BESSEMER TRUST

Estate Planning Current Developments and Hot Topics

May 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

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

Table of Contents

May 13, 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

This summary reflects estate planning developments in 2020 and thus far in 2021 (including various legislative developments and legislative proposals).

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, 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 Items 19 and 22 below);

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

(6) Crunch time for syndicated conservation easements (see Item 30 below);

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

(8) Revenue Ruling 85-13 applied to transfers between trusts (PLR 202022002) (see Item 28.d below);

(9) Assignment of income avoided on charitable donation of stock (*Dickinson*) (see Item 23 below); and

(10) Hazards of death-bed planning and of post-opinion analysis (*Moore*) (see Item 20 below).

2. Legislative Developments (Other than the SECURE Act)

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

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

b. **General Transfer Tax Proposals; 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), and a wide range of proposals were discussed in the 2020 political campaigns. 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 were to be made retroactive to January 1, 2021. In 2021, there is concern that legislation might reduce the gift exclusion amount (the Biden administration proposes reducing it to $1.0 million, not indexed) and increasing the gift tax rate from 40% to

45%. If the effective date should be some date before the date of enactment (for example, January 1, 2021, the date of introduction of the bill, or the date the bill is approved by the House Ways & Means Committee), clients might have made gifts of $11.7 million (the existing gift exclusion amount) thinking that no gift taxes would be due, only to find out that the excess $10.7 million times 45% equals a resulting gift tax of **$4,815,000.** If a couple 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 §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 only exception being OBRA in 1990.

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").

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

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

(4) **Constitutionality of Retroactive Tax Legislation (Transfer Tax Legislation in Particular).**

(a) **General Constitutionality of Retroactive Tax Legislation.** Retroactive tax legislation is not absolutely barred by the U.S. Constitution, and is almost always upheld by the Supreme Court. *See, e.g.*, *United States v. Carlton*, 512 U.S. 26 (1994); *United States v. Hemme*, 476 U.S. 558 (1986); *United States v. Darusmont*, 449 U.S. 292 (1981); *Welch v. Henry*, 305 U.S.

134 (1938); *United States v. Hudson*, 299 U.S. 498 (1937); *Milliken v. United States*, 283 U.S. 15 (1931). It has been viewed by the Supreme Court as "customary congressional practice" that is "generally confined to short and limited periods required by the practicalities of producing national legislation." *Carlton* (quoting *Darusmont*). Indeed, there are few examples of retroactive tax legislation being declared unconstitutional, but it is not out of the question that retroactive legislation could go too far and violate the Constitution (for example if it has an extended period of retroactivity or targets certain taxpayers or penalizes past conduct). *See* Erika Lunder, Robert Meltz, & Kenneth Thomas, *Constitutionality of Retroactive Tax Legislation,* CONGRESSIONAL RESEARCH SERVICE REPORT (October 25, 2012)(includes a detailed analysis of possible constitutional attacks, including Fifth Amendment Due Process, taking for purposes of the Fifth Amendment, unconstitutional ex post facto legislation [but that just applies for criminal laws], unconstitutional bill of attainder, or Fifth Amendment equal protection guarantees).

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

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

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

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

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

Eric Viehman (Houston, Texas) provides an astute analysis of reasons that retroactive decrease of the gift/estate tax exclusion amount to January 1, 2021 is unlikely.

> While a retroactive decrease in the estate/gift tax exemption effective as of January 1, 2021 may be legally possible, a key question (at least in my mind) is whether such a change is at all likely. While this is a political question and there is no crystal ball we can consult to provide a definitive answer, the following factors suggest to me that such a change is very unlikely:
>
> 1. Senator Manchin is on record as dismissing the possibility of eliminating the legislative filibuster in the Senate, and there are probably one or more other Democratic senators that will take the same position. This means any tax law changes will require 60 votes in the Senate unless they are made through the budget reconciliation process and can therefore be passed with a simple majority vote. While the required budget resolutions the House and Senate ultimately adopt later this year could include reconciliation instructions that permit (or even mandate) retroactive tax law changes, it will be politically difficult to adopt instructions that provide for a prospective effective date for income tax increases (which appears to be President-elect Biden's current intent) and a retroactive effective date for estate/gift tax law changes. And, based on recent experience, the income tax and transfer tax law changes are likely to use the same effective date.
>
> 2. With only 50 Democratic senators, it is uncertain there will be 50 votes in the Senate for any adverse estate/gift tax law changes much less retroactive ones. And with the Democrats' desire to at least hold on to their slim 12-vote majority in the House in the 2022 mid-term election, it may be a political problem for moderate Republican members of the House (an admittedly small number) to support adverse estate/gift tax changes, particularly retroactive ones. Speaker Pelosi will have little room to protect such members by letting them vote against any bill that will need to pass with no Republican votes.
>
> 3. The additional revenue the CBO and/or the Joint Committee will project as being produced through use of a retroactive effective date (say January 1, 2021) instead of a prospective one (say January 1, 2022) will almost certainly be relatively small, so making the change retroactive will not "pay" for much. Thus, there is little reason to run the political risk of making a retroactive tax law change absent a goal to "punish" those taxpayers who were not able to use all of their exemption before 2021. Since a retroactive change seems unfair and will not be scored as producing significant additional revenue, why risk a retroactive change if there is no punitive intent?
>
> In my opinion, the likelihood that any adverse estate/gift tax changes will be made effective on January 1, 2021 is exceedingly low. If a law is enacted this year decreasing the estate/gift tax exemption, I think the effective date is more likely to be January 1, 2022 than any date in 2021.

(6) **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. In light of 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 9-17 below for a more detailed discussion of these alternative approaches.

c. **President Biden Tax Proposals.**

(1) **General Tax Proposals; American Families Plan.** Some of the income tax proposals by President Biden include the following, many of which are to roll back the 2017 Trump tax cuts:

- Ending the step-up in basis at death on capital gains exceeding $1 million (increased from $100,000 during the Presidential campaign) (this proposal may also include a realization at death proposal (see Item 2.c(3) below));
- Applying the payroll tax to earnings over $400,000;
- Raising the corporate tax rate from 21% to 28%;
- Taxing capital gains as ordinary income for taxpayers having income over $1 million;
- Raising the top bracket from 37% to 39.6%;
- 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;
- Imposing a 15% minimum tax on corporate book income for C corporations with over $100 million of book income;
- Raising the tax rate on foreign profits;
- Eliminating fossil fuel subsidies; and
- Eliminating like-kind exchanges (the 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 (January 19, 2021)).

In discussing the plan to increase income taxes on those making more than $400,000, Deputy Press Secretary Karine Jean-Pierre clarified on March 19, 2021 that the $400,000 figure applies to families, and "that the level at which tax hikes would kick in for individuals isn't yet set." Nancy Cook, *Biden Determined to Tax Rich After Windfalls From Covid Crisis*, BLOOMBERG TAX DAILY TAX REPORT (March 22, 2021).

The Biden campaign had previously also proposed eliminating the cap on the Social Security payroll tax (so that the 7.65% tax [6.2% Social Security, 1.45% Medicare] would apply on all wages, not just up to the $132,900 limit [for 2019]). *See* Cooper*, Biden Seeks Boost in Capital Gains, Corporate Tax Rates,* TAX NOTES (Oct. 24, 2019); Nitti, *Reviewing The Democratic Candidates' Tax Plans: Joe Biden*, FORBES (Sept. 30, 2019).

The Biden $1.9 trillion Covid-19 relief "American Rescue Plan" 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 and the earned income tax credit (for 2021 only).

The American Families Plan, as described in late April 2021, has various tax measures including increasing the top income tax rate to 39.6 percent for taxpayers within the top 1 percent, subjecting long-term capital gains and qualified dividends to ordinary income tax rates (in addition to the 3.8% "Medicare" tax) households earning more than $1 million, eliminating stepped-up basis for gains in excess of $1 million in addition to the existing exclusion for primary residences (and this provision may include deemed realization at death as discussed in Item 2.c(3) below), taxing "carried interests" as ordinary income, eliminating real estate like-kind exchanges for gains in excess of $500,000, permanently extending the current limitation that restricts large excess business losses, applying the 3.8% tax to business income from pass through entities for those making 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 (but the plan will be the subject to 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)). 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).

The proposal in the American Families Plan to tax long-term capital gains and qualified dividends at the top income tax rate of 39.6 percent for households earning more than $1 million means that 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).

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

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

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

Dr. Janet Yellen's written responses to questions in her Senate confirmation process also pointed to a $3.5 million exemption level. See Item 2.f(4) below.

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

> Furthermore (and relevant to debates about how much a wealth tax would raise), estate taxes are inherently more prone to avoidance than wealth taxes because they apply only at one point in time per generation. A

variety of estate tax avoidance strategies involve **temporarily and artificially deflating the value** of transferred assets at the point in time that the wealth transfer is deemed to occur—and therefore valued—for tax purposes [citation omitted].

For example, **family limited partnerships (FLPs)** are used to temporarily hold investment assets in order to obtain non-liquidity discounts. Once the moment for valuing and taxing the transfer has passed, owners often dissolve the FLP so they can sell the underlying assets at will. The IRS estimates the valuation discounts for FLPs range from 30 to 65 percent [citations omitted].

As another example, donors use "string" or "hybrid" transfers, where the donor retains the ability to receive some portion of the property back, in order to deflate the value of the transferred assets. In these cases, the donor inflates the value of their retained interest at the time of the taxable gift by gaming assumed interest rates, mortality tables, and other factors. Then, their retained interest is valued at its correct (and much lower) value when it is later included in their taxable estate. In the process, a large portion of the value of the transferred assets can simply disappear for wealth transfer tax purposes. Such "string" transfers include **grantor retained annuity trusts (GRATs)** which, according to one estimate, have reduced the amount of revenue raised by estate and gift taxes by one-third [citation omitted].

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

(3) **Appreciation at Death.** The Biden campaign also proposed ending the basis step-up at death, and some institutions reported that he also favors taxation of unrealized gains at death. *See* Mermin, Holtzblatt, Khitatrakun,Lu, Matheson, & Rohaly, *An Updated Analysis of Former Vice President Biden's Tax Proposals*, Tax Policy Center (Nov. 6, 2020). Presumably, gifts would also be treated as a realization event. A threshold of some type would be applied (the elimination of the step-up in basis at death proposal applies to gains in excess of $100,000 but presumably the threshold for a realization at death system would be larger than that, and exceptions would likely apply (for example, for transfers to spouses or charity)).

For a discussion of potential planning implications of the basis step-up proposals, and the possible extension to include realization at death, see Joan Crain & Justin T. Miller, *Stepping Away from the Step-Up in Basis at Death, A Global Perspective*, LEIMBERG EST. PL. NEWSLETTER #2825 (Sept. 17, 2020). For a detailed discussion of how a realization at death approach might work, see Harry L. Gutman, *Taxing Gains at Death*, TAX NOTES (January 28, 2021).

For a discussion of the realization at death proposals by the Obama administration in 2015 and 2016, see Aucutt, Washington Update: Pending and Potential Administrative and Legislative Changes (With Selected Cases), §5.c.(3) (Nov. 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)**.

See Item 2.i below for a summary of H.R. 2286 and a Discussion Draft by Senator Van Hollen for deemed realization upon gifts and at death proposals.

Whether the American Families Plan calls for a deemed realization at death system is unclear. The White House released a Fact Sheet about the plan on April 28, 2021. The complete discussion about the increase of the capital gain rate, the repeal of basis step-up at death, and possible deemed realization at death is as follows:

End capital income tax breaks and other loopholes for the very top. The President's tax reform will end one of the most unfair aspects of our tax system: that the tax rate the wealthy pay on capital gains and dividends is less than the tax rate that many middle-class families pay on their wages. Households making over $1 million—the top 0.3 percent of all households—will pay the same 39.6 percent rate on all their income, equalizing the rate paid on investment returns and wages. Moreover, the President would eliminate the loophole that allows the wealthiest Americans to entirely escape tax on their wealth by passing it down to heirs. Today, our tax laws allow these accumulated gains to be passed down across generations untaxed, exacerbating inequality. The President's plan will close this loophole, ending the practice of "stepping-up" the basis for gains in excess of $1 million ($2.5 million per couple when combined with existing real estate exemptions) and making sure the gains are taxed if the property is not donated to charity. The reform will be designed with protections so that family-owned businesses and farms will not have to pay taxes when given to heirs who continue to run the business. Without these changes, billions in capital income would continue to escape taxation entirely.

Suggestions that the plan includes a deemed realization at death approach included the references to "making sure the gains are taxed if the property is not donated to charity" and to protections when family-owned businesses and farms are given to heirs who continue to run the business. *See* Jonathan Curry, *Biden's Next Plan Targets Like-Kind Exchanges and Stepped-Up Basis*, TAX NOTES (May 3, 2021(summarizing comments by Prof. Mitchell Gans). Also, some commentators have observed that the anticipated revenue from the provision likely contemplates a realization at death system in addition to merely increasing the capital gains rate.

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

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

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

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

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

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

An interview with David Kamin reiterates these goals. In the interview, Mr. Kamin signaled that

> the following options are among those under discussion:

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

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

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

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

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

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

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

(3) **Reconciliation Act.** The budget resolution can specify that a budget reconciliation bill will be considered to "reconcile" the work by various committees working on budget issues and to enforce budget resolution targets. Like the budget resolution, it cannot be filibustered in the Senate and only requires a majority vote. The reconciliation directive directs committees to

produce legislation by a certain date that meets specified spending or tax targets. The various bills are packaged into a single bill with very limited opportunity for amendment. Only one reconciliation act is allowed for each fiscal year, which allows the possibility of two reconciliation acts in a calendar year, as happened in 2017 and conceivably could happen again in 2021. The reconciliation bill, when ultimately approved by the House and Senate, goes to the President for approval or veto.

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

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

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

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

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

> The "Byrd bath" is purely a creature of the budget process — the parliamentarians generally don't have to review a regular-order bill. But unlike in an appellate court, there's typically no public record of why a parliamentary ruling went one way or what factors were considered in giving the advice.
>
> However, the deliberations are far from cursory or arbitrary, according to former Senate staff members who have participated in them in the past. The vetting process when a Byrd rule point of order is anticipated is extensive and often begins before the bill's markup. Senators' staffs explain the policies in the proposed

reconciliation bill to the parliamentarians. The staff members then work through the bill text with them, and the parliamentarians ask questions and sometimes give assignments to provide further explanations.

Sometimes senators offer insights into the deliberations behind the rulings. For example, on the Senate floor on March 25, 2010, then-Sen. Kent Conrad explained that the parliamentarian had advised that two provisions in the **Healthcare and Education Reconciliation Act of 2010** violated the Byrd rule, and found it persuasive that the Congressional Budget Office concluded that they didn't score for budgetary purposes (**156 Cong. Rec. S2085**). But that level of transparency is rare.

The parliamentarian is hired by the majority leadership, which means they can also be terminated by the party in control. But historically, the parliamentarian has generally continued to hold office through changes in party control. There have been six parliamentarians since the role was established in 1935. Two were fired by the majority leader and then rehired later.

…

For the budget process, the Office of the Parliamentarian assembles a collection of electronic Senate precedents that is available only to senators and their staffs. Those documents are unofficial and include precedents created after the publication of [*Riddick's Senate Procedure*] in 1992. The precedents are created by the Senate through a vote or a ruling by the presiding officer.

Similar provisions in enacted reconciliation bills provide perhaps the most persuasive precedent, especially if they are relatively recent and survived a challenge from the Senate floor.

Sometimes the precedents regarding consideration of potential Byrd rule violations are made publicly available, but usually not in their entirety. The Byrd bath process, in which the parliamentarians meet with both Democratic and Republican Senate staffers, is closed to the public, and the underlying rationale for the decision is made public only if a senator chooses to talk about it publicly. Only the ruling on whether a Byrd rule violation exists is usually announced. Although senators frequently announce when they have secured a favorable opinion from the Senate parliamentarian, they rarely explain the grounds for it. Marie Sapirie, *How the Senate's Rules and Precedents Shape the Tax Law*, TAX NOTES (March 15, 2021).

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

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

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

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

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

e. **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.

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.

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

(1) **Administration's General Priorities.** When asked on her first full day of work (January 21, 2021) about the likelihood of tax legislation in 2021, Jen Psaki, White House Press Secretary, said that the initial priorities "revolve around addressing the four crises that the President has stated that the country is facing, including getting the pandemic under control, getting people back to work, addressing our climate crises, and addressing racial equity." When asked whether tax reform would occur in 2021, she had no predictions "but at this point in time and the foreseeable future, addressing the pandemic and getting the pandemic under control, and that linkage to getting people back to work will be the President's top priority."

Top priorities of the administration at this point appear to be:

- The American Rescue Plan (COVID-19 Relief);
- Build It Back Better Plan (infrastructure and jobs);
- Immigration reform; and
- Voting rights, social justice.

These stated priorities of the administration suggest that tax legislation (other than tax measures directly related to pandemic relief) will be a low priority at least during the beginning of the year, 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 221-211 split in the House and 50-50 split in the Senate (with Vice-President Harris breaking a tie vote). The close margins may require more deliberation and negotiation and would seem to result in more moderate results. Moderation may be required, even using the reconciliation process, because a single Democratic defection may preclude passage.

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

The bolder 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 a ticking clock. Midterms are historically tough on the

president's party. Losing just one net Senate seat to Republicans would result in loss of control of the Senate for Democrats. Therefore, while the split Congress may make sweeping changes harder to achieve, the possibility of a shift of control in the House or Senate in the 2022 midterms adds urgency for Democrats to do what they can now regarding tax legislation. But Democrats may sense even more urgency to pass measures that Americans feel directly rather than haggling over tax negotiations.

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

On the other hand, Democrats may feel more comfortable 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 [MN], Brown (OH]). Also Senators Warnock and Ossof in Georgia won their 2020 races with 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.

Testimony from Janet Yellen in her Senate confirmation similarly suggests that tax reform is not the administration's initial highest priority. Her response to various questions about specific tax reform proposals emphasized economic recovery and pro-growth measures providing relief for middle-class families. For example, she committed to working with the administration in evaluating the impact of the removal of the cap on SALT deductions and the impact of the §199A deduction on small businesses. See Finance Committee Questions For the Record, United States Senate Committee on Finance, Responses by Dr. Janet Yellen (January 21, 2021). However, Dr. Yellen was more positive in affirming the proposal to reduce the estate tax exemption to $3.5 million and increase the estate tax rate to 45%. When Senator Grassley stated that the proposal would "disproportionately affect farmers and small business owners in Iowa and across the nation through wasteful compliance costs and increased taxes, Dr. Yellen responded:

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

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

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

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

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

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

> The legislative process in 2021 will be affected by the close margins in Congress. It will also be affected by some obvious priorities – COVID relief and prevention, social justice, environmental concerns, and infrastructure. But another priority is raising revenue, particularly after the 2020 surge of spending in response to the COVID pandemic on an emergency basis that postponed the issue of paying for it (appropriately so in an emergency). Even in 2021, raising revenue to make up for 2020's spending will probably proceed with caution, to avoid undoing some of the 2020 relief or jeopardizing the recipients of that relief. But sooner or later both Democrats and Republicans will have a keen interest in raising revenue again, although very likely with different reasons and different ideas how to do it and how to allocate the burden.
>
> …
>
> In any event, there may be less interest and urgency for estate tax changes (compared to income tax changes with wider and more immediate effect), less likelihood of making income tax changes (other than changes offering COVID relief) effective January 1, 2021, and even less likelihood of a January 1, 2021, effective date for transfer tax changes, for which the calendar year is less relevant.
>
> Putting all this together, while there may be little likelihood of sufficient support even among Democrats for comprehensive tax repurposing and restructuring, almost any change in the two bulleted lists above could be supported, even by Republicans, (1) if it happens in a hurry and someone who doesn't like it is simply busy with other things, (2) if it happens partially or moderately, (3) if it is given the right "curb appeal" (like "consistency" or "simplification"), or (4) if it is combined with something else that is supported or has the right revenue estimate to pay for something else that is supported. That last cited scenario is exactly what happened, for example, when "Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent" was added to the Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41) by a Republican-controlled Congress in July 2015. It raised just the right amount of revenue to fund a desired extension of the Highway Trust Fund that was scheduled to expire on the day President Obama signed the Act into law. Significantly, the first version of introduced statutory wording for that consistent basis provision had been section 6 of the "Responsible Estate Tax Act" (S. 3533), introduced on June 24, 2010, by Senator Sanders – the original predecessor of what most recently is his "For the 99.8 Percent Act" (discussed below).
>
> And perhaps dominating all of this is the recollection of Vice President Biden's role in negotiating, for example, the estate tax provisions of the 2012 Tax Act with a Republican House and Democratic Senate. As President, he will probably be just as inclined to such a role, particularly at the beginning of his term, subject to how much members of both parties will permit that, and subject of course to the increase in his other responsibilities as President.

Bottom Line. So – bottom line prediction – not much and not soon? But it is never possible to be sure. Ronald D. Aucutt, The Top Ten Estate Planning and Estate Tax Developments of 2020 (January 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)**.

g. **Wealth Tax.** The proposed Ultra-Millionaire Tax Act, co-sponsored by Senators Sanders, Warren and various others, provides a 2% annual tax on the net worth of households and trusts ranging from $50 million to $1 billion and an additional 1% annual tax (for a 3% total tax) on assets above $1 billion. Estimates are that about 100,000 Americans (or fewer than 1 in 1,000 families) would be subject to the wealth tax in 2023, and that it would raise about $3 trillion over a decade, according to an analysis by University of California Berkeley Professors Emmanuel Saez and Gabriel Zucman. Senators Sanders and Warren had both proposed an annual wealth tax in the 2019-2020 Presidential campaign. (The Sanders campaign proposal was much more intense than the 2021 proposal, with rates starting at 1% on net worth above $32 million and increasing in increments to 8% for net worth over $10 billion, applying to about 180,000 households and raising an estimated $4.35 trillion over a decade.)

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

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

h. **"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 pointed out 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 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 (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 $1.16 million currently to $3 million (indexed going forward) (in 2021, from $1.19 million 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 (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, with detailed analysis, (found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)**.

i. **Deemed Realization Proposals Under Consideration.**

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

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

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

H.R. 2286 would apply to gifts and transfers made, including transfers from decedents dying, after December 31, 2021. Consistent with the exclusion amount and rate changes in Senator Sanders' "For the 99.5 Percent Act" discussed in Item 2.h above, 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 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.

