might seem low for interests in LLCs owning real estate.

Fractional undivided interests in real estate are often valued with a 15% - 25% discount or more, (but a few cases have allowed lower discounts). *E.g.*, *Estate of Mitchell v. Commissioner*, T.C. Memo. 2011-194 (estate and IRS stipulated to the following fractional interest discounts: Beachfront property: 32% discount for 5% gifted interest and 19% discount for 95% interest owned at death; Ranch property: 40% discount for 5% gifted interest and 35% discount for 95% interest owned at death); *Ludwick v. Commissioner*, T.C. Memo. 2010-104 (17.2% discount for 50% interests in Hawaiian vacation home); *Estate of Baird v. Commissioner*, T.C. Memo. 2001-258 (60% discounts for undivided interests in timberland). A distinction from the fractional undivided interest situation, however, is that the majority interest holder of an LLC generally may have the power to decide to sell the assets and divide the proceeds among the members, without a court supervised partition proceeding.

(2) **Discounts Considered for Estate Tax Charitable Deduction Purposes.** *Warne* is consistent with other cases and rulings that have considered the values actually passing to specific charities in determining the estate tax charitable deduction.

The *Ahmanson* case is described in the *Warne* opinion (and summarized above).

Estate of Schwan v. Commissioner, T.C. Memo. 2001-174, also determined the estate tax charitable deduction based on the value actually passing to a charity, which was less than the value in the gross estate. The decedent in *Schwan* owned two-thirds of the voting and non-voting stock of a corporation. The decedent's estate plan provided that the shares would be distributed to a charitable foundation, and a redemption agreement provided that the voting shares would be redeemed. The court determined that the value to be included in the gross estate was a unitary unrestricted two-thirds interest in the corporation. However, the redemption agreement provided that the voting stock left to the foundation would be redeemed, leaving the foundation with only non-voting stock. The IRS took the position that the foundation received a bequest of money equal to the value of the voting stock and the non-voting stock—which should be valued at a discount for purposes of determining the amount of the charitable deduction. Thus, the amount of the deduction was less than the value in the gross estate. The estate argued that the foundation had the right to require the redemption of all its stock, because it received two-thirds of the voting stock, and before its redemption, it would have control and the ability to recapitalize the corporation and remove any distinction between the two classes of stock. The court concluded that it could not grant the estate's summary judgment motion on this issue because of the possibility under state law of rights of minority shareholders that would restrict the foundation's right to recapitalize and to force the redemption of all its stock.

The IRS took a similar position in a 2006 Technical Advice Memorandum. Tech. Adv. Memo. 200648028 (minority interest applies for charitable deduction purposes).

(3) Charitable Deduction Discount Analysis Is Similar to Comparable Marital Deduction Cases. If a controlling interest in an asset is left to the marital share, a control premium may be appropriate in determining the value of that asset. *See Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987) (bequest of 51% of stock of family company to surviving widow entitled to premium "control element" to increase marital deduction). However, this principle also works in reverse. The IRS took the position in several Technical Advice Memoranda that valuation *discounts* should be considered in funding marital bequests. In Tech. Adv. Memo. 9050004, the decedent left 51% of the stock of a closely held corporation to a trust for his son, and the remaining 49% to a QTIP trust. The IRS, citing the *Chenoweth* case, concluded that the stock passing to the QTIP trust should be valued with a minority interest discount. Tech. Adv. Memo. 9403005 concluded that the minority stock interest that passed to the surviving spouse had to be valued as a minority interest for purposes of the estate tax marital deduction, even though the decedent owned a controlling interest in the corporation. *See* AOD CC-1999-006, describing acquiescence in *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999), and stating that "[t]he proper funding of the QTIP trust should reflect, for example, the value of minority interests in closely-held entities or fractional interests in real estate that are used in satisfying the marital bequest".

A 1999 Tax Court memorandum case is the first case recognizing that the value of assets passing to a spouse must take into account minority interests for purposes of determining the marital deduction. In *Estate of Disanto v. Commissioner*, T.C. Memo. 1999-421, the surviving wife signed disclaimers so that only a minority interest in closely held stock passed to the wife. The court held that the stock passing to the wife must be valued as a minority interest for purposes of determining the amount of the marital deduction.

(4) Planning Alternatives to Avoid Reduction of Charitable Deduction. Under the *Warne* facts, if the Family Trust had left the entire 100% LLC interest to the foundation or a donor advised fund (DAF), and if 25% of the LLC had been later distributed to the church from the foundation or the DAF (perhaps based on knowing the decedent's desires, but under no legal obligation or even formal understanding to do so), the overall economic effect would have been the same, but no reduction of the charitable deduction would have applied because the entire 100% interest would been transferred from the estate to a single charity.

(5) Policy Rationale for Discounts When Asset Passes Entirely to Multiple Charities. The ability to avoid the reduction of the charitable deduction under the *Warne* analysis merely by leaving the asset first to a foundation or donor advised fund, which could then distribute the asset to multiple charities, raises the question of the policy rationale of denying a full charitable deduction when an asset is left in its entirety to multiple charities. The court rejected the estate's attempt to distinguish *Ahmanson* because if involved splitting an asset between an *individual* and a charity rather than between two charities. The estate argued that applying discounts when the asset passed entirely to charities "would subvert the public policy of motivating charitable donations"

and that leaving 100% of the LLC to charities should entitle the estate to a deduction of 100% of the value of the LLC. The court disagreed, focusing on allowing a charitable deduction for the value received by each donee.

Commentators have questioned the public policy rationale of denying a full charitable deduction when an asset is left entirely to charity, whether that is one charity or multiple charities, and suggesting that the case should be appealed for that reason:

> Unlike in *Ahmanson Foundation,* the decedent in *Warne* did not adopt a testamentary plan severing the voting power of Royal Gardens from its economic entitlement and then give only an economic entitlement to charity. Nor did she take any other affirmative steps to diminish the value ultimately passing to charity. Instead, the decedent merely gave a 75% membership interest in Royal Gardens to one charity and the remaining 25% membership interest to another charity. Query whether the purpose of the charitable deduction of encouraging charitable gifts would be any better effectuated by requiring the decedent in this situation to give her entire interest in Royal Gardens to either her family foundation or to her church, rather than allowing her to allocate such interests among charities as she desires?
>
> The IRS has actually been more lenient in certain cases when it comes to the application of valuation discounts for property contributed to charity. In Rev. Rul. 57-293, 1957-2 CB 153, for example, the IRS ruled that the charitable income tax deduction for a contribution of a fractional interest in artwork to a museum was equal to its fair market value multiplied by the fractional interest conveyed….
>
> Query what the result would be where an individual who owns a $10 billion art collection gives at his or her death a 50% fractional interest in the collection to the Metropolitan Museum of Art and the remaining 50% fractional interest to the National Gallery of Art? The $10 billion would clearly be included in his gross estate but should the charitable estate tax deduction be any less than the same $10 billion included in the gross estate? Any valuation discount applied in determining the charitable estate tax deduction on the basis of what is actually received by the charities would result in significant estate taxes being imposed merely because the decedent desires for the collection to be displayed at two of the country's great museums following his death. Would the purpose of the charitable deduction be better served by requiring the collection in such a case to be given to only one of the museums? Or should a valuation discount not be applied where the asset being donated is used directly for the charitable purposes of the donee charity, such as works of art to be displayed by a museum?
>
> The *Warne* case, which is appealable to the United States Court of Appeals for the Ninth Circuit, the same court that decided *Ahmanson Foundation*, would seem ripe for appeal. Richard L. Fox & Jonathan G. Blattmachr, Estate of Miriam M. Warne - *Decedent's Splitting of Charitable Bequest of 100% LLC Membership Interest Between Two Separate Charities Results in Mismatch of Value Included in Gross Estate and Amount Allowed As Estate Tax Charitable Deduction*, LEIMBERG CHARITABLE PL. NEWSLETTER #306 (March 1, 2021).

(6) **Entire Interest Passing to Charity and Spouse.** A similar situation arises if the entire interest in an asset owned by an estate (or the entire estate) passes partly to a charity and partly to a surviving spouse. The intuitive reaction may be that all the interest is passing in a manner that qualifies for a deduction, thus resulting in no estate tax, but the rationale of *Warne* (and *Disanto* and *Ahmanson*) results in a reduction of the overall charitable and marital deduction when the valuation of the asset is subject to discounts, possibly resulting in an estate tax being due.

(7) **Somewhat Analogous "Marital Deduction Mismatch" Argument for §2036 FLP Situations.** The IRS has made the similar argument in cases involving family limited partnership cases if the undiscounted value of the assets contributed to the partnership is included in the gross estate under §2036, arguing that a marital deduction is allowed only for the discounted limited partnership interest that actually passes to the surviving spouse. This situation arises when a spouse contributes assets to an FLP, retains most of the partnership interests until his death, and dies with a formula marital deduction clause that leaves assets to the surviving spouse to minimize estate taxes, and the value of the assets contributed to the partnership is included in the gross estate under §2036. In two reported cases (*Estate of Black v. Commissioner*, 133 T.C. 340 (2009), and *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21) the IRS has made the argument that while the value of the partnership *assets* is included in the gross estate (without a discount), the estate actually owns only a limited partnership or LLC interest and does not own the assets directly. The government's brief in *Black* stated the argument as follows:

> Petitioner overlooks the fact that §§2036 and 2035 include the value of property that has previously been transferred, while the marital deduction is limited to the value of the property actually passing to the surviving spouse. There is good reason for this limitation. On the death of the surviving spouse, only that property (here, the discounted value of the BILP interest) will be in includable in the spouse's gross estate under I.R.C. §2044.

All the estate can leave the spouse (i.e., all that can "pass" to the spouse for marital deduction purposes under §2056) is a discounted entity interest. Thus, there would be estate inclusion at a high level (without a discount) but the marital deduction would be allowed at a much lower level (taking into account discounts). That difference would first reduce the amount passing to the bypass trust, but if that difference were more than the remaining estate tax exemption amount available to the estate, there would be estate taxes due at the first spouse's death. *See generally* Angkatavanich, *Black Shirts (Black, Shurtz) and the Marital Deduction Mismatch*, Trusts & Estates 37 (June 2010).

The Tax Court considered a different marital deduction issue in *Estate of Turner v. Commissioner*, 138 T.C. 306 (2012). (That is the second of three reported cases involving that fact situation and is sometimes referred to as "*Turner II*.") The estate argued that the decedent's will contained a formula marital deduction clause and that the marital deduction should offset any value included in the gross estate under §2036. The marital deduction issue addressed in this supplemental opinion is whether a marital deduction is allowed for partnership assets attributable to 21.7446% limited partnership interests that the decedent had given to various family members (other than his spouse) during his lifetime. The court concluded that because the surviving spouse did not receive those 21.7446% limited partnership interests, no marital deduction is allowed for the value of assets attributable to those interests that is included in the gross estate under §2036. The court reasoned that the statutory and regulatory marital deduction provisions as well as the overall structure of the wealth transfer system support that result. The classic marital deduction mismatch issue does not arise in *Turner II* because the IRS allowed a marital deduction for the full value of assets attributable to partnership interests that the decedent owned at his death and could pass to the surviving spouse under the formula marital deduction bequest in the decedent's will.

In short, the Tax Court did not have to address the marital deduction mismatch issue in *Black* and *Shurtz* because the court held that §2036 did not apply in those cases. The classic marital deduction mismatch issue did not arise in *Turner II* because the IRS allowed a marital deduction for the full value of assets attributable to partnership interests that the decedent owned at his death and could pass to the surviving spouse under the formula marital deduction bequest.

No court has yet faced the marital deduction mismatch issue in the context of §2036 FLP cases. A tax fiction deems the value of the assets that were transferred in the §2036 transaction to be in the gross estate, and the issue is whether that same tax fiction is applied for deduction purposes as well. On the one hand, the estate owns only the discounted limited partnership interest, so arguably that is all that can "pass" to the surviving spouse for purposes of the marital deduction's "passing" requirement. On the other hand, a sense of consistency and fairness arguably may suggest that the fiction should apply for marital deduction purposes as well as estate inclusion purposes. The concept of the marital deduction is that a couple can avoid estate taxes at the first spouse's death, deferring estate taxes until the second spouse's death, and it may not be possible to avoid having to pay large estate taxes at the first spouse's death if a full marital deduction is not allowed. Take the simple situation in which all the estate is passing to the surviving spouse and the estate owns a 99% interest in the partnership that is left to the spouse. That is not a situation (like in *Turner II)* where the decedent had made gifts of most of the partnership interests to persons other than the spouse. The spouse is receiving all the estate and all the partnership interest related to the value of the assets included under §2036, so arguably there should be a marital deduction for all that value. Or consider a situation in which the decedent made a lifetime gift of all his partnership interests to the surviving spouse, but the court applies §2036. Again, the very asset that gives rise to §2036 also ends up in the hands of the surviving spouse, and a sense of consistency may suggest that the marital deduction should match the inclusion amount. The effect of allowing a full marital deduction for the undiscounted value included under §2036, however, is that no particular disadvantage exists for having §2036 apply at the first spouse's death regarding assets contributed to the FLP by that spouse (and §2036 would not apply at the surviving spouse's subsequent death as to assets contributed to the FLP by the first-decedent spouse).

