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

February 2023

Parts 1-5 are from Washington Update: Pending and Potential Administrative and Legislative Changes (February 2023). Some of the other parts are adapted from summaries authored or coauthored by Steve Akers. All of those resources are available at ***www.bessemertrust.com/for-professional-partners/advisor-insights****.*

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Important Information Regarding This Summary
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1. The 117th Congress and Potential Legislative Agenda in the Biden Administration

a. Insights from President Biden's Campaign

(1) In General

President Biden desires to reverse or roll back many of the 2017 changes. Beginning in his campaign, he has spoken of his desire to "Build Back Better" by increasing the corporate income tax rate from 21 percent to 28 percent and increasing individual income taxes for annual incomes over $400,000, including an increase in the top rate from 36 percent to 39.6 percent and taxation of capital gains at the same rates as ordinary income for individuals with taxable incomes over $1 million.

(2) Estate, Gift, and GST Taxes

His 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.

Similarly, the "Greenbook" revenue proposals of the Obama Administration, beginning in 2013, had proposed to return the estate, gift, and GST taxes to their 2009 levels, which included a top 45 percent rate and non-indexed but portable exemptions of $3.5 million for the estate and GST taxes and $1 million for the gift tax.

(3) Treatment of Appreciation at Death

In connection with the taxation of capital gains as ordinary income, President Biden has also referred to the step-up in basis, likely meaning the step-up for appreciated assets that pass from a decedent. Although, again, he has offered few details, insight may be gained from the final two Greenbooks of the Obama Administration, in 2015 (pages 156-57) and 2016 (pages 155-56), which, under the general heading of "Reforms to Capital Gains Taxation, Upper-Income Tax Benefits, and the Taxation of Financial Institutions," include a proposal labeled simply "Reform the Taxation of Capital Income." In addition to increasing the rate of tax on capital gains in general (although not as high as the rate on ordinary income), that proposal would treat the transfer of appreciated property at death (as well as by lifetime gift) as a realization event, subjecting the appreciation to income tax. That proposal was even featured in President Obama's State of the Union Address on January 20, 2015.

Additional details of the Obama Administration's 2015 and 2016 proposals included:

(a) Gifts or bequests to a spouse or charity would not be taxed, but the spouse or charity would take a carryover basis in the asset.

(b) Tangible personal property such as household furnishings and personal effects, but not collectibles, would be exempt.

(c) The gain would be taxable to a donor in the year a gift is made, and to a decedent either on the final individual return or on a separate capital gains return.

(d) Each taxpayer would be allowed an additional exclusion of capital gains at death of up to $100,000 (indexed for inflation), and each person's $250,000 exclusion of capital gain on a principal residence would be extended to all residences. Both of these exclusions would be portable to the decedent's surviving spouse "under the same rules that apply to portability for estate and gift tax purposes."

(e) Taxation of the appreciation in the value of certain small family-owned and operated businesses (no further details given) would be deferred until the business is sold or ceases to be family-owned and operated.

(f) A "15-year fixed-rate payment plan" would be allowed for the tax on appreciated illiquid assets transferred at death.

(g) The Greenbooks clarified that the income tax on capital gains deemed realized at death would be deductible for estate tax purposes.

(h) Showing acknowledgment of the complexities involved, the Greenbooks added the following:

> The proposal also would include other legislative changes designed to facilitate and implement this proposal, including without limitation: the allowance of a deduction for the full cost of appraisals of appreciated assets; the imposition of liens; the waiver of penalty for underpayment of estimated tax if the underpayment is attributable to unrealized gains at death; the grant of a right of recovery of the tax on unrealized gains; rules to determine who has the right to select the return filed; the achievement of consistency in valuation for transfer and income tax purposes; and a broad grant of regulatory authority to provide implementing rules.
>
> To facilitate the transition to taxing gains at death and gift, the Secretary would be granted authority to issue any regulations necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete records are unavailable.

b. **"For the 99.5 Percent Act" Introduced by Senator Sanders**

(1) **The "For the 99.5 Percent Act."** On March 25, 2021, Senator Bernie Sanders (I-Vermont) introduced S. 994, titled "For the 99.5 Percent Act," an updated compilation of legislative proposals he and Democrats have been offering for many years regarding the estate, gift, and GST taxes and related grantor trust income tax issues. Senator Sanders has introduced a bill like this in every Congress since 2010, when he named it the "Responsible Estate Tax Act" (S. 3533, 111th Cong., June 24, 2010). In this Congress he has changed the name from the "For the 99.8 Percent Act" he introduced on January 31, 2019. The bill includes, but is not limited to, adaptations of proposals in the Treasury Department's "General Explanations" (popularly called "Greenbooks") of revenue provisions in the budget proposals of the Obama Administration and even the Clinton Administration. A companion bill (H.R. 2576) was introduced in the House of Representatives on April 15, 2021, by Congressman Jimmy Gomez (D-California).

(a) Senator Sanders' proposals will be important to his Democratic colleagues as a source for ideas if comprehensive estate tax reform becomes a priority and political possibility. One reason for that is simply that his proposals have been written – that is, reduced to statutory wording – and they are "out there" or "on the shelf" for lawmakers to incorporate into whatever other legislation happens to be popular at the time. These proposals are distinguished in that respect from some other more fundamental ideas that are offered from time to time, such as a "wealth tax" that would have to be analyzed, modeled, written, and refined and might still face years of uncertainty about its scope, operation, and constitutionality.

(b) Senator Sanders' bill is important for another reason. Drafted legislation like this can be the source for fillers in the legislation of the day, for Republicans as well as Democrats, particularly a revenue-raiser that has just the right revenue estimate to "pay for" other legislation. That is exactly what happened when "Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent" was added to the Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41) by a Republican-controlled Congress in July 2015. It raised just the right amount of money to fund a desired extension of the Highway Trust Fund that was scheduled to expire on the day President Obama signed the Act into law. Significantly, the first introduced statutory wording for the consistent basis provision had been section 6 of Senator Sanders' "Responsible Estate Tax Act" of 2010. See Part 5.a(5)(b)i below.

(2) **Modifications to Rates and Exemptions.** Section 2 of the "For the 99.5 Percent Act" would raise rates and lower exemptions.

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

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

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

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

iv. 65 percent (the top estate tax rate in effect in 1982; this is down from 77 percent in Senator Sanders' 2019 bill) over $1 billion.

(b) The basic exclusion amount would be reduced to

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

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

(c) Portability would be retained for both estate and gift tax purposes.

(d) A detailed set of "anti-clawback" rules that had been included in Senator Sanders' 2019 bill is omitted, perhaps simply in recognition of the fact that the anti-clawback regulations have now been finalized, with a proposed "anti-abuse" refinement that Senator Sanders would presumably favor. See Part 5.c(8) below.

(e) The bill says nothing about the GST tax, which apparently would make the GST tax rate 65 percent and the GST exemption $3.5 million.

(f) These proposals would "apply to estates of decedents dying, and generation-skipping transfers and gifts made, after December 31, 2021." This is consistent with the effective dates in Senator Sanders' previous bills and reflects a long-observed drafting principle (or at least drafting preference) for estate and gift tax changes. Presumably, pursuant to that preference, if this legislation were enacted, for example, in 2022, the reference to 2021 would be changed to 2022, making the effective date January 1, 2023.

(3) **Value of Farm, etc. Real Property.** Section 3, like section 4 of the 2010 "Responsible Estate Tax Act," would, effective January 1, 2022, increase the cap on the reduction in value under the special use valuation rules of section 2032A from $750,000 ($1.19 million in 2021 and $1.23 million in 2022, after indexing since 1998) to $3 million, indexed for inflation going forward from 2022.

(4) **Land Subject to Conservation Easements.** Section 4, like section 5 of the 2010 "Responsible Estate Tax Act," would, effective January 1, 2022, increase the maximum exclusion from the gross estate under section 2031(c) by reason of a conservation easement from the lesser of $500,000 or 40 percent of the net value of the land to the lesser of $2 million or 60 percent of the net value of the land.

(5) **No Step-up in Basis for Assets in Grantor Trusts.** Section 5 would add a new section 1014(f) (redesignating the current section 1014(f) as 1014(g)), providing that property "held in a trust of which the transferor is considered the owner under subpart E of part I of subchapter J" would not receive a new basis at the deemed owner's death if "such property is not includible in the gross estate of the transferor for purposes of chapter 11." Although subpart E includes section 678, which treats "[a] person other than the grantor" as the owner of part or all of a trust, it seems that the reference in this bill to "the transferor" is intended to exclude section 678 deemed owners.

(a) This amendment would "apply to transfers after the date of the enactment of this Act." That would evidently apply to grantor trusts created and funded after enactment. It is less clear how it would apply to transfers to a trust after its initial funding, including perhaps transfers involving sales or exchanges with an existing trust.

(b) Section 5 of Senator Sanders' 2019 bill would have extended the "consistent basis" rules of section 1014(f) and the accompanying reporting rules of section 6035(a) (discussed in Part 5.a below) to property received by gift. That provision is omitted from this Congress's bill, although it presumably would be moot to the extent other legislation taxes unrealized appreciation upon gift or death.)

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

(a) Section 6 is also similar to section 276 of H.R. 3874, introduced in March 2000 by Rep. Charles Rangel of New York, the Ranking Democrat on the House Ways and Means Committee, to implement a legislative proposal in the 1998 Clinton Administration's "Greenbook." And it is almost identical to section 303 of H.R. 1264, introduced by Rep. Rangel in March 2001 as an alternative to the Republican proposals that became the 2001 Tax Act, and to three bills subsequently introduced by Rep. Earl Pomeroy (D-North Dakota): H.R. 5008 in June 2002, H.R. 1577 in April 2005, and H.R. 4242 in November 2007.

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

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

The bill includes detailed rules about "passive assets" that might be used in a business and "look-thru rules" for entities that are at least 10 percent owned by another entity.

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

> (e) Limitation on Minority Discounts—For purposes of this chapter and chapter 12, in the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092), no discount shall be allowed by reason of the fact that the transferee does not have control of such entity, or by reason of the lack of marketability of the interest, if the transferor, the transferee, and members of the family (as defined in section 2032A(e)(2)) of the transferor and transferee—
>
> (1) have control of such entity, or
>
> (2) own the majority of the ownership interests (by value) in such entity.

The words "or by reason of the lack of marketability of the interest" are new in this version. Simply stated, the objectives of the proposed new section 2031(e) are to attribute control among family members and to presume control from majority ownership, without exception, apparently not even an exception for an active trade or business. Both objectives will undoubtedly be viewed as unrealistic in many contexts, especially in the context of an active trade or business.

(7) **Grantor Retained Annuity Trusts.** Section 7 mirrors the proposals of the Obama Administration's Greenbooks regarding GRATs, generally in the form in which those proposals solidified in the 2015 and 2016 Greenbooks.

(a) Like the 2015 and 2016 Greenbooks, the bill, applicable to transfers after the date of enactment, would require any GRAT to

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

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

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

iv. have a remainder interest with a value for gift tax purposes when the GRAT is created equal to at least 25 percent of the value of the assets contributed to the GRAT or $500,000, whichever is greater (but not greater than the total value of the assets contributed) (a proposal added in the 2015 Greenbook).

(b) Section 8 of Senator Sanders' 2010 "Responsible Estate Tax Act" had included only the minimum 10-year term and the prohibition on decreases in the annuity, reflecting only the 2009 and 2010 Greenbooks that had been published before then.

(c) The 2015 Greenbook had also added that "the proposal … would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust." That would diminish the availability of some techniques for managing long-term GRATs. The "For the 99.5 Percent Act" omits that proposal.

(8) **Grantor Trusts in General.** Similarly, section 8 mirrors the proposals of the Obama Administration's Greenbooks regarding grantor trusts and provides proposed statutory language for those proposals, also generally following the 2015 and 2016 Greenbooks.

(a) The bill would add to the Code a new chapter 16 (titled "Special Rules for Grantor Trusts"), containing a single section 2901 (titled "Application of Transfer Taxes").

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

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

ii. a person other than the grantor is the deemed owner of that portion under subchapter J, if that person "engages in a sale, exchange, or comparable transaction with the trust that is disregarded for purposes of subtitle A [the federal income tax subtitle]," to the extent of "the portion of the trust attributable to the property received by the trust in such transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of consideration received by the deemed owner in such transaction." (This second category appears to target the techniques known as "BDITs" and perhaps some "BDOTs," whether as a matter of tax policy or simply to crack down on techniques known to be in use.)

(c) Tracking the Obama Administration Greenbooks, section 2901 would

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

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

iii. treat as a gift by the deemed owner, subject to gift tax, all assets of such portion at any time during the deemed owner's life if the deemed owner ceases to be treated as the owner of such portion for income tax purposes.

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

(e) Section 2901 provides that it "shall not apply to any trust that is includible in the gross estate of the deemed owner (without regard to [section 2901])." (An additional exception in Senator Sanders' 2019 bill for "any other type of trust that the Secretary determines by regulations or other guidance does not have as a significant purpose the avoidance of transfer taxes" is omitted from his 2021 bill.)

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

(g) Section 2901 would apply to

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

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

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

(h) There is considerable overlap in the effects of sections 5 and 8 of this bill. In general, section 5 appears to provide that there is no stepped-up basis at death for assets in a grantor trust if the value of those assets is not included in the decedent's gross estate, while section 8 appears to ensure that there are no such trusts by including the value of the assets of all grantor trusts in the gross estate. There are some differences, such as the application to section 678 deemed owners, the exception for "any trust that is includible in the gross estate of the deemed owner (without regard to [section 2901])," the possible application to foreign trusts, the effect of transactions between the trust and the deemed owner after the effective date, and even a one-day difference in the effective date itself (section 5 would apply "after" the date of enactment while section 8 would apply "**on or** after" the date of enactment). But, in the main, it appears that there is a lot of redundancy between these two sections, which tends to reinforce the narrative that this bill has been put together with a view toward making it easy for one or more, but not all, of the individual provisions of this bill to be "pulled off the shelf" to serve a targeted policy or revenue purpose in the consideration of legislation on almost any subject.

(9) **Elimination of GST Exemption for Certain Long-Term Trusts.** Section 9 would mandate an inclusion ratio of one for any trust that is not a "qualifying trust." A "qualifying trust" is "a trust for which the date of termination of such trust is not greater than 50 years after the date on which such trust is created."

(a) This recalls a similar proposal in the Obama Administration's Greenbooks, but would be significantly more aggressive. It would use a period of 50 years (rather than 90 years as in the Greenbooks) and would mandate an inclusion ratio of one from the beginning of a trust (rather than resetting the inclusion ratio to one on the 90th anniversary), thus apparently without any "wait and see" relief.

(b) A trust created before the date of enactment with an inclusion ratio less than one would be allowed to keep that inclusion ratio for 50 years after enactment, and then the inclusion ratio would be reset to one.

(c) Special rules would be provided for portions of trusts treated as separate trusts (see section 2654(b)(1) and Reg. §26.2654-1) and for transfers between trusts.

(10) **"Simplifying" Gift Tax Exclusion for Annual Gifts.** Section 10 would significantly limit the availability of the gift tax annual exclusion, effective January 1, 2022. It would implement a similar proposal in the Obama Administration Greenbooks, from which it borrows the characterization of "simplifying."

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

(b) While the per-donor limit in the Greenbooks would have been $50,000 (indexed for inflation), the "For the 99.5 Percent Act" would set the annual per-donor limit at twice the per-donee limit, $30,000 in 2021 and $32,000 in 2022 (also indexed for inflation).

(c) Like the Greenbooks, the bill would impose this new limitation on transfers in trust (without an exception for trusts described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

(d) Like the Greenbooks, the bill would leave in place the per-donee annual exclusion ($15,000 in 2021 and $16,000 in 2022), for example for outright gifts of cash or marketable securities.

(e) The bill would repeal section 2503(c), which now provides a special way that a trust for a minor can qualify as a present interest.

(f) As in the Greenbook proposals, the new $32,000 per-donor limit would apply to all transfers in trust, but apparently would not include a present-interest requirement at all, although it apparently would still require identification of donees to apply the $16,000 per-donee limit.

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

(h) The bill would not change the gift-splitting rules in section 2513.

c. **Deemed Realization Proposals in Congress**

(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 would cause a loss of $41.9 billion of tax revenue in 2021 alone. The statement was accompanied by a 32-page "discussion draft" 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. As discussed in the context of section 2 of Senator Sanders' "For the 99.5 Percent Act" in Part 1.b(2)(f) 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).

d. **Estate Tax Repeal Bills**

(1) On March 9, 2021, joined by several of his Republican colleagues, Senator John Thune (R-South Dakota) introduced the "Death Tax Repeal Act of 2021" (S. 617). The bill resembles repeal bills that have been introduced over the last two or three decades.

(a) S. 617 would permanently repeal the estate and GST taxes, effective for estates of decedents dying, and generation-skipping transfers, after the date of enactment. As in past bills, it would retain the estate tax under section 2056A(b)(1)(A) on distributions from qualified domestic trusts for spouses of decedents who died before the date of enactment, but only for 10 years after the date of enactment. It would immediately eliminate the estate tax under section 2056A(b)(1)(B) on the value of property remaining in QDOTs at the deaths of surviving spouses after the date of enactment.

(b) S. 617 would retain the gift tax with a 35 percent rate for cumulative gifts over $500,000 and would make permanent the current gift tax exclusion amount of $10 million indexed for inflation since 2011 (that is, $11.7 million for 2021 and $12.06 million for 2022), effective for gifts made on or after the date of enactment.

i. S. 617 would deal with the issue currently posed by the phrase "as of the end of the calendar year" in section 2505(a)(1) by treating the year in which the bill is enacted as two separate calendar years, one ending on the day before the date of enactment and the other beginning on the date of enactment.

ii. It would also restore the 2001 Tax Act's enigmatic section 2511(c), providing that "[n]otwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1." (It ignores the 2002 amendment, which changed "taxable gift under section 2503" to "transfer of property by gift.")

a. This provision appears to perpetuate the 2001 lore that the retention of the gift tax is needed to back-stop the income tax by subjecting to gift tax any transfer that would be "income-shifting," but, as in 2001, it is hard to be sure or to fully understand such a policy.

b. In any event, such a provision would presumably shut down the advantages of so-called incomplete-gift non-grantor trusts (or "ING trusts").

c. More perplexing, as in 2001, the use of the word "unless" in this provision could create the impression that a taxable gift is **avoided** by simply making the transfer to a trust that **is** a wholly-owned grantor trust as to the grantor or the grantor's spouse. That would certainly be different from the treatment of "intentionally defective" grantor trusts for which current funding is a completed gift, but which normally include no features that would subject the trust to estate tax upon the grantor's death.

(2) A companion bill, H.R. 1712, was introduced in the House of Representatives on the same day by Congressman Jason Smith (R-Missouri).

e. **Treasury's Explanation of Fiscal Year 2022 Budget Proposals ("Greenbook")**

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

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

The Greenbook (at pages 62-64) also provides details focusing and clarifying the proposal for the "deemed realization" of capital gains foreshadowed by the Obama Administration's Greenbooks for Fiscal Years 2016 (Feb. 2, 2015, pages 156-57) and 2017 (Feb. 9, 2016, pages 155-56), by President Biden's campaign, and by Representative Bill Pascrell's H.R. 2286 and Senator Van Hollen's "discussion draft" of the Sensible Taxation and Equity Promotion ("STEP") Act of 2021 discussed in Part 1.c above. That Greenbook proposal is summarized as follows:

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

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

(3) **Taxpayer, Return, and Deductibility.** The Greenbook states that the gain would be reported "on the Federal gift or estate tax return or on a separate capital gains return." Reassuringly, however, the Greenbook confirms that the gain "would be taxable income to the decedent" and, consistently with that characterization, explicitly adds that "the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any)." That means that the 39.6 percent capital gains rate and 40 percent estate tax rate would produce a combined rate of 63.76 percent ($0.396 + 0.4 \times (1 - 0.396)$) on appreciation.

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

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

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

(7) **Other Exclusions.** The Greenbook proposes a single unified exclusion of capital gains for transfers both by gift and at death of $1 million per person, indexed for inflation after 2022 and "portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes." The Greenbook adds that this would "mak[e] the exclusion effectively $2 million per married couple," without explaining exactly how that would be

accomplished for lifetime gifts when there has been no "decedent" or "surviving spouse." The Greenbook does not address whether the use of the exclusion for lifetime gifts is mandatory or elective.

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

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

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

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

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

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

The Greenbook also states:

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

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

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

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

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

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

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

(12)**Administrative Provisions.** Following the Obama Administration Greenbooks, with a few additions, the Greenbook envisions (but without details) a number of other legislative features, covering topics such as a deduction for the full cost of related appraisals, the imposition of liens, the waiver of penalties for underpayment of estimated tax attributable to deemed realization of gains at death (which, of course, could not have been foreseeable), a right of recovery of the tax on unrealized gains, rules to determine who selects the return to be filed, consistency in valuation for transfer and income tax purposes, and coordination of the changes to reflect that the recipient would have a basis in the property equal to the value on which the capital gains tax is computed.

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

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

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

2. Fiscal 2022 Budget Reconciliation

a. Budget Resolution

On August 24, 2021, the House of Representatives agreed to the Senate-approved Concurrent Resolution on the Budget for Fiscal Year 2022 (S. Con. Res. 14), establishing spending priorities of about $3.5 trillion for the fiscal year beginning October 1, 2021, and ending September 30, 2022. The votes were strictly partisan. In the Senate on August 11 the vote was 50-49, with all Democrats in favor and all Republicans opposed except Senator Mike Rounds (R-South Dakota), who did not vote. In the House on August 24 the vote was 220-212, with all Democrats in favor and all Republicans opposed. The resolution left the House Ways and Means Committee and the Senate Finance Committee with flexibility to develop tax changes to pay for the contemplated expenditures.

b. Ways and Means Committee Action

On September 15, 2021, the House Ways and Means Committee approved the "Build Back Better Act" (H.R. 5376), a package of tax changes pursuant to the budget resolution. Only one Democratic member of the Committee, Rep. Stephanie Murphy (D-Florida), joined all the Republicans in voting against it. The bill, with revisions as discussed below, was approved by the House. The Ways and Means Committee's bill included the following:

(1) **No Deemed Realization.** The Ways and Means Committee omitted any deemed realization proposals like those made in the current Congress and in the Administration's Fiscal Year 2022 Greenbook (see Parts 1.c and 1.e above).

(2) **Early Sunset for Doubled Basic Exclusion Amount.** The sunset of the 2017 Tax Act's doubling of the $5 million basic exclusion amount (indexed for inflation since 2012) would have been accelerated **from January 1, 2026, to January 1, 2022**. Thus, the basic exclusion amount would return to $5 million, indexed for inflation since 2012, which the Joint Committee on Taxation (JCT) staff projected would be $6,020,000 for 2022. This was estimated to raise $54 billion over 10 years (mostly in the first five years before the original 2026 sunset).

(3) **Closer Alignment of Grantor Trust and Transfer Tax Rules.** The bill approved by the Ways and Means Committee would have created a new chapter 16, consisting solely of a new section 2901, effectively linking the grantor trust rules and the transfer tax rules so that a trust designed

as a grantor trust would continue to be exposed to gift or estate tax with respect to the grantor. Thus the bill picked up, with some significant changes, the proposals in section 8 of Senator Sanders' "For the 99.5 Percent Act" (discussed in Part 1.b(8) above), which in turn track the Obama Administration Greenbooks. With respect to a trust or portion of a trust that is not otherwise includable in the grantor's gross estate and is funded **on or after the date of enactment** (either upon initial formation or by a contribution to an existing trust), section 2901 would

(a) include the value of such portion in the grantor's gross estate for estate tax purposes,

(b) subject to gift tax any distribution from such portion during the grantor's life, other than distributions to the grantor or the grantor's spouse or in discharge of an obligation of the grantor, and

(c) treat as a gift by the grantor, subject to gift tax, all of such portion at any time during the grantor's life if the grantor ceases to be treated as the owner of such portion for income tax purposes.