(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 – the transfer to the 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).

j. **Mark-to-Market Proposal.** Several Presidential candidates in 2020 proposed wealth taxes (as discussed in Item 2.g above), which would have questionable constitutionality. Senator Wyden (Chair of the Senate Finance Committee) instead is pushing a mark-to-market system. The Wyden proposal would eliminate the preferential rates for long-term capital gains so that all income would be taxed at applicable ordinary income rates. In addition, new "anti-deferral accounting rules" would apply to high-income taxpayers, providing (i) mark-to-market annual taxation of income from tradable property (such as stocks and bonds), and (ii) lookback taxation of income from nontradable property (a lookback charge [perhaps an interest charge on the deferred tax] would be applied to reduce incentives for the taxpayer to defer the sale of the assets). The anti-deferral accounting rules would apply to taxpayers (including individuals, estates, or trusts) that meet certain income or asset thresholds. A taxpayer would be subject to the rules if she has either $1 million of income OR $10 million of "applicable assets" in each of the prior three years (the income threshold could be satisfied in some years and the asset threshold could be satisfied for other years in the three-year test period). This threshold means that the rules would apply to "only a fraction of the richest 1 percent of Americans." For a detailed description of the proposal, see *Treat Wealth Like Wages*, by Senate Finance Committee Ranking Member Ron Wyden, available at **https://www.finance.senate.gov/imo/media/doc/Treat%20Wealth%20Like%20Wages%20RM%20Wyden.pdf.**

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

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

k. **Coronavirus Related Legislation.** Various legislative enactments in response to the coronavirus have impacted individuals, small business and nonprofits. Some of these enactments include:

- Families First Coronavirus Response Act (P.L. 116-127, 3/18/2020) (generally providing tax credits to employers with under 500 employees to pay for sick leave);
- Coronavirus Aid, Relief and Economic Security (CARES) Act (P.L. 116-136, 3/27/2020) (broad ranging measures described below);
- Paycheck Protection Program and Health Care

l. **CARES Act.** Some of the provisions of the CARES Act are very briefly summarized.

(1) **Direct Stimulus Payments to Americans.** Direct payments will be made of $1,200 per individual, plus an additional $500 per child. The payments are phased out for those with

adjusted gross income between $75,000 – $99,000 (double those amounts for joint return taxpayers) per year, and those earning over $99,000 ($198,000 for joint returns) receive no payments.

Payments made to someone who died before receiving the payment should be returned to the IRS using procedures described by the IRS. If the payment was made to joint filers, only the payment attributable to the deceased joint filer must be returned. See discussion from the IRS at **https://www.irs.gov/coronavirus/economic-impact-payment-information-center** (Question 12 addresses payments to decedents). *See also* David Fogel, *Must Economic Impact Payments to Deceased Individuals Be Returned?*, TAX NOTES (June 8, 2020).

(2) **Retirement Plan and IRA Provisions.**

(a) **IRA Contribution Deadline.** The deadline for contributing to a traditional or Roth IRA in 2020 was extended to July 15, 2020.

(b) **RMDs Waived for 2020.** Required minimum distributions (RMDs) were waived for all retirement accounts except defined benefit accounts in 2020 (this included IRAs, even inherited IRAs). It was also waived for any deferred 2019 RMDs due April 1, 2020 (account owners who turned age 70½ in 2019 would have been required to take their first distribution by April 1, 2020 and a second distribution in 2020; if they had not taken either distribution, they did not have to in 2020, and their first RMD will be in 2021 without any make up requirements for not having taken distributions in 2019 or 2020).

Initial guidance from the IRS regarding the extension of various deadlines reflected that persons who took a distribution on or after February 1, 2020 may recontribute the withdrawal as an "eligible rollover distribution" by July 15, 2020, but this was not available for non-spouse beneficiaries who inherited the IRA or retirement plan. *See* Notice 2020-23 (issued April 9, 2020) in connection with Rev. Proc. 2018-58. However, further guidance issued June 23, 2020 in Notice 2020-51, which applied to IRAs and defined contribution plans (not defined benefit plans and apparently not individual retirement annuities), explicitly granted an extension of the rollover period for recontributing the distribution until August 31, 2020. Notice 2020-51 also (1) allowed re-contribution of amounts that had been withdrawn in January (i.e., before February 1, 2020), (2) permitted repayments to all IRAs (without excepting inherited IRAs; the repayment must be made to the same IRA from which it was withdrawn), and (3) clarified that the repayment was not subject to the one-rollover-per-12-month-period limitation that generally applies to repayments.

Persons who were receiving benefits subject to the five-year rule before 2020 did not have to receive a payment in 2020, and so the payments will have to be paid over six years instead of five. The waiver of RMDs for 2020 appears to have no impact on the 10-year provision in the SECURE Act because the SECURE Act only becomes effective in 2020, and the first year the 10-year provision would start running is 2021. *See* Jamie Hopkins, *How the TCJA, CARES Act, and SECURE Act Changed Retirement Planning*, ESTATE PLANNING 2, at 8 (June 2020).

(c) **Distributions For Owners Under Age 59½.** Qualified taxpayers could take a "coronavirus-related distribution" of up to $100,000 in 2020 and avoid the 10% penalty in early distributions. Notice 2020-50 provided guidance regarding these early distributions in 2020.

- Qualified individuals were expanded beyond those listed in the statute to include individuals who experience adverse financial conditions as a result of various listed coronavirus related issues.
- The individual did not have to use the distribution for a need arising from the coronavirus and the distribution amount may exceed the adverse financial consequences experienced by the individual.
- Administrators could rely on a certification by the individual that he or she is a qualified individual unless the administrator has actual knowledge to the contrary.

- The individual could make an election on his or her 2020 income tax return (and on Form 8915-E filed with the return) either (a) to recognize all income from the distribution in 2020, (b) to recognize one-third of the income in each of 2020, 2021, and 2022, and (c) if eligible to treat the distribution as an interest-free loan from the IRA or retirement plan so long as it is recontributed by the third anniversary of the distribution.
- The election had to be made consistently for all coronavirus-related distributions received in 2020.
- The election was irrevocable once made.
- If the distribution amount is recontributed within three years, an amended 2020 return (and Form 8915-E) must be filed.

See Christopher Denicolo, Alan Gassman & Brandon Ketron, Notice 2020-50 – The IRS Issues Guidance on "Coronavirus-Related Distributions" and Other IRA and Retirement Plan Provisions Under the CARES Act, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #740 (June 23, 2020).

(d) **Loans in 2020.** The amount an individual could borrow from a 401(k) or retirement plan (not including IRAs) in 2020 was increased from $50,000 to $100,000, and the maximum repayment period was increased to six years. Notice 2020-50 also addressed these relaxed loan provisions.

(3) **Charitable Contributions.**

(a) **$300 Above-The-Line Charitable Deduction.** The charitable planning community has for years pushed for the charitable deduction to be allowed in arriving at adjusted gross income (so that it would be available to non-itemizers). Very limited relief of this sort is provided for 2020. Qualified charitable contributions up to $300 made by an eligible individual in 2020 may be deducted in determining the individual's adjusted gross income. This does not include contributions to donor advised funds or supporting organizations.

Whether this amount was increased to $600 for joint return filers in 2020 was not totally unclear. The Joint Committee on Taxation summary of the CARES Act takes the position that the $300 amount does *not* increase to $600 for joint returns. Staff of the Joint Committee on Taxation, 116th Cong., 2d Sess., Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security (CARES) Act, at 22, n. 76 (April 23, 2020). Whether the IRS and courts will agree with that interpretation is unclear. *Cf. United States v. Woods*, 134 S. Ct. 557, 568 (2013)(Joint Committee on Taxation summary of legislation, referred to as a "Bluebook," is "like a law review article, … relevant to the extent it is persuasive");§62(2)(D) ($250 educator expenses deduction has been interpreted by the IRS to be $500 for joint returns). (The deduction has been expanded to $600 for married filing jointly taxpayers in 2021, but not for 2020, as discussed in Item 2.m(7) below.)

(b) **Modification of 60% Limit for Cash Contributions to Public Charities.** The limit for deducting cash contributions to public charities in 2020 was increased from 60% to 100% of the individual's "contribution base." This increased limit does not apply to contributions to donor advised funds, supporting organizations, or private foundations (except that it is available for donations to private operating foundations and private "flow-through" foundations, because the 100% limit applies for gifts to organizations described in §170(b)(1)(A), which includes private foundations described in §170(b)(1)(F), which includes flow-through foundations and operating foundations). Excess contributions may be carried forward to offset income in the following five years, but the carry forward in subsequent years would be subject to the typical 60% limitation in those years.

The 2017 Tax Act had increased the limit for cash contributions from 50% to 60%, but many planners believed that it did not allow for "stacking" cash contributions on top of non-cash contributions (for example, allowing a deduction for long-term capital gain property up to 30%

of AGI and allowing a deduction for cash contributions up to the remaining 30% of the 60% limit). In the face of this uncertainty, the Bluebook for the 2017 Tax Act states that "the 60-percent limit for cash contributions is intended to be applied after (and reduced by) the amount of noncash contributions …." (The staff of the Joint Committee on Taxation published the Bluebook, formally the "General Explanation of Public Law 115-97," on December 18, 2018.) An example is provided of an individual with a contribution base of $100,000 making a $50,000 gift of appreciated securities and a $10,000 cash gift. The $50,000 contribution is accounted for first, using up the individual's entire 50% contribution limit under §170(b)(1)(A) and leaving $10,000 in allowable cash contributions under the 60% limit under §170(b)(1)(G). However, a footnote observes that "[a] technical correction may be needed to reflect this intent. In the absence of a technical correction, there is a concern that some might interpret the provision as requiring that the 50-percent limit for noncash contributions under section 170(b)(1)(A) be applied after (and reduced by) the amount of cash contributions allowed under the 60-percent limit of section 170(b)(1)(G)." Bluebook to 2017 Tax Act at 51, n.253. The extension of the 60% limit to a 100% of AGI limit for 2020 in the CARES Act apparently also allowed "stacking," as evidenced by the IRS's draft instructions for Form 1040 that were issued on November 25, 2020. *See* Alan Gassman & Ian MacLean, *Charities Can Enjoy Enhanced Donations from Donors Who Wish to Contribute Appreciated Assets Plus Cash to a Combined Limit of Their Adjusted Gross Income*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #304 (Dec. 17, 2020).

(c) **Corporate Donations.** The corporate charitable deduction limit was increased from 10% to 25% of taxable income for 2020.

(4) **Paycheck Protection Program.** The Paycheck Protection Program (PPP) allows small businesses (generally those with fewer than 500 employees) to receive a forgivable loan of up to 2½ times their average monthly payroll cases for the prior year in order to encourage the retention of employees. The business must certify that the loan is necessary to support the ongoing operations of the business. Under certain situations, the loans may be forgiven (computation of the permitted forgiveness amount is very complicated). The implementation and administration of this program has been complicated with many uncertainties and changes, and subsequent legislation and administrative guidance has been necessary. As an example, a frequently asked question issued on May 13, 2020 provides that loans of under $2 million would not be challenged on the basis of not having made a good faith certification of need for the loan. See Alan Gassman & Brandon Ketron, *SBA Issues New Guidance Providing Safe Harbor for Loans Under $2,000,000*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #190 (May 14, 2020). Notice 2020-32 takes the position that while the forgiveness of the loan is not cancellation-of-indebtedness income, the expenditures made with loan proceeds that are forgiven are not deductible, relying on §265 and Rev. Rul. 83-3. Examples of constant changes and clarifications being provided in the program are summarized in Alan Gassman, *PPP Loan Forgiveness Applications Can Now Be Submitted As Soon As Monies Are Spent*, FORBES (June 24, 3020).

m. **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.

(1) **No Income from Forgiveness of PPP Loans; Deductibility of Expenses.** The Act retroactively amends the CARES Act to provide that no amount is included in the gross income of a PPP participant by reason of forgiveness of a PPP loan. In addition, no deduction is denied, no ta attribute is reduced, and no basis increase is denied by reason of the exclusion from gross income. *See* Rev. Rul. 2021-2, (I.R.B. 2021-04, January 25, 2021).

(2) **2020 Recovery Rebates.** A second round of refundable tax credits, paid in advance, of up to $600, or $1,200 in the case of married filing joint taxpayers, plus $600 for each qualifying child is provided, phasing out starting at $75,000 of modified adjusted gross income at a rate of $5 per $100 of additional income. (The President called for $2,000 payments.)

(3) **Unemployment Benefits.** The $300 per week federal unemployment subsidy payments are extended for 10 weeks, through March 14, 2021.

(4) **Deferred Payroll Taxes.** An executive order created a payroll tax holiday for the last four months of 2020, with the forgiven payroll taxes to be repaid during the first four months of 2021. The 2021 Act changes the repayment schedule to twelve months of 2021.

(5) **Child Tax Credit and Earned Income Tax Credit.** Taxpayers have the option to use 2019 income to determine eligibility for the tax credits for tax year 2020, and the 2021 Act prevents unemployment benefits received in 2020 from reducing these tax credits.

(6) **Solar Energy Property Credit.** The solar energy property, fuel cell property, and small wind energy property credit was scheduled to decline from 26% to 22% in 2021, but the 2021 Act extends the solar energy credit until the end of 2022.

(7) **Charitable Deduction Relief Extended and Expanded.** The non-itemizer $300 charitable deduction is extended into the 2021 tax year, and the deduction is expanded to $600 for married filing joint taxpayers. The $600 expansion for married filing joint taxpayers apparently applies just for 2021, not for 2020. (Section 212(p) of H.R. 133 addresses the non-itemizer provision and it begins, "In the case of any taxable year beginning in 2021…."). In addition, Prof. Sam Donaldson observes that the 2021 version provides an additional itemized deduction in addition to the standard deduction rather than an adjustment in arriving at adjusted gross income (as in 2020). The 100% of AGI limit for cash contributions to pubic charities and donor advised funds is also extended to 2021, and the increase of the corporate charitable deduction to 25% of taxable income is extended to 2021. The 2021 Act also increases the §6662 penalty for overstating qualified charitable contributions from 20% to 50%.

(8) **Reduction of Medical Expense Deduction Floor.** The reduction of the medical expense deduction floor from 10% to 7.5% is extended permanently.

(9) **Full Deductions for Business Meals.** The Act provides a 100% deduction for business meals, including delivery and carryout meals, provided by a restaurant for amounts paid or incurred in 2021 or 2022.

3. 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 70 ½ (but the $100,000 limit on qualified charitable distributions from an IRA are correspondingly reduced, and (most important) (iii) substantially limiting "stretch" planning for distributions from defined contribution plans and IRAs over a "designated beneficiary'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 IRAs 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 year, when the bulk of the plan benefits are distributed to the trust, they would have to be distributed to the beneficiary, and therefore not taking advantages of the purposes that 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 to a conduit trust, rather than an accumulation trust. 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 longer 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 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 qualified 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." 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.** 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. 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 in the 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 all of the 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).

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

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. **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**.

4. Anti-Clawback Regulation

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

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

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

The operative sentence stating the anti-clawback rule is in Reg. §20.2010-1(c)(1). Ron Aucutt refers to this provision as "somewhat sacrificing readability for precision." No joke in terms of "sacrificing readability," but a news release issued contemporaneously with the release of the proposed regulations explained that the regulations "provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA [basic exclusion amount] applicable to gifts made during life or the BEA applicable on the date of death."

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

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

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

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

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

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

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

(3) **No "Off-the-Top" Use of Increased BEA.** The two different places in the preamble to the final regulation confirm that the IRS does not adopt a rule allowing "donors to utilize the increase in the BEA without being deemed to have utilized the base BEA, so that the base BEA would remain available for transfers made after 2025." Preamble to Final Regulation at 8.

(4) **Be Cautious About Using Gift Splitting.** Consider not making the split gift election, so that all gifts come from one spouse, utilizing that spouse's excess exclusion amount that is available until 2026. For this purpose, it is better for one spouse to make an $11 million gift than for both spouses to make $5.5 million gifts.

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).

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

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

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

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

(9) **Anti-Abuse Rule.** The preamble notes that a commenter recommended that the anti-clawback rule be revised so that it would not apply to gifts that are included in the gross estate, such gifts as

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

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

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

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

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

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

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

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

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

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). *Id*.

5. Other Administrative Guidance Regarding 2017 Tax Act Changes

a. **Executor or Trustee Fees and Other Miscellaneous Estate or Trust Expenses.** An amendment to regulation §1.67-4(a) (issued as a proposed regulation on May 11, 2020 and finalized by T.D. 9918 (October 19, 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.

The regulation follows up on the IRS's expressed intention in Notice 2018-61 to issue regulations providing that estates and trusts may continue to deduct certain expenses despite the adoption of §67(g) in the 2017 Tax Act, which provides that miscellaneous itemized deductions are suspended until 2026. The preamble to the regulation reasons that such expenses are allowable in arriving at adjusted gross income (§67(e)), deductions allowable in determining adjusted gross income are not "itemized deductions" (§67(d)(1)), and accordingly such deduction cannot be "miscellaneous itemized deductions" (§67(b)), so §67(g) cannot apply to them. The regulation applies to taxable years beginning after the date the regulation was published as a final regulation, but estates, non-grantor trusts, and their beneficiaries may choose to apply the amendment for taxable years beginning after 2017. For further discussion of this issue, see Item 5.a. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Excess Deductions or Losses at Termination of Estate or Trust.** Notice 2018-61 observed that the miscellaneous itemized deductions that are not deductible under §67(g) appear to include the §642(h)(2) excess deduction at the termination of an estate or trust, but the IRS was studying whether to change that approach. 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.

Section 642(h) provides that on the termination of an estate or trust, a net operating loss carryover or capital loss carryover (§642(h)(1)) or the excess of deductions over income for the last taxable year (§642(h)(2)) are allowed as deductions to the beneficiaries succeeding to the property of the estate or trust "in accordance with regulations prescribed by the Secretary." Are those miscellaneous itemized deductions that are disallowed under §67(g)? The Joint Explanatory Statement of the 2017 Tax Act specifically includes "[e]xcess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust" as one of the "above listed items" that cannot be claimed as a deduction under §67(g). That is changed under the new regulations.

The prior regulation provided that a net operating loss carryover or capital loss carryover are used to compute the adjusted gross income on the return of a beneficiary, Treas. Reg. §1.642(h)-1. In contrast, the excess of deductions over income for the last taxable year are not "above-the-line" deductions (for determining adjusted taxable income) of the beneficiary, Treas. Reg. §1.642(h)-2(a), and effectively are treated as a single miscellaneous itemized deduction of the beneficiary, subject to disallowance under §67(g). The prior regulation was written before the concept of miscellaneous itemized deductions even existed in the Code, and the IRS acknowledged that the regulation needed to be updated.

ACTEC on June 22, 2020 filed comments with the IRS regarding the proposed regulations requesting, among other things, the discretion for choosing which deductions are allocated against income and which are carried out as excess deductions on termination of the estate or trust. The American Bankers Association filed comments on June 25, 2020 which, among other things, requested various additional codes on and detailed instructions for Schedule K-1 regarding the three categories of excess deductions at the termination of an estate or trust as described in the proposed regulations and requested corresponding changes for Form 1040. The IRS has responded to each of these requests.

The regulation stipulates that each deduction comprising the section 642(h)(2) excess deduction retains its separate character in one of three categories to reported separately to beneficiaries: (1) an amount allowed in arriving at adjusted gross income; (2) a non-miscellaneous itemized deduction; or (3) a miscellaneous itemized deduction. Furthermore, deductions attributable to a class of income are allocated against that income, but the final regulation makes clear that the executor has discretion in determining which of the remaining deductions are allocated against income of the estate or trust and which are treated as excess deductions carried out to beneficiaries on termination of the estate or trust. Example 2 of Reg. §1.642(h)-5 was revised in the final regulation to make 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).

The regulations apply to taxable years beginning after the date the regulations were published as final regulations, but estates, non-grantor trusts, and their beneficiaries may choose to apply the amendment for taxable years beginning after 2017.

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."

The helpful practical impact of this generous position by the IRS (contrary to the position announced in the Joint Explanatory Statement of the 2017 Tax Act, as described above) is summarized by Ron Aucutt:

> It is common for an estate or trust to have extra expenses related to its wind-up and distributions in its final taxable year, as well as the catch-up payments of some expenses that have been deferred, at the same time the income of the estate or trust has declined because of its sales or distributions of income-producing assets. An eight-year suspension of the ability of fiduciaries to pass through those final-year excess deductions would have created pressure to artificially time the payment of expenses, the sale or distribution of assets, and the termination of the estate or trust in ways that could be unfair and frustrating to both fiduciaries and beneficiaries. Thus, these regulations provide very important relief. 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**).

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 trust beneficiaries as well as for individual beneficiaries.

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

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, 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, 2019-27 I.R.B. issued on November 9, 2020. The Notice observes that a number of states and local jurisdictions "impose either a mandatory or elective entity-level income tax on partnerships and S corporations that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction." A "Specified Income Tax Payment" is defined in the Notice as "any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation." The Notice recognizes that such payments do "not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately" but the payment is reflected in the partner's or shareholder's distributive or pro-rata share of income from the entity. Therefore, 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 of SALT taxes incurred by the entity, the state would have to enact a mandatory or elective entity-level income tax on the entity. *See generally* Alan Gassman, Brandon Ketron & Alexander Sorley, *Regulations Take SALT Out of Taxpayer Wounds for State and Local Taxes Paid by S Corporations and C Corporations*, LEIMBERG INC. TAX PL. NEWSLETTERS #208 (Dec. 23, 2020). 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. *See* New York State Bar Association Tax Section, Report on New York State's Potential Response to Internal Revenue Service Notice 2020-75 and the State's Resident Tax Credit, Rept. No. 1446 (January 20, 2021). 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).

d. **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. (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.

e. **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. Proposed regulations were released in July 2020.

Various comments were filed with the IRS, including by the American College of Trust and Estate Counsel. The ACTEC comments, among other things, requested clarification that gifts to a non-grantor trust for the benefit of a taxpayer's spouse, children, grandchildren, or parents would not be considered an "indirect" transfer that would trigger acceleration of gain. (The proposed regulations had clarified that transfers to grantor trusts would not be treated as a transfers for purposes of §1061(d).) The ACTEC comments also questioned whether various events (such as death) or estate planning transactions should be triggering events and questioned whether transfers to a related person that did not constitute a recognition event should be a triggering event. Finally, the ACTEC comments requested that the definition of related persons for purposes of the "family office exclusion" in §1061(b) be broadened to include in-laws and their family members. The Final regulations specifically addressed these various comments.

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 and stated that it continues to study. The preamble to the final regulations summarizes the comments and the approach adopted in the regulations by taking the position that the §1061(d) acceleration only applies to transfers that would be a sale or exchange.

> Commenters also recommended that the final regulations exclude specific nonrecognition transactions, including (i) transfers resulting from the death of an Owner Taxpayer; (ii) gifts to a non-grantor trust by an Owner Taxpayer; and (iii) transfers resulting from a change in tax status of a grantor trust. One commenter noted that, in light of section 1061(d)'s specific reference to section 318(a)(1), and not to section 318(a)(2), a gift to a non-grantor trust for the benefit of a taxpayer's spouse, children, grandchildren or parents should not be considered an "indirect transfer" that would trigger the application of section 1061(d). The commenter noted that Congress's use of the phrase "directly or indirectly" does not warrant disturbing the conclusion that a transfer to a non-grantor trust does not constitute an acceleration event for purposes of section 1061(d). This commenter suggested in the alternative that if a transfer to a non-grantor trust is an acceleration event for purposes of section 1061(d), only upon a subsequent distribution of the API out of the non-grantor trust should the acceleration event occur.
>
> After considering the comments, the Treasury Department and the IRS have determined that while section 1061(d) can reasonably be interpreted as an acceleration provision, in the absence of clear language to the contrary, it is more appropriate to apply section 1061(d) only to transfers in which long-term capital gain is recognized under chapter 1 of the Code. Interpreting section 1061(d) as only a recharacterization provision is consistent with the statutory language that looks to so much of the taxpayer's long-term capital gain with respect to such interest for such taxable year as is attributable to the sale or exchange of any asset held. This treatment

also prevents the acceleration of gain in the many non-abusive nonrecognition transactions described by commenters. Furthermore, it is not necessary to accelerate gain on the transfers of an API to a Section 1061(d) Related Person in a non-taxable transaction because the API will remain an API in the hands of the transferee under §1.1061-2(a). Accordingly, the final regulations provide that the Section 1061(d) Recharacterization Amount includes only long-term capital gain that the Owner Taxpayer recognizes under chapter 1 of the Code upon a transfer through a sale or exchange of an API to a Section 1061(d) Related Person.