37. Sale Decisions by Sponsors of Donor Advised Funds Contrary to Expectations of Donors, *Fairbairn, et al. v. Fidelity Investments Charitable Gift Fund*, *Pinkert v. Schwab Charitable Fund*

a. Synopsis of *Fairbairn*. On December 28 (that is a key fact), successful hedge fund managers contributed 1,930,000 shares of a publicly traded company (worth over $100 million) to a DAF. The DAF sold all those shares the next day (December 29, the last trading day of the calendar year), all within 2½ hours. At the completion of trading all those shares, the stock had declined in value by about 30%, or about $9.6 million, which reduced the charitable deduction by $3.3 million.

An executive of the company that was sponsor of the DAF sent text messages saying "[we] botched the trades" and the company "has been an awful biz partner [to the Fairbairns] throughout all of this." The Fairbairns testified that the company representatives had orally promised various things:

(1) employ state-of-the-art methods for liquidating large blocks of stock;

(2) not trade more than 10% of daily trading volume [which they didn't];

(3) not liquidate any shares until the new year; and

(4) allow the Fairbairns to advise on a price limit.

The Fairbairns sued for common law misrepresentation, breach of contract, promissory estoppel, violation of unfair competition law, and negligence.

The federal district court held for the Fund, reasoning:

(1) the plaintiffs did not establish by a preponderance of evidence that the sponsor had agreed to those items;

(2) the plaintiffs did not establish that the sponsor did not in fact employ "sophisticated state-of-the-art methods";

(3) even if the sponsor owed the Fairbairns a duty of care, due to a special relationship, there was no proof that it breached that duty;

(4) the plaintiffs did not prove that a reasonably prudent DAF would not have sold all shares within 2½ hours under the market conditions on December 29, but would have spread out liquidation over several days; and

(5) the sponsor acted consistently with its published, written policies regarding the liquidation of contributed shares.

Fairbairn, et al. v. Fidelity Investments Charitable Gift Fund, No. 3:18-cv-04881-JSC (N.D. Calif, Feb 26, 2021).

b. Planning Pointers from *Fairbairn*.

- Many DAFs have similar written policies (perhaps not to sell $100 million worth of shares ALL the NEXT day and all within 2½ hours).
- This is a recent case that made headlines in the public media.
- The DAF is in control of when to liquidate assets contributed to the fund.
- A contributor should assume the DAF will sell all the next day.
- The contributor should spread out contributions to assure the fund will not sell $100 million worth the next day, all within 2½ hours (ostensibly causing a huge price decline within that short time frame). That's why the December 28 contribution date is significant in this case.

The donor did not have time to spread out contributions and still get a charitable contribution for 2017.

c. **Synopsis of *Pinkert*.** A Magistrate Judge for the federal district court in the Northern District of California has similarly denied relief for a donor of a donor advised fund against the fund's sponsor, but the rejection of the donor's claim was based on a lack of standing rather than a substantive finding that the sponsor did not breach a fiduciary duty as in *Fairbairn*. The Schwab Charitable Fund (the "Fund") is legally independent of the Schwab Corporation, but the Fund used the brokerage services and investment products of Schwab Corporation, and "every person working for [the Fund] is actually an employee of the Schwab Corporation." The donor's assertions included that (i) cheaper alternative index funds and money-market funds could have been used, (ii) the Fund invested in retail products rather than lower-priced wholesale products available to institutional investors, (iii) the Fund could have used its marketing power to negotiate lower rates, and (iv) the Fund benefitted Schwab Corporation to the Fund's detriment. The order reasoned that the donor gave up exclusive legal control and ownership of the assets contributed to the Fund. To have standing under Article III of the U.S. Constitution, the plaintiff must have (i) suffered an injury in fact (an invasion of a legally protected interest that is concrete and particularized and actual or imminent), (ii) that is fairly traceable to the defendant's alleged conduct, and (iii) that is likely to be redressed by a favorable judicial decision. The court stated that the donor's advisory privileges regarding distribution or investment decisions do not equate to a concrete protected interest considering the Fund's exclusive legal control over the donated assets. A plaintiff must asset injury to his own legal rights, not the legal rights of others, and the plaintiff is not a beneficiary of the Fund. The court distinguished *Fairbairn* because it was a misrepresentation and breach of contract case involving allegations that the sponsor broke specific promises rather than a general claim of mismanagement (but, in fact, the court in *Fairbairn* stated that the plaintiff contended, apart from alleged promises, that the sponsor "violated the duty of care" owed to the donor). The order also reasoned that the plaintiff lacked standing under California law. *Pinkert v. Schwab Charitable Fund*, No. 3:20-cv-07657 (N.D. Calif. Order dated June 17, 2021).

38. Valuation of Publicity Rights, Undervaluation Penalties, *Estate of Michael Jackson v. Commissioner*, T.C. Memo. 2021-48

a. **Brief Synopsis.** The court in a 265 page opinion addressed the value of three assets in the estate of Michael Jackson, the "King of Pop"– the value of the decedent's "image and likeness" (i.e., publicity rights) and the value of two entities. There were huge differences between the estate's position and the IRS position for all three assets. (The values of other assets in the estate were stipulated.)

For the decedent's image and likeness, the estate's and the IRS's value positions were $3.078 million and $161 million, respectively. The court valued the rights at only $4.15 million, considering the poor state of Michael Jackson's reputation at his death. The court used a discounted cash flow analysis based on projected revenues and expenses.

The other two assets were interests in bankruptcy trusts that owned music catalogs. One of them owned a large catalog of Beatles songs; the assets were very valuable (the IRS valued the interest at $206 million in the notice of deficiency) but the decedent had borrowed heavily against the trust to fund his lifestyle and the court found that it had a net zero value. The second owned another large catalog of songs (most notably from Jackson himself). The estate and IRS valued it at $2.27 million and $114 million, respectively, and the court valued it at $107 million using a discounted cash flow analysis. In valuing these assets, the court refused to "tax affect" the income under an assumption that a C corporation would be the most likely hypothetical purchaser of the assets.