Unlike the "For the 99.5 Percent Act," this proposal would apply only to "any portion of a trust with respect to which **the grantor** is the deemed owner." It omits the additional explicit application in the "For the 99.5 Percent Act" to the extent a deemed owner engages in a leveraged "sale, exchange, or comparable transaction with the trust" that appears to have been aimed at the technique known as a "Beneficiary Defective Inheritor's Trust" ("BDIT"). (Compare Part 1.b(8)(b)ii above.)

The creation of, or addition to, such a grantor trust would not escape gift tax, but, in determining future gift or estate taxes upon one of the events described in paragraphs (a), (b), and (c) above, "amounts treated previously as taxable gifts" would be "account[ed] for" with a "proper adjustment."

(4) **Certain Sales Between Deemed Owned Trust and Deemed Owner.** Going a step beyond the "For the 99.5 Percent Act," the bill would have added a new section 1062 providing:

> In the case of any transfer of property between a trust and a person who is the deemed owner of the trust (or portion thereof), such treatment of the person as the owner of the trust shall be disregarded in determining whether the transfer is a sale or exchange for purposes of this chapter.

The result would be that gain would be recognized by the deemed owner or by the trust, as the case may be, or possibly by both of them (in the case of a substitution of assets or other in-kind exchange, for example). Rev. Rul. 85-13, 1985-1 C.B. 184, the hinge on which almost all grantor trust planning swings, would be nullified. The new rule would not apply to a trust that is fully revocable by the deemed owner.

The bill would also amend section 267 to disallow losses between "[a] grantor trust and the person treated as the owner of the trust (or portion thereof)."

Like the closer alignment of grantor trust and transfer tax rules in section 2901, this rule, as written, would apparently apply only to a trust created, and any portion of an existing trust attributable to a contribution made, **on or after the date of enactment**. The Ways and Means Committee report stated that it "is intended to be effective for sales and other dispositions after the date of enactment" – that is, regardless of when the trust was created or funded – but it adds in a footnote (footnote 935) that "[a] technical correction may be necessary to reflect this intent."

Section 1062 and section 2901 together were estimated to raise $8 billion over 10 years.

(5) **Valuation of Certain Nonbusiness Assets in Entities.** In a proposal traceable at least to the Reagan and Clinton Administrations and virtually identical to section 6 of Senator Sanders' "For the 99.5 Percent Act" (see Part 1.b(6) above), the Ways and Means Committee bill would in effect have required the valuation of nonbusiness assets in an entity by **a look-through method**.

The proposal would add a new section 2031(d) to the Code, **applicable to transfers (by gift or upon death) after the date of enactment**. Section 2031(d)(1) would read as follows:

> (d) VALUATION RULES FOR CERTAIN TRANSFERS OF NONBUSINESS ASSETS—For purposes of this chapter [estate tax] and chapter 12 [gift tax]—
>
> > (1) IN GENERAL—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092) [*see*, *e.g.*, Reg. §1.1092(d)-1(a) & (b)]—
> >
> > > (A) the value of any nonbusiness assets held by the entity with respect to such interest shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and
> > >
> > > (B) such nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.

Like the "For the 99.5 Percent Act," the proposal included a detailed list of what are considered "passive assets," detailed rules about passive assets that might be used in a business, and "look-thru rules" for entities that are at least 10 percent owned by another entity. The proposal also included a broad grant of regulatory authority, specifically including the issues of whether a passive asset is used in the active conduct of a trade or business or is held as part of the reasonably required working capital needs of a trade or business.

Unlike the "For the 99.5 Percent Act," however, the proposal does not also include a general prohibition on "minority discounts" in family owned or controlled entities, a prohibition that in the "For the 99.5 Percent Act" (see Part 1.b(6)(c) above) is not limited to "nonbusiness" entities or assets and thus would arguably have a much broader and harsher impact on family businesses.

In addition, new section 2031(d)(2)(A) would provide that "[t]he term 'nonbusiness asset' means any passive asset which (i) is held for the production or collection of income, and (ii) is not used in the active conduct of a trade or business." That implies that, for example, a vacation home that is not rented would not be valued under the proposed look-through rule, which is a bit surprising.

Also surprising, despite that broad definition of a "nonbusiness asset" (which is repeated in the Ways and Means Committee's report), a summary titled "Tax Changes for Estates and Trusts in the Build Back Better Act (BBBA)," published by the Congressional Research Service on October 22, 2021, limited its description of the proposal to only "cash and readily marketable securities," without explanation.

This proposal was estimated to raise $20 billion over 10 years.

(6) **Increased Benefit of Special Use Valuation.** In contrast to the preceding provisions that would make the estate and gift tax more burdensome, the Ways and Means Committee bill, **effective January 1, 2022**, would have increased the limit on the reduction under section 2032A in the estate tax value of real property used in a family farm or other family business resulting from valuing the real property in that farm or business use, even if that is not its "highest and best use." Currently the limit on that reduction is $750,000, indexed for inflation since 1998 ($1,190,000 in 2021 and $1,230,000 in 2022). Such an increase in the limit has often been offered by lawmakers opposed to across-the-board repeal or reduction of the estate tax as a way to target relief to the family farms and businesses that are often cited as justifications for such repeal or reduction. Unlike section 3 of Senator Sanders' "For the 99.5 Percent Act" (see Part 1.b(3) above), which would increase the limit to only $3 million, indexed for inflation going forward, the Ways and Means Committee proposal would raise the limit to $11.7 million (which happened to be the 2021 basic exclusion amount), indexed going forward. Even so, the proposal would not really reduce the estate tax on a family farm or business as such; it would merely prevent a tax, for example, on a speculative prospect of development that is faced by such businesses very unevenly. Thus, this proposal should not have been expected to be viewed by owners of family farms and businesses as much of a consolation. It was estimated to decrease revenues by $317 million over 10 years.

(7) **Other Income Tax Proposals**

(a) **Individual Income Tax Rates.** Beginning **January 1, 2022**, the 39.6 percent top individual income tax rate, suspended for eight years by the 2017 Tax Act, would have been reinstated for taxable incomes over $400,000 ($450,000 for joint returns and surviving spouses) and $12,500 indexed ($13,450 in 2022) for trusts and estates. In addition, a **new section 1A** would apply a 3 percent surcharge to "modified adjusted gross income" (defined as AGI minus any investment interest deducted "below the line," not deducted in determining AGI) over $5 million for individual returns, including joint returns of married couples (half that amount in the case of married individuals filing separately). For trusts and estates the threshold is $100,000, and AGI is determined as provided in section 67(e) (that is, after deducting certain unique fiduciary expenses, the personal exemption of section 642(b), and the distribution deduction of section 651 or 661), with a further deduction for charitable payments and set-asides under section 642(c) that was helpfully added in the November 3 update mentioned in Part 2.d below.

(b) **Capital Gain Tax Rates.** The rate of income tax on capital gains would have been increased from 20 percent to 25 percent to the extent the taxpayer is subject to the reinstated 39.6 percent top rate – that is, for taxable incomes over $400,000 ($450,000 for joint returns and surviving spouses and $12,500 indexed [$13,450 in 2022] for trusts and estates). Notably, this provision was designed to take effect **on September 14, 2021**, with an exception for gains recognized in 2021 pursuant to written binding contracts entered into before September 14, 2021.

(c) **Expansion of Tax on Net Investment Income.** Beginning **January 1, 2022**, the 3.8 percent tax on net investment income would have been expanded by effectively eliminating the "trade or business" exception in section 1411(c)(1)(A) for individuals with "modified adjusted gross income" (in this case already defined in section 1411(d) as AGI plus, in effect, net foreign earned income excluded under section 911) over $400,000 ($500,000 for joint returns and surviving spouses) and for trusts and estates with adjusted gross income in excess of the threshold for the highest income tax bracket for trusts and estates ($13,450 in 2022).

(d) **Limitation of Qualified Business Income Deduction.** Beginning **January 1, 2022**, the qualified business income deduction of section 199A (added by the 2017 Tax Act) would have been capped at $400,000 for individuals ($500,000 for joint returns and surviving spouses) and $10,000 for trusts and estates.

c. Administration's "Build Back Better Framework"

On October 28, 2021, the White House released a short document titled "Build Back Better Framework." It was widely viewed as reflecting negotiations among the Administration and members of Congress in both parties. The Framework added that its spending proposals would be "more than fully paid for by asking the wealthiest Americans and most profitable corporations to pay their fair share," including a "new surtax on multi-millionaires and billionaires." But it omitted any reference to many of the proposals that had been in the Ways and Means Committee's version of H.R. 5376, including changes to the basic exclusion amount, the treatment of grantor trusts, and the valuation of nonbusiness assets in entities.

d. House Rules Committee Version Passed by House

On the same day, October 28, 2021, the House Rules Committee released a new version of H.R. 5376, mirroring the White House Framework and omitting the transfer tax and grantor trust provisions the Ways and Means Committee had previous approved. An updated version, with both technical and substantive additions, was released on November 3, 2021.

The White House Framework's "new surtax on multi-millionaires and billionaires" proved to be the retention of the new section 1A of the original Ways and Means Committee version, effective January 1, 2022, with some significant changes in the numbers. The **threshold** for imposition of the surcharge would be **doubled** to $10 million for individual returns, including joint returns of married couples (half that amount in the case of married individuals filing separately), and $200,000 for trusts and estates. But the ultimate **rate** of the surtax would be **almost tripled**, beginning at that threshold at 5 percent (rather than 3 percent) and then increasing to 8 percent at a level of $25 million for individual returns, including joint returns of married couples (half that amount in the case of married individuals filing separately) and $500,000 for trusts and estates. And, as noted above, the November 3 update helpfully added a provision allowing the deduction for charitable payments and set-asides under section 642(c) in calculating the threshold for the surcharge.

The Rules Committee version keeps the limitation on the "trade or business" exception for the 3.8 percent tax on net investment income, but it omits the limitation of the qualified business income deduction.

The House of Representatives passed the Rules Committee version on November 19, 2021. The vote was 220-213, with no Republicans voting for it and only one Democrat (Representative Jared Golden of Maine) voting against it. The bill became stalled in the closely divided Senate.

e. **Senate Amendment and the "Inflation Reduction Act of 2022"**

On Sunday, August 7, 2022, the Senate approved an amendment of H.R. 5376 that it referred to as the "Inflation Reduction Act of 2022." The vote was strictly by party lines, with 50 Democrats (and Independents who caucus with the Democrats) in favor and 50 Republicans opposed, before Vice President Harris cast the tie-breaking vote.

The House of Representatives agreed to the Senate amendment in a party-line 220-207 vote on August 12, 2022.

President Biden signed it into law as Public Law 117-169 on August 16, 2022.

(1) The "Inflation Reduction Act" focused on major energy, environment, and health care provisions. It did not include any of the tax provisions discussed above. The "revenue raisers" were

- for taxable years beginning after December 31, 2022, a 15 percent alternative corporate minimum tax on the "adjusted financial statement income" of corporations with "average annual adjusted financial statement income" over $1 billion in three consecutive years and
- a "buyback tax" of 1 percent of the fair market value of tradeable stock repurchased after December 31, 2022, in a redemption within the meaning of section 317(b) or in a similar transaction.

(2) **Long-Term IRS Funding.** But the Inflation Reduction Act did include a provision labelled **"Enhancement of Internal Revenue Service Resources."** In a significant break from the historical pattern of annual, sometimes dramatically eleventh-hour, appropriations, the Act included the following eight amounts directed **"to remain available until September 30, 2031"** – that is, **for nine years**, to help ensure partial continuity of IRS funding free from the uncertainty and drama of those year-by-year appropriations:

- $3,181,500,000 for **taxpayer services**, "including pre-filing assistance and education, filing and account services, [and] taxpayer advocacy services";
- $45,637,400,000 for **enforcement**, including "necessary expenses for tax enforcement activities of the Internal Revenue Service to determine and collect owed taxes, to provide legal and litigation support, to conduct criminal investigations (including investigative technology), to provide digital asset monitoring and compliance activities, to enforce criminal statutes related to violations of internal revenue laws and other financial crimes, [and] to purchase and hire passenger motor vehicles";
- $25,326,400,000 for **operations support**, "including rent payments; facilities services; printing; postage; physical security; headquarters and other IRS-wide administration activities; research and statistics of income; telecommunications; information technology development, enhancement, operations, maintenance, and security; the hire of

passenger motor vehicles; … [and] the operations of the Internal Revenue Service Oversight Board";

- $4,750,700,000 for **business services modernization**, "including development of callback technology and other technology to provide a more personalized customer service";
- $403,000,000 for the Treasury Inspector General for Tax Administration;
- $104,533,803 for the Treasury Office of Tax Policy;
- $153,000,000 for the United States Tax Court; and
- $50,000,000 for "oversight and implementation support" by the Treasury Department.
- Total: $79,606,533,803.

In addition, $15,000,000 was included, available through September 30, 2023, for a task force to design an IRS-run free direct efile tax return system and report to Congress within nine months – that is, by May 16, 2023 – elaborated as follows:

> For necessary expenses of the Internal Revenue Service to deliver to Congress, within nine months following the date of the enactment of this Act, a report on (I) the cost (including options for differential coverage based on taxpayer adjusted gross income and return complexity) of developing and running a free direct efile tax return system, including costs to build and administer each release, with a focus on multi-lingual and mobile-friendly features and safeguards for taxpayer data; (II) taxpayer opinions, expectations, and level of trust, based on surveys, for such a free direct efile system; and (III) the opinions of an independent third-party on the overall feasibility, approach, schedule, cost, organizational design, and Internal Revenue Service capacity to deliver such a direct efile tax return system.

(3) **The Treasury Secretary's Response.** A month after the Act became law, on September 15, 2022, Secretary of the Treasury Yellen laid out priorities for allocation of the increased budget in a visit to an IRS facility:

- First, Treasury will fully staff **IRS Tax Assistance Centers**, where individual taxpayers can get help at an in-person location. In the last filing season, 900,000 Americans were helped in these Centers. With increased funding, Treasury projects that at least 2.7 million Americans (triple last filing season's amount) can be served. (Secretary Yellen noted that one study suggests that the average American spends 13 hours preparing and filing a return, compared to Sweden where some taxpayers can file simply by responding to a text message.)
- Second, the IRS will hire 5,000 additional customer service representatives at **call centers**. In the most recent filing season, call centers averaged a 10-to-15 percent "level of service," indicating that less than three out of every 20 calls were answered. The additional funding will greatly improve this, and Treasury is committed to reach an 85 percent level of service.
- Third, with the funds allocated for business modernization, "**the IRS will firmly move into the digital age**." For example, in many cases IRS employees manually transcribe paper returns. For the next filing season, the IRS will scan paper returns, leading to faster processing and faster refunds. In addition, the IRS will increase the capability for taxpayers to engage with the IRS online, including receiving and responding to notices from the IRS.
- Fourth, Treasury will engage "industry-leading customer service experts from the private sector" to advise on modernization efforts.

In addition, the IRS will dedicate increased budget resources to enforcement. Secretary Yellen elaborated the need for that:

> The world has become more complex. Enforcing tax laws is not as simple as it was a few decades ago. Average tax returns for large corporations now reach 6,000 pages. And more complicated partnerships have skyrocketed from less than 5% of total income in 1990 to over a third today. As a result, the tax gap – the

> amount of unpaid taxes – has grown to enormous levels. It's estimated at $7 trillion over the next decade. And since the IRS has lacked the resources to effectively audit high earners – whose audits are more complex and take more time – these high earners are responsible for a disproportionate share of unpaid taxes. To illustrate: In 2019, the top one percent of Americans was estimated to owe over a fifth of unpaid taxes – totaling around $160 billion. Data shows that less than half of all taxes from more complex sources of income are paid. Yet nearly all taxes due from wages and salaries – which are earned by ordinary Americans – are paid.

To address this, she emphasized that the IRS would refocus its enforcement priorities:

> Importantly, I've directed that enforcement resources will not be used to raise audit rates for households making under $400,000 a year relative to historical levels.

She had included that direction in an August 10, 2022, letter to IRS Commissioner Rettig.

In a follow-up memo to Commissioner Rettig on August 17, 2022, she noted that the Inflation Reduction Act had once required the IRS to produce an operational plan within six months, detailing how these additional resources would be deployed over the next decade, but that provision had been dropped from the Act to meet the requirements of the Senate parliamentary procedure rules that apply to budget reconciliation. Reviving that idea, she herself directed that such an operational plan be delivered to her within six months – that is, by February 17, 2023 (although, as that date approached, it appeared that the release of the report would occur a few weeks later).

More about the Treasury Secretary's remarks and the statistics she cited is available at https://home.treasury.gov/news/press-releases/jy0952#_ftnref10.

(4) The "omnibus" Consolidated Appropriations Act, 2023 that President Biden signed on December 29, 2022, included only $12.3 billion for the IRS for fiscal year 2023 (which ends September 30, 2023). This is lower than the $12.6 billion appropriated for fiscal year 2022 and lower than the $14.1 billion President Biden had requested for fiscal year 2023.

A Summary of the Financial Services and General Government provisions of the act (available at **https://www.appropriations.senate.gov/imo/media/doc/FSGG FY 23.pdf**) published by the Senate Appropriations Committee on December 19, 2022, commented on the reduction from the prior year by **stating** that "[f]unds have not been provided for business systems modernization since funds are available for that activity from unobligated balances in the American Rescue Plan."

f. **Senator Wyden's Mark-to-Market "Billionaires Income Tax"**

Other approaches to increasing taxes on the very wealthy have also been offered or revived during this time of negotiation, adaptation, and uncertainty. An example is Finance Committee Chair Ron Wyden's "Treat Wealth Like Wages" proposal, rolled out on October 27, 2021, as the "Billionaires Income Tax." Although the proposal was not well received, including by some Democrats, and was not included in the bill the House passed on November 19, 2021, it will remain "on the shelf" for possible future retrieval for its revenue-raising potential, as it appears to be a rather thorough drafting job. Indeed, the draft of statutory language is 107 pages long, and the following is just a simplified summary of how it would work in general if it ever were enacted.

Effective January 1, 2022, the Billionaires Income Tax would add a new Part IV, consisting of sections 490 through 498, to subchapter E of the Internal Revenue Code, which is titled "Accounting Periods and Methods of Accounting." The core provisions of Part IV would tax the appreciation of "**covered assets**" held by "**applicable taxpayers**." (Other provisions of the Billionaires Income Tax would, for "applicable taxpayers," tighten the rules applicable to deferred compensation, private placement life insurance or annuity contracts, qualified small business stock, and qualified opportunity funds.)

(1) **"Applicable Taxpayer."** An "applicable taxpayer" includes an individual taxpayer who has **either** modified adjusted gross income exceeding $100 million (the "income test") **or** covered assets with an aggregate value exceeding $1 billion (the "asset test") in **each** of the three preceding years. Either the income test or the asset test must be met in each of those three years; it is not

necessary that the same test be met each year. In applying the income test, "modified adjusted gross income" means AGI plus tax-exempt interest, excluded social security benefits, and foreign or offshore earned income excluded under sections 911, 931, and 933. In applying the asset test, values are determined under guidelines in the proposal and reduced by the taxpayer's debt. Once acquired, "applicable taxpayer" status is not terminated until the taxpayer meets **neither** the income text **nor** the asset test (applying those tests with only one-half of their respective thresholds) for **all** of the three consecutive years and has made an election (as and when the IRS prescribes) for the first of those three years.

(a) **Married Couples.** Married couples are treated as one taxpayer, and a newly married couple is an applicable taxpayer if either spouse was an applicable taxpayer before the marriage. The thresholds of the tests are halved for a married person filing separately, but both spouses are treated as applicable taxpayers if one of them meets the tests.

(b) **Trusts.** A nongrantor trust (including a trust deemed-owned under section 678 by someone other than the grantor) is an applicable taxpayer if it likewise meets one of the two tests in each of the three preceding years, but the thresholds for those tests are one-tenth of what they are for individuals – that is, $10 million for the income test (applied before any distribution deduction) and $100 million for the asset test. There are exceptions for certain charitable trusts and other trusts favored under the Internal Revenue Code. A grantor trust cannot be an applicable taxpayer, but the assets of a grantor trust (as well as the income, of course) are taken into account in applying the asset test to the grantor.

(c) **Estates.** A decedent's estate is an applicable taxpayer if the decedent was an applicable taxpayer for the year of death or any of the three preceding years. In other words, a decedent's estate will not suddenly become subject to these rules when the decedent was not. This is in contrast to some other changes in the law under consideration, such as the 3 and 8 percent surcharge on trusts, where the threshold applicable to the estate would be $200,000 instead of the $10 million threshold applicable to the decedent. (Of course, a decedent's estate will typically receive appreciated assets, whether tradable or not, with a stepped-up basis, either under current law or under the deemed realization provisions of this proposal (see paragraph (4) below), and therefore these rules might not have immediate significance for estates anyway.)

(2) **"Covered Asset."** A "covered asset" is basically any asset except a retirement plan or similar account favored under the Internal Revenue Code, cash or a cash equivalent, or a private placement life insurance or annuity contract (as defined in a new section 72(e)(12) that the proposal would add to the Code). There are special rules, including attribution rules and reporting requirements, regarding certain entities in which an applicable taxpayer holds an interest. A covered asset is a **"tradable covered asset"** if it is traded or tradable on an established market (or the substantial equivalent thereof) or electronic platform or if there otherwise is a reasonable basis to annually determine the asset's fair market value. Any covered asset that is not thereby considered "tradable" is viewed for purposes of the proposed legislation as a **"nontradable covered asset."**

(3) **Mark-to-Market for Tradable Covered Assets.** In general, a tradable covered asset (and, generally, at the owner's election, any nontradable covered asset) would be marked to market – that is, gain or loss would be recognized for income tax purposes – at the end of each year, or at any time during the year immediately before a nontaxable transfer such as an exchange for stock under section 351 or a like-kind exchange under section 2031.

(4) **Deemed Realization upon Gift or at Death.** Recalling other deemed realization proposals (see Parts 1.c and 1.e above), the proposal would provide that if an applicable taxpayer (or a defined related entity) transfers a covered asset "by gift, upon death, or in trust" (including specified in-kind distributions by estates or trusts), gain is recognized as if the asset had been sold at its fair market value. Loss is similarly recognized, but only for such transfers at death. There are certain exceptions for transfers to or for a spouse or charity.

(5) **Deferral Recapture for Nontradable Covered Assets.** If an applicable taxpayer transfers a nontradable covered asset either in a sale, exchange, disposition, or other transfer in which gain is recognized or in a nontaxable transfer such as an exchange for stock under section 351 or a like-kind exchange under section 2031, the taxpayer must pay a "deferral recapture amount" to generally emulate what would have been the interest on the tax owed if the asset had been marked to market annually throughout the taxpayer's holding period like a tradable covered asset, using an interest rate that is two percentage points lower than the rate on underpayments under section 6621(a)(2).

g. **Other Suggestions**

(1) **Wealth Tax.** Another suggestion, which has been in print a little longer than Senator's Wyden's Billionaires Income Tax, is the "Ultra-Millionaire Tax Act of 2021" introduced in this Congress on March 1, 2021, by Senator Elizabeth Warren of Massachusetts (S. 510) and Congressional Progressive Caucus Chair Pramila Jayapal of Washington (H.R. 1459). Beginning in 2023, the Ultra-Millionaire Tax Act would impose an annual tax on the net worth of individuals (treating married individuals as one) and trusts. The tax would be 2 percent over a threshold of $50 million and an additional 1 percent (totaling 3 percent) over a threshold of $1 billion.

(2) **"For the 99.5 Percent Act."** And then of course there are the proposals focusing on the transfer tax in the many editions of Senator Sanders' bill, currently called the "For the 99.5 Percent Act." (See Part 1.b above.)

3. The Administration's Fiscal Year 2023 Budget Proposals

The Treasury Department released its "General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals" (popularly called the "Greenbook") on March 28, 2022. See **https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf**. Many of its proposals resemble legislative proposals made last year (including in the Fiscal Year 2022 Greenbook) that were not included in the "Build Back Better Act" (H.R. 5376) passed by the House of Representatives on November 19, 2022.