The preamble to the final regulations addresses comments regarding the family office exception in §1061(b). The regulations eliminate certain definitions that had been used for that exception in the proposed regulations, and the preamble states that the Treasury and IRS continue to study the comments about §1061(b) and may address the application of the provision in future guidance.

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).

f. **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**.

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 Plan for 2020-2021** was published November 17, 2020 (somewhat similar to the revised format of the 2017-2018, 2018-2019, and 2019-2020 Plans).

- Part 1 of the Plan addresses implementation of the 2017 Tax Act and lists 38 projects (down from 52 in the 2019-2020 Plan, which was down from 71 in the fourth quarter update of the 2018-2019 Plan).
- Part 2 deals with identifying and reducing regulatory burdens.
- Part 3 titled "Burden Reduction" lists 24 projects, down from 25 in the 2019-2020 Plan. This "burden reduction" section, as in the 2017-2018, 2018-2019, and 2019-2020 Plans, lists final regulations regarding (1) basis consistency and (2) discretionary extensions of time to make GST exemption allocations (suggesting a likely relaxation of some of the controversial provisions in the proposed regulations for those matters).
- Part 4 lists six guidance projects (down from seven in the 2019-2020 Plan) for prioritized implementation of the Taxpayer First Act (enacted on July 1, 2019), which made changes regarding various IRS operations including the establishment of a new Independent Office of Appeals.
- Part 5 includes projects regarding partnership audit regulations.

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

(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 being able to obtain 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).

Other planners have been more 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, than 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 (January 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 that 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).

(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 4.c(9) and Item 4.d above). A year ago, informal report reports from the IRS were that only items that were 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.

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

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

> (A) at the direction of a committee if (1) a majority or unanimous agreement of the committee over trust distributions is not required, (2) the committee consists of fewer than two persons other than a grantor and a grantor's spouse, or (3) all of the committee members are not

beneficiaries (or guardians of beneficiaries) to whom all or a portion of the income and principal can be distributed at the direction of the committee, or

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

Accordingly, DING and NING transactions 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), 201925005-201925010, 201908002-201908008, 201852014, 201852009, 201850001-201850006, 201848009, 201848002, 201832005-201832009, 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 (December 4, 2020).

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

> assumes permanent extension of all individual income tax provisions in the Tax Cuts and Jobs Act that are currently set to expire on December 31, 2025 … [and] the estate and gift tax parameters and provisions in effect for calendar year 2025.
>
> The 2021 Budget supports the extension of the individual and estate tax provisions of the Tax Cuts and Jobs Act beyond their expiration in 2025, as described above, to provide certainty for taxpayers and to support continued economic growth.
>
> Office of Management and Budget President's Budget, Analytical Perspectives, ch. 11 Governmental Receipts, at 127-128 (available at **www.whitehouse.gov/omb/budget/**).

The Biden Administration might return to the approach of the Obama (and earlier) administrations of including specific tax legislative proposals. The budget proposal in the first year of an administration is understandably delayed significantly beyond the February-March timeframe that is typical for other years. But the first budget proposal of the Biden Administration will be anxiously anticipated to discover the specific tax measures being urged by the Administration.

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

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

Carol Harrington observes that some cases have referred to revenue rulings as merely "the position of a frequent litigant." *See Estate of McLendon v. Commissioner*, 135 F.3d 1017 (5th Cir. 1998) ("Whereas virtually every circuit recognizes some form of deference, the Tax Court stands firm in its own position that revenue rulings are nothing more than the legal contentions of a frequent litigant, undeserving of any more or less consideration than the conclusory statements in a party's brief."). Under this approach, taxpayers are not bound by revenue rulings (they have not been through the formal comment and review process that regulations go through), but the IRS Chief Counsel Office has said that IRS attorneys cannot argue contrary to "final guidance," which includes revenue rulings (CC-2003-014), and case law has held that the IRS is bound by its own revenue rulings. *See Rauenhorst v. Commissioner*, 119 T.C. 157 (2002) (holding the Service bound by a taxpayer-friendly revenue ruling); Mitchell M. Gans, *Deference and the End of Tax Practice*, 36 REAL PROP. PROB & TR. J 731 (2002) (arguing that the Service should be bound by revenue rulings). *See also* letter from Deborah H. Butler, Office of Chief Counsel, October 17, 2002 (indicating, in the aftermath of *Rauenhorst*, that the Service will not disavow in litigation a taxpayer-friendly revenue ruling).

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

f. **Extension of Filing and Payment Deadlines for Covid-19 Relief.** Notices 2020-18, -20, and -23 extend tax filing and tax payment deadlines falling between April 1 and July 15, 2020 to July 15, 2020 including the statutory deadline for filing Tax Court petitions. Following the issuance of Notice 2020-18, which was fairly limited in the types of extensions granted, and Notice 2020-20, which dealt with Form 709, ACTEC filed comments with the IRS on March 27, 2020 regarding many other extensions that were appropriate for various other matters important to estate planners. Notice 2020-23, in particular, was very broad in the scope of deadlines that were extended. It included that any "time sensitive action" listed in Rev. Proc. 2018-58 due to be performed between April 1 and July 15 is extended to July 15, 2020, and wide ranging actions were included in that Rev. Proc. IR 2020-66 further extends the second quarter estimated tax payment due date. An IRS webpage describing a number of transfer tax related extensions is available at **https://www.irs.gov/businesses/small-businesses-self-employed/covid-19-relief-for-estate-and-gift**.

Filings due before April 1, 2020 were not extended, even though the country was pretty shut down beginning about the third week of March. Why the IRS chose not to provide automatic relief for deadlines in late March is unknown, (but discretionary extensions could be requested for situations in which discretionary extensions are available).

g. **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.

h. **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 user fee is significantly less for taxpayers with gross income under $250,000 [$3,000 after February 1, 2021], and for taxpayers with gross income from $250,000 to $1 million [$8,500 after February 1, 2021].)

i. **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. Proposed 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 IRS 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**).

> Section 2704 addresses the valuation, for wealth transfer tax purposes, of interests in family-controlled entities. In limited cases, Section 2704 disregards restrictions on the ability to liquidate family-controlled entities when determining the fair market value of an interest for estate, gift, and generation-skipping transfer tax purposes. Also in limited cases, Section 2704 treats lapses of voting or liquidation rights as if they were transfers for gift and estate tax purposes. The proposed regulations, through a web of dense rules and definitions, would have narrowed longstanding exceptions and dramatically expanded the class of restrictions that are disregarded under Section 2704. In addition, the proposed regulations would have required an entity interest to be valued as if disregarded restrictions did not exist, either in the entity's governing documents or under state law. No exceptions would have been allowed for interests in active or operating businesses.
>
> The goal of the proposed regulations was to counteract changes in state statutes and developments in case law that have eroded Section 2704's applicability and facilitated the use of family-controlled entities to generate artificial valuation discounts, such as for lack of control and marketability, and thereby depress the value of property for gift and estate tax purposes. Commenters warned, however, that the valuation requirements of the proposed regulations were unclear and that their effect on traditional valuation discounts was uncertain. In particular, commenters argued that it was not feasible to value an entity interest as if no restrictions on withdrawal or liquidation existed in either the entity's governing documents or state law. A legal vacuum in which there is no law relevant to an interest holder's right to withdraw or liquidate is impossible, commenters asserted, and, therefore, cannot meaningfully be applied as a valuation assumption. Commenters also argued that the

proposed regulations could have produced unrealistic valuations. For example, the lack of a market for interests in family-owned operating businesses is a reality that, commenters argued, should continue to be taken into account when determining fair market value.

> **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.**

In light of these concerns, Treasury and the IRS currently believe that these proposed regulations should be withdrawn in their entirety. Treasury and the IRS plan to publish a withdrawal of the proposed regulations shortly in the Federal Register. (Emphasis added)

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 Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (March 2020) 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 (January 4, 2021). A regulatory approach that focuses on valuation discounts for passive assets in an entity as opposed to operating businesses would likely draw less 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.h above).

j. **Extension of 2021 Filing Deadlines in Texas.** As disaster relief from the 2021 winter storm, filing deadlines for Texas residents have been extended for deadlines starting on February 11 (including general April 15 deadlines) to June 15, 2021 for various individual and business tax returns. For example, the extension applies to individual income tax returns due April 15, business returns due on March 15, individual estimated income tax payments, and quarterly payroll and excise tax returns normally due April 30. Also, 2020 IRA contributions may be made until June 15, 2021. The relief is also available to taxpayers in other states impacted by winter storms that receive FEMA disaster declarations (such eligible localities are available on the "disaster relief" page on IRS/gov). IRS News Release IR-2021-43, TX-2021-2 (Feb. 22, 2021)(specifically includes individual, corporate, estate and trust, partnership, and S corporation income tax returns as well as estate, gift and GST tax returns).

k. **General Extension of 2021 Filing Deadline for Form 1040.** The IRS announced on March 17, 2021 that the filing deadline for federal income tax by individuals will be automatically extended from April 15, 2021 to May 17, 2021 and that individual taxpayers can also postpone federal income tax payments for the 2020 year to May 17, 2021. Estimated tax payments that are due on April 15, 2021 are still due April 15. No application is needed for this automatic relief, but taxpayers may request a further filing extension until October 15, 2021 by filing Form 4868. IRS News Release IR-2021-59 (March 17, 2021).

Does this extension also extend the due date for gif tax returns? The News Release specifically says that it "only applies to individual federal income tax returns." However, §6075(b)(2) says that "[a]ny extension of time granted the taxpayer for filing the return of income taxes imposed by subtitle A for any taxable year which is a calendar year shall be deemed to be also an extension of time granted the taxpayer for filing the return under section 6019 for such calendar year." (Section 6019 addresses the gift tax return.) Whether the March 17, 2021 News Release extends the April 15 deadline for gift tax returns (described in Reg. §25.6075-1(a)) is unclear. Following the notice in March 2020 allowing an extension of time for filing certain returns for Co-vid 19 relief, the IRS issued further guidance, including Notice 2020-20 that specifically addressed Form 709. The 2021 notice says that the IRS will provide formal guidance "in the coming days." While the literal language of the 2021 News Release, §6075(b)(2), and Reg. §25.6075-1(b) seem to provide that the gift tax return due date is automatically extended to May 17, 2021, there is uncertainty about whether the gift tax return due date is extended. Notice 2021-21, published March 29, 2021, provides that Form 1040 series returns and income tax payments having an original due date of April 15, 2021 are automatically postponed to May 17, 2021. It does not address Form 709, but it does acknowledge that the postponement of the due date for filing these federal income tax returns also automatically postpones the time to make 2020 contributions to IRAs, health savings accounts, Archer Medical Savings Accounts, and Coverdell education savings accounts. The Notice specifically states that "[n]o extension is provided in this notice for … the filing of any Federal return other than the Form 1040 series and the Form 5498 series for the 2020 taxable year." In light of the uncertainty regarding gift tax returns, return preparers will likely file Form 8892 specifically requesting an extension of the gift tax return due date if the IRS does not clarify that the due date for Form 709 is extended. This is particularly important because some elections must be filed on a **timely filed** Form 709 (such as the QTIP election for an inter vivos trust).

7. Estate Planning For Moderately Wealthy Clients

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

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

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

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

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

b. **Another Paradigm Shift for 2020: COVID-19.** COVID-19 resulted in a huge shift in the world in many ways in 2020, and created a paradigm shift in 2020 for estate planning as well. For a summary of special planning considerations in light of the COVID-19 pandemic, see Items 8-12 and 19-24 of ACTEC 2020 Summer Meeting Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. *See also* Alan Gassman & Wesley Dickson, *When to Unplug Great Grandpa and Other Tax Strategies to Consider*, LEIMBERG ESTATE PLANNING NEWSLETTER # 2832 (October 20, 2020); Martin M. Shenkman, Jonathan Blattmachr, Andrew Wolfe & Thomas A. Tietz, *Different Approaches to Signing/Executing Estate Planning Documents*, LEIMBERG ESTATE PLANNING NEWSLETTERS #2799 (June 11, 2020); Stuart J. Kohn & Steven L. Kriz, *The Practical Aspects of Estate Planning in the Time of Covid-19*, BNA ESTATES, GIFTS & TRUSTS J. (May 14, 2020); Martin M. Shenkman, Jonathan Blattmachr, Andrew Wolfe & Thomas A. Tietz, *Slow Return to the New Normal and Different Approaches to Signing/Executing Estate Planning Documents*, LEIMBERG ESTATE PLANNING NEWSLETTERS #2794 (May 11, 2020). The American College of Trust and Estate Counsel provided a number of outstanding resources for planners during the COVID-19 pandemic. A link to a collection of a wide variety of resources developed by ACTEC during 2020 can be found on the

ACTEC website at **https://www.actec.org/estate-planning/estate-planning-during-the-covid-19-pandemic/**.

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

Grantors who have previously created irrevocable trusts that are not fully GST-exempt may want to allocate some of the increased GST exemption amount to the trust. The Bluebook for the 2017 Tax Act (published in December 2018 about a year after the Act was passed) has a detailed footnote saying that is permitted, and the preamble to the anti-clawback final regulation suggests that the IRS agrees. See Item 4.c(8) above.

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

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

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

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

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

Portability elections must be made on a timely filed estate tax return. A simplified procedure is available to obtain an extension in certain situations if a return was not required to be filed. Rev. Proc. 2017-34.

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

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

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

Four basic approaches can be used:

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

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

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

(4) triggering the Delaware tax trap by the exercise of a nontaxable power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment (*see* Kasey A. Place, *Section 2041(A)(3): A Trap Not Easily Sprung*, 55 REAL PROP., TR., & ESTATE LAW J. (Summer 2020)Blattmachr & Pennell, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J. TAX'N 242 (April 1988), updated and reprinted 24 REAL PROP. PROB. & TR. J. 75 (Spring 1989)).

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

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

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

Another alternative is to accomplish a basis adjustment by utilizing the otherwise unused exclusion amounts of parents or grandparents by grants of general powers of appointment with what has become known as "upstream planning." *See* David A. Handler & Christiana Lazo, *Senior Powers of Appointment*, TRUSTS & ESTATES 14 (Sept. 2020). Upstream Planning is discussed Item 7.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. *See* Mickey Davis & Melissa Willms, *All About That Basis: How Income Taxes Have Reshaped Estate Planning,* ALI-CLE

PLANNING TECHNIQUES FOR LARGE ESTATES (April 2018); Turney Berry, *The "Hook" of Increased Income Tax Basis*, TRUST & ESTATES 10 (April 2018).

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

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

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

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

a. **Significance; Period of Low Values and Historically Low Interest Rates.** Transfer and freeze planning can (i) assist in shifting wealth to save estate tax for clients with assets in excess of the basic exclusion amount (perhaps only if the exclusion amount drops below its current high amount at some point in the future), (ii) provide creditor protection planning, (iii) assist in moving assets downstream during life, which is becoming more important as people have longer life expectancies and inheritances are long-delayed, and (iv) provide income shifting by transferring wealth to family members who may be in lower income tax brackets. The most obvious nontax advantage of making gifts is to allow donees to enjoy the gifted assets currently.

A further possible window of opportunity is afforded by the current historically low interest rates and lower market values resulting from the economic downturn following the outbreak of the coronavirus pandemic. For an overview of planning opportunities, see Strategic Estate Planning Opportunities During Market Volatility found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. *See also* Lawrence Katzenstein, *Estate and Charitable Planning in a Low Interest Rate Environment*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #299 (July 27, 2020).

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

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

Any DSUE from a prior deceased spouse must be applied before the client's own exclusion amount. Therefore taking advantage of the window of opportunity would require making a gift large enough to use the DSUE as well as the client's exclusion amount. See Item 4.c(6) above.

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

d. **Defined Value Transfers.**

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

(2) **"Two-Tiered *Wandry* Arrangement."** Planners vary as to whether they prefer a "*Wandry* approach" (transferring that number of units equal to $X as finally determined for federal gift tax purposes) or a "price adjustment approach" (transfer of a set number of units for a specified value but with a price adjustment provision based on the value as finally determined for federal gift tax purposes). An approach that combines the *Wandry* approach and a price adjustment approach has been described as 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*, described in Item 8.d(3) below. The two-tiered Wandry arrangement is described as follows.

> This could consist of a traditional *Wandry* transfer followed by the simultaneous sale of any shares (or other assets) left by the *Wandry* adjustment clause if the clause is triggered. In other words, the transferor makes a gift of a specified value of the shares of the entity, believing that all of the transferor's interest in the entity is equal to the value being transferred. In the event that the shares are re-valued on audit (such that the value that the transferor sought to transfer does not cover all of the shares), the transferor will have sold shares that exceed the intended gift value. The second tier of the double *Wandry* arrangement could consist of a second sale of any shares, effective as of the same date as the primary *Wandry* sale, that remain by operation of the *Wandry* arrangement in the selling taxpayer or trust's hands. The price for this second sale, if any, could be for a price equal to the gift tax value as finally determined. The sale would be supported by a note upon which interest accrues from closing and is required to be made current within a specified time period, *e.g.*, 90-days of the final determination. Apropos to 2020 transfers, the concern over dramatic estate tax changes may have well encouraged many practitioners to utilize the two-tier *Wandry* clause as future transfers might not qualify for discounts, etc. if the law changes. Further, using a two-tier *Wandry* transfer may both protect against an unintended gift tax and simultaneously avoid a *Powell* challenge for estate inclusion. In *Powell*, the taxpayer "in conjunction with others" retained control over the FLP interests transferred resulting in estate inclusion. With a traditional application of a *Wandry* clause interests in an entity could remain in the transferor's control resulting in a *Powell* challenge. Using the two-tier *Wandry* may avoid that, and do so at a time in the law before discounts might be restricted or eliminated by a Biden Administration.
>
> For the most part, these types of arrangements would rely on grantor trusts, so that, in the event that the *Wandry* problem clause is triggered, the transferor could avoid an income tax – and possibly income tax interest and penalties – for a sale transaction deemed to have occurred on the date when the original gift was made.

Joy Matak, Steven Gorin & Martin Shenkman, *2020 Planning Means a Busy 2021 Gift Tax Return Season*, LEIMBERG ESTATE PLANNING NEWSLETTERS #2858 (February 2, 2021). The Matak, Gorin & Shenkman article includes excellent suggested detailed disclosures for reporting a two-tiered *Wandry* transfer on a gift tax return and income tax return (including Schedule K-1 disclosures).

(3) ***True v. Commissioner.*** An approach very similar to the two-tiered *Wandry* arrangement was employed in *True v. Commissioner*. A gift of units in a family business was made (using a split gift election) to one daughter (Barbara True), and the transfer agreement provided that if the transfer of those interests was determined for federal gift tax purposes to be worth more than the anticipated $34,044,838 amount of the gift, "(i) the ownership interest gifted would be adjusted so that the value of the gift remained at $34,044,838, and (ii) Barbara True would be treated as having purchased the ownership interests that were removed from her gift."

Sales of business interests were made to that daughter, two other children, and a trust. According to the petition, the transfer agreement for the sales to his children "provided that if it is determined for federal gift tax purposes that the interests sold were undervalued by FMV Opinions, the purchase price would be increased to reflect the finally-determined fair market values."

The IRS alleged a gift tax deficiency of $16,591,418 by each of Mr. and Mrs. True. The taxpayers contended that the valuations were correct, but if the transferred interests were determined to have a higher value, no gift should result because of the price adjustment provisions in the transfer agreement. *Karen S. True v. Commissioner,* Tax Court Docket No. 21896-16, and *H.A. True III v. Commissioner*, Tax Court Docket No. 21897-16 (petitions filed October 11, 2016).

The case was settled favorably for the taxpayers. The father made transfers of assets worth well over $160 million under these clauses (any gifts were deemed to be made equally by the spouses under the split gift election). The IRS determined that the transfers resulted in additional gifts by the parents collectively of $94,808,104 resulting in additional combined gift taxes of 35% of that amount, or $33,182,836. The taxpayers avoided that horror show and ended up paying only an additional $4,008,642 (combined) of gift tax under stipulated decisions filed in both cases in July 2018. The taxpayers no doubt viewed an additional current outlay of about **$4 million rather than $33 million** as a **huge victory** (even if the audit may have resulted in additional value being included in the parents' estates under revised face amounts of notes).

For a more detailed discussion of *True v. Commissioner*, see Item 11.n of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

One of the straight-forward alternatives of retaining continued benefit is a sale to grantor trust transaction. The seller would continue to receive benefit from the note payments. For an excellent overview of planning with grantor trusts, the effects of sales to grantor trusts, and the effects of exercising substitution powers to accomplish a basis adjustment at death on the re-acquired assets, see Matthew S. Beard, *Curing Basis Discrepancy: Sales and Substitutions of Trust Property*, TAX NOTES (Nov. 4, 2020); Monte A. Jackel, *Grantor Trust Ownership: What Does It Mean?*, TAX NOTES (April 13, 2020).

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

For a detailed discussion of SLATs and "non-reciprocal" SLATs, including a discussion of the §§2036 and 2038 issues and creditor issues, see 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**.

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.e.(13) of Estate Planning Current Developments and Hot Topics (December 2018) found **here** and Item 25 of Estate Planning Current Developments and Hot Topics (December 2019) found **here**, both 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.

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

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

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

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

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

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

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

Austin Bramwell's position in the cited articles is that a promissory note is enforceable to the same extent that a contract is enforceable—so the note should be delivered in exchange for consideration.

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

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

At the donor's death, the value of the preferred interest is includable in the gross estate. A put right would assure that the value will be at least equal to the liquidation preference if the preferred payment right is noncumulative. Thus, a basis step up should be permitted equal to that value. There is no transfer tax on the income and appreciation to the extent it exceeds whatever the donor receives (if anything) in preferred payments. The mitigation rule in Reg. §25.2701-5(a)(3) makes the zero value rule less significant since the donor's estate will be reduced by the same amount by which the gift value was increased due to the zero value rule. *See* Stephen M. Breitstone, Mary P. O'Reilly & Joy Spence, *Get of GRIP! How to Lock in the Exemption and Still Benefit from It with the Grantor Retained Interest Partnership*, LEIMBERG ESTATE PLANNING NEWSLETTER #2827 (September 29, 2020.