The IRS assessed penalties, but the court found that the estate acted with reasonable cause and in good faith in relying on the appraisals for the reported values. *Estate of Michael L. Jackson v. Commissioner*, T.C. Memo. 2021-48 (May 3, 2021) (Judge Holmes).

b. **Wild Variances in the Positions of the Estate and the IRS.** The estate's position was that the value of the entire estate was about $7.2 million vs. $1.125 BILLION as the IRS's position in the notice of deficiency. Eventually, the parties agreed on the values of all assets except for three assets. Here are the positions of the estate and IRS, as summarized by the court:

	Reported on Estate Return	Notice of Deficiency	Estate on Brief	Commissioner on Brief
Image and likeness	$2,105	$434,264,000	$3,078,000	$161,307,045
New Horizon Trust II	-0-	469,005,086	-0-	206,295,934
New Horizon Trust III	2,207,351	60,685,944	2,267,316	114,263,615

c. Valuation of Decedent's Image and Likeness; Publicity Rights. The decedent's legal rights in property are determined under California law, where the decedent was domiciled at his death. After the California Supreme Court held that the "right to exploit name and likeness is personal to the artist" and post-mortem uses of a person's identity are not actionable in *Lugosi v. Universal Pictures*, 603 P.2d 425 (Cal. 1979), California created a statutory post-mortem right of publicity. Accordingly, this state law property right was an asset included in the gross estate. (Many states have not recognized a post-death name and likeness property right (sometimes referred to as a post-death right of publicity) to exploit the right financially and to prevent others from exploiting the decedent's name and likeness; a decedent domiciled in one of those states might have no value to be included in the gross estate attributable to enforceable post-death publicity rights.)

The estate's and IRS's values of the decedent's image and likeness on the estate tax return and in the notice of deficiency were $2,105 and $434,264,000 – an incredibly wide variance. After years of doing additional valuation work, their positions changed at trial to $3.078 million and $161.3 million, respectively – still a very wide difference.

Michael Jackson in reality had received almost no revenue for about a decade prior to his death, and the appraisal that was used to support the $2,105 value reported on the estate tax return was based on those facts. An expert for the estate ("the CEO of CMG Worldwide, Inc., an international licensing and rights-management company that specializes in representing celebrities both dead and alive") did substantial additional appraisal work after the estate tax return was filed. He projected 10 years of post-death revenues from the exploitation of Jackson's image and likeness and associated trademarks, and another expert estimated the date of death value based on those projections.

The IRS's expert "considered five 'opportunities' that he believed a hypothetical buyer could reasonably foresee at Jackson's death: themed attractions and products, branded merchandise, a Cirque du Soleil show, a film, and a Broadway musical. The court viewed the IRS's expert's analysis "as fantasy." The expert (1) valued the wrong asset (because the California statutory definition of the post-death image and likeness property right excludes musical compositions among other things, the consideration of a Cirque du Soleil show, film, and Broadway musical all involved musical copyright rights not included in the image and likeness property right, and the themed attractions and branded merchandise both involved existing intellectual property rights licenses that are distinct from image and likeness), (2) included unforeseeable events in his valuation, and (3) miscalculated the assets' value because of "faulty" math.

The court the valued the rights at only $4.15 million, providing a lengthy (and quite interesting) factual background about the poor state of Michael Jackson's reputation at this death and observing that the estate would have to spend a significant amount of money to rehabilitate his image. A discounted cash flow analysis was used after projecting revenue and expenses separately for the first 10 years and decreasing net income by 5% for each of years 11-70, and using a discount rate of 15.4%.

d. New Horizon Trust II. The second asset valued by the court was an interest in a Delaware trust (a bankruptcy trust) that owned the copyrights to The Beatles catalog, which included at least 175 songs that had been co-authored by John Lennon and Paul McCartney, as well as other copyrights. The estate valued this asset at $0 and the IRS valued it on the notice of deficiency at $206 million. The court concluded that the assets were worth about $227 million but were subject to over $300 million of debts (borrowed to fund Michael Jackson's very expensive lifestyle) and had a net value of zero.

e. **New Horizon Trust III.** The third asset was also a bankruptcy trust, the major asset of which is a music catalog that owns compositions from a variety of artists, most notably Jackson himself. The catalog included five different groups of songs with income coming primarily from three sources. The estate valued this asset at $2.27 million and the IRS valued it at $114 million. The court adopted the experts' approach of using a discounted cash flow analysis and determined a value of $107 million.

f. **Credibility of IRS's Expert.** The court made a point of noting that the IRS's expert lied twice at trial. (1) When asked if he had ever represented the IRS before and whether he wrote a valuation report for the IRS in Whitney Houston's estate tax case, he said "No, Absolutely not." The court responded "That was a lie." (After "recess and advice from the Commissioner's counsel," the expert admitted he had been retained by the IRS in that case.) (2) The expert also "testified that neither he nor his firm ever advertised to promote business. This was also a lie." He had sent an email blast bragging that he "is the expert of the century and will be testifying on behalf of the IRS," and he referred to his involvement in this "Billion Dollar Case" in a lecture given before trial. The estate moved to strike his entire testimony, as tainted by perjury. The court found that remedy "too severe," but concluded that the court would "discount the credibility and weight we give to [the expert's] opinions."

g. **Tax-Affecting.** One of the issues involved in valuing all three assets was whether to "tax-affect" the income on an assumption that a C corporation would be the most likely hypothetical buyer and would have to pay a corporate level income tax on the income. The court refused to extend the analysis of *Estate of Jones v. Commissioner* and refused to tax affect the income.

This tax-affecting analysis is quite different from the tax-affecting rationale in valuing interests in S corporations and pass-through entities in many prior cases. The traditional core justifications for tax-affecting are generally (1) that a hypothetical willing buyer in the willing-buyer-willing-seller construct of fair market value is looking for a return on the investment and necessarily will enjoy and therefore evaluate that return only on an *after-tax* basis and (2) that comparable data to use in the valuation process typically comes from public sources and therefore largely comes from C corporations, for which earnings are, again, necessarily determined on an *after-tax* basis. Corollaries to those justifications are that passthrough status (3) confers a benefit of a single level of tax compared to a C corporation, but also (4) limits the universe of potential buyers and investors, who might not be able to buy or invest without forfeiting or jeopardizing (or at least complicating) the S corporation status or other passthrough status. Thus, tax-affecting sometimes includes adjustments to accommodate those corollaries, or sometimes is followed by the application of, for example, an "S corporation premium" as the next step following the tax-affecting. That approach is incorporated in a well-known model used by many appraisers in valuing S corporation stock, referred to sometimes as the S Corporation Economic Adjustment Model and sometimes as the S Corporation Equity Adjustment Model, or, in either case, "SEAM." For example, the IRS's internal examination technique handbook for estate tax examiners more than 20 years ago (before the *Gross* case, discussed below) stated:

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

In the *Estate of Jackson* case, however, the rationale of the estate's experts was based on an assumption that "the appropriate hypothetical buyer of each asset would be a C corporation, and therefore, each of them reduced cashflows by the income-tax liability that would be paid by a hypothetical C corporation buyer." However, the court concluded that "the Estate has failed to persuade us that a C corporation would be the hypothetical buyer of any of the three contested assets."