In an election year with a sharply divided Congress, it is likely that **none** of the Greenbook proposals will be acted on. On March 15, 2022, President Biden signed the Consolidated Appropriations Act, 2022 (Public Law 117-105), which provided funding for the federal government for the fiscal year ending September 30, 2022. That Act was not a budget reconciliation act, however, leaving open the **theoretical possibility** that the budget reconciliation process could still be used to enable the Senate, without needing 60 votes to end debate, to pass a presumably trimmed-down version or replacement of the "Build Back Better Act," **possibly** including some of these Greenbook proposals. On the other hand, the funding of the government through September 30 removed one of the motivations that has produced last-minute congressional tax legislation in the past to prevent a politically embarrassing government shutdown. Then, after enactment of a very different reconciliation act on August 16, 2022 (see Part 2.e above), other tax legislation became even less likely.

So, while it is **possible** that some of the following proposals could be picked up and added to some pending bill for a number of reasons – including policy, revenue, conformity and balance, negotiation, inattention, or a combination of these, **it would not be easy**.

Even so, whenever we see legislative proposals articulated like this, it is important to pay attention, because they are constantly evolving and could be pulled from the shelf and enacted, if not this year then in the future when the political climate is different. Such proposals never completely go away. And each time they are refined and updated, we can learn more about what to watch for and how to react.

a. **Individual Income Tax Rates, Including Capital Gains**

Like last year's Greenbook (discussed in Part 1.e above), the current Greenbook proposes (at page 29) to accelerate the return of the top marginal individual income tax rate to 39.6 percent (as it was before 2018 and will be again in 2026 under the 2017 Tax Act), effective January 1, 2023. Unlike last year, however, it would lower the levels of taxable incomes at which that rate would apply to

$450,000 for joint returns, $400,000 for unmarried individuals (other than surviving spouses), $425,000 for heads of households, and $225,000 for married individuals filing separate returns. After 2023, the thresholds would be indexed for inflation using the "Chained CPI" ("C-CPI-U") that was introduced in the 2017 Tax Act. This proposal is estimated to raise approximately $187 billion over the next 10 fiscal years. (Overall, the tax increases proposed by the Greenbook are estimated to raise revenue over the next 10 fiscal years by about $2.5 trillion.)

Also mirroring last year's Greenbook, the current Greenbook proposes (at page 31) to tax capital gains and qualified dividends at the same rate as ordinary income (that is, 37 percent under current law or 39.6 percent as proposed). This would apply to taxpayers with taxable income (not adjusted gross income as in last year's proposal) over $1 million ($500,000 for married individuals filing separately). It would be effective for gains "required to be recognized" and dividends received on or after the date of enactment (not the puzzling "date of announcement" as in last year's proposal).

b. **Deemed Realization of Capital Gains**

In terms almost identical to last year's budget proposal, the Greenbook (at pages 30-33) again advocates the "deemed realization" of capital gains upon transfers by gift and at death.

(1) **Effective Date.** The proposal would take effect on January 1, 2023. But it would apply to pre-2023 appreciation; there would be no "fresh start" as, for example, in the 1976 carryover basis legislation.

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

(3) **Taxpayer, Return, and Deductibility.** The Greenbook states that the gain would be reported "on the Federal gift or estate tax return or on a separate capital gains return." Reassuringly, however, the Greenbook confirms that the gain "would be taxable income to the decedent" and, consistently with that characterization, explicitly adds that "the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any)." That means that, after all exclusions are used, the proposed 39.6 percent capital gains rate and the current 40 percent estate tax rate would produce a combined tax rate on appreciation of 63.76 percent ($0.396 + 0.4 \times (1 - 0.396)$).

(4) **Exclusion for Tangible Personal Property.** The Greenbook would exclude "tangible personal property such as household furnishings and personal effects (excluding collectibles)."

(5) **Exclusion for Transfers to Spouses.** The Greenbook would exclude "[t]ransfers to a U.S. spouse." There is no elaboration of the term "U.S. spouse" (for example, citizen or resident), and there are no special provisions targeted to spousal trusts. Transfers to a spouse would carry over the transferor's basis. Thus, the effect of excluding transfers to spouses would be simply to defer the application of the deemed realization rules until the spouse's disposition of the asset or the spouse's death.

(6) **Exclusion for Transfers to Charity.** The Greenbook would exclude "[t]ransfers … to charity." It adds that "[t]he transfer of appreciated assets to a split-interest trust would be subject to this capital gains tax, with an exclusion from that tax allowed for the charity's share of the gain based on the charity's share of the value transferred as determined for gift or estate tax purposes." Like transfers to a spouse, transfers to charity would carry over the transferor's basis.

(7) **Other Exclusions.** The Greenbook proposes a unified exclusion of capital gains for transfers both by gift and at death of $5 million per person (up from $1 million last year), indexed for inflation after 2022 and "portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes." The Greenbook adds that this would "result … in a married couple having an aggregate $10 million exclusion," but, like last year's Greenbook, it

does not explain exactly how that would be accomplished for lifetime gifts when there has been no "decedent" or "surviving spouse." The Greenbook does not address whether the use of the exclusion for lifetime gifts is mandatory or elective. But it adds, quixotically and without further elaboration, that the $5 million exclusion "would apply only to unrealized appreciation on gifts to the extent that the donor's cumulative total of lifetime gifts exceeds the basic exclusion amount in effect at the time of the gift." Could it be saying, in effect, that a lifetime gift must actually generate a gift tax liability for the donor to use this $5 million exclusion of gain during life? So the first $12 million or so of gifts would trigger recognition of gain, and after that gifts with $5 million of appreciation would escape deemed realization, and after that gifts would trigger gain again? Odd.

But in an apparent reversal of last year's Greenbook (see Part 1.e(7) above), the current Greenbook states that "[t]he recipient's basis in property, whether received by gift or by reason of the decedent's death, would be the property's fair market value at the time of the gift or the decedent's death" (except, presumably, for excluded transfers to spouses and to charity discussed above). Last year's Greenbook, not surprisingly, included the caveat that "the donee's basis in property received by gift during the donor's life would be the donor's basis in that property at the time of the gift to the extent the unrealized gain on that property counted against the donor's $1 million exclusion from recognition." Could it be that the current Greenbook would increase that proposed $1 million exclusion to $5 million and at the same time allow a stepped-up basis even if the gain is excluded? Although surprising, that would be a significant simplification.

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

The Greenbook also confirms that the exclusion under current law for capital gain on certain small business stock under section 1202 would apply.

(8) **Netting of Gains and Losses.** For transfers at death, capital losses and carry-forwards would be allowed as offsets against capital gains and up to $3,000 of ordinary income, mirroring the current income tax rules for lifetime realization events in sections 1211 and 1212. There is no mention of relaxing the rules of section 267 prohibiting the deduction of losses from sales or exchanges between related persons, but it seems almost certain that those rules would be relaxed in any provision for taking losses into account at death, where transfers to related persons are the norm.

(9) **Valuation.** As noted above, the Greenbook contemplates that a transfer generally "would be valued at the value used for gift or estate tax purposes." The Greenbook adds that "a transferred partial interest generally would be valued at its proportional share of the fair market value of the entire property." In other words, no entity-level discounts. But, elaborating the word "generally," which is new this year, the Greenbook also helpfully adds that "this rule would not apply to an interest in a trade or business to the extent its assets are actively used in the conduct of that trade or business."

(10) **Special Rules for Trusts and Entities.** The Greenbook provides that transfers into, and distributions in kind from, a trust would be recognition events, unless the trust is a grantor trust deemed wholly owned and revocable by what the Greenbook calls "the donor." Again there is no exclusion or exemption for pre-2023 gain, and indeed the Greenbook explicitly states that the proposal would apply to "certain property owned by trusts … on January 1, 2023." In other words, this proposed recognition treatment would apply to distributions of appreciated assets to both current and successive or remainder beneficiaries of preexisting trusts, including, for example, a pre-2023 GRAT. With regard to revocable trusts, the deemed owner would recognize gain on the unrealized appreciation in any asset distributed (unless in discharge of the deemed owner's obligation) to anyone other than the deemed owner or the deemed owner's "U.S.

spouse" (again undefined), and on the unrealized appreciation in all the assets in the trust when the deemed owner dies or the trust otherwise becomes irrevocable.

Last year's Greenbook went a lot farther and, surprisingly, provided that the rules about transfers into and distributions in kind from a trust would also apply to a "partnership" or "other non-corporate entity," without further explanation. The current Greenbook clarifies that this extension to such entities applies "if the transfers have the effect of a gift to the transferee."

The Greenbook also proposes, in effect, a 90-year mark-to-market rule:

> Gain on unrealized appreciation also would be recognized by a trust, partnership, or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years. This provision would apply to property not subject to a recognition event since December 31, 1939, so that the first recognition event would be deemed to occur on December 31, 2030.

Again assets of partnerships and other entities are included, in this case without a gift-equivalent requirement or other explanation. Because December 31, 2030, is 91, not 90, years from December 31, 1939, it appears that the Greenbook contemplates recognition only at the end of the year, but the Greenbook does not clarify that. And, because it does not depend on any arguable recognition "event" like a gift, death, or other transfer, this 90-year mark-to-market rule is probably the feature of this proposal that would most likely attract a constitutional challenge.

(11) **Deferral of Tax.** The Greenbook also provides that "[t]axpayers could elect not to recognize unrealized appreciation of certain family-owned and -operated businesses until the interest in the business is sold or the business ceases to be family-owned and operated." This is a helpful clarification of last year's Greenbook, which provided only that the "[p]ayment of tax … would not be due." Deferral could increase the amount of tax if there is more appreciation, but it could also prevent the payment of tax to the extent the value of the business declines (which sometimes happens after the death of a key owner). That approach would apparently also tax the realization event at whatever the tax rates happen to be at the time, which might sometimes be a vexing consideration in the executor's decision to make this election.

If that election is made, would it still be true, as the Greenbook states in the context of exclusions immediately before its discussion of deferral, that "[t]he recipient's basis in property, whether received by gift or by reason of the decedent's death, would be the property's fair market value at the time of the gift or the decedent's death"? Probably not, because mere deferral of deemed realization (regardless of the amount of gain deferred) is much different from the total escape from realization provided by the limited exclusion. Thus, the loss of a stepped-up basis at intervening deaths could make this ultimate income tax liability much more severe than under current law.

And of course the statutory language implementing this Greenbook proposal should be expected to include definitions of a "business," "family-owned," and "family-operated" and possibly rules for the identification of assets that should be excluded from the deferral because they are not used in the business, and such definitions and rules might also create or aggravate challenges over a long-term deferral. The IRS would also be authorized to require reasonable security at any time from any person and in any form acceptable to the IRS, which could be another complication for the family business, for example in raising capital, over a long-term deferral.

In addition, the Greenbook would allow "a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made." Details about start dates and interest rates are not provided, but the proposal appears much broader and more robust than, for example, section 6166 with its multiple qualification tests.

(12) **Administrative Provisions.** The Greenbook envisions (but without details) a number of other legislative features, covering topics such as a deduction for the full cost of related appraisals, the waiver of penalties for underpayment of estimated tax attributable to deemed realization of gains at death (which, of course, would not have been foreseeable), a right of recovery of the tax on unrealized gains, rules to determine who selects the return to be filed, consistency in valuation

for transfer and income tax purposes, and coordination of the changes to reflect that the recipient would have a basis in the property equal to the value on which the capital gains tax is computed.

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

(14) **Revenue Estimate.** Taxing capital gains at the same rate as ordinary income for taxpayers with taxable income over $1 million and the proposed "deemed realization" of capital gains together are estimated to raise approximately $174.5 billion over the next 10 fiscal years.

c. **Minimum Tax on the Wealthiest Taxpayers**

This provision, new in the current Greenbook (at pages 34-36), is an adaptation of Senator Wyden's "Treat Wealth Like Wages" proposal, rolled out to a very lukewarm reception as his "Billionaires Income Tax" on October 27, 2021. See Part 2.f above. The Greenbook version proposes a minimum tax, effective January 1, 2023, of 20 percent of total income, generally including unrealized capital gains, for taxpayers with "wealth" (that is, assets minus liabilities) greater than $100 million. Taxpayers could choose to pay the minimum tax liability in equal annual installments over nine years for the first year of minimum tax liability and over five years for subsequent years. The minimum tax payments would be treated as a prepayment to be credited against subsequent taxes on realized gains to avoid taxing the same amount of gain more than once.

Taxpayers with tradable assets constituting less than 20 percent of their wealth would be treated as "illiquid" and could elect to include the unrealized gain only for tradable assets in determining the annual minimum tax, "subject to a deferral charge upon, and to the extent of, the realization of gains on any non-tradable assets" (not to exceed 10 percent of unrealized gains). No estimated payments would be required for the minimum tax. Taxpayers with wealth over the $100 million threshold would have to report annually the total basis and total estimated value of assets in each specified asset class, with alternatives to appraisals available for valuing non-tradable assets.

This proposal is estimated to raise approximately $361 billion over the next 10 fiscal years. The constitutionality of either the wealth trigger, or the taxation of unrealized appreciation, or both, might be challenged in court.

Statutory language for this proposal, with some embellishments, appears in the "Billionaire Minimum Income Tax Act" (H.R. 8558), introduced on July 28, 2022, by Representative Steve Cohen (D-Tennessee), with 32 cosponsors (all Democrats). Among the embellishments in H.R. 8558 is a provision requiring the "wealth" used to determine the applicability of the tax to any taxpayer to include (1) any asset of a trust treated as owned by the taxpayer under sections 671-679, (2) any asset of any other trust if the asset or the income (in whole or in part) therefrom is "distributable" to the taxpayer (not including distribution rights are contingent upon the death of another trust beneficiary), and (3) any gratuitous transfers by the taxpayer within the last five years (other than charitable contributions, transfers to a spouse or former spouse incident to divorce under section 1041, and transfers to a spouse who is also subject to this tax). Under H.R. 8558, the requirement for annual reporting contemplated by the Greenbook would be spelled out in regulations.

d. **Modify Income, Estate and Gift Tax Rules for Certain Grantor Trusts**

The Greenbook (at page 40) laments that "[i]ndividuals who own assets expected to appreciate in value use two common techniques for reducing estate taxes that exploit the gift and income tax features of grantor trusts to remove value from their gross estates." Those two exploitative techniques turn out to be GRATs (which many would point out were created by Congress in section 2702(b)(1)) and sales of appreciating assets to grantor trusts (which, likewise, many would point out are facilitated by Congress's use of the phrase "treated as the owner" in sections 673 through 677 and its treatment of income tax as a liability of that owner under section 671). Be that as it may, the Greenbook (at pages 40-42) invites Congress to blaze a new trail.

(1) **GRATs.** Like the Obama Administration Greenbooks, and similarly to section 7 of Senator Sanders' "For the 99.5 Percent Act" (discussed in Part 1.b(7) above), the Greenbook would impose on GRATs

- a minimum term of 10 years,
- a maximum term of the life expectancy of the annuitant plus 10 years,
- a prohibition on any decrease in the annuity during the GRAT term (which otherwise might be used to reduce the amount includable in the grantor's gross estate if the grantor dies before the end of the GRAT term),
- a minimum remainder value equal to the greater of 25 percent of the assets contributed to the GRAT or $500,000 (but not more than the value of assets contributed to the GRAT), which would put an end to the very common and effective technique of zeroed-out or nearly-zeroed-out GRATs, and
- a prohibition on the grantor's acquisition of any asset from the GRAT in an exchange without recognizing gain or loss on the exchange.

This proposal would apply to GRATs created on or after the date of enactment. If this proposal gained traction and was given a reasonable chance of being enacted, that might encourage the creation and funding of GRATs before enactment, which would avoid the first four limitations, particularly the huge fourth limitation of a minimum 25 percent remainder value. But merely creating a GRAT before enactment would not necessarily avoid the fifth limitation, because the proposals discussed in Part 3.b(10) above and paragraph (2) below would apparently also require a GRAT to recognize gain if the annuity payments were made with appreciated assets. (The gain recognition risk might be minimized, if feasible, by using a longer term GRAT in which the annuity amounts were low enough that they could be satisfied out of income, not with in-kind distributions.)

(2) **Recognition of Gain on Sales Transactions with Grantor Trusts.** For trusts not fully revocable by the deemed owner, "the transfer of an asset for consideration between a grantor trust and its deemed owner" would result in the recognition of gain. The proposal uses the term "deemed owner" (which implies that it includes a person other than the grantor under section 678) and also the term "grantor trust" (which sometimes implies that a trust treated as owned by a person other than the grantor is not included). The proposal would apply both to sales and to transfers in satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property. It would apply to transactions on or after the date of enactment. And it would significantly overlap with the deemed realization proposals for trusts discussed in Part 3.b(10) above.

(3) **Payment of Income Tax by Deemed Owner as Gift.** The payment by the "deemed owner" of income tax on the income of a "grantor trust" would be a gift by the deemed owner "unless the deemed owner is reimbursed by the trust during that same year" in which the tax is paid. Again, the proposal uses the clashing terms "deemed owner" and "grantor trust."

The Greenbook states that the gift would generally occur "on December 31 of the year in which the income tax is paid." Acknowledging the need for some exceptions to that rule, the Greenbook adds "if earlier, immediately before the owner's death, or on the owner's renunciation of any reimbursement right for that year." But even that addition does not specifically provide for cases where the reimbursement is made only in the trustee's discretion and not as the deemed owner's "right," or where the "reimbursement right" terminates other than by the owner's renunciation, or when grantor trust (or "deemed owned") status itself terminates other than by the owner's death. Likewise, the Greenbook does not address how to determine the year in which the deemed owner pays the income tax on the trust's income when some of the deemed owner's income tax liability is paid by quarterly estimated payments, three of which have been made in the year before the income tax return is filed, or by overpayments applied from the previous year's return. It is almost certain, however, that all such payments would be treated as made in the year the tax is due, because otherwise the notion of being "reimbursed by the trust during that same year" would make no sense.

And of course the annual reimbursement of such taxes pursuant to either a requirement or an exercise of discretion pursuant to an understanding or prearrangement would create a risk of including the value of the trust assets in the grantor's gross estate under section 2036 as applied in Rev. Rul. 2004-64, 2004-2 C.B. 7.

This proposal would apply to all trusts created on or after the date of enactment (which, if the proposal gains any traction, could provide an incentive to create and fund grantor trusts before the date of enactment).

(4) **Revenue Estimate.** These proposals together are estimated to raise approximately $41.5 billion over the next 10 fiscal years.

e. **Consistent Valuation of Promissory Notes**

(1) **Background.** Loans with an interest rate equal to the applicable federal rate (AFR) incorporated into section 7872 are not treated as gifts, but the lender may take the position that the note should be discounted for gift tax purposes on a later re-transfer or for estate tax purposes at death because the interest rate is lower than a commercial rate at the time. Section 7872, added to the Code by the Deficit Reduction Act of 1984 (Public Law 98-369, July 18, 1984), authorized the issuance of regulations to address the estate tax valuation of notes, and proposed regulations were promptly promulgated but have never been finalized. Meanwhile, although the note is included in the decedent's gross estate, it is possible that it could be valued **for estate tax purposes** at less than its face amount, under general valuation principles, because section 7872 is not an **estate tax** valuation rule. That would be especially true if interest rates rise between the date of the sale and the date of death.

Section 7872(i)(2) states:

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

Proposed Reg. §20.7872-1 (published on August 20, 1985, barely a year after the enactment of section 7872) states:

> For purposes of chapter 11 of the Internal Revenue Code, relating to estate tax, a gift term loan … that is made after June 6, 1984, shall be valued at the lesser of:
>
> > (a) the unpaid stated principal, plus accrued interest; or
> >
> > (b) the sum of the present value of all payments due under the note (including accrual interest), using the applicable Federal rate for loans of a term equal to the remaining term of the loan in effect at the date of death.
>
> No discount is allowed based on evidence that the loan is uncollectible unless the facts concerning collectibility of the loan have changed significantly since the time the loan was made. This section applies with respect to any term loan made with donative intent after June 6, 1984 [the effective date of section 7872], regardless of the interest rate under the loan agreement, and regardless of whether that interest rate exceeds the applicable Federal rate in effect on the day on which the loan was made.

The estate planner's answers to the proposed regulation would include the arguments that

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

With respect to the first point, it is arguable that section 7872(i)(2) itself requires consistency even in the absence of regulations (although it still might be unclear what "consistency" means in that context). Tax Court Judge Tannenwald distinguished between "how" regulations and "whether" regulations in *Estate of Neumann v. Commissioner*, 106 T.C. 216 (1996). Section 2663(2) provides that "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this chapter, including … regulations (consistent with the principles of chapters 11 and 12) providing for the application of this chapter [the GST tax] in the case of transferors who are nonresidents not citizens of the United States." This, Judge Tannenwald held, refers to a "how" regulation that is not a necessary condition to the imposition of the GST tax on transfers by nonresident noncitizens. Similar results with reference to the phrase "under regulations" (which is the phrase also used in section 7872(i)(2)) were reached in *Francisco v. Commissioner*, 119 T.C. 317 (2002), and *Flahertys Arden Bowl, Inc. v. Commissioner*, 115 T.C. 269 (2000). Compare section 465(c)(3)(D), which provides that a special rule "shall apply only to the extent provided in regulations prescribed by the Secretary." *Alexander v. Commissioner*, 95 T.C. 467 (1990). Also compare *Frazee v. Commissioner*, 98 T.C. 554 (1992), and *Estate of True v. Commissioner*, T.C. Memo. 2001-167, *aff'd*, 390 F.3d 1210 (10th Cir. 2004), discussing other proposed regulations under section 7872.

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

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.

The 2015-2016 Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015, released on July 31, 2015, included a project, new that year, titled "Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872." It was retained in the 2016-2017 Priority Guidance Plan but dropped from the slimmed-down 2017-2018 Plan published October 20, 2017, by the Trump Administration. It is not clear that this guidance project was related to Proposed Reg. §20.7872-1, which it does not cite. This project was joined in the 2016-2017 Plan by an item under the subject of "Financial Institutions and Products" described as "Regulations under §7872. Proposed regulations were published on August 20, 1985." When the promissory notes project was dropped from the subject of "Gifts and Estates and Trusts" in the 2017-2018 Plan, that item under "Financial Institutions and Products" remained. It was carried over to the 2018-2019 Plan, but dropped from the 2019-2020 Plan. See Part 5.k(1) below.

(2) **The Current Greenbook Proposal.** Rather than following through on the existing statutory authority to adopt regulations addressing the issue, however, Treasury is now proposing in the Greenbook (at pages 43-44) a legislative solution that would limit the discount rate used to value the note for estate tax purposes to "the greater of the actual rate of interest of the note, or the applicable minimum interest rate for the remaining term of the note on the date of death." The Greenbook adds:

> The Secretary and her delegates (Secretary) would be granted regulatory authority to establish exceptions to account for any difference between the applicable minimum interest rate at the issuance of the note and actual interest rate of the note. In addition, the term of the note would be treated as being short term regardless of the due date, or term loans would be valued as demand loans in which the lender can require immediate payment in full, if there is a reasonable likelihood that the note will be satisfied sooner than the specified payment date and in other situations as determined by the Secretary.

Exceptions "to account for any difference between the applicable minimum interest rate at the issuance of the note and actual interest rate of the note" would certainly be appropriate. Otherwise, for example, a note with a commercially reasonable interest rate, such as a note a seller of a home might take back from an unrelated buyer, might be artificially overvalued for estate tax purposes if its true value was depressed because market interest rates had risen.

Subject to what such regulations might provide, it appears that valuing a note by discounting future payments of principal and interest at a discount rate equal to that interest rate would be tantamount to simply valuing the note at its face amount of unpaid stated principal plus accrued interest, the same as in Proposed Reg. §20.7872-1(a) or, for that matter, the general rule in Reg. §20.2031-4 (both quoted above).