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

(4) **Section 2519 Deemed Transfer.** **Another planning possibility is to make a** §2519 deemed transfer (if a large QTIP exists for the client's benefit), which **is discussed in Item 3.j.(8)** of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** For example, if the client makes a gift of 1% of the income interest, the client will make a deemed gift of the remainder interest under §2519, will make a gift of the 1% income interest under §2511, and will make a gift of the retained 99% income interest under §2702 if the beneficiary of the remainder interest is a "family" member as defined in §2702. At the client's death, none of the QTIP trust assets will be included in the gross estate under §2044, but the QTIP trust assets attributable to the 99% income interest (i.e., 99% of the trust) will be includable in the gross estate under §2036. However, the deemed gift attributable to the §2036 inclusion (i.e. 99% of the trust) is not added into the estate calculation as an adjusted taxable gift. Treas. Reg. §20.2044-1(e) Ex.5. Accordingly, 99% of the trust value is included in the gross estate *once*, and under the anti-clawback regulation, the estate exclusion amount is at least equal to the exclusion amount applied against the 100% gift resulting from the §2519 transaction.

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

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

(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 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?

h. **Transfer Planning During a Period of Legislative Uncertainty and in Low-Interest Rate Environment.** A great deal of uncertainty exists regarding whether gift/estate exclusion amounts will be reduced, whether rates will be increased, whether other transfer tax reforms might be implemented (for example, attacking valuation discounts, GRATs, and future transfers to grantor trusts). 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).

i. **Transfers With Flexibility to "Undo" the Transfer.** While the likelihood of retroactively reducing the gift exclusion amount in 2021 is very unlikely (see Item 2.b(5) 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 include the following:

(1) making a gift that does not exceed the applicable gift exclusion amount (somewhat similar to standard "A/B formula" testamentary bequests, perhaps with a pour-over to a spouse, QTIP trust, or incomplete gift trust);

(2) making transfers to a QTIPable trust if the spouse is to be a beneficiary of the trust (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, and 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, but observe that a "Clayton" provision, opening the beneficiaries beyond just the spouse if the QTIP election is not made, likely cannot be used for inter vivos QTIP trusts [the §2523 gift regulations have no provision similar to Reg. §20.2056(b)-7(d)(3), and until the period for making the election has passed, the donor may 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 be problematic for an additional three years under §2035] and using this approach would mean that the spouse would receive income from the trust for life with no sprinkling provision);

(3) making transfers to a QTIPable trust including a disclaimer provision that would pass assets to a trust for descendants if the 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), but whether the disclaimed assets from an inter vivos QTIP could pass to a SLAT is not certain because §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," *Id.*, and in any event, the disclaimant-spouse could not have a power of appointment over disclaimed assets;

(4) making transfers to trusts with a disclaimer provision that if a particular beneficiary disclaims, the disclaimed assets would be returned to the donor (which would leave nine months after the gift for "wait and see" planning, but in the meantime beneficiaries could not accept any benefits); for an outstanding discussion 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);

(5) using some combination of the above (for example, 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, or a gift to a QTIPable trust with a disclaimer provision);

(6) selling assets for a note (possibly to a GST-exempt grantor trust), because the transferor could delay the decision to forgive the note until more certainty emerges regarding legislation, but in the meantime, future appreciation in the sold assets would be shifted; or

(7) attempting to rescind the gift later based on the changed circumstance (but this approach has a great deal of uncertainty, *see generally* New York State Bar Association Tax Section Report on the Rescission Doctrine" (Report No. 1216) (8/11/2010) at **www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1216-Report.pdf**, citing Sheldon I. Banoff, *Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud*, TAXES – THE TAX MAGAZINE, at 942 (Dec. 1984), and David H. Schnabel, *Revisionist History: Retroactive Federal Tax Planning* (2009) (unpublished manuscript), mentioning that an earlier version is published at 60 TAX LAWYER 685 (2007)).

Each of these (and several others) are discussed in more detail in Items 9-17 below.

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

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

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

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

In *Knop v. Knop*, 830 S.E.2d 723 (Va. 2019), father made annual gifts of interests in a closely-held company to his three children. Eventually, the children collectively owned about 44% of the company. The father later wanted to give or sell some of the company's real estate for a scenic easement, but the bylaws required approval of holders of 90% of the stock and the children refused to consent. The father responded by asserting that the prior transfers were ineffective because stock certificates reflecting the transfers had not been prepared or delivered. The family documented the ownership transfers by reflecting the change of ownership on the Schedule K-1s issued each year.

The Virginia Supreme Court held that without delivery of the stock certificates, there was no relinquishment by the father of his interest in the company.

Items 9-17 Discuss Transfer Planning Alternatives to Minimize Risk of Gift Taxes Due to Retroactive Gift Tax Legislation.

9. 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 gift tax audit or court decision, but would be based very objectively merely on what Congress does.

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

b. **Possible *Procter* Attack.** The IRS might conceivably argue that the assignment with a condition subsequent would not be recognized under the reasoning of *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944), which rejected 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 only purports to transfer a specified amount and nothing else.

The full Fourth Circuit Court of Appeals concluded that the provision imposed a condition subsequent to the transfer, and that the condition subsequent violated public policy for three reasons: (1) the provision discouraged the collection of gift tax because any attempt to collect the tax would defeat the gift; (2) the condition obstructed the administration of justice by requiring a court to pass on a moot case; and (3) the provision would reduce a Federal court's final judgment to a declaratory judgment. Observe that none of those three reasons applies to a formula assignment that merely takes into account retroactive gift tax law changes.

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

> The court's holding speaks to a procedural defect with the provision, namely, that the clause created a condition subsequent that could not become operative until a final judgment had been rendered, but once a judgment had been rendered it could not become operative because the matter involved had already been concluded by such final judgment…. "[T]he court in *Procter* [held] that because the adjustment was intended to take effect subsequent to the court's judgment, it cannot avoid the imposition of gift tax, because the tax is imposed on the

judgment, and is then final." Diana S.C. Zeydel and Norman J. Benford, *A Walk Through the Authorities on Formula Clauses*, ESTATE PLANNING, December 2010, at 4.

Tiffany Carmona and Tye Klooster, *Wandry v. Commissioner-The 'Secret Sauce' Estate Planners Have Been Waiting For?* 26 PROB. & PROP. 10, 11 (Nov./Dec. 2012).

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

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

Conservation easement cases that have rejected various types of "savings clauses" based on *Procter* have also pointed out that the subsequent event is a finding that a problematic clause is "determined to be noncompliant." *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126, 141 (Oct. 28, 2019). Similarly, *Belk v. Commissioner*, 774 F.3d 221, 230 (4th Cir. 2014), emphasized that a saving clause purported to alter contract rights triggered by "a determination that c[ould] only be made by either the IRS or a court." (That analysis was quoted in *Coal Property*.)

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. **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.

10. 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 Karbijanian, *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 10.c below.

(8) ***Clayton* Provision Probably Not Available.** A "*Clayton*" provision, opening the beneficiaries beyond just the spouse if the QTIP election is not made, likely cannot be used for inter vivos QTIP trusts. See Item 10.e 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 10.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 10.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). Upon filing the gift tax return reporting the transfer, if the QTIP election is not made, the donor can allocate her GST exemption if desired. If the QTIP election is made, the donee spouse 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 purposes only, meaning that the donor could allocate her 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 10.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 10.e below

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

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

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

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

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

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

d. ***Clayton* Uncertainty.** The non-elected portion of an inter vivos QTIP should continue to give the spouse a mandatory income interest and permit distributions to no one other than the spouse during his or her lifetime. The *Clayton* regulation (based on the result in *Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992)) provides that the portion of the assets for which the

QTIP election is not made may pass to a trust having different terms than the required terms for a QTIP trust — including a trust that would be similar to a standard "bypass trust" for the spouse that would not be in the spouse's estate for estate tax purposes. Reg. § 20.2056(b)-7(d)(3). However, that provision, is only in an estate tax regulation and is not in the 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 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, Richard Franklin 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, 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; Treas. 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 to the QTIP trust may be treated as the donor of the continuing trust for his or her benefit after the death of the donee spouse. Can a creditor argue that the assets originally came from the original donor, and that when they end up in a trust for her benefit, she should be treated as having created that trust, so that it is a self-settled trust reachable by her creditors? Indeed, that result is a possibility if the assets pass to the trust for the original donor spouse. Under the traditional "relation back" doctrine, the original donor spouse is still treated as the transferor of the trust for state law purposes. Therefore, for state law purposes, the trust may be treated as a "self-settled trust" and subject to claims of the donor's creditors unless the donor resides in a state with a domestic asset protection trust (DAPT) statute. *See generally* Gans, Blattmachr & Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP. 52, at 56 (July/August 2007). If the client does not live in a self-settled trust state with a DAPT statute, an attempt to incorporate the laws of a self-settled trust state may not be effective for creditor purposes. The comments to the new Uniform Voidable Transfers 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 2, ¶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 that trigger estate inclusion under § 2041 as well?

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

The creditor issue likely will be avoided if the laws of a DAPT state are applicable and the donor spouse is merely a discretionary beneficiary, or if the applicable state law includes a statute that protects lifetime QTIP trusts in this circumstance after the donee spouse's death. (At least eighteen 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 2, ¶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 10.(13) aboveb(13) above.

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

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

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

h. **Approaches for Addressing Reciprocal Trusts Issue.** If both spouses want to make gifts and want to take steps to minimize gift tax in the unlikely event of retroactive gift tax legislation, if each spouse creates a QTIPable trust for the other spouse, the IRS might argue that the trusts are includable in each spouse's gross estate under the reciprocal trust doctrine. See Item 25 below. An alternate approach might be for Spouse A to create a QTIPable trust for Spouse B and for Spouse B to make a gift outright to Spouse A with a provision that if Spouse A disclaims the gift, any disclaimed assets would pass to a trust for descendants. (Whether Spouse A could disclaim and have the assets pass to a trust for the benefit of Spouse A and descendants is not clear because of the reference in §2518(b)(4)(A) to "spouse of the DECEDENT," as discussed in Item 10.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 Treas. 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 found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

11. 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 at §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 keeping the instrument from specifying that any disclaimed asset will revert to the donor. If the instrument does not direct that disclaimed assets will revert to the donor, do not assume that is what would happen under state law. If a reversion to the donor is desired, the instrument should explicitly direct that, for example, "any disclaimed assets shall revert to me."

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

f. **Complexities for Disclaimers from a Trust.** If a deed from A is given to B, and B disclaims, local law will often provide that the property reverts to A. In that simple example, the manner of disclaiming the property is easy. B simply disclaims, and the property reverts to A. Similarly, if a gift is made to a trust with a single beneficiary and on trust termination the assets pass to that beneficiary or his or her estate, the beneficiary can simply disclaim. But the disclaimer process can get much more complicated when the gift is made to a trust with multiple beneficiaries. Each beneficiary could disclaim his or her interest in the trust, including potential remainder beneficiaries. Determining the portion of the trust represented by each beneficiary's interest could be difficult.

Obtaining disclaimers from multiple beneficiaries, some of whom may be minors and some of whom may have very small potential interests, can become quite complicated. To avoid such complexities, planners have recommended that the trust instrument specify that the property may be disclaimed (1) by a particular beneficiary (on behalf of all beneficiaries) or (2) by the trustee.

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

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

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

In order to allow an administratively convenient disclaimer by all beneficiaries, one alternative might be to draft a trust with a single beneficiary (or minimal beneficiaries) but include a limited power of appointment allowing the addition of more beneficiaries (including remainder beneficiaries) 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 to assure that the trustee is the trustee of 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 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 statue 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 10.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 10 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).

12. 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.

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

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

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

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

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

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

e. **Discounting Note Value.** Depending on the specific fact situation, a valuation discount may possibly apply in valuing the note. Even though §7520 provides that no gift is considered to have been made when a loan is made in return for a note bearing interest at the AFR, that does not mean the note is necessarily worth its face amount. *See* Michael S. Strauss & Jerome M. Hesch, *A Noteworthy Dichotomy: Valuation of Intra-family Notes for Transfer Tax Purposes*, 45 BLOOMBERG TAX MGMT. ESTATES, GIFTS & TR. J. 4 (Jan. 9, 2020). Planners may consider applying a valuation discount if a subsequent gift is made of part of the note. *See* Alan S. Gassman, Jerome B. Hesch & Martin B. Shenkman, *Biden 2-Step for Wealthy Families: Why Affluent Families Should Immediately Sell Assets to Irrevocable Trusts for Promissory Notes Before Year-End and Forgive the Notes If Joe Biden Is Elected, A/K/A What You May Not Know About Valuing Promissory Notes and Using Lifetime Q-Tip Trusts*, LEIMBERG EST. PL. NEWSLETTER #2813 (August 10, 2020).

14. 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 success 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 ground 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 14.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 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 who acted 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.

15. 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.)

16. 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.

17. 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.

18. Tax-Affecting in Valuing S Corporation Shares (Or Interests in Other Passthrough Entities) Under the Income Approach, *Kress v. United States* and *Estate of Jones v. Commissioner*

a. **Tax-Affecting Historical Overview.** "Tax-affecting" is an issue that arises when a passthrough entity is valued under an income approach, with the income being multiplied by a capitalization factor to arrive at the value of the entity. Tax-affecting refers to the step in the valuation of a closely-held business that seeks to adjust for certain differences between passthrough entities and C corporations. Typically, the passthrough entity in mind is an S corporation, but tax-affecting can be applied in the partnership context too. Significantly, *Estate of Jones* discussed below) involved tax-affecting for both an S corporation (SSC) and a partnership (SJTC).

At one time, the IRS internal valuation guide and the IRS internal examination technique handbook endorsed these adjustments in valuing S corporation with the income approach. That changed in 1999 following the first Tax Court case to directly address the concept in a gift tax case. *Gross v. Commissioner*, T.C. Memo. 1999-254, *aff'd*, 272 F.3d 333 (6th Cir. 2001). In *Gross* the taxpayer's appraiser tax-affected the value of stock of an S corporation, by using an assumed undiscounted corporate income tax rate of 40 percent. Judge Halpern viewed that as "a fictitious tax burden, equal to an assumed corporate tax rate of 40 percent." He tied the idea of tax-affecting for an S corporation to the "*probability*" that the corporation would lose its S status and concluded that "[w]e do not … think it is reasonable to tax affect an S corporation's projected earnings with an undiscounted corporate tax rate without facts or circumstances sufficient to establish the likelihood that the election would be lost."

The IRS jumped on the decision in *Gross*, viewed it as a Tax Court ban on tax-affecting, rewrote its internal guidance, and took very strong stands against tax-affecting in subsequent cases. Subsequent Tax Court cases agreed with the rejection of the tax-affecting concept in valuing S corporations. *E.g.*, *Gallagher v. Commissioner*, T.C. Memo. 2011-148 (Judge Halpern: "As we stated in *Gross v. Commissioner*, … the principal *benefit* enjoyed by S corporation shareholders is the *reduction* in their total tax burden, a *benefit* that should be considered when valuing an S corporation. [The estate's expert] has advanced no reason for ignoring such a benefit, and we will not impose an unjustified *fictitious* corporate tax rate burden on [the corporation's] future earnings.")

b. **Turning Tide, *Kress v. United States* and *Estate of Jones v. Commissioner*.** Several cases in the last two years suggest the tide might be turning regarding the tax-affecting issue. *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. March 26, 2019), had little particular discussion of the tax-affecting issue, but the court generally adopted the approach of the taxpayer's report, which included tax-affecting in its income approach analysis.

Five months later, the Tax Court approved the tax-affecting rationale in an opinion directly discussing the concept. *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101 (August 19, 2019, Judge Pugh). The court concluded that "tax-affecting" the earnings of the S corporation and limited partnership was appropriate in determining the valuations of the entities under the income method. The court explained that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax-affecting the earnings of a flowthrough entity per se. Instead, Judge Pugh viewed the issue as fact-based, and noted that the court in those cases had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases. In particular, Judge Pugh observed that the taxpayer's expert considered both the advantages as well as disadvantages of being a pass-through entity.

For a more detailed discussion of *Kress*, see Item 33 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. For a more detailed discussion of *Estate of Jones*, see Item 34.b.- c. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**, which is excerpted from a summary and analysis of *Estate of Jones* by Ronald D. Aucutt available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

c. ***Cecil v. Commissioner*.** Five years ago, the Tax Court tried a case, still awaiting decision, that includes tax-affecting for valuing S corporation stock as one of its issues. *Estate of William Cecil v. Commissioner*, Cause Nos. 14639-14 and 14640-14 (trial held February 2016). In *Cecil*, both the taxpayer AND the IRS's expert used tax-affecting in their analysis. The Tax Court may have a hard time rejecting tax-affecting as a matter of law when both experts agree in its application. (Tax-affecting is not the only issue in the case.)

d. **IRS Has Not Given Up.** Anecdotal indications are that the IRS is continuing to press the tax-affecting issue in audits despite the *Kress* and *Jones* cases.

19. In Determining Value of Nonvoting Interests in LLCs, Tax Court Repudiates IRS Valuations That Assumed the Voting Interest Would Also Be Acquired in the Same Willing-Buyer-Willing-Seller Transaction, *Grieve v. Commissioner*

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

a. **Synopsis.** In *Grieve v. Commissioner*, T.C. Memo. 2020-28 (March 2, 2020), Judge Kerrigan upheld a donor's gift tax valuation of 99.8% nonvoting interests in two limited liability companies that he had given in 2013 to a GRAT and to another irrevocable trust (in return for a private annuity). The assets held by the LLCs were largely cash, cash equivalents, and marketable securities. The donor's gift tax return applied entity-level discounts for lack of control and marketability totaling about 35%.

The Tax Court did not use an alternative approach the donor offered at trial that included discounting the value of interests in entities held by one of the LLCs being valued (resulting in "multiple-tiered discounts") and applying slightly different entity-level discounts. The court explained that it had found no justification for using a net value significantly lower than the value to which the taxpayer had previously admitted on the appraisal attached to the gift tax return (without any specific criticism of the multiple-tiered discounting approach).

The court firmly rejected a valuation offered by the IRS that assumed that a buyer of the 99.8% interest would start by seeking to buy the 0.2% controlling interest, which would have almost eliminated any entity-level discounts (leaving a discount of just over 1.4%). The use of that kind of far-reaching assumption has been described as the "game theory" approach. *See* Radd L. Riebe, *Two Court Cases Provide Significant Developments*, TRUSTS & ESTATES 68 (Jan. 2021) (describing game theory as a "strategic interaction to optimize decision making of independent and competing players").

b. **Facts.**

(1) **Background.** The donor, Pierson M. Grieve, resided in Florida when he filed his Tax Court petition, but from 1983 to 1996 he had been the chairman and chief executive officer of Ecolab, a public corporation headquartered in St. Paul, Minnesota. Ecolab stock was the underlying asset involved in the funding of the GRAT, and the Tax Court trial in March 2019 was held in St. Paul.

Around 1990, Mr. Grieve established the Grieve Family Limited Partnership to preserve and manage his family wealth. The general partner of the limited partnership was the Pierson M. Grieve Management Corp. (PMG). In the early 2000s, Mr. Grieve's daughter Margaret became involved in helping Mr. Grieve manage the family wealth, and in 2008 she purchased PMG from Mr. Grieve for $6,200 and became its president.

In 2012, Mr. Grieve created an irrevocable trust for the benefit of his children, with South Dakota Trust Co., LLC, as the trustee.

The LLCs in question, Rabbit 1, LLC (Rabbit), and Angus MacDonald, LLC (Angus), were created under the law of Delaware in 2013 and 2012, respectively. PMG owned the Class A voting units in each LLC, comprising 0.2% of the ownership interests of the LLC, and PMG's owner, Margaret, was the chief manager of the LLCs. The Class B nonvoting LLC units, comprising 99.8% of the ownership interests, were owned by Mr. Grieve's revocable trust in the case of Rabbit and by Mr. Grieve himself in the case of Angus. Margaret was the trustee of the revocable trust.

The assets of both LLCs were largely cash, cash equivalents, and marketable securities. The fair market values of those assets on the respective dates of transfer were $9,067,074 for Rabbit (as adjusted by stipulation in the Tax Court) and $31,970,683 for Angus.

Under the LLC agreements, the holders of all Class A voting units had to consent to the transfer of any units to anyone other than a lineal descendant of Mr. Grieve or his wife (who died in 2012), or a trust for the exclusive benefit of any one or more such lineal descendants and/or their spouses, or, in the case of Rabbit, a charitable organization

(2) **2013 Gifts.** On October 9, 2013, Mr. Grieve's revocable trust transferred its 99.8% nonvoting ownership interest in Rabbit to a two-year GRAT, with annuity payments defined as percentages of what the opinion describes as "the fair market value of assets transferred to the trust for Federal gift tax purposes." The percentage increased by slightly less than 20% from the first payment to the second payment, and the percentages were designed to "zero out" the GRAT – that is, to produce a gift tax value of the remainder equal to zero after applying the section 7520 rate of 2.4% for October 2013.

On November 1, 2013, Mr. Grieve transferred his 99.8% nonvoting ownership interest in Angus to the 2012 irrevocable trust, in exchange for a single-life private annuity that on that date had a fair market value of $8,043,675. Thus, Mr. Grieve made a gift to the irrevocable trust in the amount by which the value of the 99.8% interest exceeded $8,043,675.

c. **Positions of the Parties.**

(1) **Gift Tax Return.** Mr. Grieve's 2013 gift tax return reported values for the 99.8% nonvoting interests that were based on appraisal reports prepared by Value Consulting Group (VCG), using a cost approach and adjusted net-asset method to determine the fair market value of the assets of the LLCs and applying lack of control discounts of 13.4% for Rabbit and 12.7% for Angus and lack of marketability discounts of 25% for each LLC. To determine these discounts, VCG looked at studies of closed-end mutual funds and closely held equity interests, including restricted stock studies. In the Tax Court, VCG's valuation of the Rabbit interest was adjusted slightly by a stipulated change (from $9,102,757 to $9,067,074) to the fair market value of Rabbit's assets as of the transfer date of October 9, 2013.

(2) **Notice of Deficiency.** The IRS issued a notice of deficiency substantially increasing the values of the LLC interests. See the table below.

(3) **Taxpayer's Position in the Tax Court.** In the Tax Court, Mr. Grieve offered additional valuation reports prepared by Will Frazier and others in the well-known valuation firm of Stout. These reports independently valued the assets held by the LLCs, including the application of minority interest and lack of marketability discounts to limited partnership interests and venture capital funds held by Angus (*i.e.*, employing multiple-tiered discounts) and determined combined values slightly less than the values VCG had used. The reports used a market approach and asset method similar to VCG's, but with different discounts for lack of control calculated separately for equity securities and for cash and short-term investments. The reports agreed with VCG's 25% lack of marketability discounts, supported by analysis that the Tax Court explicitly acknowledged "considered factors that we outlined in <u>Mandelbaum v. Commissioner</u>, T.C. Memo. 1995-255, <u>aff'd</u>, 91 F.3d 124 (3d Cir. 1996), [including] the holding period, the risk of the underlying assets, and the company's distribution policy." Finally, the Stout reports also introduced an income approach, which the court described as follows:

> Mr. Frazier used the nonmarketable investment company evaluation (NICE) method which he developed as a valuation technique applicable to entities that hold a portfolio of investment assets. The NICE method determines a price that an investor would pay for the subject interest that lacks control and marketability by taking into consideration the investment risks and expected returns. In applying the NICE method, empirical studies were used to determine the incremental required rates of return in the light of information asymmetry (lack of control) and the cost of illiquidity (lack of marketability).

Giving equal weight to those market and income approaches, the Stout reports determined fair market values of the transferred 99.8% interests on the transfer dates that were slightly less than the values VCG had determined, which had been used on the gift tax return.