The Tax Court refused to allow tax-affecting in valuing an S corporation on the income method in *Gross v. Commissioner*, T.C. Memo. 1999-254, and Tax Court cases after that time consistently refused to allow tax-affecting until the *Estate of Jones v. Commissioner* case in 2019, T.C. Memo. 2019-101 (Judge Pugh). In *Jones*, the court explained that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax-affecting the earnings of a flowthrough entity per se. The court viewed those cases as concluding that (1) assuming a zero income tax rate on the earnings properly reflected the overall tax savings of operating as an S corporation (*Gross v. Commissioner*), (2) the taxpayer's expert did not justify tax-affecting the earnings in balancing the burden of the individual level tax with the benefit of the reduced total tax burden (*Estate of Gallagher v. Commissioner*), and (3) tax-affecting the earnings resulted in a post-tax cash flow but the expert applied a pre-tax discount rate (*Estate of Giustina v. Commissioner*). In *Jones*, on the contrary, Judge Pugh concluded that the taxpayer's appraiser considered both the advantages as well as the disadvantages of operating as an S corporation and that the taxpayer's expert's "tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate." Judge Pugh viewed the issue as fact-based, and noted that the court in the prior cases had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases. For a more detailed discussion of *Estate of Jones* (as well as another 2019 federal district court case that accepted an expert's report using tax-affecting, *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. 2019)), see Items 33 and 34 of Estate Planning Hot Topics and Current Developments (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights).

Some planners thought that the *Estate of Jones* case might represent a "crack in the 20-year old dam" of the Tax Court's reluctance to recognize tax-affecting. Judge Holmes's discussion in *Estate of Jackson* suggests otherwise.

Judge Holmes distinguished *Estate of Jones* primarily as a case in which the IRS's expert did not contest tax affecting:

> We distinguish Estate of Jones as an instance where the experts agreed to take into account the form of the business entity and agreed on the entity type. The Commissioner argued there, as he does here, that we shouldn't tax affect, but his own experts didn't seem to be on board. As we observed, "[t]hey do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers." Estate of Jones, at *39.
>
> We do not hold that tax affecting is never called for. But our cases show how difficult a factual issue it is to demonstrate even a reasonable approximation of what that effect would be. In Estate of Jones, there was expert evidence on only one side of the question, and that made a difference.
>
> That was not the case here.

h. **Penalties.** The IRS asserted valuation understatement penalties and penalties for negligence or disregard of the rules under §6662. A procedural issue under §6751 requires that no penalty assessment is allowed unless it is personally approved by the immediate supervisor of the individual making the penalty determination. Neither the estate nor the IRS offered any evidence at trial about approval by the immediate supervisor. The estate asserted that requirement was not met, but the estate had the burden of persuasion on this issue and the court concluded that the estate failed to enter any evidence of the failure to obtain supervisory approval. (This is the classic difficulty of "proving a negative.") In Judge Holmes' unique and witty style: "*Thriller* is part of the record here. So are demons, vampires, monsters, ghosts, and even the funk of 40,000 years. But the record lacks any evidence that the Commissioner's agent failed to obtain supervisory approval."

   The court concluded, though, that reasonable cause and good faith existed because the estate based its values on an appraisal from a reputable accounting firm and reliance on the appraisal was reasonable even though the value of the assets was far different than the court's value. The $2,105 appraised value of the post-death image and likeness rights reported on the estate return was very low but was because Jackson "made almost no money attributable to his name and likeness in the last decade of his life." The appraisal "followed standard appraisal procedure in this area -- it focused on the last 10 years of Jackson's life." Even though the court disagreed with the appraisal, "the Estate reasonably relied on it in good faith once it discovered how little revenue Jackson had been earning from use of his name and likeness." Similarly, the court noted that its opinion shows how complicated the valuation of that second bankruptcy trust (New Horizon Trust III) was, that the appraisal was reasonable given all the facts and circumstances, and that it was reasonable for the estate to rely on it and it did so in good faith.

i. **Planning Considerations Regarding Post-Death Right of Publicity.** The right of publicity allows an individual to exploit the commercial use of his name, image, and identity and to sue others who misappropriate the individual's name and likeness. The right of publicity developed out of the right of privacy. Most states now recognize the right, either by case law or statutes, and about half the states recognize that it survives death. There is little uniformity among the states; some states are explicit about the ability to transfer the right, and others aren't. Jurisdiction and governing law issues are still being developed. As expressed in *Estate of Jackson*, the general rule is that the law of the decedent's domicile governs as to the contours of any post-death right of publicity. The law is still developing as to whether an individual can incorporate the laws of another state's statute regarding post-death rights by transferring the publicity rights to an entity created and operated in that state prior to death.

Two major estate planning issues need to be addressed: (1) What is the individual's vision of how his or her reputation should be preserved and used (if the individual wants those rights restricted, will that restriction be recognized to diminish the value of the rights for estate tax purposes?); and (2) How can ownership of the publicity right by structured to integrate with the individual's estate plan?

Exploiting an individual's right of publicity requires management as a business, and ideally it will be housed in a business structure. Issues that arise generally regarding business succession will also apply to this property right.

Tom Abendroth (Chicago, Illinois) suggests several specific planning considerations:

(1) Place the right of publicity (and related copyrights, trademarks, and endorsement contracts) in multiple entities to allow the desired division of control and ownership (including transfers of particular interests to irrevocable trusts).

(2) Transfer methods are generally the same that we use for other business structures (such as a seed gift and subsequent sale to an irrevocable grantor trust, or GRATs, or growing businesses).

(3) Divide the various attributes among different entities, and owners can dis-aggregate the interest and potentially lower its value for estate tax purposes, as opposed to the decedent's owning all rights associated with the right of publicity at his death.

> For example, one entity could be created to manage endorsement contracts, appearance contracts and related existing contracts. It could receive a percentage fee for this, or actually be the recipient of the contract income. Another entity could own and license the right of publicity (to the management entity). A third could own memorabilia and other tangible assets (a potentially significant category in its own right for athletes). Tom Abendroth, *Estate Planning With the Right of Publicity*, ACTEC Estate & Gift Tax Committee (June 2021).

(Judge Holmes in *Estate of Jackson* noted that the IRS's expert kept trying to aggregate all assets associated with his right of publicity, including copyrights in musical compositions and performances, but those had already been transferred to separate entities.)