The Greenbook states that "[t]he proposal would apply to valuations as of a valuation date on or after the date of introduction." Presumably that means the introduction of legislation specifically drafted to implement proposals in this Greenbook, but it is left to the legislation itself to clarify that. In any event, the date of introduction is a rather bold effective date approach, usually reserved for cases where Congress perceives a particular abuse or other need for urgency. An argument for urgency, of course, could be somewhat awkward in a context that includes proposed regulations that have been pending since 1985. On the other hand, the argument described above that section 7872(i)(2) itself already requires consistency could make it awkward to object to that effective date as a surprise or as unfair.

This proposal is estimated to raise approximately $6.4 billion over the next 10 fiscal years.

f. **Limited Duration of GST Exemption**

The Greenbook (at page 48) muses that "[a]t the time of the enactment of the GST provisions, the law of most States included the common law Rule Against Perpetuities (RAP) or some statutory version of it …" It's easy to see where that is headed.

The Greenbook (at pages 48-49) proposes that

> the GST exemption would apply only to: (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor [for example, to grandchildren but not great-grandchildren of the transferor], and to younger generation beneficiaries who were alive at the creation of the trust; and (b) taxable terminations occurring while any person described in (a) is a beneficiary of the trust.

Therefore, trusts would continue to be exempt, not for the full life of the trust (for example, throughout the entire applicable rule against perpetuities period), but only for the life of any first- or second-generation beneficiary or any younger generation beneficiary who was alive at the creation of the trust. The "reset" rule of section 2653(a) would not apply. The Greenbook states that the special rule in section 2653(b)(2) for "pour-over trusts" created from a trust (whether under the trust instrument or under a decanting authority) would continue to apply, with such pour-over trusts deemed to have the same date of creation as the initial trust for purposes of determining the duration of the GST exemption.

This provision limiting the duration of the allocation of GST exemption would apply retroactively to existing trusts, but for purposes of determining the duration of the GST exemption "a pre-enactment trust would be deemed to have been created on the date of enactment."

By allowing allocation of GST exemption and only limiting how long it lasts, the Greenbook proposal could be less harsh than, for example, section 9 of Senator Sanders' "For the 99.5 Percent Act" (discussed in Part 1.b(9) above), which in effect would deny any exemption **allocation** if the trust **could** last longer than 50 years.

Not surprisingly, this proposal focused on trust distributions to great-grandchildren is not projected to affect revenue over the next 10 fiscal years.

g. **Miscellaneous Trust and Estate Tax Provisions**

A section of the Greenbook (at pages 45-47) titled "Improve Tax Administration for Trusts and Decedents' Estates" proposes a number of changes, none of which were included in last year's Greenbook.

(1) **Expanded Definition of Executor.** The definition of executor would be moved from section 2203 to section 7701, and the authorized party could act for all tax purposes (including with respect to pre-death tax liabilities). This would apply after enactment regardless of a decedent's date of death.

(2) **Increased Benefit of Special Use Valuation.** As in the House Ways and Means Committee's version of the "Build Back Better Act" (discussed in Part 2.b(6) above), the Greenbook proposes to increase the limit on the reduction in value of special use property from $750,000 (indexed, $1.23 million in 2022) to $11.7 million, applicable for decedents dying on or after the date of enactment. As noted in Part 2.b(6), however, despite this proposal's family-business-friendly curb appeal, it would not really reduce the estate tax on a family farm or business as such; it would merely prevent a tax, for example, on a speculative prospect of development that is faced by such businesses very unevenly.

(3) **Extension of 10-Year Estate and Gift Tax Lien.** The automatic 10-year lien for estate and gift tax would be extended during any deferral or installment period for unpaid estate and gift taxes. This provision would apply for existing 10-year liens and for the automatic lien that applies for gifts made or estates of decedents dying on or after the date of enactment.

(4) **Reporting of Estimated Value of Trust Assets.** In a change that could be very burdensome and very significant, trusts would be required to file with the IRS annual reports including the name, address, and taxpayer identification number (TIN) of each trustee and grantor of the trust, and general information with regard to the nature and estimated total value of the trust's assets (which might be satisfied by identifying an applicable range of estimated total value on the trust's income tax return). The reporting requirement would apply to taxable years ending after the date of enactment for trusts valued over $300,000 or with gross income over $10,000.

(5) **Revenue Estimate.** These proposals together are estimated to decrease revenue by $326 million over the next 10 fiscal years, probably attributable to the relaxation of the limit on the availability of special use valuation.

h. **Not Included in the Greenbook**

The Fiscal Year 2023 Greenbook proposals do not include the following measures that were in the September 15, 2021, House Ways and Means Committee version of the "Build Back Better Act" (discussed in Part 2.b above):

- A reduction of the estate and gift tax exclusion amount prior to 2026.
- A new section 2901 aligning the income tax and transfer tax treatment of grantor trusts (although, as discussed above, the Greenbook would remove two huge tax advantages of grantor trusts -- (1) the grantor's payment of income taxes as a transfer free of gift tax and (2) the grantor's ability to enter into sales, swaps, or other transactions with the trust without an income tax recognition event).
- Look-through valuation rules for nonbusiness assets in entities.

4. Requirements of the Regulatory Process

a. **Effects of Executive Orders**

(1) Executive Order 13789 of April 21, 2017, famous for ordering the action that led to the withdrawal in October 2017 of the August 2016 proposed section 2704 regulations, also directed the Treasury Department and the Office of Management and Budget (OMB) to "review and, if appropriate, reconsider the scope and implementation of the existing exemption for certain tax

regulations from the review process set forth in Executive Order 12866 and any successor order."

(2) Executive Order 12866, which was signed by President Clinton on September 30, 1993, requires generally that Treasury

(a) periodically provide the Office of Information and Regulatory Affairs (OIRA) within OMB with a list of its planned regulatory actions, including those it believes are "significant regulatory actions" (section 6(a)(3)(A) of Executive Order 12866),

(b) for each "significant regulatory action," provide to OIRA "(i) [t]he text of the draft regulatory action, together with a reasonably detailed description of the need for the regulatory action and an explanation of how the regulatory action will meet that need; and (ii) [a]n assessment of the potential costs and benefits of the regulatory action, including an explanation of the manner in which the regulatory action is consistent with a statutory mandate and, to the extent permitted by law, promotes the President's priorities and avoids undue interference with State, local, and tribal governments in the exercise of their governmental functions" (section 6(a)(3)(B) of Executive Order 12866), and

(c) for each "significant regulatory action" that is likely to have an annual effect on the economy of $100 million or more, include the following regulatory impact assessment (section 6(a)(3)(C) of Executive Order 12866, emphasis added):

> (i) An assessment, *including the underlying analysis*, of *benefits* anticipated from the regulatory action (such as, but not limited to, the promotion of the efficient functioning of the economy and private markets, the enhancement of health and safety, the protection of the natural environment, and the elimination or reduction of discrimination or bias) together with, to the extent feasible, a *quantification* of those benefits;
>
> (ii) An assessment, *including the underlying analysis*, of *costs* anticipated from the regulatory action (such as, but not limited to, the direct cost both to the government in administering the regulation and to businesses and others in complying with the regulation, and any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness), health, safety, and the natural environment), together with, to the extent feasible, a *quantification* of those costs; and
>
> (iii) An assessment, *including the underlying analysis*, of costs and benefits of potentially effective and reasonably feasible *alternatives* to the planned regulation, identified by the agencies or the public (including improving the current regulation and reasonably viable nonregulatory actions), and *an explanation why the planned regulatory action is preferable to the identified potential alternatives*.

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

> any regulatory action that is likely to result in a rule that may:
>
> (1) Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;
>
> (2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;
>
> (3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or
>
> (4) Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive order.

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

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

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

  (a) Under paragraph 3 of the new Memorandum of Agreement, the frequency of providing the list of planned tax regulatory actions referred to in paragraph (2)(a) above is quarterly.

  (b) Under paragraph 8, the new Memorandum of Agreement was effective immediately, except that the regulatory impact assessment described in paragraph (2)(c) above was not required until the earlier of April 11, 2019, or "when Treasury obtains reasonably sufficient resources (with the assistance of OMB) to perform the required analysis."

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

(7) This did not work too badly in the tax context in the Trump Administration. For example, there did not appear to have been excessive delays. And there has been some bipartisan support for this type of oversight. So it is possible – but not certain – that it will continue in some form throughout the Biden Administration.

b. **Cases Construing the Administrative Procedure Act**

In *Hewitt v. Commissioner*, 128 AFTR 2d 2021-7033 (11th Cir. Dec. 29, 2021), *rev'g and rem'g* T.C. Memo. 2020-89, the Court of Appeals for the Eleventh Circuit held that the proceeds formula in Reg. §1.170A-14(g)(6)(ii), applicable upon judicial extinguishment of a conservation easement, was invalid because the IRS had failed to comply with the Administrative Procedure Act ("APA") by failing in the preamble to the final regulations to address a comment on the proposed regulations that the appellate court considered significant. The Tax Court and a three-judge panel of the Sixth Circuit have rejected that argument and have held that the formula is valid. *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. 180 (reviewed by the Court) (2020), *aff'd*, 129 AFTR 2d 2022-1031 (6th Cir. March 14, 2022), *rehearing en banc denied*, 130 AFTR 2d 2022-5017 (6th Cir. July 6, 2022). See Nancy A. McLaughlin, *Conservation Easements and The Proceeds Regulation*, 56 REAL PROP., TRUST & EST. LAW J. (Summer 2021), and 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 this difference of opinion is ultimately resolved as the Eleventh Circuit sees it, the burden of preparing final regulations and the preambles thereto might significantly increase. The effect on the regulatory process, especially in light of the additional burdens already imposed under the executive orders discussed above, is hard to predict.

5. 2022-2023 Priority Guidance Plan

On November 4, 2022, the Treasury Department and the IRS released the second Priority Guidance Plan in the Biden Administration (**https://www.irs.gov/pub/irs-utl/2022-2023-pgp-initial.pdf**) for the plan year from July 1, 2022, through June 30, 2023. The introduction to the 2022-2023 Plan states:

> We are pleased to announce the release of the 2022-2023 Priority Guidance Plan.
>
> In Notice 2022-21, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (Service) solicited recommendations for items to be included in the plan from all interested parties, including taxpayers, tax practitioners, and industry groups. The Treasury Department and the Service recognize the importance of public input in formulating a Priority Guidance Plan that focuses resources on guidance items that are most important to taxpayers and tax administration. Solicitation of input on, and issuance of, this plan reflects an emphasis on taxpayer

> engagement with the Treasury Department and the Service through a variety of channels, consistent with the directive of the Taxpayer First Act, Pub. L. 116-25, 133 Stat. 981.
>
> The 2022-2023 Priority Guidance Plan contains 205 guidance projects that are priorities for allocating Treasury Department and Service resources during the 12-month period from July 1, 2022 through June 30, 2023 (the plan year). The projects on the plan will be the focus of our efforts during the plan year. However, the plan does not provide any deadline for completing the projects.
>
> Some projects that were on the 2021-2022 Priority Guidance Plan are not included on the 2022-2023 plan because they are no longer considered priorities for purposes of allocating resources during the 2022-2023 plan year. Some of those projects may be considered for inclusion on a future priority guidance plan. …
>
> We intend to update the 2022-2023 plan during the plan year to reflect additional items that have become priorities, guidance that is published during the plan year, and projects that may result from legislative developments. The periodic updates allow us flexibility throughout the plan year to consider comments received from taxpayers and tax practitioners relating to additional projects and to respond to developments arising during the plan year.
>
> The published guidance process can be fully successful only if we have the benefit of the insight and experience of taxpayers and practitioners who must apply the rules. Therefore, we invite the public to continue to provide us with their comments and suggestions throughout the plan year.

The 2022-2023 Plan includes the following 11 items under the subject heading of "Gifts and Estates and Trusts":

a. **Item 1: The Consistent Basis Rules**

(1) Item 1 is described as "Final regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016." In the 2020-2021 Plan, this was Item 14 of Part 3, which was titled "Burden Reduction," and in the 2021-2022 Plan it was Item 2 under the heading of "Gifts and Estates and Trusts."

(2) On July 31, 2015, the day that funding for the Highway Trust Fund was scheduled to expire, President Obama signed into law the Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41), extending that infrastructure funding for three months, with the $8 billion cost funded by various tax compliance measures. One of those was section 2004 of the Act, labelled "Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent," which of course has nothing to do with highways or veterans' health care other than raising money. The provision added new provisions to the Code.

(a) New section 1014(f) requires in general that the basis of property received from a decedent "whose inclusion in the decedent's estate increased the liability for the tax" may not exceed the value as finally determined for estate tax purposes, or, if there is no final determination (as in the case of property sold while an estate tax audit is still in progress or, within the statutory period for assessments, has not begun) the value reported on the estate tax return.

(b) New section 6035 requires every executor (or person in possession of property with the statutory duties of an executor) who is required to file an estate tax return – that is, in general, if the gross estate plus adjusted taxable gifts exceeds the applicable filing threshold – to furnish to the IRS and to the recipients of property interests included in the decedent's gross estate a statement setting forth the value of those property interests reported on the estate tax return. This statement is due 30 days after the estate tax return is filed or, if the return is filed after its due date (including extensions), 30 days after that due date. Every such statement must be supplemented if a value is adjusted, for example on audit.

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

(3) Previously (and **still the law** unless an estate tax return was or is filed after July 31, 2015), under section 1014(a)(1), the basis of property acquired from a decedent is simply "the fair market value of the property at the date of the decedent's death," with appropriate adjustments in section 1014 for the alternate valuation date and so forth. It is possible for the recipient of property from a decedent to claim, for income tax purposes, that the executor somehow just got

the estate tax value too low, and that the heir's basis should be greater than the estate tax value. Usually, of course, such claims are made after the statute of limitations has run on the estate tax return. Such claims can be accompanied by elaborate appraisals and other evidence of the "real" date-of-death value that, long after death, is hard to refute. Invoking principles of "privity," the Service is able to insist on using the lower estate tax value when the recipient was one of the executors who signed the estate tax return, but otherwise it has had no tool to enforce such consistency.

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

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

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

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

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

(5) In the Obama Administration, the Treasury Department's annual "General Explanations" of revenue proposals associated with the President's budget proposals (popularly called the "Greenbook") included a provision, last found on pages 195-96 in the 2015 Greenbook (see **https://home.treasury.gov/system/files/131/General-Explanations-FY2016.pdf**), to require the income tax basis of property received from a decedent or donor to be equal to the estate tax

value or the donor's basis. The Greenbooks provided that the executor or donor would be required to report the necessary information to both the recipient and the Service.

(a) The Greenbook proposal would have been effective

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

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

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

(b) Statutory language for this proposal appeared

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

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

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

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

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

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

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

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

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

2015. A return filed after the date of enactment might have been due, and filed, on August 1, 2015, **making the statement due August 31, 2015**.

(7) In response to that accelerated application, Notice 2015-57, 2015-36 I.R.B. 294, released on August 21, 2015, extended to February 29, 2016, the due date of any statements required by section 6035 that otherwise would be due before February 29, 2016. The Notice cited section 6081(a), which allows extensions of time only for up to six months except in the case of taxpayers who are abroad. February 29, 2016, is the closest date the calendar allows to six months after August 31, 2015. So Notice 2015-57 implied that it was the only extension there would be.

(a) Notice 2015-57 also stated that "[t]he Treasury Department and the IRS expect to issue additional guidance to assist taxpayers with complying with sections 1014(f) and 6035."

(b) Notice 2016-19, 2016-9 I.R.B. 362, released on February 11, 2016, provided: "Statements required under sections 6035(a)(1) and (a)(2) to be filed with the IRS or furnished to a beneficiary before March 31, 2016, need not be filed with the IRS and furnished to a beneficiary until March 31, 2016."

i. In other words, the "due date" is not "extended" (confirming the implication of Notice 2015-57), but executors "need not" comply with any due date earlier than March 31, 2016.

ii. Indeed, Notice 2016-19 affirmatively added that "[t]he Treasury Department and IRS recommend that executors and other persons required to file a return under section 6018 wait to prepare the statements required by section 6035(a)(1) and (a)(2) until the issuance of proposed regulations by the Treasury Department and the IRS addressing the requirements of section 6035" and that "[t]he Treasury Department and the IRS expect to issue proposed regulations under sections 1014(f) and 6035 very shortly."

(c) Notice 2016-27, 2016-15 I.R.B. 576, released on March 23, 2016 (three weeks after the publication of the proposed regulations discussed in paragraph (10) below), extended the same relief through June 30, 2016. The stated rationale was that "[t]he Treasury Department and the IRS have received numerous comments that executors and other persons have not had sufficient time to adopt the systemic changes that would enable the filing of an accurate and complete Form 8971 and Schedule A."

(8) Meanwhile, the IRS developed Form 8971 (January 2016) for reporting the information for which the due date was originally August 31, 2015, then was February 29, 2016, and then "need not" be observed before June 30, 2016. Form 8971 itself is to be filed only with the IRS. It includes a Schedule A that is to be given to each respective beneficiary (like a K-1), as well as to the IRS.

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

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

(b) The Instructions to Form 8971 (September 2016) candidly state (emphasis added):

> All property acquired (**or expected to be acquired**) by a beneficiary must be listed on that beneficiary's Schedule A. If the executor hasn't determined which beneficiary is to receive an item of property as of the due date of the Form 8971 and Schedule(s) A, **the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution** on that beneficiary's

Schedule A. (**This means that the same property may be reflected on more than one Schedule A.**) A supplemental Form 8971 and corresponding Schedule(s) A may, but aren't required to, be filed once the distribution to each such beneficiary has been made.

(c) It is striking that the Instructions refer to property "expected to be acquired" while Schedule A refers to "property you received." This interchangeability of "acquired" and "received" could have been used as the basis for regulations that construed the requirement to file Form 8971 to apply only when property had been distributed by the estate or otherwise "received." See Part 5.a(10)(b)i below.

(9) Certain regulations were explicitly contemplated and authorized by the statute.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

viii. A supplemental Form 8971 to report a change in value or otherwise correct or complete information on an original Form 8971 would not be required to be filed until 30 days after the property is distributed. Proposed Reg. §1.6035-1(e)(4)(ii). (That, of course, should have been acknowledged as the appropriate occasion for **any** reporting under section 6035. See paragraph (8) above.)

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

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

i. Echoing the Form 8971 Instructions, Proposed Reg. §1.6035-1(c)(3) states:

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

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

ii. After-discovered and omitted property that is not reported on an (initial or supplemental) estate tax return before the estate tax statute of limitations runs (thus including all property and omissions discovered after the statute runs) would be given a value, and therefore an initial basis, of zero. Proposed Reg. §1.1014-10(c)(3)(i)(B). Moreover, if the after-discovered or omitted property would have increased the gross estate enough to cause an estate tax return to be required, but no estate tax return was filed, the estate tax value of **all** property subject to the consistency rule would be considered to be zero. Proposed Reg. §1.1014-10(c)(3)(ii). **Thus, a very innocent omission by the executor could result in a very harsh penalty for beneficiaries. The statutory support for these zero basis rules is very questionable, because such property appears to be neither "property the final value of which has been determined for purposes of the [estate] tax" within the meaning of section 1014(f)(1)(A) nor property "with respect to which a statement has been furnished under section 6035(a)" within the meaning of section 1014(f)(1)(B).**

iii. Proposed Reg. §1.6035-1(f) would impose a seemingly open-ended requirement on a recipient of a Schedule A to in turn file a Schedule A when making any gift or other retransfer of the property that results wholly or partly in a carryover basis for the transferee. The preamble again cites the regulatory authority granted in section 6035(b)(2) and also a concern "that opportunities may exist in some circumstances for the recipient of such reporting to circumvent the purpose of the statute (for example, by making a gift of the property to a complex trust for the benefit of the transferor's family)." While such property does indeed continue to have a basis determined in part with reference to the value at the time of someone's death in the past, section 6035 imposes the reporting requirement only on an "executor," and section 1014(a) itself applies only to property acquired "from a decedent," creating great doubt about the statutory authority for

Proposed Reg. §1.6035-1(f), especially when one of the explicit changes Congress made to Treasury's Greenbook proposal was to apply it only to transfers at death, not to lifetime gifts.

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

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

b. In addition, the preamble to the proposed regulations states:

> One commenter requested the creation of a process to allow an estate beneficiary to challenge the value reported by the executor. There is no such process under the Federal law regarding returns described in section 6018. The beneficiary's rights with regard to the estate tax valuation of property are governed by applicable state law. Accordingly, the proposed regulations do not create a new Federal process for challenging the value reported by the executor.

In other words, the preamble not only confirms the potential for these rules to create tension within families (see paragraph (11) below), it also suggests that Treasury is either indifferent to that problem or considers itself unable to address it.

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

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

(a) The *Van Alen* opinion itself, discussed in paragraph (4) above, reveals how mischievous a "consistency" requirement might be in this context.

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

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

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

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

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

(14) The Trump Administration Priority Guidance Plans suggested that Treasury and the IRS would revisit the proposed basis consistency regulations in the context of "burden reduction." The Office of Information and Regulatory Affairs' Unified Agenda of Regulatory and Deregulatory Actions confirmed that "[t]he final regulations will provide less burdensome guidance to taxpayers enabling them to satisfy the requirements of sections 1014(f) and 6035." In light of the surprising and unnecessarily burdensome requirements of the proposed regulations identified in paragraph (10)(b) above, this placement of the regulation project under "burden reduction" provided some encouragement that some or all of those requirements would be relaxed in the final regulations. Although the 2021-2022 and 2022-2023 Priority Guidance Plans have not had a separate "burden reduction" category, there is no reason to think that the civil servants in the Treasury Department and IRS would have changed their view. In fact, the Fall 2021 Unified Agenda of Regulatory and Deregulatory Actions released by the Office of Information and Regulatory Affairs on December 10, 2021, confirmed that "[t]he final regulations will provide less burdensome guidance to taxpayers enabling them to satisfy the requirements of sections 1014(f) and 6035." **Treasury and the IRS cannot undo the ill-advised statute, but they could apply the statute in a reasonable way to provide a more practical reporting date and could reconsider the zero-basis rule and continuous reporting requirement that the statute does not appear to authorize. That would in fact be "burden reduction."**

b. **Item 2: Basis of Grantor Trust Assets**

(1) Item 2 is described as "Guidance regarding availability of §1014 basis adjustment at the death of the owner of a grantor trust described in §671 when the trust assets are not included in the owner's gross estate for estate tax purposes."

(2) A project described as "Guidance on basis of grantor trust assets at death under §1014" was new in 2015, but dropped in the 2021-2022 Plan.

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

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

(5) Chief Counsel Advice 200923024 (Dec. 31, 2008) opined that "the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust [by reason of the replacement of an independent trustee with a related or subordinate party] results in taxable income to the grantor." After citing and discussing Reg. §1.1001-2(c), Example 5, *Madorin v.*

Commissioner, 84 T.C. 667 (1985), and Rev. Rul. 77-402, 1977-2 C.B. 222 (which addressed the reverse conversion to nongrantor trust status), the Chief Counsel's office noted (emphasis added) that "the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner **which is generally not treated as an income tax event**" (emphasis added). Because of the interrelationship with certain partnership transactions and section 754 basis elections, however, the Chief Counsel's office viewed the overall transaction as "abusive" and wanted to explore other ways to challenge it. But it nevertheless believed that "asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations."

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

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

   (a) Rev. Proc. 2015-37, 2015-26 I.R.B. 1196, added "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code" to the list of "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise." That designation was continued in section 5.01(12) of Rev. Proc. 2016-3, 2016-1 I.R.B. 126, section 5.01(10) of Rev. Proc. 2017-3, 2017-1 I.R.B. 130, section 5.01(8) of Rev. Proc. 2018-3, 2018-1 I.R.B. 130, section 5.01(8) of Rev. Proc. 2019-3, 2019-1 I.R.B. 130, section 5.01(9) of Rev. Proc. 2020-3, 2020-1 I.R.B. 131, section 5.01(11) of Rev. Proc. 2021-3, 2021-1 I.R.B. 140, section 5.01(11) of Rev. Proc. 2022-3, 2022-1 I.R.B. 144, and section 5.01(11) of Rev. Proc. 2023-3, 2023-1 I.R.B. 144.