(4) **IRS's Position in the Tax Court.** In the Tax Court the IRS relied on the approach of Mark Mitchell, which has reportedly exasperated the appraisal community in other cases where the IRS has invoked it. The court described Mr. Mitchell's approach this way:

> In his valuation reports Mr. Mitchell sought the price at which a 99.8% noncontrolling interest would actually be bought or sold. According to Mr. Mitchell there was no empirical data on the sale of a 99.8% noncontrolling interest. His valuations were based upon the premise that the reasonable buyer of a 99.8% interest could be expected to seek to maximize his or her economic interest by consolidating ownership through the purchase of the 0.2% interest. Mr. Mitchell also contends that a willing buyer would consider the likelihood of purchasing the 0.2% interest.
>
> Mr. Mitchell determined that a hypothetical willing seller would seek first to acquire the class A [voting] units for a premium. According to his reports and testimony, purchasing the class A units would result in consolidated control and further maximize the value of the class B [nonvoting] units by reducing any discount sought by a hypothetical willing buyer.

d. **Result in the Tax Court.** The Tax Court totally rejected Mr. Mitchell's approach that a buyer of the 99.8% class B interest would start by seeking to buy the 0.2% class A controlling interest, which Mr. Mitchell assumed (without empirical data) could be purchased for a 5% premium. His approach would have almost eliminated any entity-level discounts (leaving a discount of just over 1.4%). Judge Kerrigan stated that the facts did not show that the scenario assumed by Mr. Mitchell was "reasonably probable" and bluntly noted that "[w]e do not engage in imaginary scenarios as to who a purchaser might be," citing *Estate of Giustina v. Commissioner*, 586 F. App'x 417, 418 (9th Cir.

2014), *rev'g and rem'g* T.C. Memo. 2011-141. (In a similar context in *Estate of Jones v. Commissioner,* T.C. Memo. 2019-101, discussed **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**, Judge Pugh had also cited *Giustina*, in that case rejecting rather than affirming an asset-based approach.) In *Grieve*, Judge Kerrigan added:

> Mr. Mitchell's valuations relied on an additional action [that is, in addition to a hypothetical sale of the 99.8% class B units]. He concluded that to determine the value of what a willing buyer would pay and what a willing seller would seek for the class B [nonvoting] units, a premium to purchase the class A [voting] units has to be taken into account. Elements affecting the value that depend upon events within the realm of possibility should not be considered if the events are not shown to be reasonably probable [citing *Olson v. United States*, 292 U.S. 246, 257 (1934)]. The facts do not show that it is reasonably probable that a willing seller or a willing buyer of the class B units would also buy the class A units and that the class A units would be available to purchase. To determine the fair market values of the class B units we look at the willing buyer and willing seller of the class B units, and not the willing buyer and willing seller of the class A units.
>
> Neither respondent nor Mr. Mitchell provided evidence to show support for his valuations. His reports did not include empirical data which back up his calculation of the 5% premium to purchase the class A units of either entity. He provided no evidence showing that his methodology was subject to peer review. Respondent cited no caselaw in support of Mr. Mitchell's methodology. Accordingly, we reject Mr. Mitchell's valuations of the class B units of Rabbit and Angus. See Estate of Hall v. Commissioner, 92 T.C. at 340; Estate of Deputy v. Commissioner, T.C. Memo. 2003-176, slip op. at 20; Estate of Smith v. Commissioner, T.C. Memo. 1999-368, slip op. at 40.

In contrast, Judge Kerrigan did not criticize Mr. Frazier's reports, although she concluded that:

> We are not convinced that the higher discount for lack of control for Rabbit and lower values in the Frazier reports should be substituted for the values that the parties stipulated and the discounts petitioner provided in the VCG reports. See Estate of Hall v. Commissioner, 92 T.C. at 337-338; Estate of Deputy v. Commissioner, slip op. at 12 n.6.

As a result, undoubtedly reassured by the very similar results in the Stout reports, the court accepted the values that had been reported on the gift tax return, with the slight adjustment that had been stipulated in the fair market value of the underlying assets owned by Rabbit.

For a summary of the court's rejection of the IRS's "imaginary scenarios" approach, see Andrew Mosher & Carsten Hoffmann, *Stout's Appraisal of the Taxpayer's LLC Reiterated the Accepted Approaches to Valuing Minority Interests in Privately Held Investment Entities,* Stout Court Case Alert (April 20, 2020)(summarizing the IRS's approach as the "IRS' Game Theory Hypothesis").

The following table summarizes the parties' positions and the court's conclusion:

Values Determined for the 99.8% Nonvoting LLC Interests Transferred (including the effective discount (rounded) from 99.8% of the value of the LLC's assets)

LLC (including the value of the LLC's assets)	Initial Positions		Positions in Tax Court		Tax Court's Conclusion
	Gift Tax Return (VCG)	IRS Notice of Deficiency	Taxpayer (Stout, Will Frazier)	IRS (Mark Mitchell)	
Rabbit ($9,067,074)	$5,903,769 (35.0%*)	$9,048,866 (0.4%*)	$5,884,000 (35.0%)	$8,918,940 (1.4%)	$5,880,626 (35.0%)
Angus ($31,970,683)	$20,890,934 (34.5%)	$31,884,403 (0.1%)	$19,854,000 (37.8%)	$31,456,742 (1.4%)	$20,890,934 (34.5%)

* Based on the $9,102,757 estimated value of Rabbit's assets before the stipulated correction.

As noted above, the taxable gift in the case of Angus was the excess of this amount over the $8,043,675 value of the annuity Mr. Grieve took back, in other words $20,890,934 minus $8,043,675, or $12,847,259. Because Mr. Grieve's wife died in 2012, it is possible that he had a DSUE amount from a portability election to apply against that gift. (According to the opinion, the IRS's notice of deficiency would have increased the value of the Angus interest transferred to the irrevocable trust by $10,993,469 (from $20,890,934 to $31,884,403), but, without explanation, would have increased the net value of the resulting gift by only $7,852,480 (from $9,966,659 to $17,819,139).

e. **Analysis.**

(1) **Apparently No Challenge of the LLCs Themselves.** The valuation discounts reflected in the IRS Notice of Deficiency – 0.4% for Rabbit and 0.1% for Angus – are tantamount to simply ignoring the LLCs altogether and simply treating the underlying assets of the LLCs as the subjects of the gifts. Yet there is no indication in the court's opinion that the IRS had encouraged the court to disregard the LLCs or to question, for example, whether the LLCs were formed for a "legitimate and significant nontax reason," which is the standard the Tax Court used in *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005) (reviewed by the Court) in the context of section 2036 (which does not necessarily apply in a gift tax context). Nor is there any indication that the IRS had asked the court to apply section 2703 or 2704.

(2) **Apparently No Section 2036(a)(2) Exposure Under *Powell* and *Cahill*.** *Grieve* is a gift tax case, and Mr. Grieve was alive when the Tax Court decided the case. Therefore there was no occasion for the IRS or the court to raise or address the issue that the 99.8% nonvoting interests might have "the right, … in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom," under section 2036(a)(2) as applied in *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017) (reviewed by the Court), and *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84. In light of *Powell* and *Cahill*, however, it may be noted in passing that neither Mr. Grieve nor his revocable trust retained any interest in Rabbit and Angus, and that in any event the Rabbit and Angus nonvoting units, as the opinion notes, "could not vote on or participate in any proceedings in which the entity or its members took action."

(3) **Concurrent Testimony of Experts.** In a footnote to her opinion, Judge Kerrigan stated that "[w]ith agreement of the parties we directed the expert witnesses to testify concurrently. The procedure was implemented in substantially the same way as in Rovakat, LLC v. Commissioner, T.C. Memo. 2011-225 [affirmed, 529 Fed. Appx. 124 (3d Cir. 2013)]."

In *Rovakat*, Judge Laro had explained:

> To implement the concurrent testimony, the Court sat at a large table in the middle of the courtroom with all three experts, each of whom was under oath. The parties' counsel sat a few feet away. The Court then engaged the experts in a three-way conversation about ultimate issues of fact. Counsel could, but did not, object to any of the experts' testimony. When necessary, the Court directed the discussion and focused on matters that the Court considered important to resolve. By engaging in this conversational testimony, the experts were able and allowed to speak to each other, to ask questions, and to probe weaknesses in any other expert's testimony. The discussion that followed was highly focused, highly structured, and directed by the Court.

The engagement of expert witnesses around a table like this has been referred to colloquially as "hot tubbing," and Judge Laro actually cited an article titled "Experts in the Tub" (21 Antitrust 95, 97 (2007)).

(4) **Game Theory Approach Rejected.** The court rejected the IRS's appraiser's approach of assuming that a hypothetical purchase of the 99.8% non-voting units would first purchase the 0.2% voting units, reasoning that such assumption was not reasonably probable and the court would not "not engage in imaginary scenarios as to who a purchaser might be," quoting this guidance from *Olson v. United States* (292 U.S. 246 257 (1934):

> Elements affecting value that depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable should be excluded from consideration for that would be to allow mere speculation and conjecture to become a guide for the ascertainment of value--a thing to be condemned in business transactions as well as in judicial ascertainment of truth.

(5) **Formula Clause for GRAT Annuity Payments.** As noted above, for the GRAT to which Mr. Grieve's revocable trust contributed the nonvoting Rabbit units, the annuity payments were defined as percentages of what the opinion describes as "the fair market value of assets transferred to the trust for Federal gift tax purposes." As the court noted in a footnote:

> The parties stipulated that petitioner will not owe additional gift tax if we determine that he understated the initial fair market value of assets transferred to the GRAT if, within a reasonable time, the GRAT pays to petitioner, or to his personal representative in the event of his passing, an amount equal to the difference of the properly payable annuity and the annuity actually paid.

Thus the formula clause worked, even though the GRAT was designed to produce a taxable gift of zero, which could have made the "final determination" of federal gift tax value less obvious. The formula clause used in *Grieve*, of course, is specifically authorized by Reg. §25.2702-3(b)(1)(ii)(B). Even so, for the IRS to force the formula clause to be respected, in this case by entering into the stipulation with the donor, is somewhat comparable to what we might have observed in the recent settlement of cases involving defined value clauses in the broader gift tax context. *See Estate of Donald Woelbing v. Commissioner* (Tax Court Docket No. 30261-13) and *Estate of Marion Woelbing v. Commissioner* (Tax Court Docket No. 30260-13) (petitions filed Dec. 26, 2013; stipulated decisions entered March 25 and 28, 2016); *Karen S. True v. Commissioner* (Tax Court Docket No. 21896-16) and *H.A. True III v. Commissioner* (Tax Court Docket No. 21897-16) (petitions filed Oct. 11, 2016; stipulated decisions entered July 9 and 6, 2018).

As such, *Grieve*, along with *Woelbing* and *True*, might provide a template for the resolution of cases involving defined value clauses, even as the IRS is probably still searching for a case in which it might successfully challenge the effectiveness of such a clause, standing alone, to prevent, defeat, or diminish a valuation challenge.

It also did not seem to matter in *Grieve* that the annuity payments determined by formula were, as the court put it, "to be paid within 105 days of [the respective anniversaries of the funding of the GRAT]." Specifically, neither the IRS nor the court seemed to be concerned that the explicit reference to the 105-day grace period of Reg. §25.2702-3(b)(3) even though it is not a governing instrument requirement might require valuation of the remainder for gift tax purposes to be based on the later permissible payment dates.

It is also interesting, as in Chief Counsel Advice (CCA) 201939002, that the IRS is auditing GRATs at all, although in this case it is easier to understand in a context where clearly Mr. Grieve's other transfer to an irrevocable trust in 2013 produced a taxable gift. The stipulation described in the court's footnote might provide an explanation of why such audits make sense. If, to settle a case, the IRS requires the grantor of a GRAT to explicitly confirm an increase in the annuity payments, more value presumably will be brought back into the grantor's estate to be taxed in the future, and the IRS is given one more tool to use in tracking and enforcing those annuity payments.

(6) **Multi-Level Tiered Discounts.** *Grieve* rejected on procedural grounds the approach offered by an expert at trial for the taxpayer applying tiered discounts (because that approach resulted in a value considerably lower than the value reported on the appraisal attached to the gift tax return), but without any specific criticism of the multiple-tiered discounting approach.

20. 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 downpayment 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. *Estate of Howard V. Moore v. Commissioner,* T.C. Memo. 2020-40 (April 7, 2020, Judge Holmes).

b. **Basic Facts.**

(1) **Background.** Mr. Moore's story is one of a compelling rise from poverty. He grew up in a home thatched out of arrowweed, left school after the eighth grade, became a "land leveler" in a local economy with so little cash that he was often paid with some of the land that was leveled, and slowly assembled over 1,000 acres that were consolidated into what became Moore Farms. He endured a long battle with alcoholism and had a dysfunctional family (including one son leaving for many years after he had borrowed a tractor belonging to one of his brothers, who then fired shots at the tractor, causing thousands of dollars of damage).

At age 88, Mr. Moore negotiated with potential buyers about selling the farm property, but before completing the sale he had a serious heart attack and was told he had less than six months to live. In December 2004, while in hospice care in the hospital, he worked with an estate planning attorney who developed an estate plan, focused primarily on Mr. Moore's stated goals of maintaining control and eliminating estate tax. As part of that plan, he created various trusts and a family limited partnership on December 20, 2004, four days after leaving the hospital.

(2) **Trusts.**

(i) **Living Trust.** Mr. Moore transferred all of his real and intangible personal property to a revocable trust (the "Living Trust"). On Mr. Moore's death, the trust provided for a formula transfer to a charitable lead trust of a fractional part of the trust assets to result in the "least possible federal estate tax." After paying expenses, claims, taxes, and specific distributions of personal property and real estate, the balance was left to the "Children's Trust" for the benefit of Mr. Moore's four children.

(ii) **Charitable Lead Annuity Trust.** It is not clear from the opinion when the charitable lead trust (the "Charitable Trust") was funded. The Living Trust contained a formula transfer to the Charitable Trust of a sufficient amount to minimize estate taxes so it may only have been funded under the formula transfer in the Living Trust following Mr. Moore's death. By the time of trial, the trust had distributed $2.5 million, ultimately passing to various charities. The opinion is confusing about the funding following Mr. Moore's death, though, because it reports that the estate tax return claimed a deduction for a transfer to the Charitable Trust of $4,745,671, but the IRS determined that only $516,000 had been transferred to the Charitable Trust following Mr. Moore's death.

(iii) **Children's Trust.** The "Children's Trust" apparently was created under the Living Trust following Mr. Moore's death. It directed specific distributions of certain property among the four children in trust, with the remaining assets being held in equal shares in trust for the four children.

(iv) **Family Management Trust.** The only asset of the irrevocable "Management Trust" was a 1% general partner interest in the family limited partnership ("FLP") described below. The trustees were two of Mr. Moore's children. The trust assets were to pass to the four children following Mr. Moore's death.

(v) **Irrevocable Trust.** The "Irrevocable Trust" was for the benefit of the four children. One son was the trustee. Following Mr. Moore's death, the trust was directed to "distribute an amount equal to the value of any asset of this trust which is includible in my gross estate for federal estate tax purposes" to the Living Trust to be distributed in accordance with its terms (i.e., under the formula distribution to the Charitable Trust and to the Children's Trust). As discussed below, Mr. Moore funded this trust in February 2005 from the Living Trust with $500,000, and several weeks later he transferred all of his interest in the FLP to this trust.

(vi) **Family Limited Partnership.** The FLP was created with initial nominal contributions so the Management Trust held a 1% general partnership interest, and the limited partnership interests were held by Mr. Moore (95%) and by the four children (collectively 4%). The FLP was funded in early February 2005 with a 4/5ths interest in Moore Farms and with a separate farm, and in late February with $1.8 million from an investment account held by the Living Trust. (The farm properties are collectively referred to as the "farm" below, but references to the farm properties are not clear in the opinion. Four-fifths of Moore Farms and all of the separate farm (called "Doval Farms") were transferred to the FLP, but the rest of the opinion just referred to "Moore Farms," and "Moore Farms" was included in the estate under §2036. Whether that included all of the farms owned by the FLP is not clear in the opinion.)

(3) **Sale of Farm.** Meanwhile, Mr. Moore had been engaged in negotiations with a prospective buyer of the farm, and before or shortly after his transfer of a 4/5th interest in the farm to the FLP there was a contract to sell the farm for about $16.5 million. That sale closed very shortly after his transfer to the FLP. (**Observation**: The opinion is not clear about the exact timing, suggesting in some references that the transfer and sale occurred on the same day and in other references that they were separated by up to five days.) Upon closing of the sale, the FLP transferred its 4/5ths interest in the farm (and the Living Trust transferred its remaining 1/5th interest) to the buyer, with Mr. Moore being allowed to continue living on and to operate the farm property for the short remaining balance of his lifetime.

(4) **Transfers.** Mr. Moore made various transfers over the next couple months. Some of the transfers were, as the court put it, "quite complex."

- The attorney was paid the $220,000 balance of his $320,000 design fee (80% came from the FLP and 20% from the Living Trust; Mr. Moore had paid $100,000 upfront).
- 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 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, a grandson also received $500,000 as a gift (he did not give a note to the FLP).

- The FLP distributed $2 million to the Living 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 thought this was 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 and the Living Trust never repaid the FLP.
- In late February, the Living Trust transferred $500,000 to the Irrevocable Trust (treated as a $125,000 gift to each of the four children).
- "A couple weeks later," in early March 2005, the Living Trust transferred its entire limited partnership interest in the FLP to the Irrevocable Trust in return for $500,000 cash (the cash that had been given to the Irrevocable Trust) and a note for $4.8 million. (Footnote 9 of the opinion says that the purchase price was based on an $11.5 million net asset value of the FLP minus a 53% discount, resulting in a purchase price of $5.3 million. That math does not work precisely if Mr. Moore still owned a 95% interest in the FLP at his death. $5.3 million/(.95 x $11.5 million) = .485, reflecting a 51.5% discount. If we assume that the Living Trust owned all of the partnership, $5.3 million/$11.5 million = .46, reflecting a 54% discount.)

(5) **Mr. Moore's Death.** Mr. Moore died at the end of March 2005. Mr. Moore was a resident of Arizona, and his personal representative and trustee was also a resident of Arizona when the petition was filed. If the case is appealed, it would be appealable to the Ninth Circuit 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. **Opinion.**

(1) **Value of Farm is Included in Gross Estate Under §2036.** A three-part test is applied for determining whether §2036(a)(1) applies to a transfer to an FLP – (1) a transfer of assets was made to an FLP, (2) the transfer was not a bona fide sale for adequate and full consideration, and (3) the decedent retained an interest or right in the transferred property (citing *Estate of Bongard v. Commissioner*, 124 T.C. 95, 112 (2005)).

(i) **Bona Fide Sale for Full Consideration Exception to §2036 Not Satisfied.** "[I]n the context of a family limited partnership, a sale is *bona fide* only if the record establishes the existence of a legitimate and significant nontax reason for creation of the family limited partnership and the transfer of assets to it. Estate of Bongard, 124 T.C. at 118."

- **Motive.** The estate maintained that Mr. Moore's "principal reason for forming the FLP and transferring his interest in Moore Farms to it was to bring his family together so that they could learn how to manage the business without him." After discussing prior cases that had found that the bona fide sale exception was satisfied (*Mirowski*, *Stone*, and *Bigelow*), the court summarized that "the transfers that we've found were motivated by genuine nontax purposes were of businesses that required active management." (The court also acknowledged that the bona fide sale requirement could also be satisfied by "[t]he desire to consolidate marketable assets and manage them as a family asset for continuing investment purposes," citing *Purdue*.) The *Moore* facts did not meet that standard:

> In these cases, there was no business to run. Moore sold Moore Farms just five days after he transferred four-fifths of it to the FLP. [But see the Observation in Item 20.b(3) above.] What's more, we find that he knew a month before the sale closed that he would sell it. This means as a practical matter that there was no farm for Moore's children to manage together. The only assets left in the FLP for Moore's children to manage were liquid, and they didn't even actually manage them. Other than the FLP's startup meeting, the children have never met to make and review investment decisions. They have an investment adviser who handles that for them, and there simply is no business to run.

- **Creditors.** The estate argued that the FLP would function as a protection from creditors. The court suggested that asset protection could never meet the bona fide sale exception, but in any event, Mr. Moore had no legitimate concern with creditor claims.

> While protection from creditors can be considered a legitimate–though not significant–nontax reason to form an FLP, <u>see</u> <u>Estate of Mirowski</u> …, there is no credible evidence that Moore or any of his children had a legitimate concern with possible creditor claims.

- **Other Factors.** The FLP was planned when death was imminent as "part of an attempt to avoid federal gift and estate taxes." The court would not "ignore the testamentary essence of the whole plan," as evidenced by the absence of bargaining, negotiating, or questioning. The plan was implemented unilaterally by Mr. Moore.
- **Adequate and Full Consideration Requirement Not Addressed.** Footnote 16 of the opinion observes that because the transfer to the FLP did not meet the "bona fide" requirement, the court did not need to discuss whether it was made for full consideration.

(ii) **Retained Enjoyment.** The court addressed, as what it called "an alternate holding," whether Mr. Moore retained "possession or enjoyment" of the assets transferred to the FLP. (**Observation**: This was not an "alternate" holding; a decedent's retention of possession or enjoyment of transferred assets is an integral requirement for §2036(a)(1) to apply.)

The court found that Mr. Moore "had, at the very least, an implied agreement to retain possession or enjoyment of the farm property upon the transfer of four-fifths of Moore Farms to the FLP and even after the sale of the entire farm." Factors mentioned by the court to support this finding include the following:

- **Continued Occupancy.** "We've held time and time again that a decedent's continued occupancy of property after its transfer to an entity is evidence of an implied agreement.
- **Use of Sale Proceeds in FLP "As His Own."** Mr. Moore retained outside the FLP sufficient assets for his personal needs, but he "didn't use them. Instead, he scooped into FLP assets to pay personal expenses."
- **Relationship to Assets Remained Unchanged.** Mr. Moore's relationship to his assets remained unchanged; he kept control over the FLP assets. Although two children were co-trustees of the Management Trust that was the general partner of the FLP, the "children typically did things because Moore asked them to, and giving them nominal 'power' was no different from Moore's keeping that power." An implicit understanding existed that Mr. Moore "would continue to use his assets as he desired and that his relationship with them changed formally, not practically."

(iii) **Conclusion as to §2036(a)(1) Inclusion.** Because Mr. Moore "retained possession or enjoyment of the farm, and because his transfer of part ownership to the FLP lacked a substantial nontax purpose, the value of Moore Farms should be included in the value of the estate under section 2036(a)(1)." As discussed in Item 20.d(3) below regarding the application of §2043, apparently the court is including 100% of the farm in the gross estate under §2036, not just the 4/5ths transferred to the FLP.

Observation: Apparently, the court is combining two different transfers as triggering §2036 inclusion – (1) the transfer of 4/5ths of the farm to the FLP and the attributable portion of the sale proceeds, and (2) the sale of 1/5th of the farm directly to a third party and the retention of enjoyment of the sale proceeds attributable to that 1/5th. Whether the 1/5th interest is included in the gross estate under §2033 or §2036(a)(1) makes no difference in this case, but the opinion is not explicit in its analysis of why the 1/5th interest is included under §2036.