(4) To the extent possible, give the structure the characteristics of an active business (which may not be possible if all management responsibilities are outsourced). A business structure may achieve income tax benefits (such as qualifying for business deductions and avoiding the 3.8% NII tax) and estate tax benefits (such as qualifying for the bona fide sale for full consideration exception to §2036 and §2038). *Id.*

39. Intergenerational Split Dollar Life Insurance, Estate Tax Treatment of Repayment Right, *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60

a. **Synopsis.** Mrs. Morrissette (actually her revocable trust) paid large lump sum premiums ($29.9 million) for Dynasty Trusts to purchase universal life insurance policies on the lives of her three sons to fund buy-sell agreements to assure that ownership of a long-term very successful business would remain in the family. The advances were made under split dollar arrangements providing that Mrs. Morrissette would be repaid the amount of the advances or, if greater, the cash surrender values of the policies. The reimbursement amount would be repaid when the split dollar agreements were terminated at the respective deaths of the sons, when the trusts cancelled the policies, or when the parties mutually agreed to terminate the agreements. The estate valued the rights to be repaid for the premium advances at about $7.5 million (primarily because of the delay of when the repayments would be made), and the IRS valued the reimbursement rights at the cash surrender value of the policies at the date of Mrs. Morrissette's death (about $32.6 million).

The court held that (a) the advanced premiums or cash surrender values are not included in the estate under §2036 or §2038 because the $29.9 million premium advance transfers were made in a bona fide sale for adequate and full consideration, (b) the special valuation rules of §2703 do not require inclusion of the cash surrender values of the policies in the estate because the safe harbor exception in §2703(b) was satisfied, (c) the value of the estate reimbursement rights was determined under a discounted cash flow analysis, using an assumption that the repayment would be made three years after the estate tax return was filed (which greatly increased the value as compared to assuming that the repayment would not be made until the sons' respective deaths), and (d) the 40% gross valuation misstatements penalty under §6662 was appropriate, and the estate's reliance on its appraiser's valuation of the rights was not reasonable. *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60 (May 13, 2021) (Judge Goeke).

For an excellent summary of this second *Morrissette* opinion (sometime referred to as "*Morrissette II*") and of general planning issues involving intergenerational split dollar life insurance, see Mitchell Gans & Martin Shenkman, *Morrissette II: Why the Tax Court May Have Improperly Applied the Hypothetical Purchaser Framework*, LEIMBERG ESTATE PLANNING NEWSLETTER #2896 (July 19, 2021)

b. Basic Facts. The Morrissette family owned a moving and logistics company with a history going back to 1943. Three sons were involved in the business, and significant family disharmony endangered a long-term goal of maintaining ownership of the business within the family. Mrs. Morrissette (actually her revocable trust) paid large lump sum premiums ($29.9 million) for Dynasty Trusts to purchase universal life insurance policies on the lives of her three sons. (The advance was made by Mrs. Morrissette's sons as trustees of the revocable trust, when Mrs. Morrissette could not participate because of her Alzheimer's disease.) Each trust purchased policies on the lives of the other two sons, and a shareholder's agreement provided that at the death of a son, trusts for the surviving sons would purchase the shares owned by the deceased son. Under split dollar agreements with each of the Dynasty Trusts, the revocable trust would be repaid the advance solely from the cash surrender values of the policies if the split dollar agreement was terminated before a son's death or from the death benefit if an agreement terminated as a result of a son's death. Accordingly, the revocable trust was entitled to receive the aggregate premiums paid (without added interest) on the policies on that child's life (or the cash surrender value of such policies, if greater). In addition, the split dollar agreement could be terminated by the cancellation of policies by a Dynasty Trust or by the mutual agreement by both parties to terminate the agreement. Mrs. Morrissette's revocable trust provided that the split dollar reimbursement rights would be distributed at Mrs. Morrissette's death to each Dynasty Trust that was the counterparty to the agreements.

Mrs. Morrissette died in September 2009. About ten months later, one of the sons inquired about cancelling the policies (his reasons for the inquiry are unclear), but the estate planning attorney advised "that the IRS had three years to audit the estate tax return and insisted that the policies remain in effect until the IRS audit was settled." The estate filed the estate return about six months later, including the reimbursement rights under the split dollar arrangements in her estate at a value of about $7.5 million (compared to the $29.9 million lump sum premiums she had paid), considering the fact that her revocable trust would not receive the payments for many years in the future (as her children died—actuarially expected to be about 15 years later) or when the split dollar agreements were terminated before that time.

In an initial opinion, the court held that the split dollar agreements complied with the economic benefit regime, the decedent did not make taxable gifts of the premiums when the $29.9 million advance was made, and the Dynasty Trusts did not have current access to the cash surrender values immediately. *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016). The court entered an Order on June 21, 2018 denying the taxpayer's motion for summary judgment that §2703(a) was inapplicable (based on the court's reasoning in *Cahill v. Commissioner*) concluding that "[t]he restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2)." The IRS and estate subsequently filed motions for partial summary judgment regarding §2036(a)(2),

§2038(a)(1), and trying again regarding §2703(a). The court entered an Order dated February 19, 2019 denying the taxpayer's motions for summary judgment that §2036(a)(2), §2038(a)(1), and §2703(a) do not apply. The court merely reasoned that *Estate of Cahill* "is directly on point" as to §2036(a)(2) and §2038(a)(1) but denied the IRS's motion for summary judgment regarding those sections because a material factual dispute exists concerning the issue of full and adequate consideration as to §2036 and §2038 and concerning whether the transfer satisfied the safe harbor in §2703(b).

For a more complete discussion of the facts and the holdings of the prior decision and orders, see Item 27 of Estate Planning Current Developments and Hot Topics (December 2016) found here and Item 13.c.(6) of Estate Planning Current Developments and Hot Topics (December 2019) found here, both of which are available at www.bessemertrust.com/for-professional-partners/advisor-insights).

c. **Business Purpose.** A key to the court's conclusion that §2036, §2038, and §2703 do not apply (as discussed below) is the business purpose for the life insurance based on the family disharmony and the need for insurance to fund the buy-sell agreements in order to persuade Mrs. Morrissette's sons to retain the business and to keep the ownership of the business within the family. Those facts would not be present in every case involving intergenerational split dollar life insurance, and without those facts and the need for the life insurance (apart from potential tax advantages), those Code sections may have applied to negate any significant valuation discount advantages from the intergenerational split dollar arrangement.