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

   (c) It is hard to believe that it is a coincidence that Rev. Proc. 2015-37 was published in the Internal Revenue Bulletin on June 29, 2015, the **day before** Letter Ruling 201544002 was issued. If those two contemporaneous events are related, then the no-rule position of Rev. Procs. 2015-37, 2016-3, 2017-3, 2018-3, 2019-3, 2020-3, 2021-3, 2022-3, and 2023-3 might have been aimed only at foreign trusts, and so might this proposal first announced in the 2015-2016 Priority Guidance Plan a month later on July 31, 2015.

(8) Then again, the revival of this project might stem from something much more recent and dramatic than a 2015 private letter ruling.

   (a) On March 8, 2022, Rep. Bill Pascrell (D-New Jersey), Chair of the House Ways and Means Committee's Oversight Subcommittee, wrote to Secretary of the Treasury Yellen, urging her "to expand efforts to crackdown on tax abuse by wealthy families," (See his office's press release at **https://pascrell.house.gov/news/documentsingle.aspx?DocumentID=5043**.) This is an excerpt from the analysis in his letter:

> One of those strategies is to claim stepped-up basis for assets in an irrevocable grantor trust upon the grantor's death. A common estate planning technique used by wealthy individuals is to transfer assets to an irrevocable grantor trust while the individual is still alive. The trust's property will generally not be included in the individual's gross estate at death, thereby avoiding the estate tax. Internal Revenue Code section 1014 generally provides that the basis of property acquired from a decedent is the fair market value at the decedent's death ("stepped-up basis"). Property is eligible for this treatment if it is acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent. Also eligible for the

> stepped-up basis treatment is property included in the decedent's estate for federal estate tax purposes. Thus, assets outside the estate in an irrevocable trust do not qualify for Code section 1014's stepped-up basis treatment under long-established interpretations of the language of Code section 1014.
>
> … Complicating matters is a 2012 private letter ruling (PLR 201245006) that seemed to imply that a transfer from an irrevocable grantor trust to another taxpayer at the grantor's death would qualify as a "bequest, devise, or inheritance," thus potentially qualifying for stepped-up basis treatment.
>
> While the IRS announced it would no longer issue private letter rulings on this issue in 2015, it has not followed up with regulations, despite Treasury including this issue in its Priority Guidance Plan in 2015-2016. However, the 2021-2022 Priority Guidance Plan does not include it.
>
> I would like to request that you promulgate regulations clarifying that the phrase "bequest, devise, or inheritance" in Code section 1014(b)(1) does not apply to the termination of grantor trust status upon the grantor's death or to the transfer of an irrevocable grantor trust's property upon a grantor's death. Further, the regulations should be promulgated through notice-and-comment rulemaking to ensure they withstand Administrative Procedure Act scrutiny.

(b) The letter overlooks the relevance of the fact that the trusts in Letter Ruling PLR 201245006 (which the letter cites) and in Letter Ruling 201544002 (which apparently triggered the no-ruling position the letter cites) were created by non-U.S. persons and otherwise would not have "avoid[ed] the estate tax" But Representative Pascrell is perhaps just as concerned about a basis step-up without realization of gain for trusts that are subject to estate tax. The principal deemed realization provision in his bill, H.R. 2286 (which his letter also cites) expressly cites "includible in the gross estate" as one of the tests for the trusts to which it would apply. See the description of H.R. 2286 in Part 1.c above.

(c) It might have come to a head in a Ways and Means Committee hearing on June 8, 2022, where Representative Pascrell initiated the following exchange with Secretary Yellen:

> Rep. Pascrell: "In March I wrote to you suggesting that the Department issue regulations on irrevocable grantor trusts to limit rampant abuse of the infamous stepped-up basis loophole. And we talked a good game about tax reform and we didn't do anything, really. We tried. I appreciate your response and your willingness to work on the issue. This loophole is used by some of the wealthiest Americans as a way to avoid paying their fair share. And we're defining it. I think both sides are zeroing in on that really. We speak more of it than they do. Can you tell me specifically how and when the Treasury Department and the Internal Revenue Service will implement the guidance?"
>
> Secretary Yellen: "We are working very hard on that and …"
>
> Rep. Pascrell: "Yeah, I've heard that before, but when?"
>
> Secretary Yellen: "Very soon. Very soon."
>
> Rep. Pascrell: "Thank you."

About five months later, this project appeared (or reappeared) in the Priority Guidance Plan.

c. **Item 3: "Anti-Abuse" Addition to the "Anti-Clawback" Regulations**

Item 3 is described as "Regulations under §2010 addressing whether gifts that are includible in the gross estate should be excepted from the special rule of § 20.2010-1(c). Proposed regulations were published on April 27, 2022." This was also Item 3 under the heading of "Gifts and Estates and Trusts" in the 2021-2022 Plan.

Regulations to prevent "clawback" were proposed in November 2018 (REG-106706-18, 83 FED. REG. 59343 (Nov. 23, 2018)) and finalized in November 2019. The proposed "anti-abuse" addition to the regulations contemplated by this Priority Guidance Plan project was published in the Federal Register on April 27, 2022 (REG-118913-21, 87 FED. REG. 24918). Although neither the statute nor the regulations use the word "clawback," the regulations carry out the mandate of the 2017 Tax Act in new section 2001(g)(2), which provides that Treasury

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

(1) **The Problem Under the 2017 Tax Act.** The concern that prompted that mandate for regulations is that the remedy added in 2010 as subsection (g) (now paragraph (1) of subsection (g)) addressed only changes in tax **rates**, and the 2017 Tax Act did not change any rates when it **doubled the basic exclusion amount ("BEA")**. New paragraph (2) obviously contemplated that regulations would reach a similar result for the potential sunset of the doubled exclusion amount, but left the details to the IRS and Treasury.

(a) To illustrate the concern, assume that an unmarried individual made a **$9 million gift** (the donor's only lifetime gift) in 2019 when the indexed exclusion amount was $11.4 million. With no change in the law, the donor dies in 2026 with a **taxable estate of $20 million**. Assume further that the 2026 $5 million exclusion amount (indexed) is $6.8 million. (These numbers – $9 million, $11.4 million, and $6.8 million – are the same numbers that are used in the examples in the 2019 regulations and the 2022 proposed addition to the regulations.) With a 40 percent rate and the exclusion amount used up, the **intuitively correct estate tax** is 40 percent of $20 million, or **$8 million**. But, as illustrated in **the table below**, without anti-clawback relief the estate tax turns out to be **$8,880,000**, producing a **"clawback penalty" of $880,000**.

(b) Other ways to look at this $880,000 million are:

i. 40 percent of the amount by which the $9 million gift exceeded the $6.8 million date-of-death exclusion amount; or

ii. the gift tax on the gift if the gift had been made in 2026; or

iii. the additional estate tax on a taxable estate of $29 million **if the gift had not been made at all**.

In other words, **all the benefit the 2017 Tax Act apparently promised this donor for making a gift before the sunset would be wiped out by the sunset**.

(2) **The Solution Under Reg. §20.2010-1(c).** Pursuant to section 2001(g)(2) and corresponding guidance projects identified in the 2017-2018, 2018-2019, and 2019-2020 Treasury-IRS Priority Guidance Plans, proposed anti-clawback regulations were published in November 2018 (REG-106706-18, 83 FED. REG. 59343, Nov. 23, 2018), and final regulations were released November 22, 2019 **(T.D. 9884, 84 FED. REG. 64995, Nov. 26, 2019)**. New Reg. §20.2010-1(c) (with the former paragraphs (c), (d), and (e) re-lettered (d), (e), and (f)) states the heart of the anti-clawback rule, applicable to the extent the credit is based on the basic exclusion amount (emphasis added):

> If the total of the **amounts allowable as a credit in computing the gift tax** payable on the decedent's post-1976 gifts, within the meaning of section 2001(b)(2), to the extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3), **exceeds** the credit allowable within the meaning of section 2010(a) in computing the estate tax, again only to the extent such credit is based solely on such basic exclusion amount, in each case by applying the tax rates in effect at the decedent's death, then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate that is attributable to the basic exclusion amount is **the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable** on the decedent's post-1976 gifts.

In other words, in the example above, because $9 million of basic exclusion amount used for the 2019 gift (the only post-1976 lifetime gift) is greater than the $6.8 million basic exclusion amount otherwise allowable in computing the 2026 estate tax, that larger amount of $9 million is used for estate tax purposes instead of $6.8 million to calculate the credit for estate tax purposes. The elimination of the clawback penalty under that rule is illustrated in the following table, by changing the entry on line 9a from $6.8 million (the 2026 basic exclusion amount) to $9 million (the amount of the 2019 basic exclusion amount used for computing the gift tax).

Calculation of the Estate Tax with and without Clawback Using the Estate Tax Return, Form 706 (August 2019) as a Template			
Line		**Illustrating Clawback**	**Under Reg. §20.2010-1(c)***
3c	Taxable estate (death in 2026)	20,000,000	20,000,000
4	Adjusted taxable gifts ($9,000,000 gift made in 2019)	9,000,000	9,000,000
5	Add lines 3c and 4	29,000,000	29,000,000
6	Tentative tax on the amount on line 5	11,545,800	11,545,800
7	Total gift tax paid or payable	0	0
8	Gross estate tax (subtract line 7 from line 6)	11,545,800	11,545,800
9a	**Basic exclusion amount [BEA]**	**6,800,000**	*** 9,000,000**
9b	DSUE amount [not applicable]	0	0
9c	Restored exclusion amount [not applicable]	0	0
9d	Applicable exclusion amount (add lines 9a, 9b, and 9c)	6,800,000	9,000,000
9e	Allowable credit amount (tentative tax on line 9d)	2,665,800	3,545,800
10	Adjustment [not applicable]	0	0
11	Allowable applicable credit amount (line 9e minus line 10)	2,665,800	3,545,800
12	Subtract line 11 from line 8	8,880,000	8,000,000
16	Net estate tax [same as line 12 in this case]	8,880,000	8,000,000
* The greater of the 2026 BEA or the BEA used to calculate the credit in 2019	Intuitively correct tax	8,000,000	8,000,000
	Clawback penalty	880,000	0

(3) **Comment on This Approach**

(a) The approach of the 2010 explicit statutory anti-clawback rule in section 2001(g)(1) – specifically section 2001(g)(1)(A) – was that the rates in effect at the time of death would be used to calculate the hypothetical "tax imposed by chapter 12" on pre-2026 adjusted taxable gifts – in other words, the "total gift tax paid or payable" that is deducted on line 7 of the return. Before the proposed regulations were released, therefore, there was speculation that the regulations under section 2001(g)(2) would mirror the regulations under section 2001(g)(1) and provide (using the above table as an example) that line 7 would be changed from zero to $880,000 (which is what the 2019 gift tax would have been if 2026 law had applied in 2019). After subtracting that amount, line 8, and therefore line 12, would be $880,000 smaller, which would exactly eliminate the clawback penalty.

(b) But the regulations take a different approach. The preamble to the proposed regulations implies that other approaches were considered, but concludes that "in the view of the Treasury Department and the IRS, the most administrable solution would be to adjust the amount of the credit … required to be applied against the net tentative estate tax" to a credit "based on the larger amount of BEA … that was used to compute gift tax payable" – in other words, by adjusting the basic exclusion amount ("BEA") entered on line 9a of the estate tax return.

(c) By increasing the amount on line 9a, rather than the amount on line 7, the regulations achieve the same result, because both line 7 and line 9a are subtractions in the estate tax calculation. But line 7 already required over two pages of instructions (pages 6-9 in the September 2021 version), including a 24-line worksheet, to complete. An incremental increase of complexity in what already had a reputation for being a challenge might have been easier to process than adding a new challenge to line 9a, which previously required only 21 words of instructions. Needless to say, IRS personnel see more returns than any member of the public does, they see the mistakes, and they hear the complaints. Presumably – hopefully – they contributed to the assessment that the line 9a approach is "the most administrable solution." And in a way it mirrors section 2001(g)(2) itself, which expresses Congress's clawback concern in 2017 in terms of the basic exclusion amount.

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

(4) **The "Off the Top" Option.** There had also been speculation that the regulations might address the option of making, for example, a $5 million gift during the 2018-2025 period (assuming no previous taxable gifts) and treating that gift as using only the temporary "bonus" exclusion resulting from the 2017 Tax Act, which is sometimes described as using the exclusion "off the top," still leaving the exclusion of $5 million (indexed) to generate a credit to be used against the estate tax after 2025. Example 2 was added to the final regulations to illustrate what the preamble to the final regulations acknowledges is the **"use or lose"** nature of the doubled exclusion amount when a donor uses some but not all of the exclusion amount available from 2018 through 2025.

(5) **Preservation of Portability Elections**

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

(b) In that light, it is not particularly reassuring, standing alone, that the preamble to the final regulations stated:

> The regulations in §§ 20.2010-1(d)(4) and 20.2010-2(c)(1) confirm that the reference to BEA is to the BEA in effect at the time of the deceased spouse's death, rather than the BEA in effect at the death of the surviving spouse.

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

> The temporary regulations in § 20.2010-2T(c)(1)(i) confirm that the term "basic exclusion amount" referred to in section 2010(c)(4)(A) means the basic exclusion amount in effect in the year of the death of the decedent whose DSUE amount is being computed. Generally, only the basic exclusion amount of the decedent, as in effect in the year of the decedent's death, will be known at the time the DSUE amount must be computed and reported on the decedent's estate tax return. Because section 2010(c)(5)(A) requires the executor of an estate electing portability to compute and report the DSUE amount on a timely-filed estate tax return, and because the basic exclusion amount is integral to this computation, the term "basic exclusion amount" in section 2010(c)(4)(A) necessarily refers to such decedent's basic exclusion amount.

What **is** helpful and reassuring is that the final 2019 regulations themselves (not just the preamble) add Examples (3) and (4), which illustrate scenarios where a DSUE amount from a predeceased spouse who dies before 2026 is applied to the surviving spouse's gifts before 2026 and to the calculation of the estate tax when the surviving spouse dies after 2025.

(6) **A Possibly Surprising Collateral Result.** If large amounts of the increased credit attributable to the new doubled basic exclusion amount are used to shelter gifts from gift tax before 2026 (like the $9 million gift in the example), then after 2025 the donor might have to wait for many years or even decades for the indexed $5 million amount to catch up so there can be more credit available for gift tax purposes.

(7) **An Anti-Abuse Warning**

(a) The preamble to the 2019 final regulations added:

> A commenter recommended consideration of an anti-abuse provision to prevent the application of the special rule to transfers made during the increased BEA period that are not true inter vivos transfers, but rather are treated as testamentary transfers for transfer tax purposes. Examples include transfers subject to a retained life estate or other retained powers or interests, and certain transfers within the purview of chapter 14 of subtitle B of the Code. The purpose of the special rule is to ensure that bona fide inter vivos transfers are not subject to inconsistent treatment for estate tax purposes. Arguably, the possibility of inconsistent treatment does not arise with regard to transfers that are treated as part of the gross estate for estate tax purposes, rather than as adjusted taxable gifts. An anti-abuse provision could except from the application of the special rule transfers where value is included in the donor's gross estate at death. Although the Treasury Department and the IRS agree that 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.

(b) The commenter the preamble cites is the Tax Section of the New York State Bar Association, in its February 20, 2019, letter to Treasury and the IRS available at **https://nysba.org/NYSBA/Sections/Tax/Tax%20Section%20Reports/Tax%20Section%20Reports%202019/1410%20Report.pdf**.

(c) For an in-depth discussion of this issue, see Lynagh, *Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion*, 45 Tax Mgmt. Est., Gifts & Tr. J. 183 (May 14, 2020).

(d) To illustrate the circumstances in which such an anti-abuse rule might apply, consider again the example above, a $9 million gift in 2019 and an otherwise taxable estate of $20 million and basic exclusion amount of $6.8 million in 2026, except that the gift is of such nature that the value of the property is included in the donor's gross estate under, for example, section 2036, thereby making the taxable estate $29 million (assuming no intervening change in value), **while the gift itself is excluded from "adjusted taxable gifts" (line 4 of the estate tax return) under the last phrase of section 2001(b)**. In that case, the **intuitively correct estate tax** seems to be the tax on a taxable estate of $29 million, which is **$8,880,000** (as shown under "Illustrating Clawback" in the above table, calculated on the tax base of $29,000,000 on line 3 after adding adjusted taxable gifts in that case). Two ways of looking at that $8,880,000 are:

i. $11,545,800 (the tax on $29,000,000 under the section 2001(c) rate schedule) minus $2,665,800 (the applicable credit amount, which is the tax on the applicable exclusion amount of $6,800,000 under the section 2001(c) rate schedule) = $8,880,000, or

ii. 40 percent times (the taxable estate of $29,000,000 minus the applicable exclusion amount of $6,800,000) = 0.4 × $22,200,000 = $8,880,000.

Thus, application of the anti-clawback calculation in this case would not eliminate an $880,000 clawback penalty, it would in effect produce an $880,000 anti-clawback bonus, as the following table indicates.

Same Comparison, Except that the 2019 $9,000,000 Gift is a "String Gift" Again Using the Estate Tax Return, Form 706 (August 2019) as a Template

Line		Without Reg. §20.2010-1(c)	Under Reg. §20.2010-1(c)*
3c	Taxable estate (in 2026, including $9,000,000 string gift)	29,000,000	29,000,000
4	Adjusted taxable gifts (string gift omitted under §2001(b))	0	0
5	Add lines 3c and 4	29,000,000	29,000,000
6	Tentative tax on the amount on line 5	11,545,800	11,545,800
7	Total gift tax paid or payable	0	0
8	Gross estate tax (subtract line 7 from line 6)	11,545,800	11,545,800
9a	**Basic exclusion amount [BEA]**	**6,800,000**	*** 9,000,000**
9b	DSUE amount [not applicable]	0	0
9c	Restored exclusion amount [not applicable]	0	0
9d	Applicable exclusion amount (add lines 9a, 9b, and 9c)	6,800,000	9,000,000
9e	Allowable credit amount (tentative tax on line 9d)	2,665,800	3,545,800
10	Adjustment [not applicable]	0	0
11	Allowable applicable credit amount (line 9e minus line 10)	2,665,800	3,545,800
12	Subtract line 11 from line 8	8,880,000	8,000,000
16	Net estate tax [same as line 12 in this case]	8,880,000	8,000,000
* The greater of 2026 BEA or BEA used in 2019	Intuitively correct tax	8,880,000	8,880,000
	Unintended anti-clawback bonus	0	880,000

That "bonus" is undoubtedly what prompted the IRS and Treasury to consider an "anti-abuse provision."

(8) **The Proposed "Anti-Abuse" Addition.** The April 2022 proposal would do what the 2019 preamble foretold and would address the "anti-clawback bonus" the preceding table illustrates. The proposal would add a new subparagraph (3) to the anti-clawback paragraph (c) that was added to Reg. §20.2010-1 in 2019. The new subparagraph (3) provides exceptions from the anti-clawback rules of paragraph (c) for "transfers includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b)." It elaborates such transfers as "**including without limitation**" four specific types of transfers:

(a) "Transfers includible in the gross estate pursuant to section 2035 [gifts completed by a transfer or by a relinquishment of a power within three years of death], 2036 [transfers with a retained life estate], 2037 [transfers taking effect at death], 2038 [revocable transfers], or 2042 [life insurance proceeds], regardless of whether all or any part of the transfer was deductible pursuant to section 2522 [charitable gifts] or 2523 [gifts to the donor's spouse]." This is as forecast in the 2019 preamble. It would simply preserve the "clawback," in effect, that provisions like section 2036 (and their predecessors) have been designed to achieve since at least the 1930s.

(b) "Transfers made by enforceable promise to the extent they remain unsatisfied as of the date of death." Such transfers were not explicitly targeted in the 2019 preamble. But, because the donor/promisor keeps the enjoyment of the property until the promise is satisfied, there certainly is a resemblance to section 2036. As the preamble observes, such transfers have been excluded from adjusted taxable gifts under Rev. Rul. 84-25, 1984-1 C.B. 191.

(c) "Transfers described in §25.2701-5(a)(4) or §25.2702-6(a)(1)" of the regulations. This fulfills the explicit attention of the 2019 preamble to "certain transfers within the purview of chapter 14 of subtitle B of the Code." In two helpful paragraphs, the current preamble explains why Treasury and the IRS did not consider it necessary to also amend Reg. §25.2701-5 (as the comments of the Tax Section of the New York State Bar Association had recommended) or, similarly, Reg. §25.2702-6(b).

(d) Transfers that would have fit one of those three categories "but for the transfer, relinquishment, or elimination of an interest, power, or property, effectuated within 18 months of the date of the decedent's death by the decedent alone, by the decedent in conjunction with any other person, or **by any other person**" (emphasis added), unless "effectuated by the termination of the durational period described in the original instrument of transfer by either the mere passage of time or the death of any person" (Proposed Reg. §20.2010-1(c)(3)(ii)(B)). While similar to the existing three-year rule of section 2035, this provision is conspicuously extended to affirmative actions not by the decedent but "by any other person." The exception for "the termination of the durational period described in the original instrument of transfer" may encourage more attention to the provision of such durational periods in original transfer documents.

Of course, the phrase "including without limitation" leaves open the possibility that scenarios other that the four scenarios spelled out would also be excepted from the anti-clawback rules. But the description "includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b)" ought to be quite objective and easy to apply in most cases.

This exception from the anti-clawback rules would not apply to "[t]ransfers includible in the gross estate in which the value of the taxable portion of the transfer, determined as of the date of the transfer, was 5 percent or less of the total value of the transfer." The preamble explains this limitation by comparison to similar rules applicable to reversionary interests in sections 2037(a)(2) (estate tax consequences of the retention of a reversionary interest), 2042(2) (estate tax consequences of the possession of an "incident of ownership" in a life insurance policy) , and 673(a) (consequences of a reversionary interest on the determination of grantor trust treatment). That makes sense because the types of transfers targeted by the exception do resemble reversionary interests. A 5 percent de minimis rule might also make sense because such transfers by definition would use a small amount of the doubled basic exclusion amount ("BEA") compared to the total amount transferred. The preamble adds that "[t]his bright-line exception … is proposed in lieu of a facts and circumstances determination of whether a particular transfer was intended to take advantage of the increased BEA without depriving the donor of the use and enjoyment of the property."

The proposed addition to the regulations includes seven reasonably helpful, but not particularly surprising, examples, illustrating the treatment of various combinations and amounts of gifts of cash and promissory notes, gifts to GRATs and GRITs, and use of DSUE amounts. Among other things, the examples confirm the results of the examples in the 2019 regulations (see paragraph (5) above) that in the case of a portability election the DSUE amount is applied before the surviving spouse's basic exclusion amount.

(9) **Effective Date.** The contemplated addition to the regulations would apply only prospectively – that is, only to the estates of decedents dying on or after April 27, 2022, the date the proposed addition was published in the Federal Register. But it should also be noted that it would apply to the calculation of the future **estate tax**, even if the **gift** includible, or treated as includible, in the gross estate was made before April 27, 2022. Thus, it should be expected to first apply to the estate of someone who dies after December 31, 2025, when the "sunset" enacted in 2017

occurs, which the preamble to the proposed addition acknowledges. In that way, it would achieve the "anti-abuse" outcome described above with respect to gifts made and other lifetime actions taken since 2017 that result in estate includability, even if those lifetime actions were taken before April 27, 2022 – indeed, as early as January 1, 2018.

The Ways and Means Committee's proposal (see Part 2.b(2) above) to accelerate the "sunset" to January 1, 2022, could have meant that, unless the "anti-abuse" addition was made before the end of 2021, some persons who had made post-2017 gifts with potential for inclusion in the gross estate might die before the regulations were effective. Those persons' estates might have benefited from the unintended anti-clawback bonus. Or the regulations might have provided for retroactive application to those estates, which is sometimes done in true "abuse" cases. Such planning after December 31, 2017, by persons who die on or after April 27, 2022, would have been caught in any event.

d. **Item 4: Simplified Extension of Time to Elect Portability**

(1) Item 4 is described as "Guidance on portability regulatory elections under §2010(c)(5)(A)." This is the first time it has appeared in the Plan.