(2) **Effect of Transfer of FLP Interests to Irrevocable Trust Not Addressed Directly.** The second issue for the court's review (as summarized by the court) was not discussed, at least directly, in the opinion. The opinion did not refer to any transfers from the FLP to Mr. Moore or other use of FLP assets by him after he transferred his limited partnership interest to the Irrevocable Trust (but Mr. Moore did continue to live on the farm itself for the remaining few weeks of his life). (**Observation**: Even if Mr. Moore retained no possession of enjoyment of FLP assets after the transfer of his limited partnership interest, a relinquishment of his retained interest within three years of his death would cause inclusion of the transferred assets under §2035(a)(2).)

(3) **Application of §2043 Consideration Offset.** The court observed that prior to the *Powell* case in 2017, the analysis would end there regarding §2036 inclusion. The proceeds from the farm's sale would be included in the gross estate under §2036 and the value of the FLP attributable to the contribution would be excluded. "But then we decided Estate of Powell v. Commissioner, 148 T.C. 392 (2017). We discovered and analyzed there, apparently for the first time, section 2043(a) of the Code as it applies to family limited partnerships."

The court proceeded with an extended discussion of §2043, fortunately avoiding *Powell*'s doughnut and doughnut hole analogies, but applying a formula approach. The general formula applied by the court is:

> Value in Gross Estate = Consideration (d/o/death) included under §2033 + FMV (d/o/death) of §2036 transfer – Consideration (d/o/transfer)

Mr. Moore's limited 95% partnership interest was valued at $5.3 million by the estate and at $8.5 million by the IRS. The opinion pointed out that the net value in the estate does not depend on which of these is correct because they net out in the formula.

In applying the facts to the formula, bear in mind that the opinion appears to treat all of the farm sale proceeds as includable under §2036, including both the 80% in the FLP and the 20% paid to the Living Trust.

Plugging the facts into the formula for the Moore estate, and taking into consideration that the values at the date of death and on the date of transfer to the FLP were roughly the same because the dates were within weeks of each other:

> Value in Gross Estate = Consideration (d/o/death) included under §2033 + FMV (d/o/death) of §2036 transfer – Consideration (d/o/transfer) (the §2043 consideration offset)
>
> Consideration (d/o/death) included under §2033 = *Either $5.3 million or $8.5 million for the 95% LP interest in the FLP + (0.2 x value of farm at date of death)* – money that left the estate between the time of the sale and Mr. Moore's death
>
> + FMV (d/o/death) of §2036 transfer = Value of farm at date of death
>
> - Consideration (d/o/transfer) = *Either $5.3 million or $8.5 million for the 95% LP interest in the FLP + (0.2 x value of farm at date of death)*
>
> Simplifying the equation (because the two items in italics above offset each other): 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 opinion pointed out that further complexity would result if the distributions from the FLP to the Living Trust had not been fully spent. Example 5 in the opinion illustrates this phenomenon.

Example 5: Discounted Interest, But Not Simple. Now assume the same facts as example 4 [which described the transfer of land worth $1,000 to a FLP in return for a partnership interest valued with a 25% discount for lack of control] except this time the FLP sells the land for $1000. Then, the FLP makes a distribution of $400 back to the aging father. Under the formula this produces a strange result. Included in the estate is $400 cash (section 2033), $450 for the FLP interest (section 2033),[20] $1000 for the transferred land (section 2036), less $750 (section 2043)–in all the estate now has a value of $1100. Had the aging man just sold the land he would have only $1000 in his estate.

[20] $450 = $600 (what's left in the FLP after the $400 distribution) * 0.75 (to reflect the 25% discount).

The amount included under §2033 would be the date of death full **undiscounted** value of the remaining distribution proceeds plus the discounted value of the partnership interest, based on the value of partnership assets after the distribution. The §2043 consideration offset would be the **discounted** value of the partnership interest at the date of transfer. The net value included in the estate would increase as a result of the distribution in an amount attributable to the difference between the undiscounted value of the remaining unspent distribution proceeds and the discounted value of the FLP at the date of transfer attributable to the amount of the later distributed assets. Thus, in the court's example, the $100 increase in the value of the estate (from $1,000 to $1,100) is the 25% discount multiplied by the $400 distribution back to the father.

(4) **Deductibility of Purported Loan to FLP and Attorney's Fees.**

(i) **Purported Loan to FLP Not Deductible.** Although the estate tax return reported the estate as owing $2 million to the FLP as the result of the "loan" of $2 million from the FLP to the Living Trust, the court found no evidence that the transfer was a loan. There was no promissory note, no interest charged or paid, no collateral, no maturity date, no payments made, and no demand for payments.

(ii) **Attorney's Fees Not Deductible.** A $475,000 payment for "administrative attorney's fees" was not deductible because of the absence of evidence that the "fees were necessarily incurred in the administration of the estate." The fee was a flat fee, there was no detail about the intricacy of the work or the time put in, and when asked to describe the work performed for the estate, the attorney "was vague and testified only that his work continues to this day." There were no claims against the estate and all of Mr. Moore's property was in the Living Trust "so it's unclear what administration [the attorney] is responsible for." (Prior to Mr. Moore's death, the attorney was also paid a $320,000 "design fee" for the structuring and implementation of the estate planning transfers.)

(5) **No Charitable Deduction for Formula Transfer Attributable to Additional Value in Gross Estate Resulting From Estate Tax Audit.** Formula transfers to charity (to the Charitable Trust) were included in two places. (1) The Living Trust transferred to the Charitable Trust a portion of assets in the Living Trust sufficient to "result in the least possible federal estate tax payable as a result of my death." (2) The Irrevocable Trust (which owned the 95% limited partnership interest in the FLP) instructed the trustee to "distribute an amount equal to the value of any asset of this trust which is includible in my gross estate for federal estate tax purposes" to the Living Trust to be distributed in accordance with its terms (which included the formula charitable transfer described immediately above).

The IRS did not contest at least some of the charitable deduction claimed on the Form 706 for the formula amount left to the Charitable Trust based on values reported on the Form 706. Thus, the initial funding of the formula charitable transfer based on values of assets and deductions reported on the Form 706 was respected, at least in part. (See Item 20.e(11)(ii) below.)

The issue addressed by the court was whether an additional charitable deduction should be allowed as a result of "any increase in the value of Moore's estate" resulting from the estate tax examination and litigation. The court gave two reasons for denying "any charitable deduction for funds that might be transferred to the Charitable Trust under article 5, section 2 of the Irrevocable Trust": (1) a limitation based on the particular language of the trust agreement; and (2) a requirement that the charitable deduction must be ascertainable at a decedent's date of death.

(i) **Particular Trust Language Limitation.** The literal language of article 5, section 2 of the Irrevocable Trust refers to transferring to the Living Trust "an amount equal to the value of any asset *of this trust* which is includible in my gross estate." (Emphasis in court opinion). The Irrevocable Trust owned the limited partnership interest, not the FLP assets. The additional amount included in the gross estate was an amount equal to the value of the farm transferred to the FLP, not the limited partnership interest itself. Therefore, the literal language of the Irrevocable Trust did not transfer any additional amount to the Living Trust.

Observation: In one respect, this is nit-picking over words (and suggests that different drafting might have avoided the court's analysis), but in a broader respect this raises the same issue that has been referred to in the marital deduction context (at the death of the first spouse) as the "marital deduction mismatch" issue. An "amount" is included in the gross estate equal to the full undiscounted value of the farm, but all the trust owns to leave to charity is a discounted partnership interest. Indeed, footnote 23 of the opinion indicates that the IRS made an alternative argument that even if the formula clause is respected, "the Irrevocable Trust lacks the assets to donate a sum large enough to eliminate the estate tax." This issue is discussed in Item 20.e(11)(vi) below.

(ii) **Charitable Deduction Must be Ascertainable at Death.** A "much more general problem" is that charitable deductions cannot depend on actions of the decedent's beneficiary or executor, and the charitable deduction must be ascertainable at a decedent's date of death. Whether the Living Trust would get additional funds from the Irrevocable Trust to transfer to the Charitable Trust was not determinable at Mr. Moore's death, but only after an audit that ultimately resulted in additional property being included in the gross estate. "For the exception to apply, it would have to have been *almost certain* that the Commissioner would not only challenge, but also successfully challenge the value of the estate." (Emphasis added).

The court distinguished the *Christiansen* and *Petter* cases (in which, interestingly, Judge Holmes wrote the Tax Court opinions). In *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), *aff'd*, 586 F.3d 1061 (8th Cir. 2009), a sole beneficiary disclaimed all of the estate (under a fractional formula) in excess of a stated dollar amount, with the disclaimed assets passing to a charitable lead trust and foundation. In *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd,* 653 F.3d 1012 (9th Cir. 2011), a gift was made of LLC units, with units up to a stated dollar value passing to trusts for the donor's children and the excess units over that stated value passing to charity. Although both of those cases recognized formula-based transfers to charity, the court reasoned that in those cases "the transfer itself was not contingent on the happening of some event… [V]alue was at issue, but not whether there would be a transfer to the donee at all." The court contrasted those situations with the *Moore* facts:

> Article 5, section 2 of Moore's Irrevocable Trust does not say that the Living Trust will receive a transfer of assets of unknown value. It says that whether the Living Trust will even receive a transfer of assets is unknown–contingent on an examination by the Commissioner. This is unlike Estate of Christiansen, where we *knew* the charity would get a transfer of assets, just not the value, or Estate of Petter, where we *knew* the charity would get some transfer of value, just not how much. Here, we *don't know* if the charity would get any additional assets at all. (Emphasis in original).

The court seems to draw a big distinction between formulas based just on the *value* of assets and formulas based on other issues, such as what assets are in the gross estate or the amount of allowable deductions.

(iii) **Unknown From Case Facts.** The court's actual holding is that no charitable deduction is allowed for funds that might be transferred from the Irrevocable Trust to the Charitable Trust under the formula transfer clause in the Irrevocable Trust. Even aside from a formula transfer from the Irrevocable Trust, the Living Trust itself made a formula transfer. Unless all of the Living Trust assets were originally allocated to the Charitable Trust under the Living Trust's formula charitable transfer, additional assets should have been transferred to the Charitable Trust directly from the Living Trust in an amount to result in the "least possible federal estate tax." The opinion does not directly address whether that transfer would be respected to qualify for a charitable deduction (but suggests that it would not).

Also, the opinion focused on not allowing an additional charitable deduction because of the inclusion of the farm in the gross estate. Would an additional charitable deduction be allowed for other reasons raised in the estate tax audit, such as disallowed deductions or gift tax paid within three years of death?

(6) **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.

e. **Observations.**

(1) **Long Delay.** This Tax Court memorandum decision (not a reviewed opinion involving negotiations with all Tax Court judges) was long delayed. Apparently, some of the issues in the case raised difficult issues for the court.

Altogether, the Moore family had to wait ten and a half years from the filing of the Tax Court petition in September 2009 and over 15 years from Mr. Moore's death in March 2005 to reach this point, and the estate and the IRS still have to agree on the computations (and the opinion ended with an acknowledgement "that computations will be difficult").

(2) **Death-Bed Planning.** Judge Holmes began his opinion by observing that after building a "thriving and very lucrative farm," the decedent's health went bad and he entered hospice care. "Then he began to plan his estate."

(3) **Emphasis on Businesses Requiring Active Management to Satisfy "Legitimate and Significant Nontax Purpose" Requirement.** One sentence in the *Moore* opinion makes the observation that "[t]he desire to consolidate marketable assets and manage them as a family asset for continuing investment purposes is also a genuine nontax motive under section 2036. Estate of Purdue v. Commissioner, T.C. Memo. 2015-249." Other than that one sentence, the opinion emphasizes that active management by family member partners is a necessary element in order for

a court to find the existence of a legitimate and significant nontax reason for the FLP (the test announced in *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005)). The opinion states that prior cases finding that the bona fide test was satisfied involved "businesses that required active management."

The opinion also states that protection from creditors cannot be a "significant" nontax reason to form an FLP. (It says that creditor protection "can be considered a legitimate – though not significant – nontax reason to form an FLP.") That is startling as a carte blanche statement.

(4) **Active Involvement of Other Family Member-Partners.** At a minimum, the opinion points out the desirability of having other family members actively involved in planning, discussing (i.e., "negotiating") provisions about the partnership structure, having partner meetings, and being actively involved in decisions about the management of partnership assets.

This is especially important if a purpose of the FLP is to facilitate the family's working together. Administer and manage the partnership in a way that is consistent with the stated purpose.

(5) **Retention of Possession or Enjoyment of Transferred Assets.** Cases have made clear that the retention of "possession or enjoyment" of transferred assets to trigger the application of §2036(a)(1) can be shown by an implied agreement. In this case, the court acknowledged that the decedent "kept sufficient assets for his personal needs," but the fact that the decedent then proceeded still to use assets of the partnership for personal expenses evidenced retained possession or enjoyment of the transferred assets. From a planning standpoint, be wary of actually using partnership assets (or partnership distributions) for personal purposes.

(6) **Treating Sale of Decedent's Retained One-Fifth of Farm as §2036 Transfer; Use of Farm Property.** We are all very familiar with treating property contributed to an FLP or LLC as a §2036 transfer, with the transferred property (undiscounted) being included in the gross estate. In this case 4/5ths of the farm was contributed to the FLP and included in the gross estate under §2036(a)(1). But somewhat surprisingly, the remaining 1/5th interest that Mr. Moore retained in his Living Trust until the sale was treated as a transfer with retained enjoyment. Note — a sale to an unrelated party was treated as a §2036 transfer! The use of the sale proceeds could not have been the reason for that; sales to third parties typically are not considered as §2036 transfers no matter what the seller does with the sale proceeds. Typically the bona fide sale for full consideration exception would apply to third party sales. Clearly, there was a legitimate and significant nontax reason for selling the farm to a third party – it was to dispose of the farm. What was unusual in this case was that the decedent apparently contracted to continue living on the property, and to be in charge of making farm operations decisions, for the remainder of his very short life expectancy. (He lived about three months after the sale.) But even if that was treated as retained enjoyment, that would not explain why the bona fide sale for full consideration exception did not apply. Perhaps a small concession was made on the purchase price for the short period of time that the buyers agreed to allow their elderly neighbor to continue living on the property (though that seems unlikely and the court's opinion gives no hint of that). If such a price concession was made, that may have kept the full consideration requirement from being satisfied. But the court did not discuss why the bona fide sale for full consideration exception did not apply to the sale of the decedent's retained 1/5th interest in the farm.

As a practical matter, it made no difference in this case whether the sale proceeds from that 1/5th interest was included in the gross estate under §2033 or §2036, but the complete absence of any analysis of treating a sale of property to a third party as a §2036 transfer is interesting, to say the least.

(7) **Effect of Subsequent Transfer of All Interests in the FLP.** The court specifically listed as one of the four issues for consideration whether the subsequent transfer of the Living Trust's interest in the FLP to the Irrevocable Trust removed the value from the gross estate that was otherwise includable under §2036, but the court did not, at least directly, discuss that issue. Footnote 17 of the opinion merely states that because the value of the farm is included in the gross estate under §2036(a)(1) the opinion does not address "the subsequent transfer of the Living Trust's assets [i.e.,

the 95% interest in the FLP] to the Irrevocable Trust" and whether it "also triggers their inclusion under section 2036."

This is important because a way of defeating the inclusion of assets contributed to an FLP in the gross estate under §2036(a)(1) is to transfer all of the interest in the FLP so that the decedent has not retained an interest in the assets contributed to the FLP "for life or for any period not ascertainable without reference to his death." That may not work to avoid §2036 for two reasons: (1) the decedent continues to enjoy the transferred property even though he is no longer a partner, or (2) if, as in *Moore*, the transfer occurs in more than one step and is completed by the relinquishment of a retained interest described in §2036 within three years of death (§2035(a)(2)).

As to the first of those two reasons, interestingly, no distributions or transfers from the FLP appear to have been made after the decedent transferred his 95% interest to the Irrevocable Trust. However, Mr. Moore apparently did continue to make some use of partnership transfers that had been made to him prior to the date of the transfer of interests to the trust (including the payment of his income taxes attributable to his part of the pass-through income from the sale of the farm; the opinion states that Mr. Moore spent the $2 million that he received from the FLP "before he died, mostly on income tax that he owed on the sale of the farm," but because Mr. Moore died in late March less than two months after the sale on February 4, it is likely that the income tax had not been paid before the date of death).

Undoubtedly, the second reason also would apply. Section 2035(a)(2) would have caused the property contributed to the partnership to continue to be in the estate because the retained interest that would otherwise cause inclusion under §2036 was relinquished within three years of the decedent's death.

A few cases have recognized that a subsequent transfer of an interest in an FLP can prevent the inclusion of partnership assets under §2036. Value attributable to interests that have been transferred at least three years earlier should not be subject to §2036(a)(1) if no implied agreement of continued retained enjoyment exists (*see* the *Estate of Jorgenson*, *Estate of Kelly*, and *Estate of Rosen* cases).

(8) **De Facto Trustee Discussion.** Several cases over the last several years have addressed situations in which a grantor effectively made all trust decisions, and have considered whether the grantor should effectively be treated as if he were the trustee. *E.g.*, *United Food & Commercial Workers Unions v. Magruder Holdings, Inc.*, Case No. GJH-16-2903; *SEC v. Wyly,* 2014 WL 4792229 (S.D.N.Y. September 25, 2014) (failure to comply with fiduciary constraints regarding trust distributions caused a trust to be treated as a grantor trust for non-tax purposes).

The court in *Moore* had a similar discussion in the context of concluding that Mr. Moore's relationship to the assets contributed to the FLP did not change after the transfer: "Moore's children typically did things because Moore asked them to, and giving them nominal 'power' was no different from Moore keeping that power."

(9) **Section 2043 "Consideration Offset" Analysis.**

(i) **Statutory Provision.** Section 2043(a) provides as follows:

> (a) IN GENERAL.—If any one of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to 2038, inclusive, and section 2041 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.

(ii) **Reliance on *Powell* §2043 Analysis.** The opinion says that the Tax Court "discovered" and first analyzed §2043(a) as it applies to family limited partnerships in *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017). In that case, the plurality opinion raised the issue on its own with no argument or briefing from any party. (Whether the IRS raised the §2043 issue in *Moore* is unknown.) The *Powell* case addressed the "double inclusion issue" when both the assets transferred to the partnership and the partnership interest itself are included in the gross estate.

While reasoning that the reduction under §2043 for the value received when assets were transferred to the partnership avoids a double inclusion, the analysis in *Powell* acknowledged that double taxation (which it called "duplicative transfer tax") could result if the assets contributed to the partnership appreciated between the date of contribution and the date of death.

The *Moore* opinion notes that example scenarios applying §2043 in the FLP context "lead to what may seem odd results," but the court stated that it "must nevertheless apply the Code as it is written and interpreted in a Division Opinion." (A "Division Opinion" is more commonly referred to as a "T.C. opinion" – not, for example, a "memorandum opinion" – generally strengthened when an opinion, as in *Powell*, is "Reviewed by the Court." But see the discussion below.) However, the §2043 discussion in *Powell* was controversial among the judges in that case and did not clearly have the support of a majority of judges participating in that opinion (and is likely dictum because the discussion had no impact on the ultimate outcome of the case). The "plurality" opinion (which espoused the double inclusion analysis) was joined by only 8 judges (including Judge Halpern (who wrote that opinion) and Judge Holmes (who also wrote the *Moore* opinion) , each of whom is now a Senior Judge, not one of the 16 current "regular" Tax Court judges, and therefore will not be participating in future decisions for which he was not the trial judge), a concurring opinion (that expressly rejected the double inclusion analysis) was joined by 7 judges, and 2 judges concurred in the plurality opinion in result only. The concurring opinion, which rejected the double inclusion analysis, reasoned that the inclusion of the partnership assets in the gross estate under §2036 meant that the partnership interest itself was merely an alter ego of those same assets and should not also be included in the gross estate. That approach has been followed by twenty-one FLP cases prior to *Powell* in which §2036 was applied, and the IRS has not made that argument in *any* other FLP cases even though substantial additional estate tax liability would have resulted in situations involving significant appreciation of partnership assets.

(iii) **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).

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 be not includible in the gross estate *both* under §2042 and under §2033 as to the decedent's partnership interest under the reasoning that "unwarranted double taxation" would otherwise result. 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 23 years, 22 cases have held that 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.

(iv) **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**.

(v) **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.

(10) **No Discussion of §2036(a)(2).** The IRS argued, in the alternative, that the FLP assets should be included in the gross estate under §2036(a)(2). Footnote 17 of the opinion states that the court does not address the IRS's §2036(a)(2) arguments in light of the fact that the FLP's assets are included in the gross estate under §2036(a)(1).

(11) **Formula Transfer Following Resolution of Estate Tax Examination Not Recognized.** The opinion addresses whether a "future" charitable contribution deduction should be allowed with respect to "any increase in the value of Moore's estate," particularly with respect to the transfer of additional funds from the Irrevocable Trust to the Living Trust. (That would include assets in the Irrevocable Trust includable in the gross estate, such as value attributable to the FLP, but would not literally include additions to the net estate value by the disallowance of a deduction for the attorney's fee or the inclusion of gift taxes attributable to an additional gift made within three years of death.)

(i) **No Impact on Defined Value Clause Cases.** Various cases have recognized the effectiveness of clauses leaving amounts to charity under formulas based on the valuation of hard-to-value assets. Defined value clauses use a formula to allocate assets that are transferred, with a certain value passing for family members and the excess that was transferred passing to another (non-taxable) person or entity (*see Succession of McCord*, *Hendrix*, *Estate of Christiansen*, *Estate of Petter*). *Moore* does not impact those cases, because its formula was based on determinations other than valuation (i.e., whether assets are included in the gross estate). The court carefully distinguished formulas based on valuation as compared to other issues impacting whether a transfer is made;

indeed Judge Holmes authored the Tax Court opinions in the *Christiansen* and *Petter* cases approving defined value clauses involving formula charitable transfers.

The defined value clause cases addressed, among other arguments, a public policy argument based on *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944). *Moore* has none of that type of discussion, and its refusal to recognize the formula clause was not based on any public policy concerns.

(ii) **Confusion Regarding Charitable Deduction Based on Assets as Reported on Form 706.** The opinion is confusing as to the IRS's treatment of the charitable deduction and the court's ultimate determination of the allowable charitable deduction. The opinion indicates that the estate claimed a deduction for $4,745,671 on the Form 706 as filed, but the IRS determined that only $516,000 should be allowed. Presumably, the $4,745,671 reported on the Form 706 did not take into account the inclusion of FLP assets under §2036, but was based only on values as reported. The opinion does not address the discrepancy of the amount of allowable charitable deduction based on assets as reported on the estate tax return.

(iii) **Formula Transfer Based on Determinations Following Estate Tax Examination; Distinction Between Valuation Issues and Other Issues.** The primary concern addressed by the court is that charitable deductions must be ascertainable at a decedent's date of death, and the Living Trust would get additional funds from the Irrevocable Trust (which could pass to charity under the formula transfer in the Living Trust) only after an audit and ultimate determination that additional value should be included in the estate. A problem with the "ascertainable at the date of death" argument in this context is that the *Christiansen* case allowed a charitable deduction under a formula disclaimer based on values as finally determined for estate tax purposes, and value changes determined in litigation following the estate tax examination in that case resulted in additional charitable deduction.