d. **Sections 2036 and 2038.** The IRS argued, among other things, that the reimbursement rights should be included in the estate at an amount "at least in the amount of the transferred premiums, $30 million total, or the cash surrender value of the underlying policies, approximately $32.6 million total" in part because of retained possession, enjoyment or a right to income from the transferred property under §2036(a)(1), a retained right to designate who can enjoy the property or income under §2036(a)(2), and a power to alter enjoyment of the property under §2038(a). The court rejected that argument, reasoning that the bona fide sale for adequate and full consideration exception under those sections was satisfied. The exception requires (1) a legitimate and significant nontax purpose and (2) adequate and full consideration in money or money's worth. Nontax reasons existed for the arrangement (to keep the business in the family). The opinion had a long discussion of the family disharmony and the plan to retain the sons in the business management, maintain control over the business, assure that ownership remained in the family, and avoid the need to sell the business to pay estate taxes as sons died. Adequate and full consideration existed even though the economic value of the right to sell or collect on reimbursement rights was worth less than the $29.9 million advance because other benefits were present than just the economic value of the reimbursement rights "such as management succession and efficiency and capital accumulation."

e. **Section 2703.** The IRS also argued that the reimbursement right should be valued at the full cash surrender value of the policies because the revocable trust would receive the cash surrender value upon the termination of the split dollar agreement and the restriction that the split dollar agreement could be terminated only with the mutual agreement of the parties was a "restriction on the right to sell or use" property that had to be ignored in valuing the property under §2703(a). The court had previously denied the estate's motion for summary judgment that §2703(a) did not apply (relying on the decision in *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84) but left open for trial whether the safe harbor exception under §2703(b) applied. "Section 2703(b) provides an exception where the restriction is a bona fide business arrangement, not a device to transfer property to members of the decedent's family for less than adequate and full consideration, and comparable to the terms of similar arrangements in arm's-length transactions," and in this *Morrissette II* decision the court concluded that the §2703(b) exception applied. The §§2036, 2038, and 2703 rulings were unequivocal taxpayer victories. But the taxpayer victories ended there.

f. **Value of Reimbursement Rights.** The estate valued the reimbursement rights on the estate tax return at about $7.5 million. The estate conceded that a mechanical mistake in one of the taxpayer's expert's appraisal meant that the appraiser's value would have been about $10.4 million, but another appraiser for the estate valued the reimbursement rights at about $7.8 million. (The reimbursement payment rights at the date of the decedent's death would have been about $32.6 million, the cash surrender value of the policies, but the revocable trust had no way to force the immediate cancellation of the split dollar agreements and immediate payment.) The IRS's notice of deficiency valued the reimbursement rights at about $32 million, the cash surrender value of the policies. The IRS's expert valued the reimbursement rights at about $17.5 million assuming the split dollar agreements remained in effect until the sons' deaths and at about $27.9 million assuming they were terminated three years after the estate tax return was filed. (**Observe:** The assumed termination date has the biggest impact on the valuation of the reimbursement rights – in this case $17.5 million vs. $27.9 million in the IRS's expert's opinion.)

In valuing the reimbursement rights of the revocable trust, the estate's and IRS's experts both applied a discounted cash flow analysis. The primary factors in the analysis were determining (a) the appropriate discount rates to determine the present value of the anticipated cash flows and (b) the repayment schedule.

For the discount rates, the court agreed with the IRS's expert's use of returns on corporate bonds and company specific debt (discount rates of 6.4% and 8.85% for the two insurance companies after applying a small illiquidity premium) and rejected the taxpayer's expert's use of life settlement data (which reflected discount rates of 15% and 18%) because of the lack of transparency in that data.

Much more important in the ultimate valuation determination was the court's agreement with the IRS position assuming that the split dollar agreement would be ended following the decedent's death (three years after the estate tax return was filed) rather than much later at the sons' subsequent deaths. The taxpayer argued that no pre-arranged plan for early termination existed and that the policies would be retained until the sons' respective deaths. The court pointed to an inquiry by one of the sons 10 months after the decedent's death about cancelling the policies, but an attorney advised "that the IRS had three years to audit the estate tax return and insisted that the policies remain in effect until the IRS audit was settled." The court accepted the IRS's proposed termination date of three years after the estate tax return was filed. The court said that the "key factor in setting the December 31, 2013, maturity date [i.e., about three years after the estate tax return was filed] is the brothers' complete control over the split-dollar agreements.… [T]here are grounds for setting an earlier maturity date, but we will use respondent's date."

A significant factor in the court's reasoning is that the trusts that owned the policies could trigger the acceleration of the decedent's reimbursement rights by cancelling the policies, and one of the sons actually asked about cancelling the policies before the estate tax return was filed for the estate. Furthermore, the revocable trust left to each Dynasty Trust the decedent's interest in the reimbursement rights that were attributable to the policies owned by that trust. Changes in those facts might have led to a somewhat different outcome as to the termination date used for valuing the reimbursement rights considering that the assumed termination date was the biggest factor in the valuation of the reimbursement rights. But the judge's ultimate decision regarding the valuation issue appears colored by the court's "gut reaction" that the estate had grossly undervalued the rights. For example, the court rationalized that the decedent received adequate and full consideration for purposes of satisfying the bona fide sale for adequate and full consideration exception to §2036 and §2038 even though the immediate value of the reimbursement right was economically worth far less than the $29.9 million advance because of other nontax benefits the overall insurance and business succession plan achieved, but the court observed its agreement with the IRS "that a rational investor would not give up approximately $23 million in value to achieve the nontax purposes achieved through the split-dollar agreements." And in the discussion of penalties, the court made very clear its view of having the revocable trust "pay $30 million and [turn] it into $7.5 million for estate tax reporting purposes. They should have known that the claimed value was unreasonable and not supported by the facts."

g. **Penalties.** The IRS revenue agent initially did not believe that an accuracy related penalty was appropriate, but his supervisor convinced him that the 40% gross valuation misstatement penalty under §6662(h) should be imposed. While reliance on professional advice may provide a reasonable cause defense if the reliance was reasonable and in good faith, the court reasoned that the estate's reliance on its professional appraisal was not reasonable (among other things, the court pointed out that the sons should have known that valuing a right to receive repayment of about $30 million (or more) at only $7.5 million "was unreasonable and not supported by the facts," and the appraiser lowered the value from his initial opinion following a review of the appraisal by the estate's attorney), and the estate did not rely on it in good faith. The harsh 40% penalty may deter taxpayers and planners from using intergenerational split dollar life insurance arrangements and claiming extremely large valuation discounts. *See* Kristen A. Parillo, *Tax Court Decision Could Chill Split-Dollar Arrangement*, TAX NOTES (June 9, 2021).

The court did not criticize the professional appraiser's credentials or experience as a professional appraiser. Indeed, the estate produced a second professional appraiser from a highly respected appraisal firm who also valued the reimbursement right at the trial and similarly valued the reimbursement right at far less than the court's determination. This factual situation is unlike that in *Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26, in which the court held that reliance on an appraisal did not meet the reasonable cause exception where the estate relied on an unsigned draft report by an accountant who had some experience preparing appraisals (having written 10-20 valuation reports) but did not have any appraiser certifications. This leaves taxpayers (and their planners) in the precarious position of having to determine the correctness of a professional appraisal that is based on technical analysis and is not just a summary estimate of value.