(2) Portability, allowing a surviving spouse to use any estate and gift tax exclusion the predeceased spouse did not use, was enacted in 2010 for two years (2011 and 2011). It was made permanent by the American Taxpayer Relief Act of 2012. Section 2010(c)(5)(A) requires that portability be elected – it is not automatic. The election must be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse, and the return must be timely filed. Section 6075(a) specifies that the due date for "[r]eturns made under section 6018(a)" (estate tax returns) is "9 months after the date of the decedent's death." Section 6081(a) allows the IRS to extend that due date, but states that "[e]xcept in the case of taxpayers who are abroad, no such extension shall be for more than 6 months." Reg. §20.6018-1 makes that six-month extension automatic by the filing of Form 4768 before the nine-month due date.

But, going back to section 6075(a) and its reference to section 6018(a), when finalizing the portability regulations in 2015, Treasury and the IRS noted in the preamble (T.D. 9725) that for "estates that are under the value threshold described in section 6018 for being required to file an estate tax return…, the due date for the portability election is prescribed by regulation, not by statute." Therefore, they provided in Reg. §20.2010-2(a)(1) that a further extension of time, beyond nine months, "may be available under the procedures applicable under §§301.9100-1 and 301.9100-3 of this chapter to an estate **that is not required to file a return** under section 6018(a), as determined without regard to this paragraph (a)" (emphasis added). In other words, so-called "9100 relief" (which is available to extend only regulatory, not statutory, due dates) is available with respect to an estate tax return that is not required for estate tax purposes (that is, under section 6018(a)) but is filed solely for the purpose of electing portability (a portability-only return).

In that spirit, Notice 2012-21, 2012-10 I.R.B. 450 (Feb. 17, 2012), allowed executors of decedents dying between January 1, 2011 (when portability took effect) and June 30, 2011, an extension of time to 15 months after the decedent's death to file Form 4768 if the gross estate did not exceed the $5 million basic exclusion amount. Rev. Proc. 2014-18, 2014-7 I.R.B. 513 (Jan. 27, 2014), both extended and simplified that relief by allowing the late filing of a portability-only return anytime through **December 31, 2014**, merely by filing the return with the statement "FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)" at the top of the return. Then Rev. Proc. 2017-34, 2017-26 I.R.B. 1282 (June 9, 2017), extended similar relief through the later of **January 2, 2018**, or the **second anniversary of the decedent's date of death**, again by filing the return with the statement "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)" at the top of the return. The two-year limitation on the relief was designed to prevent prejudice to the government from a lack of available records, and also avoided the possibility that the period for filing a claim for refund of gift or estate tax paid by the surviving spouse or the surviving spouse's estate would have expired before the portability election was made under the relief procedure.

(3) Now Rev. Proc. 2022-32 states that "the IRS has continued to issue numerous letter rulings under § 301.9100-3 granting an extension of time to elect portability under § 2010(c)(5)(A) in situations in which the decedent's estate was not required by § 6018(a) to file an estate tax return and the time for obtaining relief under the simplified method had expired." To relieve a "significant burden on the available resources of the IRS" and to respond to "a need for continuing relief" for taxpayers, Rev. Proc. 2022-32 extends the simplified method to **the fifth anniversary of the decedent's date of death**.

(4) As with Rev. Procs. 2014-18 and 2017-34, the requirements for qualifying for the relief procedure are:

(a) the decedent (1) was survived by a spouse, (2) died after December 31, 2010, and (3) was a citizen or resident of the United States;

(b) the executor was not required to file an estate tax return under section 6018(a) based on the value of the gross estate and adjusted taxable gifts (without regard to the need to file for portability purposes);

(c) the executor did not file an estate tax return within the time required by Reg. §20.2010-2(a)(1);

(d) the election is made on a complete and properly prepared Form 706 (meaning that it is prepared in accordance with §20.2010-2(a)(7)) that is filed on or before the fifth annual anniversary of the decedent's data death; and

(e) the following statement appears at the top of the Form 706 – "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)." (Rev. Proc. 2022-32, §§3.01 & 4.01.)

(5) A Form 706 that is filed within the five-year period will be considered to have been filed timely in accordance with §20.2010-2(a)(1). As with the previous grants of relief, if a later determination is made that the executor was required to file an estate tax return (based on the value of the gross estate and adjusted taxable gifts), relief under this revenue procedure is deemed null and void *ab initio*.

(6) This relief procedure does not extend the period of limitations for filing a claim for refund with respect to an overpayment of tax (for example, if the surviving spouse paid a gift tax or died and paid an estate tax that could have been avoided with the applicable exclusion amount made available under the portability election). In that case, however, a claim for refund filed in anticipation of a Form 706 being filed to elect portability will be considered a protective claim for refund.

(a) Accordingly, if a decedent died after 2010, and if the surviving spouse paid a gift tax or estate tax for which the period of limitations on a refund will end before a "complete and properly prepared Form 706" can be filed, the taxpayer should file a protective claim for refund before the end of the limitations period stating that it is in anticipation of a complete return being filed pursuant to this revenue procedure.

(b) On the other hand, if the surviving spouse has progressed to the point of filing a gift tax return, or has died and an estate tax return is prepared, it is more likely that professional advice would have been sought and the opportunity to elect portability would have been discovered.

(7) If an estate does not qualify for relief under Rev. Proc. 2022-32 (*i.e.*, it does not file a complete and properly prepared Form 706 by the fifth anniversary of the decedent's death), it may still request relief by submitting a ruling request under Reg. §301.9100-3.

(8) Rev. Proc. 2022-32 is effective July 8, 2022.

e. **Item 5: Effect of Events Between Death and the Alternate Valuation Date**

(1) Item 5 is described as "Regulations under §2032(a) regarding imposition of restrictions on estate assets during the six-month alternate valuation period. Proposed regulations were published on November 18, 2011." This project first appeared in the 2007-2008 Plan.

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

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

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

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

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

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

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

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

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

in value resulting from the "mere lapse of time," which are ignored in determining the alternate value under section 2032(a)(3).

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

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

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

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

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

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

   (a) Examples 7 and 8 of Proposed Reg. §20.2032-1(c)(5) specifically address the discount-bootstrap technique – Example 8 in the context of a limited liability company and Example 7 in the context of real estate – and leave no doubt that changes in value due to "market conditions" do not include the valuation discounts that might appear to be created by partial distributions.

   (b) And perhaps most significantly, Example 1 reaches the same result with respect to the post-death formation of a limited partnership.

(9) The Office of Information and Regulatory Affairs' Spring 2020 Unified Agenda of Regulatory and Deregulatory Actions, released on June 30, 2020, offered the following concise summary of the scope of the proposed regulations:

> In cases where section 2032 election has been made, the regulations would provide guidance on: (1) The effect of certain post-death transactions on assets includible in the decedent's gross estate; (2) the treatment of assets the title to which is transferred at death by contract; (3) the determination of the portion of trusts in which the decedent retained an interest that are includible in the decedent's gross estate under

> section 2036; (4) the effect of the grant of a qualified conservation easement under section 2031(c) during the 6-month period after the date of death; and (5) the types of factors, the impact of which affect the fair market value of assets includible in the decedent's gross estate, that will be recognized under section 2032.

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

f. **Item 6: Effect of Guarantees and Present Value Concepts on Estate Tax Deductions**

(1) Item 6 is described as "Final regulations under §2053 regarding the deductibility of certain interest expenses and amounts paid under a personal guarantee, certain substantiation requirements, and the applicability of present value concepts in determining the amount deductible. Proposed regulations were published on June 28, 2022." Previously, as in Item 5 in the 2021-2022 Plan, this project has been described simply as "Regulations under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate." Proposed regulations were released on June 24, 2022, and published as REG-130975-08, 87 FED. REG. 38331 (June 28, 2022).

(2) This project first appeared in the 2008-2009 Plan as an outgrowth of the project that led to the amendments of the section 2053 regulations that had been proposed in April 2007 and finalized in October 2009. The significance of present value concepts is elaborated in this paragraph in the preamble to the 2009 regulations (T.D. 9468, 74 FED. REG. 53652 (Oct. 20, 2009)) (emphasis added):

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

(3) Specifically addressing that issue, a new Proposed Reg. §20.2053-1(d)(6) would require, except for unpaid principal of mortgages and other indebtedness deductible under Reg. §20.2053-7, a present-value discounting of claims and expenses not paid or expected to be paid within a "grace period" ending three years after the decedent's death. Under Proposed Reg. §20.2053-1(d)(6)(i)(B), the discount rate to be used would be the applicable federal rate determined under section 1274(d) for the month in which the decedent died, compounded annually. Whether that is the mid-term rate (3-9 years) or long-term rate (over 9 years) would be determined by the length of time from the date of the decedent's death to the date of payment or expected date of payment. Proposed Reg. §20.2053-1(d)(6)(vi) provides that any such discounted deduction is "subject to adjustment" to reflect any change in the amount or timing of the payment while the statute of limitations on assessment of estate tax has not run or a claim for refund is pending – basically an application of the existing rule in Reg. §20.2053-1(d)(2).

(4) A new Proposed Reg. §20.2053-3(d) (with the current paragraphs (d) and (e) redesignated paragraphs (e) and (f)) addresses the deduction of interest as an estate administration expense.

(a) Proposed Reg. §20.2053-3(d)(1)(i) affirms the nondeductibility of interest on federal estate tax deferred under section 6166, in accordance with section 2053(d)(1)(D), which was added to the Code in 1997.

(b) Proposed Reg. §20.2053-3(d)(1)(ii) and (iii) affirm and amplify the requirement of Reg. §20.2053-3(a) that to be deductible the payment of interest must be "actually and necessarily incurred in the administration of the decedent's estate."

   i. Proposed Reg. §20.2053-3(d)(1)(ii) states that interest on federal estate tax deferred under section 6161 or 6163 meets that requirement because of "a demonstrated need to defer payment," while other interest on unpaid federal tax or interest payable under state or local law "generally" meets that requirement.

   ii. But Proposed Reg. §20.2053-3(d)(1)(iii) provides that interest does not meet that requirement "to the extent the interest expense is attributable to an executor's negligence, disregard of applicable rules or regulations (including careless, reckless, or intentional disregard of rules or regulations) as defined in [Reg. §1.6662-3(b)(2)], or fraud with intent to evade tax." Because the proposed regulation confirms that interest on federal tax is "generally" deductible, it should be presumed (hoped?) that this exception would be applied with moderation and balance.

(c) Proposed Reg. §20.2053-3(d)(2) addresses "[i]nterest on a loan entered into by the estate to facilitate the payment of the estate's tax and other liabilities or the administration of the estate." It proposes that such interest "may be deductible depending on all the facts and circumstances." In general, citing Reg. §20.2053-1(b)(2), the proposed regulation would require that the loan and the interest expense be "bona fide," and, again echoing Reg. §20.2053-3(a), would require that "both the loan to which the interest expense relates and the loan terms must be actually and necessarily incurred in the administration of the decedent's estate and must be essential to the proper settlement of the decedent's estate." The proposed regulation then goes on to provide a non-exclusive list of 11 factors it describes as "factors that collectively may support a finding that the interest expense also satisfies the additional requirements under §20.2053-1(b)(2) and paragraph (a)." For example:

   i. Proposed Reg. §20.2053-3(d)(2)(viii) (emphasis added) cites favorably the factor that "[t]he estate's illiquidity does not occur after the decedent's death as a result of the decedent's **testamentary estate plan to create illiquidity**." The preamble (emphasis added) distinguishes the case where "illiquidity has been created **intentionally** (whether **in the estate planning**, or by the estate …") and later adds a reference to a "need for the loan … **contrived** to generate, or increase the amount of, a deduction for the interest expense." A lot of entirely legitimate "estate planning," especially in the context of family-owned and -operated businesses, includes the creation of safeguards to preserve family ownership, which necessarily prevent or seriously limit transfers outside the family. The side effect could of course be viewed as "illiquidity." Estate planners would welcome some assurance in the final regulations that such legitimate business planning is not the target of these regulations, possibly with both positive and negative examples involving family businesses.

   ii. Proposed Reg. §20.2053-3(d)(2)(ix) and (x) view negatively the fact that the lender is a beneficiary of the estate. Specifically, as "factors that collectively may support a finding that the interest expense also satisfies the additional requirements" of the regulations, these subdivisions state (emphasis added):

      > (ix) The lender is **not a beneficiary** of a substantial portion of the value of the estate, and is not an entity over which such a beneficiary has control (within the meaning of section 2701(b)(2)) or the right to compel or direct the making of the loan.
      >
      > (x) The lender or lenders are **not beneficiaries** of the estate whose individual share of liability under the loan is substantially similar to his or her share of the estate.

   It is understandable that the IRS and Treasury would be concerned about structures that might try to convert distributions to beneficiaries in their capacities as beneficiaries into interest payments that are deductible in computing the estate tax. Or concerned about borrowing from a family-owned entity that might own enough liquid assets to have accommodated the funding of the estate's tax and other obligations with a simple distribution, as analyzed in *Estate of Koons v. Commissioner*, 686 Fed. Appx. 779, 119 AFTR 2d 2017-1609 (11th Cir. 2017), *aff'g* T.C. Memo. 2013-94, and cases cited therein. But it is also the experience of many estate planners that the option of borrowing from a family-owned entity, including an operating business, may be not only the most convenient but also the most protective of the viability of that entity or business whose owners are faced with tax liabilities that shareholders of public corporations, for example, could satisfy simply by sales of stock that do not affect the company. The proposed regulations would not prohibit the deduction of interest in such cases; they simply offer "factors" to be weighed. Again, estate planners would welcome some assurance in the final regulations that such weighing would be appropriately balanced.

(5) In any event, *Graegin* loans (see *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477), which prohibit prepayment of either principal or interest and therefore have been held to allow a full undiscounted estate tax deduction for the payment of interest that might be deferred for, say, 15 years, would lose that element of their effectiveness. Even if such loans satisfy the "bona fide" and "actually and necessarily incurred" tests (which is not assured), the interest would be expected to be paid more than three years after the decedent's death and thus would be discounted under Proposed Reg. §20.2053-1(d)(6).

(6) Reg. §20.2053-4(b) and (c), part of the 2009 amendments of the regulations, incorporate the "qualified appraisal" and "qualified appraiser" concepts from the context of valuing charitable gifts for income tax purposes into the context of valuing claims against the estate for estate tax purposes. The preamble to the current proposed regulations acknowledges that those concepts are an awkward fit, and proposed amendments to those regulations would replace it with a list of requirements for an appraisal that is more focused on the section 2053 context. One of those requirements, in Proposed Reg. §20.2053-4(b)(1)(iv)(F) and (c)(i)(iv)(F), is that the appraisal be signed by the appraiser "under penalties of perjury." That is apparently an unprecedented requirement, and it is especially surprising in a context that requires the appraiser to be unrelated and therefore less likely to have first-hand knowledge of the underlying facts.

(7) New Proposed Reg. §20.2053-4(d)(5)(ii) addresses the "personal guarantees" component of the guidance project. Currently, Reg. §20.2053-4(d)(5) affirms that under section 2053(c)(1)(A), except for pledges or subscriptions addressed in Reg. §20.2053-5, deducting a claim based on a promise or agreement requires that the promise or agreement was bona fide (that is, was bargained for at arm's length and, in the case of a claim involving a family member, meets the requirements of Reg. §20.2053-1(b)(2)(ii)) and was in exchange for adequate and full consideration in money or money's worth. The new subdivision (ii) would provide that those tests are met by a decedent's agreement to guarantee a debt of an entity if, at the time the guarantee is given, either the decedent had an interest in the entity and had control of the entity within the meaning of section 2701(b)(2) or the maximum liability of the decedent under the guarantee did not exceed the fair market value of the decedent's interest in the entity. The amount deductible is reduced to the extent the guaranteed debt is taken into account in computing the value of the gross estate or the estate has a right of contribution or reimbursement.

(8) As proposed, the changes would apply to the estates of decedents dying on or after the date the final regulations are published in the Federal Register.

g. **Item 7: Qualified Domestic Trust Elections**

Item 7, new in the 2022-2023 Plan, is described as "Regulations under §20.2056A-2 for qualified domestic trust elections on estate tax returns, updating obsolete references." Reg. §20.2056A-2 is among the qualified domestic trust (QDOT) regulations added in 1995. There is no reason to think that this project is intended to make any substantive changes, in contrast to merely "updating obsolete references."

h. **Items 8 and 9: Allocation of GST Exemption**

(1) Item 8 is described as "Regulations under §2632 providing guidance governing the allocation of generation-skipping transfer (GST) exemption in the event the IRS grants relief under §2642(g),

as well as addressing the definition of a GST trust under §2632(c), and providing ordering rules when GST exemption is allocated in excess of the transferor's remaining exemption." It is identical to Item 6 in the 2021-2022 Plan, which is the first time it appeared. It is evidently related to Item 9 and is intended to address not only the consequences of the relief described in Item 9 but also, as the description says, the definition of a "GST trust" for purposes of the deemed allocation rules of section 2632(c) and ordering rules when too much GST exemption is ostensibly allocated.

(2) Item 9 is described as "Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption. Proposed regulations were published on April 17, 2008." This project first appeared in the 2007-2008 Plan. In the 2021-2022 Plan it was Item 7 under "Gifts and Estates and Trusts," and in the 2020-2021 Plan it was Item 18 of Part 3, which was titled "Burden Reduction."

(3) The background of this project is section 564(a) of the 2001 Tax Act, which added subsection (g)(1) to section 2642, directing Treasury to publish regulations providing for extensions of time to allocate GST exemption or to elect out of statutory allocations of GST exemption (when those actions are missed on the applicable return or a return is not filed).

(a) Before the 2001 Tax Act, similar extensions of time under Reg. §301.9100-3 (so-called "9100 relief") were not available, because the deadlines for taking such actions were prescribed by the Code, not by the regulations.

(b) The legislative history of the 2001 Tax Act stated that "[n]o inference is intended with respect to the availability of relief from late elections prior to the effective date of [section 2642(g)(1)]," and section 2642(g)(1)(A) itself directs that the regulations published thereunder "shall include procedures for requesting comparable relief with respect to transfers made before the date of the enactment of [section 2642(g)(1)]." Section 2642(g)(1)(B) adds:

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

(c) Shortly after the enactment of the 2001 Tax Act, Notice 2001-50, 2001-2 C.B. 189, acknowledged section 2642(g)(1) and stated that taxpayers may seek extensions of time to take those actions under Reg. §301.9100-3. The Service has received and granted many requests for such relief over the years since the publication of Notice 2001-50.

(4) In addition, Rev. Proc. 2004-46, 2004-2 C.B. 142, provides a simplified method of dealing with pre-2001 gifts that meet the requirements of the annual gift tax exclusion under section 2503(b) but not the special "tax-vesting" requirements applicable for GST tax purposes to gifts in trust under section 2642(c)(2).

(a) Gifts subject to Crummey powers are an example.

(b) In such cases, GST exemption may be allocated on a Form 709 labeled "FILED PURSUANT TO REV. PROC. 2004-46," whether or not a Form 709 had previously been filed for that year.

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

(5) Proposed Reg. §26.2642-7 (REG-147775-06) was released on April 16, 2008. When finalized, it will oust Reg. §301.9100-3 and become the exclusive basis for seeking the extensions of time Congress mandated in section 2642(g)(1) (except that the simplified procedure for dealing with pre-2001 annual exclusion gifts under Rev. Proc. 2004-46 will be retained). In addition to an "extension of time … to allocate GST exemption," as the Priority Guidance Plan cites, the proposed regulations would also apply to elections out of deemed allocations under section 2632(b)(3) for direct skips and section 2632(c)(5)(A)(i) for indirect skips and transfers made to a GST trust, and elections under section 2632(c)(5)(A)(ii) to treat any trust as a GST trust for purposes of section 2632(c)).

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

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

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

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

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

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

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

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

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

(10) These regulations ought to have been close to completion for a long time now.

(a) The current Item 9 last appeared in the 2015-2016 Plan. It was removed in the 2016-2017 Plan, perhaps so these regulations could be issued at the same time as the ETIP-related regulations envisioned by the project discussed in Part 5.k(4) below. Or it might have been thought that the consistent basis and section 2704 regulations alone may have kept Treasury and the IRS busy through June 2017, while most of the objectives of the section 2642(g) regulations were being served anyway by Reg. §301.9100-3.

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

(c) Like the consistent basis regulations of Item 1 discussed in Part 5.a above, there is no reason to assume that whatever "burden-reducing" changes Treasury and the IRS have had in mind would not continue to be their objective when finalizing these regulations, even though "burden reduction" has been dropped as a separate category of projects.

(11) In addition, Item 29 under the heading of "General Tax Issues" in the 2022-2023 Plan is described simply and broadly as "Guidance under §301.9100 regarding relief for late regulatory elections." Like the project aimed particularly at section 2642(g) elections, it appeared under the heading of "Burden Reduction" in the Priority Guidance Plans during the Trump Administration.

i. **Item 10: Taxation of Transfers from Certain Expatriates**

(1) Item 10 is described as "Final regulations under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates. Proposed regulations were published on September 10, 2015." This project first appeared in the 2008-2009 Priority Guidance Plan, but was dropped from the Plans during the Trump Administration, and then reappeared as Item 8 under the heading of "Gifts and Estates and Trusts" in the 2021-2022 Plan.

(2) The Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART" Act) enacted a new income tax "mark to market" rule (section 877A) when someone expatriates on or after June 17, 2008, and a new succession tax on the receipt of certain gifts or bequests from someone who expatriated on or after June 17, 2008. The new succession tax is provided for in section 2801, comprising all of new chapter 15.

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

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

Nevertheless, it seems likely that the longer it takes to finalize these regulations consistently with the June 17, 2008, effective date the harder it is going to be, and that the harder it is the longer it might take. A dilemma that has led some to think that this provision of the HEART Act will never take effect, and that Congress must intervene to provide a more workable approach.

(4) When this project first appeared in the 2008-2009 Plan, Treasury and IRS personnel referred to it as a top priority. Evidently the implementation of what amounts to a succession tax on transferees, not transferors or their estates, is quite complicated and challenging. Perhaps the interest in broader deemed realization legislation (see Parts 1.c, 1.e, and 3.b above) has given this project new cause for optimism, or pessimism, as the case may be.

(5) The regulations proposed in 2015 (§§28.2801-1 through -7 and related procedural sections, REG-112997-10) are about 18,000 words long and were accompanied by a preamble of about 8,600 words. The preamble included the estimate that there would be 1,000 respondents annually.

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

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

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

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

(8) There are some oddities and surprises in the calculation of the tax.

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

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

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

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

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

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

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

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

> (b) *Disclosure of return and return information* – (1) *In general*. In certain circumstances, the Internal Revenue Service (IRS) may be permitted, upon request of a U.S. citizen or resident in receipt of a gift or bequest from an expatriate, to disclose to the U.S. citizen or resident return or return information of the donor or decedent expatriate that may assist the U.S. citizen or resident in determining whether the donor or decedent was a covered expatriate and whether the transfer was a covered gift or covered bequest. The U.S. citizen or resident may not rely upon this information, however, if the U.S. citizen or resident knows, or has reason to know, that the information received from the IRS is incorrect. The circumstances under which such information may be disclosed to a U.S. citizen or resident, and the procedures for requesting such information from the IRS, will be as provided by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b)).

> (2) *Rebuttable presumption*. Unless a living donor expatriate authorizes the disclosure of his or her relevant return or return information to the U.S. citizen or resident receiving the gift, there is a rebuttable presumption that the donor is a covered expatriate and that the gift is a covered gift. A taxpayer who reasonably concludes that a gift or bequest is not subject to section 2801 may file a protective Form 708 in accordance with §28.6011-1(b) to start the period for the assessment of any section 2801 tax.