The Tax Court in *Christiansen*, in an opinion written by Judge Holmes, who (as noted above) decided the *Moore* case, reasoned as follows regarding the estate tax examination contingency argument:

> The transfer of property to the Foundation in this case is not contingent on any event that occurred after Christiansen's death (other than the execution of the disclaimer [which is recognized in charitable deduction regulations])–it remains 25 percent of the total estate in excess of $6,350,000. **That the estate and the IRS bickered about the value** of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its occurrence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a **settlement or final adjudication of a dispute about the past, not the happening of some event in the future**. Our Court is routinely called upon to decide the fair market value of property donated to charity–for gift, income, or estate tax purposes. And the result can be an increase, a decrease, or no change in the IRS's initial determination. (Emphasis added.)

The Eighth Circuit affirmance in *Christiansen* also emphasized that a regulation about charitable lead trusts recognizes that references to values "as finally determined for Federal estate tax purposes" are sufficiently certain to be considered "determinable" for purposes of qualifying as a guaranteed annuity interest. Reg. §20.2055-2(e)(2)(vi)(a). 586 F.3d 1061 (8th Cir. 2009).

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* 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).

If *Moore* is appealed, the appeal would be heard by the Ninth Circuit Court of Appeals (which also approved the *Petter* defined value clause case involving a formula charitable transfer).

(iv) **Contrast with Marital Deduction Formula Transfers.** 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.*, *Turner II* (discussed in Item 20.e(11)(vi) below).

(v) **Formulas Regarding Terms of Charitable Lead Trust.** Regulations acknowledge that the terms of a charitable lead trust may be determined under a formula, as long as the amount to be paid to charity is determinable.

> An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the appropriate valuation date. For example, the amount to be paid may be a stated sum for a term of years, or for the life of the decedent's spouse, at the expiration of which it may be changed by a specified amount, but it may not be redetermined by reference to a fluctuating index such as the cost of living index. In further illustration, the amount to be paid may be expressed in terms of a fraction or a percentage of the net fair market value, as finally determined for Federal estate tax purposes, of the residue of the estate on the appropriate valuation date, or it may be expressed in terms of a fraction or percentage of the cost of living index on the appropriate valuation date. Reg. §20.2055-2(e)(2)(vi)(a).

In particular, the regulation acknowledges that the annuity amounts can be based on values "as finally determined for Federal estate tax purposes." PLRs have recognized various formula structures for determining the terms of testamentary charitable lead annuity trusts in order to "zero out" the value of the remainder interest. *E.g.*, PLRs 199927031, 9840036, 9631021, 918040, 9128051, 8946022. Private rulings have approved clauses designed to limit the remainder interest in a charitable lead annuity trust to the amount of the testator's remaining GST tax exemption. *E.g.,* PLRs 200714009, 199927031, 984036. *See* Mary Hester, *Charitable Lead Trusts: The Time is Right*, 110 J. TAX'N 4 (Jan. 2009).

Those rulings do not recognize a formula that determines the *amount passing to* a charitable lead trust, as opposed to a formula that determines the *terms of* a charitable lead trust. Cases, however, such as *Christiansen* and *Petter*, have approved formulas that determine the amount that passes to charity, and there would seem to be no reason that a formula could not be used similarly to determine the amount that passes to a charitable lead trust. The issue raised in *Moore* is what types of such formulas will be recognized (in particular, whether formulas based on what assets are included in a decedent's gross estate after an estate tax examination will be recognized).

(vi) **Analogy to "Marital Deduction Mismatch" Issue.** The first rationale in *Moore* for not respecting the formula transfer provision in the Irrevocable Trust was that the clause directed the transfer to the Living Trust of any assets of the Irrevocable Trust that were included in the decedent's gross estate, but the Irrevocable Trust merely owned a limited partnership interest, not the FLP assets that were included in the estate under §2036. This raises the same issue that has been referred to as the "marital deduction mismatch" issue in the marital deduction context (at the death of the first spouse). An "amount" is included in the gross estate equal to the full undiscounted value of the farm, but all the trust owns to leave to charity is a discounted partnership interest. Footnote 23 of the opinion indicates that the IRS made an alternative argument that even if the formula clause is respected, "the Irrevocable Trust lacks the assets to donate a sum large enough to eliminate the estate tax."

This issue in the marital deduction context was summarized by the Tax Court in *Estate of Turner v. Commissioner*, 138 T.C. 306 (2012) (sometimes referred to as "*Turner II*").

> In some cases the Internal Revenue Service has taken the position that even when section 2036(a) applies, the marital deduction is measured by the value of what actually passes to the surviving spouse, which is a discounted partnership interest, and not by the value of the underlying assets. Estate of Black v. Commissioner, 133 T.C. 340, 342 (2009); Estate of Shurtz v. Commissioner T.C. Memo. 2010-21. This produces a mismatch between values for the gross estate inclusion and the marital deduction calculation. However, this type of mismatch is not present in this case: respondent allowed an increased marital deduction that he calculated on the basis of the value of assets transferred in exchange for the partnership interests that Clyde Sr. held at death, rather than on the basis of the discounted values of the general and limited partnership interests that Clyde Sr. owned at death, to the extent that they passed to Jewell [Clyde Sr.'s wife]. The estate recognizes that, and we leave this mismatch problem for another day.

(vii) **No Concern With Transfer Under Formula Even Though Not Respected for Tax Purposes.** A concern with some defined value clauses is that the clause may require a transfer (for example, to a spouse, a charity, or a retention by the grantor) according to the contract even though the transfer is not respected for tax purposes. That would not happen under the formula clause in the Living Trust in *Moore* because the amount left to charity under that clause was an amount that resulted in the least possible federal estate tax. The court determined that an additional transfer to charity would not reduce the estate tax, so the additional transfer presumably would not be made under the terms of the agreement.

21. 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." Treas. 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. *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.**

(i) **Sale-Leaseback and Whether §2036 Applies.** In *Estate of Maxwell v. Commissioner*, 3 F.3d 591 (2nd Cir. 1993), a sale of property to the decedent's son for a note secured by a mortgage, with a retained use of the property under a lease, triggered inclusion under §2036. The court held that the sale-leaseback was not a bona fide sale where the decedent continued to live in the house and the purported annual rent payments were very close to the amount of the annual interest payments the son owed to the decedent on the note. The court observed that the rent payments effectively just cancelled the son's mortgage payments. The son never occupied the house or tried to sell it during the decedent's lifetime. The son never made any principal payments on the mortgage (the decedent forgave $20,000 per year, and forgave the remaining indebtedness at her death under her will). The court concluded that the alleged sale was not supported by adequate consideration even though the mortgage note was fully secured; the note was a "façade" and not a "bona fide instrument of indebtedness" because of the implied agreement (which the court characterized as an "understanding") that the son would not be asked to make payments.

(ii) **Estate Inclusion Under §§ 2033, 2035 and 2038 For Property Transferred Under Note That Is Not Respected.** In *Estate of Musgrove v. United States*, 33 Fed. Cl. 657 (1995), the decedent transferred $251,540 to his son less than a month before his death (at a time that he had a serious illness) in exchange for an interest-free, unsecured demand note, which by its terms was canceled upon the decedent's death. The court determined that the property transferred was included in the decedent's estate under any of §§2033, 2035, or 2038. The court reasoned that the promissory note did not constitute fair consideration where there was an implied agreement that the grantor would not make a demand on the obligation and the notes were not intended to be enforced.

(iii) **Advances from FLP Treated as Distributions Supporting Inclusion of FLP Assets Under § 2036 Even Though Notes Were Given For the Advances.** Assets of an FLP created by the decedent were included in the estate under §2036 in *Rosen v. Commissioner*, T.C. Memo. 2006-115 Part of the court's reasoning was that advances to the decedent from the partnership evidenced "retained enjoyment" of the assets transferred to the FLP even though the decedent gave an unsecured demand note for the advances. The purported "loans" to the decedent were instead treated by the court as distributions from the FLP to the decedent. There was an extended discussion of actions required to establish bona fide loans.

In *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40, an FLP distributed $2 million to the decedent, purportedly as a loan, though no documentation of the loan existed. The decedent used those funds for various personal purposes, which the court pointed to as retained enjoyment for inclusion purposes under §2036(a)(1). In addition, the FLP transferred $500,000 to each of the decedent's four children in return for five-year notes bearing interest at a rate of 3.6% (the mid-term AFR for that month was 3.83%). The notes had no amortization schedule, no payments were made, and no efforts were made to collect on the notes. Even though the children signed notes and the debt was not proportionate to the children's ownership in the FLP (both of which weighted 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 (analyzing each of the eleven factors addressed in *Rosen v. Commissioner*). The transfers were treated as gifts from the decedent (who owned a 95% limited partner interest at the time of the transfers).

(iv) **Valid Debt for § 2053 Deduction.** The nine factors listed above from the *Miller* case were mentioned in *Estate of Holland v. Commissioner*, T.C. Memo. 1997-302, to support the finding that the decedent's estate did not owe bona fide indebtedness that could be deducted under §2053, which allows a deduction for any indebtedness, but only "to the extent that [it was] contracted bona fide and for an adequate and full consideration in money or money's worth." A variety of cases have mentioned one or more of these factors in analyzing the deductibility of a debt as a claim under §2053(a)(3), *e.g.*, *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40 (loan from FLP to decedent not a legitimate loan), or of post-death interest paid on a loan as an administrative expense under §2053(a)(2), *Estate of Duncan v. Commissioner*, T.C. Memo. 2011-255.

One of the requirements for being able to deduct a debt as a claim or interest on a loan as an administrative expense under §2053 is that the debt is bona fide in nature and not essentially donative in character. A variety of factors apply in determining the bona fides of an obligation to certain family members or related entities for purposes of the debt deduction under §2053. Treas. Reg. § 20.2053-1(b)(2)(ii)-(iii).

(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.

(i) **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.

(ii) **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.

(iii) **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, §12.03 (2d ed. 1997).

(iv) **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.

22. 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 on the basis of 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. **Basic Facts.**

Founding of WEC. Mrs. Nelson's father cofounded (with another family) a company providing gas compression equipment for the oil and gas industry in 1971. The other family's interest was purchased in 1975. The company was successful and acquired various other businesses, many of which were related to the oil and gas industry. In 1990, Warren Equipment Co. (WEC) was organized as a Delaware corporation that served as a holding company owning 100% of six subsidiaries with operating businesses (including one business that the court analyzed as a subsidiary of WEC even though it was actually wholly owned by one of the other subsidiaries, making it an indirect, or third-tier, subsidiary of WEC), a seventh subsidiary that provided administrative services to the businesses, and an eighth subsidiary that owned the real estate on which the various businesses operated. Mr. Warren died in 1999, and by 2008 WEC was owned primarily by his four children (including his daughter, Mrs. Nelson).

Creation of FLP. Mrs. Nelson transferred her shares, representing about 27% of the common stock of WEC, to an FLP on October 1, 2008. As the court described it, the FLP "was formed as part of a tax planning strategy to (1) consolidate and protect assets, (2) establish a mechanism to make gifts without fractionalizing interests, and (3) ensure that WEC remained in business and under the control of the Warren family." Mrs. Nelson's WEC stock comprised 99% of the value of the FLP's assets.

Mrs. Nelson and her husband were the sole general partners (collectively owning the 1% general partner interest), and Mrs. Nelson owned most of the limited partner interests (93.88%), with the balance of the limited partner interests being owned by custodianships and trusts for family members.

Both WEC and the FLP had transfer restrictions in their governing documents, but the appraisals did not seem to apply any reduction in the value of the stock of WEC or the partnership interests of the FLP by reason of the transfer restrictions (so no §2703 issue was raised).

Gift and Sale of FLP Interests. About three months after the FLP was formed, Mrs. Nelson made a gift on December 31, 2008, of an interest in the FLP to a trust (the "Trust") for her husband and her four daughters of which her husband was the trustee (this was what has come to be referred to as a spousal lifetime access trust, or "SLAT"). The gift assignment provides:

> [Mrs. Nelson] desires to make a gift and to assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND

> AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.

Two days later, on January 2, 2009, Mrs. Nelson sold additional limited partner interests in the FLP to the Trust in return for a $20 million note. The note provided for 2.06% interest on unpaid principal, was secured by the limited partner interest that was sold, and required annual interest payments through the end of 2017 (suggesting that it was a 9-year note). (The interest rate was the mid-term AFR for January 2009, applicable for debt instruments over 3 years but not over 9 years). The Sale and Assignment document provides:

> [Mrs. Nelson] desires to sell and assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 * * *, as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment * * *.

Appraisals of WEC and FLP Interests, Determination of Percentage Interests Transferred. Mrs. Nelson engaged Barbara Rayner of Ernst & Young to appraise the WEC stock owned by the FLP (which she determined to be $860 per share, or about $56.6 million). That value was then used by Roy Shrode to appraise the limited partner interests in the FLP, and he determined that a 1% limited partner interest was worth $341,000 and that the gift and sale equated, respectively, to transfers of 6.14% and 58.65% limited partner interests (rounded).

The partnership agreement was subsequently amended to reflect transfers of 6.14% and 58.65% limited partner interests to the Trust, and these ownership percentages were reflected on the Schedules K-1 for the FLP from 2008 through 2013, and proportional cash distributions from the FLP were based on those percentage ownerships of limited partner interests.

Gift Tax Returns. Mr. and Mrs. Nelson reported the 2008 gift by Mrs. Nelson as a split gift. Their 2008 Form 709s each reported a gift to the Trust "having a fair market value of $2,096,000 as determined by independent appraisal to be a 6.1466275% limited partner interest," and half of that amount was a gift by each spouse for gift tax purposes. The sale was not reported on the 2009 gift tax returns for the Nelsons.

The IRS selected the 2008 and 2009 gift tax returns for examination. A proposed settlement agreement was negotiated in the administrative appeals process. In light of those settlement discussions, the partnership agreement was amended to reduce the percentage interest owned by the Trust by 26.24%, from 64.79% to 38.55%, resulting in a proportional 40% reduction in the interest owned by the Trust). The settlement was never completed. (As discussed in Item 22.d below, query if the family is much better off with the result of the *Nelson* opinion than if the settlement had been completed and the percentage ownership reductions had been required?)

IRS Appraisal Expert. The IRS engaged Mark Mitchell as its expert appraiser. (He has served as a valuation expert for the IRS in other cases, including *Hoffman v. Commissioner*, T.C. Memo. 2001-209, and *Grieve v. Commissioner*, T.C. Memo. 2020-8.)

Texas Residents. Mr. and Mrs. Nelson were residents of Texas when they filed their petitions (so the case is appealable to the Fifth Circuit Court of Appeals if it is appealed).

c. **Court Analysis.**

(1) **Burden of Proof.** The taxpayers argued that the burden of proof shifted to the IRS under §7491(a) because they produced credible evidence as to factual issues, but the court ruled that was moot because it resolved the issues on the basis of a preponderance of the evidence.

(2) **Transfers of Percentage Interests Based on Appraised Values Rather Than Transfers of Dollar Values Based on Values as Finally Determined for Gift Tax Purposes.** The taxpayers argued that Mrs. Nelson transferred limited partner interests worth $2,096,000 and $20 million as finally determined for gift tax purposes, despite the language in the Assignment documents. They contended that this intent was evidenced by their subsequent actions to modify the purported

transferred amounts to reflect settlement discussions with the IRS about the values of the limited partner interests.

The court disagreed, looking to the plain language of the assignments, which transferred interests worth specified dollar amounts "as determined by a qualified appraiser within" 90 days for the gift and 180 days for the sale. The court contrasted the defined value cases that addressed transfers of property worth specified dollar amounts based on values as finally determined for gift or estate tax purposes (*Wandry*, *Hendrix*, *Petter*, *Christiansen*).

> Therefore, to decide whether the transfers were of fixed dollar amounts or fixed percentages, we start with the clauses themselves, rather than the parties' subsequent actions.
>
> …
>
> The transferred interests thus are expressed in the transfer instruments as an interest having a fair market value of a specified amount as determined by an appraiser within a fixed period. The clauses 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.…
>
> … By urging us to interpret the operative terms in the transfer instruments as transferring dollar values of the limited partner interests on the bases of fair market value as later determined for Federal gift and estate tax purposes, petitioners ask us, in effect, to ignore "qualified appraiser * * * [here, Mr. Shrode] within * * * [a fixed period]" and replace it with "for federal gift and estate tax purposes." While they may have intended this, they did not write this. They are bound by what they wrote at the time. As the texts of the clauses required the determination of an appraiser within a fixed period to ascertain the interests being transferred, we conclude that Mrs. Nelson transferred 6.14% and 58.35% of limited partner interests in [the FLP] to the Trust as was determined by Mr. Shrode within a fixed period.

(3) **Valuation of WEC (Holding Company, 27 Percent of the Common Stock of Which Was the FLP's Primary Asset).** The six underlying operating company subsidiaries were valued separately by the taxpayers' expert. Three of the subsidiaries (a Caterpillar dealership and two other subsidiaries involved in heavy equipment dealer operations) were valued on a net asset value method, which the taxpayer's expert had viewed as common for that industry. One other subsidiary was valued using the income approach, and two other subsidiaries were valued using a combination of the income approach and market approach. The value of the subsidiary that owned the real estate was determined by a third-party appraiser. The administrative subsidiary (which provided administrative services to all of the businesses) was ignored for valuation purposes (agreed to by both the taxpayers' and IRS's experts). Those values were combined and the value of WEC's debt and preferred stock were subtracted to determine that WEC's common equity was worth $363.7 million on a controlling basis before discounts. The appraiser then applied lack of control and lack of marketability discounts in valuing the 27% of common stock of WEC that was owned by the FLP.

The taxpayers' expert applied a 20% lack of control discount. The IRS's expert used no lack of control discount, reasoning that the analysis of the underlying values of the subsidiaries resulted in noncontrolling interest values. Both experts agreed that a 30% lack of marketability discount was appropriate. The court ultimately determined that the minority interest that the partnership owned in the holding company was valued using a 15% lack of control discount and 30% lack of marketability discount.

The court primarily addressed two issues regarding the valuation of WEC. First, the experts disagreed as to whether the valuation of the various subsidiaries was of a controlling or noncontrolling value and therefore whether lack of control discounts should be applied in valuing the 27% of common stock of WEC that was owned by the FLP. The court concluded that the separate values of the subsidiaries reflected "at least some elements of control," but that "some discount should apply in valuing a minority interest in WEC common stock." The court reduced the lack of control discount from 20% to 15%.

Second, the taxpayer's appraiser used both the income approach (reflecting a value of $335.1 million) and market approach (reflecting a value of $269.8 million) to value two of the operating subsidiaries, concluding that the value of the two was "reasonably represented as $309.0 million." The court concluded that the evidence was not sufficient to support using a market approach to value those subsidiaries, suggesting that the undiscounted value of the two subsidiaries should have been $335.1 million rather than $309 million (a difference of $26.1 million), but it is not clear how the court took that difference into consideration in concluding that the value of the WEC stock was $912 per share. (The taxpayers' expert valued the FLP's WEC stock at $860 per share, and the court's $912 per share number appears almost totally attributable to applying a 15% rather than a 20% lack of control discount [$860 x 85%/80% = 913.75, close to $912].) Perhaps the court did not mention this difference because the IRS's expert had not disagreed with the taxpayers' expert's undiscounted value of the holding company.

(4) **Discounted Value of Limited Partner Interests.** The taxpayers' expert began with using the appraised value of WEC and adding the other FLP assets and making adjustments for lack of control and lack of marketability discounts to value the transferred limited partner interests.

(i) **Lack of Control Discount.**

Both experts based their lack of control discounts on the lack of control discounts in the case of what they viewed as comparable closed-end funds. The taxpayers' expert concluded that a 15% lack of control discount applied.

The IRS's expert analyzed 30 closed-end funds but reasoned that the FLP was not comparable to any of them. Without explaining the expert's reasoning, the opinion states that "[h]e determined that there would be almost no possibility of a lack of control disadvantage for a minority owner of [the FLP] except 'under certain circumstances, the precise nature of which cannot be exactly determined with reference to empirical/market data.'" He applied a 5% discount "to account for that remote possibility," which he reduced by another 2% because of the low probability that the FLP "would undertake any significant change in its operating profile," resulting in a 3% lack of control discount.

The court stated that none of the closed-end funds were comparable, and rejected both experts' analyses. The court found the IRS's expert's explanation of how he arrived at his discount unconvincing, but then seemed to adopt that expert's analysis, concluding that "we do agree with him that the possibility of a lack of control disadvantage for a minority owner is remote. We therefore adopt a 5% lack of control discount …"

Observation: Neither the expert (so far as the opinion reveals) nor the court explained *why* "the possibility of a lack of control disadvantage for a minority owner is remote."

(ii) **Lack of Marketability Discount.**

The taxpayers' expert relied on certain studies of sales of restricted stock and sales of private, pre-IPO stock in applying a 30% discount.

The IRS's expert similarly examined several studies of sales of restricted stock and pre-IPO stock, but involving more recent data, and also used "quantitative models that looked at the role of liquidity premiums in calculating the value of a forgone put option on the basis of the Black-Scholes model." Applying that analysis, he concluded that the approximate range of discounts was 20% to 35%, and used 25% "because 25% was approximately equal to the mid-point of these two ranges."

Observation: The actual average, or arithmetic mean, or "mid-point," of 20% and 35% is 27.5%, and the geometric mean is approximately 26.5%, neither of which would have been difficult to compute.

The court reasoned that prior cases had disregarded the studies that had been used by the taxpayers' expert and that the IRS's expert's analysis was more thorough. Without explanation, the court found as reasonable the IRS's expert's reasoning that the FLP's lack of marketability discount "should be incrementally lower than WEC's [lack of marketability] discount because the marketability of WEC shares was considered in computing the WEC discount."

Observation: What??? If the subsidiary businesses were fairly marketable resulting in low marketability discounts for them, the marketability discount for the intra-family FLP that was controlled by the parents had to be even lower? Why are those two marketability discounts tied to each other? That reasoning would seem to suggest that the lack of marketability discount for partnerships owning marketable securities should be zero. Perhaps the court has a reasonable justification for approving this statement, but the opinion does not describe that reasoning.

The court stated that "[w]hile the IRS's expert's] contention is reasonable, he provides no support for his conclusion that 25% is appropriate other than his claim that 25% was equal to the median of the ranges (we note that 28% is the median)." Therefore, the court used a 28% marketability discount.

(5) **Conclusion.** The court ultimately determined that the 27% interest that the partnership owned in the holding company WEC was valued by using discounts of 15% for lack of control (slightly lower than the taxpayers' expert's position of 20%) 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 by using discounts of 5% for lack of control (compared to 15% by the taxpayer's expert and 3% by the IRS's expert) and 28% for lack of marketability (compared to 30% by the taxpayers' expert and 25% by the IRS's expert).

The fair market values of the gift and sale transfers, as compared to the anticipated amounts, are as follows.