Morrissette II's approach as to penalties is contrasted with the approach in the recent *Estate of Michael Jackson* case (discussed in Item 38 above), in which the court held that reliance on a professional appraisal constituted reasonable cause even though the appraised value was miniscule compared to the court's determination of value ($2,105 vs. $4.15 million for the value of the decedent's image and likeness).

40. Savings Clause Rejected in Conservation Easement Cases, *TOT Property Holdings, LLC v. Commissioner* (And Others)

a. **Synopsis of *TOT Property Holdings, LLC v. Commissioner*.** In a case reminiscent of the *Belk v. Commissioner* Fourth Circuit Court of Appeals case seven years ago, the Eleventh Circuit has similarly rejected a savings clause as an impermissible "condition subsequent" clause (citing *Commissioner v. Procter*) in a conservation easement case, with an extended discussion of savings clauses. The court concluded that the easement did not satisfy the "protected in perpetuity" requirement of §170(h)(5)(A) because upon termination or extinguishment of the easement, the grantee would receive an amount reduced by the increase in value of the easement after the grant attributable to improvements, which is inconsistent with the regulations. The taxpayer argued that several clauses in the easement deed overrode extinguishment payment provision to the extent required by regulations. The last phrase of the extinguishment clause provided that the payment proceeds be "determined in accordance with Section 9.2 **or 26 C.F.R. Section 1.179A-14, if different**." Section 9.2 (which provided how the payment amount would be calculated) concluded as follows: "It is intended that this Section 9.2 **be interpreted to adhere to and be consistent with 26 C.F.R. Section 1.179A-14**." These savings clauses were referred to by the court as the "Treasury Regulation Override." The court also upheld substantial taxpayer penalties. *TOT Property Holdings, LLC v. Commissioner*, 127 AFTR 2d 2021-2420 (11th Cir. June 23, 2021).

The court emphasized the difference between clauses that merely assist in interpreting operative provisions in a deed or other agreement (which are taken into consideration for tax purposes) and clauses that impose a condition subsequent – a subsequent IRS or court determination that the provision in the deed would be inconsistent with regulations -- and are not respected for tax purposes. The court relied primarily on two Fourth Circuit Court of Appeals cases in its analysis, *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014), and *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). The court observed that in *Belk*,

> The Fourth Circuit held that the clause was unenforceable because it rested on a future occurrence to save the deed and deduction and amounted to an "ask . . . to 'void' the offending . . . provision to rescue the[ ] tax benefit." Id. There was also "no open interpretive question for the savings clause to 'help' clarify." Id. at 230. Instead, the Belks hoped for the court to rewrite their easement deed where — if their intent had truly been as they said — they would have written the deed to be compliant with the applicable regulations in the first

> place. Id. "[T]o apply the savings clause as the Belks suggest[ed]" would be "sanctioning the very same 'trifling with the judicial process' [the court] condemned in" the second of our guiding Fourth Circuit cases (discussed next), and would lead to the "dramatic[ ] hamper[ing] [of] the Commissioner's enforcement power" and tax collection "grind[ing] to a halt." Id. (citation omitted).

The court also relied on *Procter*, which refused to give effect to a clause that would reduce the amount of a gift if a court of last resort determined any part of the transfer was subject to gift tax

> because the only way a gift tax could be assessed was by way of collection and court proceedings, and the above-quoted clause, if valid, would operate to nullify any such proceedings. Id. Such a condition subsequent was void as "contrary to public policy." Id. "It is manifest," explained the court, "that a condition which involves this sort of trifling with the judicial process cannot be sustained." Id. Thus, the clause impermissibly contained a condition subsequent that attempted to save the assignment from taxation and was unenforceable. Procter reasoned that the clause "ha[d] a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat" the attempt. Id. The Fourth Circuit also held that "the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case" since "the only possible controversy" would be "the validity of the" clause's operation "between the donor and persons not before the court." Id.

The taxpayer argued that the Override provisions in the easement deed were not conditioned on any adverse action by the IRS or a court, so the Override clauses were interpretive provisions that should be recognized for tax purposes. The court disagreed because "whether Section 9.2 is 'different' from §1.170A-14(g) or whether Section 9.2's formula can be interpreted as consistent with the regulation are questions that only the IRS or a court can determine."

In summary, the court held that the Override provisions are unenforceable savings clauses, not merely interpretive provisions "because the formula in Section 9.2 is unambiguous, the Override nullifies it, and it does so only in the event of some future occurrence."

b. **Similar Cases.** Other conservation easement cases have reasoned similarly. *E.g.*, *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019); *Pine Mountain Preserve, LLLP v. Commissioner*, 51 T.C. 247 (2018); *Palmolive Building Investors, LLC v. Commissioner*, 149 T.C. 380 (2017); *Railroad Holdings LLC v. Commissioner,* T.C. Memo. 2020-22; *Carter v. Commissioner*, T.C. Memo. 2020-21.

For a discussion of the court's analysis in *Coal Property Holdings, Belk,* and other savings clauses cases, see Item 37 of Estate Planning Current Developments and Hot Topics (December 2019) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights. For a summary of *Railroad Holdings* see Item 39.b. of Heckerling Musings 2020 and Estate Planning Current Developments (August 2020) found here and available at www.bessemertrust.com/for-professional-partners/advisor-insights.

c. **Chief Counsel Memorandum Regarding Amendment Clauses.** Chief Counsel Memorandum AM 2020-01 (March 27, 2020), provides that an amendment clause in an easement does not necessarily violate the requirements of §170(h), but the amendment clause must be considered in the context of the deed as a whole and the surrounding facts and circumstances. The Memorandum provides an example of a permissible amendment clause.

d. **Application to Defined Value Clauses and Savings Clauses Generally.** These cases are interesting regarding their discussion of savings clauses generally and their strict rejection of clauses that change results after the fact based on court or IRS determinations. For a discussion of the application of these cases to defined value clauses and savings clauses generally, see Item 21.e.-f. of Estate Planning Current Developments and Hot Topics (December 2020) found here and Item 39.e. of Heckerling Musings 2020 and Estate Planning Current Developments (August 2020) found here, both available at www.bessemertrust.com/for-professional-partners/advisor-insights.

e. **Analysis of Status of Intense Attack on Conservation Easements.** For an analysis of the 26 (26!! – talk about an area of intense IRS focus) decided conservation easement cases in 2020, see 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).