(c) The preamble further explains:

> Section 28.2801-7 provides guidance on the responsibility of a U.S. recipient, as defined in §28.2801-2(e), to determine if tax under section 2801 is due. The Treasury Department and the IRS realize that, because the tax imposed by this section is imposed on the U.S. citizen or resident receiving a covered gift or covered bequest, rather than on the donor or decedent covered expatriate making the gift or bequest, U.S. taxpayers may have difficulty determining whether they are liable for any tax under section 2801. Nevertheless, the same standard of due diligence that applies to any other taxpayer to determine whether the taxpayer has a tax liability or a filing requirement also applies to U.S. citizens and residents under this section. Accordingly, it is the responsibility of each U.S. citizen or resident receiving a gift or bequest, whether directly or indirectly, from an expatriate (as defined in section 877A(g)(2)) to determine its tax obligations under section 2801. Thus, the burden is on that U.S. citizen or resident to determine whether the expatriate was a covered expatriate (as defined in section 877A(g)(1)) and, if so, whether the gift or bequest was a covered gift or covered bequest.

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

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

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

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

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

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

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

This encourages the expatriate transferor to cooperate with transferees.

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

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

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

> By designating a U.S. agent, the trustee of the foreign trust agrees to provide the agent with all information necessary to comply with any information request or summons issued by the Secretary. Such information may include, without limitation, copies of the books and records of the trust, financial statements, and appraisals of trust property. … Acting as an agent for the trust for

> purposes of section 2801 includes serving as the electing foreign trust's agent for purposes of section 7602 ("Examination of books and witnesses"), section 7603 ("Service of summons"), and section 7604 ("Enforcement of summons") with respect to … [a]ny request by the Secretary to examine records or produce testimony related to the proper identification or treatment of covered gifts or covered bequests contributed to the electing foreign trust and distributions attributable to such contributions; and … [a]ny summons by the Secretary for records or testimony related to the proper identification or treatment of covered gifts or covered bequests contributed to the electing foreign trust and distributions attributable to such contributions.

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

j. **Item 11: Actuarial Tables**

(1) Item 11 is described as "Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests. Proposed regulations were published on May 5, 2022." This item was new in the 2018-2019 Plan.

(2) The previous mortality tables, based on 2000 census data, became effective May 1, 2009. Before that, mortality tables had taken effect on May 1, 1989, May 1, 1999, and May 1, 2009. Section 7520(c)(2) mandates revision of the tables at least once every 10 years. Thus, the tables provided by this guidance project were due by May 1, 2019. They were delayed in part because the decennial life table data that form the basis for those tables was not compiled and made available by the National Center for Health Statistics of the Centers for Disease Control and Prevention until August 2020.

(3) New tables, based on 2010 census data, are applied in lengthy proposed regulations (REG-122770-18) released on May 4, 2022, and published in the Federal Register on May 5, 2022 (87 FED. REG. 26806). The new tables are available on the IRS website at **https://www.irs.gov/retirement-plans/actuarial-tables**. The 2010 census data on which these new tables are based show significantly increased longevity, especially for older persons, compared to the 2000 census data. Accordingly, these new tables will produce significantly higher values for life interests and significantly lower values for remainder interests following life interests. For any given section 7520 interest rate, this will result, for example, in larger charitable deductions for charitable lead annuity trusts (CLATs) for the life of an individual, but smaller charitable deductions (and more difficulty satisfying the 10 percent remainder test and 5 percent exhaustion test) for charitable remainder annuity trusts (CRATs). Valuations based on a fixed term and not life expectancies (as in term loans and GRATs) are affected only by the monthly section 7520 rate and will not be affected by these new tables.

(4) In view of the tardiness of these tables, the proposed regulations include special effective date and transitional rules.

   (a) The new tables will generally take effect on what is described as "the applicability date of the Treasury decision adopting these regulations as final regulations."

   (b) That date is "**proposed**" to be "the first day of the month following the date on which the Treasury decision adopting these regulations as final regulations is published in the Federal Register." (The implication of the word "proposed" is that the final regulations could provide differently, although that seems unlikely.)

   (c) Under Proposed Regs. §§20.2031-7(d)(3) and 25.2512-5(d)(3) (other specific proposed regulations have similar provisions), for gifts or dates of death on or after January 1, 2021, and before the "applicability date," the mortality component of any applicable value, including a charitable deduction, may be determined under either the 2000 tables or these new 2010 tables "at the option of the donor or the decedent's executor."

      i. That choice must be the same choice with respect to all valuation elements of the same transfer and, for estate tax purposes, all transfers occurring at death. Specifically, those proposed regulations state:

      > The decedent's executor [or "with respect to each individual transaction, the donor"] must consistently use the same mortality basis with respect to each interest (income, remainder, partial,

etc.) in the same property, and with respect to all transfers occurring on the valuation date. For example, gift and income tax charitable deductions with respect to the same transfer must be determined based on factors with the same mortality basis, and all assets includible in the gross estate and/or estate tax deductions claimed must be valued based on factors with the same mortality basis.

ii. The **interest rate** will be the applicable rate under section 7520 (which rates have continued to be published monthly without interruption) in effect for the month of the transfer or death.

iii. Applying the rules already contained in Reg. §§1.7520-2(a)(2), 20.7520-2(a)(2), and 25.7520-2(a)(2), the preamble notes that, in the case of a charitable deduction, if the taxpayer elects under section 7520(a) to use the rate for one of the two preceding months, and that elected month is "prior to January 1, 2021" (in other words, it is November 2020 or December 2020), then **only the 2000 mortality tables** may be used to compute **the mortality component**.

(d) The proposed regulations say nothing about transfers or deaths on or after May 1, 2019, and before January 1, 2021, thus implying that all valuations in such cases must be made under the 2000 mortality tables.

i. To illustrate, consider the case of a charitable lead annuity trust (CLAT) created for the lifetime of the creator's spouse by gift or at death on or after May 1, 2019, but before January 1, 2021. As noted above, the significantly increased longevity reflected in the 2010 census data would result in a significantly larger charitable deduction than the proposed regulations would allow. It seems that the donor or the decedent's estate is entitled to that larger deduction by statute. Even conceding that the delay in completing these tables was due to circumstances beyond anyone's control and thus was not anyone's "fault," it certainly wasn't the fault of that donor or decedent, and it is not fair to deny the donor or the estate what the statute mandates.

ii. And suppose the annuity payment from the CLAT was defined as a percentage of the value of the property transferred to the CLAT (as allowed by Reg. §20.2055-2(e)(2)(vi)(a)), and that percentage was determined by a formula intended to achieve a certain estate or gift tax result – "zeroing out" the CLAT, for example. And, for a pre-2021 transfer, it is likely that the gift or estate tax return has already been filed. The IRS has been wary of attempts to change those kinds of calculations in a manner that looks retroactive, as seen as early as *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *rev'g and rem'g* 2 T.C.M. 429 (1943), *cert. denied*, 323 U.S. 756 (1944), and as recently as *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40. Therefore, whether the transition date in the final regulations is May 1, 2019, or January 1, 2021, or something in between, it is essential that the election allowed by the transitional rule relate back to the original transfer date for all purposes, with no possibility of challenge. This could be achieved, for example, by explicitly stating in the regulations that choosing the option provided by the transitional rule will not be treated as a condition subsequent or in any other way that would prevent or limit the application of a formula or other condition in a transfer document intended to determine the amount, value, character, or tax treatment of a transfer in whole or in part with reference to the mortality assumptions, even if a return reporting that transfer has already been filed.

k. **Notable Omissions from the Priority Guidance Plan**

(1) **Valuation of Promissory Notes**

(a) A project described as "Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872" first appeared in the 2015-2016 Plan, but was dropped in the 2017-2018 Plan (the first Plan in the Trump Administration).

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

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

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

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

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

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

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

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

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

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

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.

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

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

ii. The interest of the IRS was especially apparent after the docketing of *Estate of Davidson v. Commissioner*, T.C. Docket No. 13748-13, in which the IRS asserted $2.8 billion in estate, gift, and generation-skipping taxes owed. On July 6, 2015, the case was settled for just over $550 million. Addressing Mr. Davidson's sales both in Chief Counsel Advice 201330033 (issued Feb. 24, 2012; released July 26, 2013) and in its answer in the Tax Court, the IRS argued that the notes should be valued, not under section 7520, but under a willing buyer-willing seller standard that took account of Mr. Davidson's health. *See also Estate of Kite v. Commissioner*, T.C. Memo. 2013-43.

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

(h) On the other hand, Treasury and the IRS might have given up on regulatory guidance in favor of seeking new legislation. See the discussion of the Fiscal Year 2023 Greenbook proposal in Part 3.e(2) above.

(2) **Defined Value Clauses**

(a) A project described as **"Guidance on the gift tax effect of defined value formula clauses under §§2512 and 2511"** was also new in 2015 but dropped in the 2017-2018 Plan.

(b) Defined value clauses have an interesting history. See, for example, Technical Advice Memorandum 8611004 (Nov. 15, 1985) (approving a transfer of "such interest in X Partnership … as has a fair market value of $13,000"); *Knight v. Commissioner*, 115 T.C. 506 (2000) (disregarding the use of such a technique to transfer "that number of limited partnership units in [the partnership] which is equal in value, on the effective date of this transfer, to $600,000"); *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev'g* 120 T.C. 358 (2003) (reviewed by the Court) (approving a defined value clause, with the excess going to charity); *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), *aff'd*, 586 F.3d 1061 (8th Cir. 2009) (approving a formula disclaimer in favor of charity); *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011) (approving a defined value clause, with the excess going to charity); *Hendrix v. Commissioner*, T.C. Memo. 2011-133 (approving a defined value clause, with the excess going to charity); *Wandry v. Commissioner*, T.C. Memo. 2012-88, *nonacq.*, AOD 2012-004, 2012-46 I.R.B. (approving a type of defined value clause, with the excess remaining with the transferor).

(c) The taxpayers' actual implementation of defined value clauses (that is, returning property to the donors where it might be taxed as part of their estates) was likely an element of the settlements in *Estate of Donald Woelbing v. Commissioner* (Tax Court Docket No. 30261-13, stipulated decision entered March 25, 2016) and *Estate of Marion Woelbing v. Commissioner* (Tax Court Docket No. 30260-13, stipulated decision entered March 28, 2016); and possibly in *Karen S. True v. Commissioner* (Tax Court Docket No. 21896-16, stipulated decision entered July 9, 2018) and *H.A. True III v. Commissioner* (Tax Court Docket No. 21897-16, stipulated decision entered July 6, 2018).

(d) Another example of the IRS and the taxpayer agreeing to give effect to a formula – in this case a formula for determining the annuity payments from a GRAT – is the stipulation in *Grieve v. Commissioner*, T.C. Memo. 2020-28 (Judge Kerrigan). In that case, in addition to other transfers, there was a two-year GRAT with annuity payments determined as stated percentages of what the opinion describes only 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.

They never had the opportunity to make such a payment, however, because the taxpayer won the case on the underlying valuation issue.

(e) *Nelson v. Commissioner*, T.C. Memo. 2020-81 (June 10, 2020, Judge Pugh), involved a gift to a trust of a limited partner interest "having a fair market value" of a specified dollar amount, "as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment," followed two days later by a sale to the same trust described in the same way, except that the time for obtaining the appraisal was 180 days instead of 90 days. The taxpayer argued unsuccessfully that this permitted an adjustment to the transfer based on the values finally determined for gift tax purposes, as in *Wandry*. Significantly, the IRS not only accepted the formulas based on appraisals within a specified time but actually advocated for them, obviously not offended by such formula transfers as it is by *Wandry* clauses. This is understandable, because by the time the IRS looks at the return the transferred quantity will already have been determined, and the IRS can contest the valuation of that quantity.

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

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

Maybe, in this guidance project, Treasury was proposing to accept that invitation. Meanwhile, the settlements described in paragraph (c) above, the parties' stipulation in *Grieve* quoted in paragraph (d) above, and the Tax Court's apparent respect for that stipulation in *Grieve* all might suggest that actually giving effect to defined value clauses in audit, settlement, or litigation to cut down the tax benefits of an estate planning technique might have become a "new normal."

(3) **"Material Participation" by Trusts and Estates**

(a) Also in the 2017-2018 Priority Guidance Plan, a project described as "Guidance regarding material participation by trusts and estates for purposes of §469," which had been in previous Plans under the heading of "General Tax Issues," was omitted.

(b) This guidance could have shed light on the application to trusts and estates of the "trade or business" exception in section 1411(c)(1)(A)(i) to the 3.8 percent tax on net investment income under section 1411 (enacted in 2010). Congress applied that requirement in 2010 to the "trade or business" exception by including in section 1411(c)(1)(A)(i) the qualifier "not described in paragraph (2)" and by including in subparagraph (A) of paragraph (2) "a passive activity (within the meaning of section 469)," thus incorporating into section 1411 the definition of section 469(c)(1) that "[t]he term 'passive activity' means any activity (A) which involves the conduct of any trade or business, and (B) in which **the taxpayer does not materially participate**."

(c) Chief Counsel Advice 201244017 (issued Aug. 3, 2012; released Nov. 2, 2012) took the position that

> a trust cannot meet the qualifying tests of 469(c)(7)(B) because those tests are intended to apply only to individuals. Only individuals are capable of performing "personal services" …, and the statute specifically states that the personal services must be performed <u>by the taxpayer</u>.

(d) Final regulations addressing many issues under section 1411 were issued on November 26, 2013, but did not address the issue of material participation in the context of trusts. The preamble (T.D. 9644) candidly acknowledged Treasury's sympathy with the problems of material participation and the difficulty of dealing with those problems, which it described as "very complex." The preamble to proposed regulations published on December 2, 2013, cited the preamble to the November 26, 2013, final regulations and deferred the issue of material participation by estates and trusts, including QSSTs, which it said "is more appropriately addressed under section 469."

(e) Then, in the section 469 case of *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (March 27, 2014), the Tax Court (Judge Morrison) held that the material participation by the trust in real estate operations may be determined by considering the activities of the trustees, including the activities of some of the trustees in their roles as employees of an LLC wholly owned by the trust, and that by that standard the court was "convinced that the trust materially participated in the trust's real-estate operations."

(f) There has been no acquiescence or nonacquiescence or any other formal indication of the IRS's view of this subject in light of *Aragona*. But five months after the *Aragona* decision, on August 26, 2014, the 2014-2015 Treasury-IRS Guidance Plan, under the heading of "General Tax Issues," included for the first time a project described as "Guidance regarding material participation by trusts and estates for purposes of §469." That project was repeated in two more annual Plans but was dropped from the 2017-2018 Plan, thus essentially leaving the regular published Tax Court decision in *Aragona* as the last word on the subject.

(g) And this issue might become moot if an expansion of the tax on net investment income such as the proposal described in Part 2.b(7)(c) above is enacted.

(4) **Allocation of GST Exemption at the End of an ETIP**

(a) A project described as "Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP" first appeared in the 2012-2013 Plan and then was dropped from the 2016-2017 Plan.

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

> The issues presented here are best illustrated by considering the following fact pattern:
>
> > Taxpayer creates an irrevocable trust, Trust Z, in which a qualified annuity interest (as defined in section 2702(b)) is payable to the taxpayer or his estate for 10 years. Upon the termination of the annuity interest, Trust Z is to be separated into two trusts, Trust A and Trust B. Trust A is for the exclusive benefit of Taxpayer's children and grandchildren. Trust B is for the exclusive benefit of Taxpayer's children. Trust A is to receive from Trust Z so much of the Trust Z's assets as is equal to Taxpayer's remaining GST exemption, if any. Trust B is to receive from Trust Z the balance of Trust Z's assets, if any, after funding Trust A. The taxpayer is alive at the end of the 10 years.
>
> Presumably, the transfer to Trust Z is an indirect skip to which GST exemption will be automatically allocated at the end of the ETIP. Will the automatic allocation rules apply to all the assets remaining in Trust Z at that time? If so and if the taxpayer wants to allocate GST exemption only to the assets going to Trust A, the taxpayer should timely elect out of the automatic allocation rules of section 2632(c), and then affirmatively allocate GST exemption only to the assets going into Trust A at the end of the ETIP. Is that possible?
>
> In the alternative, the automatic allocation rules may apply only to the transfer going into Trust A because Trust B is not by definition a GST trust. Because of the application of the ETIP rules, the transfer from the taxpayer for GST purposes would occur only at the time that the assets are funded into Trust A. If that is the case, then the taxpayer does not need to do anything affirmatively to ensure that GST exemption is allocated to Trust A and not Trust B as he or she desires.
>
> It has been our experience that many trusts are structured in a manner similar to the above referenced fact pattern. By letter dated November 10, 2004, the AICPA submitted comments on the proposed regulations on electing out of deemed allocations of GST exemption under section 2632(c). In that letter, guidance was requested on these issues. The preamble to the final regulations (T.D. 9208) acknowledged this request for the inclusion in the regulations of an example addressing the application of the automatic allocation rules for indirect skips in a situation in which a trust subject to an ETIP terminates upon the expiration of the ETIP, at which time the trust assets are distributed to other trusts that may be GST trusts. According to the preamble, the Treasury Department and the Internal Revenue Service believed that this issue was outside the scope of the regulation project and would consider whether to address these issues in separate guidance.

(5) **Private Trust Companies as Fiduciaries**

(a) Privately owned and operated trust companies are becoming an option that families with large trusts are turning to in increasing numbers, and state law authority for such private trust companies is being continually refined. Until 2014, every Priority Guidance Plan since 2004 had included an item referring to private trust companies.

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

ii. In the 2005-2006, 2006-2007, and 2007-2008 Plans, it was described as "Guidance regarding the consequences under various **estate, gift, and generation-skipping**

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

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

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

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

vi. Following the first appearance of this project in the 2004-2005 Plan, the IRS identified the treatment of private trust companies for estate tax purposes under sections 2036, 2038, and 2041 as "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise." Rev. Proc. 2005-3, 2005-1 C.B. 118, §§5.07, 5.08 & 5.09. This designation has continued to the present. Rev. Proc. 2023-3, 2023-1 I.R.B. 144, §§5.01(12), (13) & (14).

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

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

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

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

iv. Effect on a trust's status under the GST tax either as a trust created before the effective date or as a trust to which GST exemption has been allocated.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(6) **Decanting**

(a) The 2011-2012 Priority Guidance Plan included "Notice on decanting of trusts under §§2501 and 2601." This project was new in 2011-2012, but it had been anticipated for some time, especially since the publication at the beginning of 2011 of Rev. Proc. 2011-3, 2011-1 I.R.B. 111, in which new sections 5.09, 5.16, and 5.17 included decanting among the "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise." Rev. Proc. 2023-3, 2023-1 I.R.B. 144, §§5.01(8), (16) & (19) continues this designation.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

a. The Basics: *Gregory v. Helvering*

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

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

> When subdivision (B) [the predecessor of section 368(a)(1)(D)] speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" … of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose – a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.
>
> In these circumstances, **the facts speak for themselves** and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

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

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

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

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

b. ***Estate of Powell v. Commissioner,* 148 T.C. 392 (2017) (reviewed by the Court)**

(1) **Facts.** The decedent Nancy Powell and her son Jeffrey were both residents of California. Jeffrey, acting under a power of attorney from Nancy, contributed approximately $10 million in cash and marketable securities to a limited partnership and took back, on Nancy's behalf, a 99 percent limited partner interest. Jeffrey and his brother contributed unsecured promissory notes in exchange for the other 1 percent interest, with Jeffrey's 0.5 percent interest being the only general partner interest and his brother's 0.5 percent interest being another limited partner interest. On the same day, Jeffrey purportedly contributed Nancy's limited partner interest to a charitable lead annuity trust (CLAT), even though his authority to make gifts under his power of attorney was limited to "a class composed of the principal's [Nancy's] children, any of such children's issue, or any or all to the full extent of the federal annual gift tax exclusion." Already, Jeffrey on both sides of the transaction, the disproportionate contributions to the partnership, the flimsy contributions by the general partners, and the questionable transfer to the CLAT signaled this as a "bad facts" cases. But then Nancy died seven days later, with Jeffrey as executor. Seven concurring Tax Court judges viewed this as "what is best described as aggressive deathbed tax planning."

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

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

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

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

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

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

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

(4) ***Byrum* "Fiduciary Duty" Limitation Distinguished**

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

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

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

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

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

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

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

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

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

(5) **Section 2043 and Double Taxation.** On his own, Judge Halpern explored a convoluted and seemingly unnecessary analysis of the effect of section 2043, which had not been raised, argued, or briefed by either of the parties. The opinion echoes themes like "recycling" and "pooling" that have been used to evaluate family limited partnerships in other contexts (*see*, *e.g.*, *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121) and offers its own metaphor of

doughnuts and doughnut holes to refer, respectively, to retained interests and valuation discounts. While repeatedly using words like "limits" and "limiting" to refer to section 2043, the opinion, in footnote 7, observes that the result could be "a duplicative transfer tax" (translated double taxation) in some cases, although not this one.

(6) **The Effect of *Powell* as a Precedent**

(a) Seventeen judges participated in *Powell*. Eight judges, counting Judge Halpern, joined Judge Halpern's opinion. Judges Foley and Paris concurred in the result only, while Judge Lauber, joined by six other judges, wrote a concurring opinion. Thus, while there was no dissent from what should have been a very easy decision in a case with extremely bad facts, Judge Halpern's opinion did not even speak for a majority of the judges. Judge Lauber wrote that "[t]he Court's exploration of section 2043(a) seems to me a solution in search of a problem." Yet, particularly because of the section 2043 detour, we now have a Tax Court opinion, dignified by the caption "Reviewed by the Court," that reaches one of the most understandable outcomes, but by way of one of the least understandable opinions, ever seen.

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

c. **Introduction to Intergenerational Split-Dollar Arrangements (*Cahill, Morrissette,* and *Levine*)**

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

In each of these cases a revocable trust, which of course became irrevocable when the grantor died, made payments toward premiums on life insurance owned by irrevocable trusts created by the same grantor and insuring lives of family members in the next generation. (In this summary, that revocable trust will be called the **"premium-paying trust"** and that irrevocable trust will be called the **"policy-owning trust."**) In each of these two cases, upon the death of an insured a portion of the death benefit equal to the greater of the total premiums paid or the cash surrender value of the policy immediately before the insured's death would be payable to the premium-paying trust. Herein lies one perceived benefit of intergenerational split-dollar arrangements: because the insureds are members of the next generation, their deaths are actuarially likely to occur long after the grantor's death, and this reimbursement right of the premium-paying (now irrevocable) trust is valued for estate tax purposes at a significant discount reflecting the time-value of money.

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

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

d. ***Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018, Judge Thornton)**

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

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

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

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

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

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

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

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

e. ***Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60 (May 13, 2021, Judge Goeke)**

(1) ***Facts.*** In the *Morrissette* case, Clara Morrissette, a resident of Virginia, was the grantor of the trusts, including a revocable trust that she had established in 1994 with herself as the initial trustee, funded with all her shares in a group of family-owned moving and logistics companies with a history going back to 1943. In August 2006, a court appointed a company employee as the conservator of Clara's estate for a two-month term. Shortly thereafter, Clara's three sons, who were active in the business, became co-trustees of Clara's revocable trust, and the conservator established three irrevocable multigenerational trusts, one for each of Clara's sons and their families. All those trusts, Clara's sons, and other trusts holding interests in the business executed a shareholders agreement providing, among other things, that upon the death of any of the sons the surviving sons and their respective trusts would purchase the stock held by or for the benefit of the deceased son. On October 4, 2006, the three new irrevocable trusts became the policy-owning trusts by purchasing universal life insurance policies on the lives of the two other sons to fund the trusts' purchases under the shareholders agreement. On October 31, 2006, Clara's revocable trust became the premium-paying trust by forming two split-dollar arrangements with each policy-owning trust and contributing a combined $29.9 million to those trusts, which the trusts used to make the lump-sum premium payments on the life insurance policies. At that time, the sons' life expectancies ranged from 14.6 to 18.6 years. Contemporaneously with these transactions, the revocable trust agreement was amended to provide that upon Clara's death the split-dollar rights would be distributed to the three multigenerational trusts, respectively, that owed the reimbursement amounts.