	Value of Transfer Anticipated by Taxpayers	Value of Transfer (and Increase in Value) Asserted by IRS	Value of Transfer (and Increase in Value) Determined by Court
Gift	$2,096,000	$3,522,018 (+$1,426,018)	$2,524,983 (+$428,983)
Sale	$20,000,000	$33,607,038 (+$13,607,038)	$24,118,933 (+$4,118,933)
Total	$22,096,000	$37,129,056 (+$15,033,056)	$26,643,916 (+$4,547,916)

Applying the 45% gift tax rate that was in effect in 2008 and 2009, the court, on July 28, 2020, issued orders and decisions determining the total gift tax deficiencies to be $2,016,564. But a comparison of the amounts in the above table shows that this is only about 30% of what the IRS was demanding, making the case, in effect, a 70% taxpayer victory.

d. **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. In *Wandry v. Commissioner*, T.C. Memo. 2012-88, the IRS argued that "if petitioners prevail it will likely require the preparation and filing of numerous corrective returns." A much preferable planning design is to make the gifts and sales to

grantor trusts. Even if the ownership percentages change as a result of a gift tax audit, all of 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).

In *Nelson*, the taxpayers attempted to make adjustments in the percentages that were transferred on the basis of settlement discussions with IRS appeals. The *Nelson* court's analysis indicates that adjusting the percentage interests transferred was not appropriate. But if the percentage interests transferred had changed, no amended income tax returns would have been needed because the transfers were made to the Trust, which was a grantor trust (if for no other reason, because the grantor's spouse was a beneficiary of the trust), so all of the income was reported on Mrs. Nelson's income tax return, whether the interests were owned by Mrs. Nelson or by the Trust.

(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. One would assume that the family in retrospect may be delighted that they "lost" their argument that the assignments were defined value transfers, and that they would be satisfied with paying an additional $2 million of gift tax 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.

The assignments in *Nelson* provided that the appraisal would be determined within 90 days for the gift transaction and within 180 days for the sale transaction. The gift and sale were made two days apart. Surely the plan was to use the same appraisals for both purposes. Why different time periods were allowed for obtaining the appraisals for the two different transactions is unclear. Perhaps the parties realized that, as a practical matter, obtaining an appraisal of a holding company that owned six operating subsidiaries and two other non-operating subsidiaries, and then subsequently using that appraisal to obtain an appraisal of the limited partner interests all within 90 days was not realistic. Or perhaps they did not want to extend the due date of the gift tax return (maybe in the hope of attracting less attention) and therefore needed the appraisal for the December 31 gift before April 15. Whether the appraisals were indeed obtained within 90 days is not addressed in the opinion. Even if the appraisals were obtained outside that window, they were used to determining the percentage interests that were transferred, and the IRS raised no objections about the specific time frame in which the appraisals were completed.

(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 December 31, 2008, gift plus $4,118,933 as the additional gift at the time of the January 2, 2009, sale) 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 §23036(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, severable and de minimis, 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). *See* Rev. Rul. 56-439, 1956-2 C.B. 605; *Wang v. Commissioner,* T.C. Memo. 1972-143 (no split gift election allowed where consenting spouse's interest in trust receiving gift assets was not ascertainable); *Robertson v. Commissioner,* 26 T.C. 246 (1956) (gift splitting allowed for full amount transferred); *see generally* D. Zeydel, *Gift-Splitting — A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules,* 106 J. TAX'N 334 (June 2007). Interestingly, Letter Ruling 200130030 allowed gift splitting for the full amount of the transfer without discussing the value (in particular, that it had no value) of the donee spouse's severable interest.

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

Consider whether the donor-spouse should request that the donee-spouse contractually agree to gift splitting in case a divorce action should commence before the gift tax return is filed.

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

Gift splitting should be allowed in full if:

- Distributions of both income and principal to the donee-spouse are subject to an ascertainable standard of distribution under §2514, preferably a standard based upon the spouse's accustomed standard of living;
- The trustee must consider other resources available to the spouse before exercising its discretion to distribute income or principal to the spouse; and

The resources that are, and are expected to be, available to the spouse for the remainder of his or her lifetime are sufficient to meet the spouse's living expenses, such that the likelihood that the trustee will need to exercise its discretion to distribute income or principal to the spouse is so remote as to be negligible.

23. Charitable Gift Followed by Redemption Not Treated as Anticipatory Assignment of Income, *Dickinson v. Commissioner,* T.C. Memo. 2020-128 (Sept. 3, 2020)

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 it 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 based on 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."

24. 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 (December 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).

25. 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."

   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 (January 21, 2021).

d. **Regulations and Effective Date.** The Treasury Secretary has broad regulatory authority and must promulgate regulations by January 2, 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 20%).

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.

26. 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 (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 several 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 *Perracchio* (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 of 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 of 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 Chenowith 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, in referring to the *Chenowith* 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 left 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 of 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.

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 of 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 of the estate and all of the partnership interest related to the value of the assets included under §2036, so arguably there should be a marital deduction for all of that value. Or consider a situation in which the decedent made a lifetime gift of all of 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).

27. Tax Effects of Settlements and Modifications; Rulings Giving Retroactive Effect to Trust Modifications; Ruling Implicitly Extending Rationale of Revenue Ruling 95-58 to Section 2042; 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 summary found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. This Item includes several brief miscellaneous comments.

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

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

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

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

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

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

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

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

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

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

e. **Modification Rulings Giving Retroactive Tax Effect to Retroactive Modifications.** Various private letter rulings in the last several years have given retroactive tax effect to retroactive trust modifications. *See* PLRs 201837005, 201920001-201920003, and 201941008-201941023 (all involved eliminating scrivener's error). For a summary of these various PLRs, see Item 21.e of Heckerling Musings 2020 and Estate Planning Current Developments found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

f. **Modification Ruling Impliedly Extending Rev. Rul. 95-58 Analysis to Section 2042.** Based on the facts involving PLR 201919003, the ruling in effect extends Rev. Rul. 95-58 (addressing trustee removal powers) to §2042, but the ruling analysis does not directly discuss that issue. For a description of the ruling, see Item 21.f of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. For a more detailed discussion of background regarding the extension of Revenue Ruling 95-58 to §2042, see Item 21.f. of Heckerling Musings 2020 and Estate Planning Current Developments found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

g. **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 remaindermen in the 2019 PLRs were treated as having purchased the interests of the life beneficiary and the contingent remaindermen (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 remaindermen, as the deemed purchaser, do not pay tax on amounts **received** in the commutation (as the fictional purchaser, they are just receiving what is left in the trust after they have bought out everyone else), but they "realize gain or loss on the property exchanged." So they recognize gain on the assets **paid out** to others less the amount of their uniform basis attributable to those assets. 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).

For a detailed discussion of planning implications of these rulings, see Item 22 of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

h. **Commutation of Spouse's Interest in QTIP Trusts.** 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 remaindermen 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.

28. 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"), 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 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 under three different alternatives – a (i) BDOT, (ii) BDIT, or (iii) QSST.

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

For a detailed discussion of the use of BDOTs, see Item 16 of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. *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). 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. September 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 new ruling, Trust 1 prohibits a distribution of "Shares," but allows for a distribution of the proceeds from the sale of the Shares, and because the beneficiary had reached age 40, the beneficiary could withdraw the proceeds of the sale. A Subtrust of Trust 1 agreed to sell an LLC that held the Shares (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.

29. 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 29.f below.)

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

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

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

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

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

(3) **Section 2036(a)(2).** In a few cases, the IRS has also made a §2036(a)(2) argument, that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the

income or property contributed to the entity. Two cases have applied §2036(a)(2) where the decedent had some interest as a general partner (*Strangi* and *Turner*), and one case applied §2036(a)(2) when the decedent held merely a limited partnership interest (*Powell*, as discussed in Item 29.c(1) below).

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

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

(ii) **Overview of *Powell* and *Cahill.*** *Powell* (discussed in Item 29.c(1) below) and *Cahill* (discussed in Item 29.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 29.e below for a discussion of the *Helmholz*, *Tully*, and *Bowgren* cases.) The taxpayer in *Morrissette* made these arguments (so far, unsuccessfully) in that pending Tax Court case, as discussed in Item 29.c(3) below.

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

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

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

c. **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 (May 18, 2017) is a "reviewed" Tax Court decision that may be the most important Tax Court case addressing FLPs

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

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

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

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

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

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

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

(2) **Synopsis of *Estate of Cahill* and Settlement.** In *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018) (Judge Thornton), the decedent's revocable trust had advanced $10 million to an irrevocable trust under a split dollar agreement for the trust to purchase life insurance policies on the lives of the decedent's son and his wife. The estate valued the estate's right eventually to be reimbursed for its advances at only $183,700, because of the long period of time before the policies would mature at the insureds' deaths. The IRS argued, among other things, that the reimbursement right should have a value equal to the full cash surrender value of the policies (about $9.6 million) in part because of §§2036, 2038, and 2703. The court rejected the estate's motion for a partial summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) did not apply and that Reg. §1.61-22 applied in valuing the decedent's reimbursement rights.

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

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

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

(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 estate filed a motion for partial summary judgment that §2703(a) is inapplicable (but, unlike in *Cahill*, the taxpayer did not request a summary judgment regarding §§2036 and 2038). Three days after the entry of the *Cahill* decision, the Tax Court entered an Order in *Morrissette* on June 21, 2018 denying the taxpayer's motion for summary judgment that §2703(a) was inapplicable, observing that "the termination restriction prevented the decedent from terminating the split-dollar arrangements unilaterally and receiving repayment of the premium or, if greater, the policy's cash surrender value," and concluding that "[t]he restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2)." Order in Docket No. 4415-14 (June 21, 2018) (Judge Goeke). The IRS filed a motion for partial summary judgment regarding §§2036 and 2038 on November 21, 2018, and the estate on January 15, 2019 filed its response in opposition to the IRS motion and its own cross motion for partial summary judgment that §2036(a)(2), 2038(a)(1), and 2703(a) do not apply.

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

The court entered an Order dated February 19, 2019 denying the taxpayer's motions for summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) do not apply. The court reasoned merely that *Estate of Cahill* "is directly on point" regarding §§2036(a)(2) and 2038(a)(1) but denied the IRS's motion for summary judgment because a material factual dispute exists concerning the issue of full and adequate consideration. The Order made no mention whatsoever of the taxpayer's analysis of cases that placed outer limits on the application of the "in conjunction with" provisions in §§2036(a)(2) and 2038. Similarly, the Order denied the taxpayer's motion for summary judgment that §2703(a) did not apply based on *Estate of Cahill* and denied the IRS's motion for summary judgment that §2703 applied because a genuine dispute of material fact exists as to whether the transfers were a device to transfer property to members of decedent's family for less than full and adequate consideration.

The trial was held October 8-11, 2019. Apparently the primary issues for the trial were (1) whether the bona fide sale for full and adequate consideration exception under §§2036(a)(2) and 2038(a)(1) applies, (2) whether the transfers were a device to transfer property to members of decedent's family for less than full and adequate consideration under §2703(b), and (3) whether the 20%

accuracy related penalty under §6662 applies. Following the trial, the trial judge (Judge Goeke) purportedly said "I look forward to your briefs because for me this is going to be a hard case."

The taxpayers argued that the life insurance purchase arrangement was a bona fide sale or business transaction that provided funding for a buy-sell agreement. The trials also included evidence about whether the transfers from the decedent were for full and adequate consideration.

For a brief summary of the arguments and evidence from the four-day trial, see Aysha Bagchi, *$30 Million Estate Tax Case Going to be 'Hard,' Judge Says*, BLOOMBERG DAILY TAX REPORT (October 15, 2019).

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

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

(1) **No Revocable Transfer.** Confirm that the transfer is not revocable. Especially be wary if the gift is made under a power of attorney to confirm that it is not a voidable transfer. If community property is transferred to an entity, or a transfer of made of a community property interest in the entity, confirm that the transfer is authorized and cannot be set aside by a spouse if only one spouse participates in the transfer.

(2) **Avoid Transfers under Power of Attorney.** A number of §2036 cases involve FLPs/LLCs that have been created by an agent under a power of attorney for the decedent. Avoid that if possible. If a power of attorney is used for making gifts, make sure that it authorizes gift transfers.

(3) **Satisfy Bona Fide Sale for Full Consideration Exception.** Pull all stops to build the best possible case for satisfying the bona fide sale for full consideration exception to §2036. Planning should include (a) connecting the nontax purposes to the actual facts, (b) customizing the agreement to accomplish the nontax purposes, (c) having a real "pooling" of assets among family members if possible, (d) reflecting the nontax purposes in all communications, (e) acquiring some assets requiring active management and arrange the management activities to be consistent with the nontax purposes, (f) carefully following all formalities required in the agreement, timely file tax returns and information returns, properly maintain capital accounts (more than just listing capital accounts on tax returns), and conduct periodic meetings of the owners even though not legally required, and (g) maintaining a source of income or resources for living expenses other than from the entity.

(4) **Transfer Voting Units.** If the client makes transfers of interests in the entity, generally give voting units, retaining only non-voting units. If voting units are retained, make sure that the client does not have the right to vote on issues that affect the power to amend or revoke the agreement.

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

(6) **Elimination of Unanimous Partner Approval Requirement for Dissolution.** The partnership agreement in Powell "allows for the partnership's dissolution with the written consent of all partners." The omission of this explicit requirement of unanimous consent for dissolution in the partnership or LLC agreement would at a minimum allow a sympathetic judge to point to a significant distinction from the facts of Powell. That is not a panacea however, because even if the partnership agreement is silent about dissolution, state law likely allows the dissolution with the consent of all partners.

(7) **Avoid Having the Decedent or Decedent's Agent as General Partner.** Strangi focused primarily on the decedent's ability to take actions as general partner as a §2036(a)(2) trigger (even though the decedent in that case did not own a majority controlling interest of the entity that served as general partner). One of the court's reasons for applying §2036(a)(2) was that the son could make distribution decisions and also owed duties to the decedent under the power of attorney from the decedent.

Even if the client has given all of the limited partnership interests and has only a small general partner interest, the small general partner interest could conceivably cause §2036(a)(2) to apply to all prior gifts of limited partnership interests.

(8) **Limiting Donor's Powers as Manager of LLC or as General Partner of Limited Partnership.** 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, investment and administrative powers should not trigger estate inclusion, and even distribution powers should not trigger estate inclusion if discretion over distributions is subject to a definite standard. If the donor retains an interest in the general partner and can participate in distribution decisions, consider providing that Class A limited partners must consent to establishing reasonable reserves (at least for more than a baseline established in a budget that is approved from time to time by all of the partners), or have someone else as a "special general partner" to establish reasonable reserves or to do other things that might be sensitive as to estate inclusion issues such as approving transfers of interests in the entity, determining whether to reinvest income, gain, and refinancing proceeds or to distribute them to partners.

Even if the donor has transferred all of the donor's interests in the entity to others (such a trust with an independent trustee), if the donor serves as a manager of or in some other management position with the entity, the IRS might argue that the donor's authorities, in conjunction with others, constitute the right 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), which includes 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). Consider limiting the authority of the donor 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.

(9) **Special Voting Interests to Make Liquidation/Dissolution Decisions.** One planning alternative may be to have a special partnership or member interest that would have the exclusive

ability to vote on liquidation or dissolution decisions or to amend the partnership with respect to such powers. The first rationale of the court's reasoning in Powell under §2036(a)(2) would then no longer apply—the decedent could not participate with anyone in deciding when to dissolve the partnership/LLC.

(10) **Removal of Managers.** Do not allow the donor as a limited partner to participate in the decision to remove a general partner or manager, or permit the donor to participate in removal decisions as long as a replacement must be appointed who is not related or subordinate to the donor.

(11) **Trust Owners with Independent Trustee.** If all of the partners/members were irrevocable trusts with independent trustees, any dissolution proceeds would pass to the irrevocable trusts, and the decedent could not join with the trustee in making distribution decisions. Therefore, the court's "in conjunction with" analysis would no longer give the decedent the ability to designate who could receive the income or property contributed to the partnership/LLC.

Even if the trust includes the donor as a discretionary beneficiary (which might subject the trust to creditor claims) or even if the trust is an incomplete gift trust, the trustee would still have enforceable fiduciary duties.

(12) **Transfer All Interests during Life.** Some clients have created FLPs/LLCs with the contemplation that some or most of the limited partner/member interest would be retained until the client died, and valuation discounts would apply to those interests for estate tax purposes. In light of the result in Powell, suggesting that §2036(a)(2) will always apply unless the bona fide sale for full exception is applicable, clients in the future may consider only contributing to entities an amount for which the client would contemplate eventually giving or selling all of his or her retained interests (and having the foresight to do so at least three years before death). Appropriate discounts should apply in valuing the gifts or in determining sale prices, and §2036 would not apply to include the entity's assets in the estate (without a discount) under §2036.

(13) **"Claim Victory" and Dissolve FLP/LLC with Prior Successful Transfers.** If a client has previously created an FLP/LLC and has made gifts or sales of interests in the entity to trusts that have experienced substantial appreciation, consider dissolving the entity (at least three years before death) so that the trusts would own the value apart from the FLP/LLC, thus negating any possible §2036 taint.

(14) **Rationale for Estate Inclusion for Basis Adjustment Purposes.** If a decedent dies without estate tax concerns and the estate would like to include the FLP assets in the estate without a discount for basis-adjustment purposes, the Powell reasoning provides a rationale for including the assets in the estate (at least those interests retained by the decedent or transferred within the prior three years) as long as the transfer to the partnership did not qualify for the bona fide sale for full consideration exception to §2036.

For a discussion of the efficacy of this position, including the effects of Tech. Adv. Memo. 9515003, see Item 12.d.(3) of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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" language as in §2038. Several §2038 cases have limited the application of this provision in determining whether a decedent held a joint power to terminate a trust. For example, a power in a trust agreement to terminate the trust with the consent of all beneficiaries was not a power to revoke, alter, or amend the trust in conjunction with others because state law conferred the right to terminate a trust with the consent of all beneficiaries, and the trust provision "added nothing to the rights which the law conferred." *Helvering v. Helmholz*, 296 U.S. 93 (1935), *aff'g* 75 F.2d 245 (D.C. Cir. 1934) (reasoning that this power exists under state law in almost all situations, and to hold otherwise would cause all trusts to be taxable). This exception seems analogous to the power under state law of all partners to agree to amend the partnership agreement or to cause the liquidation of the partnership.

Another example is *Tully Estate v. Commissioner*, 528 F.2d 1401 (Ct. Cl. 1976). In *Tully*, decedent was a 50% shareholder. The corporation and decedent entered into a contract to pay a death benefit to the decedent's widow. Even though the beneficiary designation was irrevocable, the IRS argued that it could be amended for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary. The court's analysis is analogous to the broad extension of §2036(a)(2) to FLPs:

> In light of the numerous cases where employee death benefit plans similar to the instant plan were held not includable in the employee's gross estate, we find that Congress did not intend the 'in conjunction' language of section 2038(a)(1) to extend to the mere possibility of bilateral contract modification. Therefore, merely because Tully might have changed the benefit plan 'in conjunction' with T & D and DiNapoli, the death benefits are not forced into Tully's gross estate. 528 F.2d at 1404-05.

Another example is *Estate of Bowgren v. Commissioner*, T.C. Memo. 1995-447, *rev'd and remanded on other grounds*, 105 F.3d 1156 (7th Cir. 1997). In *Bowgren*, the decedent transferred real estate to a land trust and later gave beneficial interests in the trust to her children. The court held that when

> the only method by which the decedent could have terminated or modified the beneficial interests of the children was to act not by herself … but as a beneficiary with the unanimous consent of the children, i.e., all the other beneficiaries … [s]uch a power is not a retained power under section 2036(a)(2), see Stephens, Maxfield, Lind & Calfee, Federal Estate and Gift Taxation 4-148 n.52 (6th ed. 1991), and is a power to which section 2038(a) does not apply, see sec 20.2038-1(a)(2).

A possible distinction of applying the logic of these §2038 cases to the "in conjunction with" language in §2036(a)(2) is that the regulations under §2038 specifically state that a settlor's ability to act in concert with all donees/beneficiaries is not a retained power under §2038, but the analogous provisions in the regulations under §2036 regulations do not include that same statement. *See* Reg. §§20.2038-1(a)(2) (§2038 does not apply "[i]f the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law"); 20.2036-1(b)(3). However, applying the "in conjunction with" clause in a different manner in those two situations does not seem supportable under any policy rationale.

The taxpayer's attorneys in *Powell* and in *Cahill* (which applied the *Powell* reasoning in the context of an intergenerational split dollar case about a year after *Powell*) did not make any arguments about these cases that have placed outer limits on the reach of §2036(a)(2) and §2038. However, the taxpayer's attorney in *Morrissette*, did argue that the cases precluded a sweeping application of §2036(a)(2) and §2038(a)(1) because of the ability to join together with others in undoing transactions, but the court summarily denied the taxpayer's §§2036(a)(2)/2038(a)(1) summary judgment motion on the basis of the *Cahill* decision without even mentioning these cases. See Item 29.c(3) above.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Including the partial inclusion of FLP assets in *Miller* and *Bongard*, 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 Miller 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*, 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).

30. Savings Clause Rejected in Conservation Easement Cases, *Coal Property Holdings, LLC v. Commissioner* and *Railroad Holdings LLC v. Commissioner*

a. **Synopsis of *Coal Property Holdings, LLC v. Commissioner*.** In a case reminiscent of the *Belk v. Commissioner* Fourth Circuit Court of Appeals case five years ago, the Tax Court has rejected a savings clause as an impermissible "condition subsequent" clause (citing *Commissioner v. Procter*) in a conservation easement case. *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (Oct. 28, 2019) (Judge Lauber). The court concluded that the easement did not satisfy the "protected in perpetuity" requirement of §170(h)(5)(A) and granted summary judgment denying any charitable deduction for the easement. The easement deed also provided that the amount to be paid to the donee would be the amount required by the regulations "if different from" the formula in the deed. The Tax Court concluded that clause "constitutes a 'condition subsequent' saving clause, which we and other courts have consistently declined to enforce."

For a discussion of the court's analysis in *Coal Property Holdings, Belk,* and other savings clauses cases, see Item 37.b. of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Synopsis of *Railroad Holdings LLC v. Commissioner*.** *Railroad Holdings LLC v. Commissioner,* T.C. Memo. 2020-22 (February 5, 2020) (Judge Gustafson) is very similar to *Coal Property Holdings*; indeed, Judge Gustafson said the easement deed in *Railroad Holdings* "bears the same essential flaw" as in the *Coal Property Holdings* case. The court rejected the taxpayer's argument that a construction provision should cause the deed to satisfy the regulatory requirements. See Item 39.c. of Heckerling Musings 2020 and Estate Planning Current Developments found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. For a more detailed summary of *Railroad Holdings*.

c. **Similar Cases.** Other conservation easement cases have reasoned similarly. *E.g.*, *Pine Mountain Preserve, LLLP v. Commissioner*, 1holdings to defined value clauses and savings clauses generally, see Item 51 T.C. 247 (2018); *Palmolive Building Investors, LLC v. Commissioner*, 149 T.C. 380 (2017); *Carter v. Commissioner*, T.C. Memo. 2020-21.

d. **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.

e. **Application to Defined Value Clauses and Savings Clauses Generally.** These cases are interesting regarding their discussion of saving 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 available at **www.bessemertrust.com/for-professional-partners/advisor-insights** and Item 39.e. of Heckerling Musings 2020 and Estate Planning Current Developments found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

f. **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**).

31. 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**.