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

Clara's gift tax returns for 2006 (the year of the transactions) through 2009 (the year of her death) reported annual gifts to the multigenerational trusts in accordance with the "economic benefit" regime for the taxation of split-dollar arrangements under the 2003 regulations, Reg. §1.61-22(d). Under the regulations, those gifts were the annual cost of the life insurance protection under the applicable premium rate table issued by the IRS, less the amount of premiums paid by each respective multigenerational trust. Those gifts totaled $636,657 for those four years. Because the multigenerational trusts became the owners of the revocable trust's reimbursement rights upon Clara's death, the multigenerational trusts (as the Tax Court's 2021 opinion puts it) were then "on both sides of the agreements," which "terminated the split-dollar arrangements" and "also precluded any future gift tax … under the economic benefit regime," but "did not result in cancelation of the underlying life insurance policies."

Clara's sons, as her executors, reported on the estate tax return a total value of $7,479,000 for the split-dollar receivables, as determined by an appraiser. They later conceded that because of an error in the appraiser's original calculations the appraised value should be $10,449,000.

One of Clara's sons died in 2016. His trust distributed its nonvoting stock in the company to a marital trust and its voting stock to three subtrusts for each of his three children, two of whom, along with one other of Clara's grandchildren, worked in the business at the time of the Tax Court trial.

(2) **Court Proceedings and Outcome.** The IRS asserted that Clara should have reported the $29.9 million as gifts (rather than the $636,657 of net economic benefit reported as gifts under the economic benefit regime for 2006 through 2009). The executors moved for partial summary judgment that the economic benefit regime applied, which the Tax Court granted pursuant to its 2016 decision, as noted in paragraph c above.

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

The *Morrissette* case was tried in Washington, D.C., in October 2019, briefed in the first quarter of 2020, and decided by Judge Goeke on May 13, 2021. ***Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60 (*Morrissette II*)**. Judge Goeke held that the "bona fide sale for an adequate and full consideration in money or money's worth" exception in sections 2036(a) and 2038(a)(1) and the "bona fide business arrangement … [that] is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth … [and that has] terms … comparable to similar arrangements entered into by persons in an arms' length transaction" exception in section 2703(b) were satisfied and therefore those sections did not apply. These were unequivocal taxpayer victories. The *Morrissette* opinion's analysis of the bona fide business arrangement, testamentary device, and comparability with arm's-length transactions prongs of the exception in section 2703(b) is a rare exposition of Chapter 14, more than three decades after Chapter 14 took effect on October 9, 1990.

Regarding valuation, Judge Goeke was more sympathetic with the IRS. Most significantly, it accepted the lower discount rates for calculating present value of 6.4 and 8.85 percent derived by the IRS's appraiser from yields in the life insurance industry and in the particular insurance companies, rather than the range of 15 to 18 percent used by the appraiser on whose appraisal the executors had relied in preparing the estate tax return.

Judge Goeke also agreed with the IRS that the maturity date used in that present value calculation should be December 31, 2013, not the life expectancies of the sons as the executors' experts had used. He noted:

> When the 2006 plan was implemented, the [revocable] trust agreement was amended to distribute the split-dollar rights to the respective dynasty trusts that owned the underlying policies. Such a distribution indicates an intent … to give the dynasty trusts complete control after Mrs. Morrissette's death.

Against that background, facts that Judge Goeke found supported a December 31, 2013, maturity date included "the decision to purchase policies with high premiums and modest death benefits and July 2010 emails between [one of the executors and the advisors that had been involved in the planning] that discuss the possibility of canceling certain policies." As Judge Goeke put it, those emails included one advisor's response "that he insisted that the policies not be canceled until the three-year period of limitations on the estate return had expired" and that advisor's warning "that the IRS would likely see problems with the values of the split-dollar rights that the estate had planned to report on the return." The estate tax return had been filed on December 10, 2010, a couple weeks before the extended due date, which, applying the three-year statute of limitations, forms the basis for an assumed cancellation (maturity) date of December 31, 2013. Judge Goeke even noted that "there are grounds for setting an earlier maturity date, but we will use respondent's date."

On December 13, 2021, Judge Goeke entered a Decision, based on calculations implementing its opinion to which the parties had agreed, determining an estate tax deficiency of $12,575,459.24 and an accuracy-related penalty of $3,232,339.89, both subject to interest. That indicates estate tax values of the reimbursement rights significantly higher than those asserted by the executors. But the deficiency is significantly less than the approximately $39.4 million the opinion states the IRS had asserted in its notice of deficiency, and, to that extent, the case could also be viewed as a taxpayer victory.

(3) **More on "In Conjunction With Any Person"**

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

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

(b) Judge Goeke rejected that argument, commenting that:

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

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

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

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

(4) **Comparison of *Cahill* and *Morrissette*.** The facts in *Morrissette* clearly seemed better than the facts in *Cahill*, and the less harsh result should not be surprising.

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

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

(c) The premium payments were not financed with borrowing in *Morrissette*, as they were in *Cahill*. See the further discussion of this factor in reference to *Levine* in paragraph f(4)(c) below and the elaboration of this point in paragraph g(7) below.

(d) Perhaps most importantly, the context in *Morrissette* of a family-owned business that has been operating for 75 years was more supportive of "bona fide sale" arguments under sections 2036(a) and 2038(a)(1) and a "bona fide business arrangement" argument under section 2703(b). As Judge Goeke noted in contrasting *Morrissette* with *Cahill*, "Estate of Cahill did not involve active business operations with related financial considerations such as management efficiency and succession, capital accumulation and long-held grudges that put those financial considerations at risk."

f. ***Estate of Levine v. Commissioner*, 158 T.C. No. 2 (Feb. 28, 2022, Judge Holmes)**

(1) **Facts.** Marion Levine, a resident of Minnesota, and her first husband George Levine, who died in 1974, had opened a supermarket in 1950, which grew into a 27-store supermarket chain, and in 1959 they had built the successful and profitable Penn Lake Shopping Center. Marion sold the supermarket chain in 1981 and used the sale proceeds to invest in other real estate ventures, including real estate lending businesses, several mobile-home parks, two Renaissance fairs (in Arizona and North Carolina), and a stock portfolio she had started in the early 1960s.

Marion had a daughter and a son, who were each married with children of their own. She developed a trusting relationship with Bob Larson, an accountant whom she met when he and his wife, who was Marion's hairdresser, were invited to and attended Marion's daughter's wedding. Bob became the overseer of the accounting and tax work for Marion's companies and, with Marion's son and son-in-law, managed the day-to-day business of the properties.

Marion created a revocable trust in 1988 with herself as trustee. She named her children and Bob as successor trustees, promoted them to co-trustees in 1996, and resigned and made them sole trustees in 2005. At about the same time she appointed Bob the third attorney-in-fact, with her two children, under a statutory power of attorney, which provided that disagreements would be decided by majority vote because her children did not always agree.

In 2007, Marion engaged an estate planning attorney who began by reviewing and updating her business documents, in some cases restructuring her businesses, and placing some of her real estate assets in a grantor retained annuity trust (GRAT) and a qualified personal residence trust (QPRT) to simplify succession and save taxes. Because many of Marion's assets were illiquid, the attorney suggested life insurance as a way to help pay estate tax, and, when it became evident that Marion's children had no estate plans of their own, he suggested intergenerational split-dollar life insurance as a way to give them a head-start on their estate planning. He had experience with split-dollar life insurance, but not in an intergenerational context. Judge Holmes' opinion notes that the attorney "wasn't looking to do anything radical" and makes it clear that he paid attention to details and to the need to tailor the planning to Marion's specific circumstances and objectives. The attorney explained the arrangement to Marion, her children, and Bob in a detailed letter and also in a helpful discussion with them.

The attorney settled the irrevocable insurance trust in 2008 in South Dakota with a South Dakota trustee, because South Dakota "has no rule against perpetuities, but does have a taxpayer-friendly state income tax and a favorable premium tax." The trust was a directed trust under South Dakota law, with an "investment committee" consisting of one member, Bob Larson. As Judge Holmes described it:

> Levine picked Larson for this role because he had long been very close to the Levine family yet was not a part of it. Levine knew the relationship between her children was fraught. She wanted someone she could trust to manage not just the trust but the relationship – and her children understood this.

Because Marion's son had a medical condition that would have made him uninsurable at a reasonable price, Marion, her children, and Bob agreed that the insurance trust would buy last-to-die policies on the lives of Marion's daughter and son-in-law. Marion approved the transaction but limited the amount to be invested in the policies to $6.5 million, not the $10 million that her attorney had assumed in illustrating the proposal. In what Judge Holmes described as "an investment decision made by Levine and her children," the premiums were paid largely from short-term (one-year or five-year) loans made to Marion's businesses and secured by properties of those businesses, with the largest loan made to Penn Lake Shopping Center. Under the split-dollar arrangement, upon the death of the last to die of the insureds or upon the earlier termination of the arrangement, the life insurance trust would pay to the revocable trust the greater of the advance ($6.5 million) or the then cash surrender value of the polices. Termination could be directed only by the insurance trust, acting alone (in other words, by Bob as the trust investment director), and if the insurance trust did terminate the arrangement it would receive nothing. Unlike the premium-paying trusts in *Cahill* and *Morrissette*, the revocable trust could not terminate the arrangement or participate in the termination of the arrangement.

Marion's 2008 and 2009 gift tax returns reported gifts of $2,644 (determined under the 2003 split-dollar regulations – see paragraph (3)(d) below). Upon her death in 2009, her personal representative (Bob Larson) reported the reimbursement right on the estate tax return, in Judge Holmes' words, "as an asset worth about $2 million." The estate and the IRS later stipulated that the value of the reimbursement right at Marion's death was $2,282,195.

(2) **Issue.** The issue was whether the gross estate included the $6,153,478 cash surrender value of the policies at Marion's death (under section 2036, 2038, or 2703), as the IRS asserted, or only the $2,282,195 stipulated value of the reimbursement right, as the estate argued. The IRS also asserted that a 40 percent gross undervaluation penalty should apply.

(3) **The Court's Analysis**

(a) **Style.** Judge Holmes often makes his opinions readable and interesting, frequently including details of both background and analysis that might not be found in other opinions, and his opinions are often very witty. The *Levine* opinion is no exception. Noting that Marion's investments included two Renaissance fairs, Judge Holmes freely made use of Renaissance images and metaphors to illustrate elements of his analysis. For example, he introduces his summary of the estate tax audit by remarking that "[t]he Commissioner issued his challenge, and the joust between the IRS and the Estate began."

(b) **Sections 2036 and 2038**

i. **The Arrangement Itself.** Judge Holmes determined that section 2036(a)(1) did not apply because Marion could not surrender the policies or terminate the split-dollar arrangement and therefore did not retain anything. Although Bob, who as the sole member of the investment committee had the power to terminate the arrangement, was also a co-agent under Marion's power of attorney, he could not terminate the arrangement and surrender the polices as attorney-in-fact on Marion's behalf because Marion had no power to do that herself. Therefore, Marion did "not retain any right to possession or enjoyment of the property transferred."

Judge Holmes noted that in comparison to *Cahill* and *Morrissette* this case presented "novel questions." An important factual difference from *Morrissette* and *Cahill* is that in those cases the donor could act together with the owner of the polices to terminate the split-dollar arrangement (and thereby receive the cash surrender value of the policy immediately), but in *Levine* the insurance trust had the sole right to terminate the arrangement. As Judge Holmes put it, "[u]nlike what we saw in *Morrissette II* and *Estate of Cahill*, we see here a carefully drafted arrangement that expressly gives the power to terminate *only* to the Insurance Trust" (emphasis is the court's).

ii. **General Contract Principles.** Noting what he called the IRS's "first pass at the Estate in this part of their joust" that under general contract principles all of the parties to a contract could amend it at any time, Judge Holmes viewed that as insufficient to cause the decedent to have a right "in conjunction with" another to designate who could enjoy the property under section 2036(a)(2) or to alter, amend, or terminate the arrangement under section 2038. Relying on *Helvering v. Helmholz*, 296 U.S. 93 (1935), and *Estate of Tully v. United States*, 528 F.2d 1401 (Ct. Cl. 1976), and also citing the more contemporary analogy of conservation easements addressed in *Pine Mountain Pres. LLLP v. Commissioner*, 151 T.C. 247, 282 (2018), *rev'd in part, aff'd in part, vacated and remanded*, 978 F.3d 1200 (11th Cir. 2020), he concluded that rights to modify contracts under general default rules of contract are not rights held "either alone or in conjunction with any other person" under section 2036(a)(2) or 2038.

iii. **Bob Larson's Fiduciary Duties.** The IRS also argued that Marion, through her agent, Bob Larson, "stood on both sides of these transactions and therefore could unwind the split-dollar transactions at will." Although Judge Holmes might have dismissed this contention more summarily in light of his previous analysis, he lived up to his reputation for detail while maintaining his Renaissance allusions. In going along nevertheless with the IRS's urging to look more granularly at the factual context of Bob Larson's fiduciary roles, he wrote:

> We therefore conclude that the Commissioner doesn't win as a matter of law here.
>
> But we do think he's correct that we also must avoid being so blinded by any formal gleam from the Estate's armor that we overlook some practical chinks that deals like this may have: Can the Commissioner dismount from purely legal or theoretical arguments and start wielding shorter, sharper weapons forged from the particular facts of particular cases?

Judge Holmes looked to *United States v. Byrum*, 408 U.S. 125 (1972), which had held that the fiduciary duties of a donor-shareholder to minority shareholders prevented a decedent's retained right to vote transferred stock from causing inclusion in the gross estate under section 2036(a)(2). *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005), and *Powell* had both distinguished *Byrum* on the ground that in *Byrum* the decedent held fiduciary duties to other shareholders. In *Strangi* the potential fiduciary duties were owed "essentially to himself" because the decedent could act with others to dissolve a partnership and, through his son-in-law who was his agent under a power of attorney and general partner, could determine the amount and timing of distributions. Similarly, in *Powell*, the duties were "owed almost exclusively to decedent herself," and the partners could act unanimously to dissolve the partnership. In contrast to *Strangi* and *Powell*, Bob's power to terminate did not, in effect, give Marion rights over the cash surrender values because he also had conflicting fiduciary duties to other beneficiaries. Judge Holmes noted that Bob owed fiduciary duties to Marion's grandchildren, who were beneficiaries of the life insurance trust in addition to decedent's children, and those grandchildren would have received nothing if Bob had terminated the arrangement early.

Judge Holmes concluded with this analysis:

> We therefore find it more likely than not that the fiduciary duties that limit Larson's ability to cancel the life-insurance policies were not "illusory". It also persuades us that we cannot characterize his ability to unload the policies and realize their cash-surrender values as a right retained by Levine, either alone or in conjunction with Larson, to designate who shall possess or enjoy the property transferred or the income from it.
>
> We conclude that this precludes the inclusion of the cash-surrender values of the life-insurance policies in Levine's estate under section 2036(a)(2).

In short, maybe Judge Holmes viewed the resolution of this issue as very fact-specific, turning on the particular status of Marion's grandchildren as beneficiaries of the insurance trust. Or maybe this is just an example of Judge Holmes being Judge Holmes, meticulously answering the *Strangi*/*Powell* argument the IRS chose to make while also dignifying the significance of the grandchildren as beneficiaries that the estate chose to emphasize (the estate's "blunt parry" to the IRS's "subtle thrust," in Judge Holmes' entertaining Renaissance vocabulary). In any event, it undoubtedly strengthened the estate's case and facilitated Judge Holmes' analysis that (1) the decedent, Marion (either by herself or through an agent acting on her behalf), could not participate in a decision to terminate the split-dollar arrangement, and (2) the person with that power, Bob, was not a family member or a beneficiary of any trust involved.

Judge Holmes held – but without repetition or elaboration – that the same reasons prevented section 2038 from applying.

(c) **Section 2703.** Judge Holmes held that section 2703 did not apply to cause the reimbursement right to be valued at the current cash surrender value of the policies. Section 2703(a)(2) requires the determination of "the value of any property … without regard to … any restriction on the right to sell or use such property." In a refreshingly simple and straightforward section 2703 analysis, Judge Holmes noted that the "property" referred to is "property of an estate, not some other entity's property." Therefore, "property" could not refer to the life insurance policies that were owned by the life insurance trust and were never owned by the decedent. (And, in contrast to *Cahill* and *Morrissette*, "property" could not even refer to the termination right, because the termination right was also held exclusively by the insurance trust.) Judge Holmes simply concluded that the inability to cause the immediate surrender of the policies and payment of the cash surrender value to the estate was not a restriction on what was owned by the estate, which was the receivable itself (the value of which had been stipulated).

(d) **Gift Tax.** Previously, in a companion gift tax case, Judge Holmes had granted summary judgment in favor of Marion's estate, following the affirmation in *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016) (*Morrissette I*), that the rules of Reg. §1.61-22(d)(1), (2)(i), and (3) applicable to the "economic benefit regime" defined in Reg. §1.61-22(c)(1)(ii)(A)(2) applied, making the annual gifts equal to the "cost of current life insurance protection." *Estate of Levine v. Commissioner*, Order, Docket No. 9345-15 (July 13, 2016).

Significantly, in the summary of the tax reporting in his estate tax opinion, Judge Holmes remarked (emphasis added):

> [T]he value of gifts made in bargain sales is usually measured as the difference between the fair market value of what is given and what is received. … Not so here. The Secretary, **for whatever reason**, has issued regulations that provide a different measure of value when split-dollar life insurance is involved. See Treas. Reg. § 1.61-22(d)(2).

Then he concluded his opinion with this observation (citation omitted):

> If there is a weakness in this transaction, it lies in the calculation of the value of the gift between Levine and the Insurance Trust – the difference between the value that her Revocable Trust gave to the Insurance Trust and what it got in return. But the gift-tax case is not this estate-tax case.
>
> And the problem there is traceable to the valuation rule in the regulations. No one has suggested that this rule is compelled by the Code and, if it isn't, the solution lies with the regulation writers and not the courts.

This comment recalls other times that courts have suggested that the IRS, by regulations or otherwise, could take positions that are harsher than the results courts have sometimes reached in litigation – for example, Tax Court Judge Hamblen's comment on the valuation of intra-family promissory notes in *Frazee* and the Ninth Circuit's comment as part of its consideration of defined value clauses in *Petter*. See Parts 5.k(1)(d) and 5.k(2)(f) above.

(e) **Penalty.** Needless to say, the court summarily concluded:

> The Estate having almost entirely prevailed [that is, having conceded only a slight increase in the stipulated value of the receivable from "about $2 million" to $2,282,195], no accuracy-related penalties apply.

(f) **Status.** The opinion is a "regular" Tax Court opinion, not a "memorandum opinion," implying an element of "law-making" that every Tax Court judge is obliged to follow and not just the application of law to particular facts.

(4) **Observations: Comparisons and Contrasts with Previous Cases**

(a) **Purposes.** In *Levine*, while perpetuation of the operating businesses might have been a factor, as in *Morrissette*, the principal objective that influenced the structure may have been Marion's desire to encourage and enable her children's own estate planning. In a footnote, Judge Holmes commented:

> While [Marion's attorney] created the Insurance Trust to own the life-insurance policies taken out as part of the split-dollar transaction, we find him credible when he said that he also viewed the Insurance Trust as something [Marion's children] could use in their own eventual estate planning.

(b) **Health, Competence, and Involvement.** In *Powell*, *Morrissette*, and *Cahill*, the relevant estate planning decisions had been made not by the decedent but by the decedent's agent – a son of the decedent acting under a power of attorney in *Powell* and *Cahill* and an employee of the family business appointed by a court as a temporary conservator in *Morrissette*. In contrast, Marion Levine made or, as appropriate, participated with her children in making the decisions, although her children and Bob Larson, acting under her power of attorney, executed documents needed to implement those decisions.

The opinion reports that Marion (who was born in 1920) suffered a stroke in 2003, lost her driver's license in 2004 or 2005 after her children arranged for her to take a driver's test, and began to show signs of dementia in 2008, "but [as Judge Holmes put it] even as she neared 90, Levine still wanted to know what was going on." For example, as noted in the summary of the facts in paragraph (1) above, it was Marion who made the decision to limit the premium payment to $6.5 million.

Again with a Renaissance flair, Judge Holmes places Marion's physical and mental deterioration in context this way (emphasis added):

> With the split-dollar deal **done**, [the attorney] had **finished** hammering into place the paper armor he had designed to protect as many of Levine's assets from tax as he legally could. He was **just in time**; **within months**, Levine's physical and mental health began to deteriorate more rapidly. She became more forgetful and began to not recognize her family and friends. At the start of 2009, she became bedridden. On January 22 she died.

As discussed in paragraph g(3) below, it is often better, if possible, that the principal actually participates, so that "this is want Mom wanted" actually has substance.

(c) **Loans.** While the financing of the insurance premiums by a loan from a financial institution might have been off-putting to Judge Thornton in *Cahill* (see paragraph g(7) below), Judge Holmes characterized the loans in *Levine* as "an investment decision made by Levine and her children" and added in a footnote that "Larson credibly testified that they could have paid all the premiums in cash if they had decided to take that route." With the short-term (one-year or five-year) business loans as the immediate source of the cash, the businesses were liable for repayment, making the premiums funded, in effect, by distributions on Marion's account from her various business entities.

(d) **Stipulation.** The satisfactory result for the Levine estate reflected a stipulated value for the discounted present value of the receivable that was only slightly higher than the value reported on the estate tax return. This is in contrast to *Cahill* and *Morrissette* and may not be a concession the IRS will be eager to make in other cases.

(e) **Deferred Income Tax Consequences.** Marion's estate emphasized that discounting the value of the reimbursement right may merely result in a deferral of taxes. The basis of the reimbursement right would be the finally determined discounted estate tax value, and when the reimbursement right is satisfied the difference between the amount received and the basis of the reimbursement right would be income. (The income might be ordinary income; *see*, *e.g.*, sections 1271-1276 relating to original issue discount and *Hudson v. Commissioner*, 20 T.C. 734 (1953) (reviewed by the Court), *aff'd sub. nom. Ogilvie v. Commissioner*, 216 F.2d 748 (6th Cir. 1954); *but cf.* section 1278(a)(1)(D)(i) relating to the settlement of a judgment.)

(f) **Limitations and Tradeoffs.** "Economic benefit" intergenerational split-dollar life insurance remains a challenge, requiring balancing of a number of factors. For example, in all the decided cases, the senior-generation premium-payer died relatively soon after the arrangement was created – 15 months in *Cahill*, just under three years in *Morrissette*, and less than a year in *Levine*. Had they lived longer, there would not only have been more reportable gifts in more years, but the "cost of current life insurance protection" used to measure those gifts would presumably increase because the insured younger-generation family members were growing older. For the same reason, the present-value discounts available for valuing the receivables would be based on lower life expectancies, tending to produce higher estate tax values. Indeed, in the *Morrissette* case, one of Clara Morrissette's sons died while her estate tax case was still pending. In any event, those discounted values result in lower bases and ultimately more income tax, as discussed in paragraph (e) above.

Against all this mathematical backdrop the drama of IRS challenges, taxpayers' responses, and courts' reactions may continue to play out. Or, as Judge Holmes might say, let the jousts continue.

g. **What To Do**

(1) **Have a legitimate and significant nontax reason**.

(a) Most of the taxpayer victories in section 2036 cases have rested on the exception for "a bona fide sale for an adequate and full consideration in money or money's worth." In *Estate of Bongard v. Commissioner*, 124 T.C. 95, 118 (2005), the majority opinion by Judge Goeke (who now has also decided the *Morrissette* case) embraced and applied the principle that (emphasis added):

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

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

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

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

ii. Keeping special heirloom assets in the family.

iii. Institutionalizing intra-family communication.

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

v. Avoiding public litigation through alternative dispute resolution.

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

vii. Simplifying responses to divorce.

viii. Otherwise increasing asset protection.

ix. Allowing amendment without formalities of trust law.

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

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

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

(2) **Learn what people are doing in the commercial world.**

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

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

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

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

(b) But if the parent's only contribution to the transaction was "All I want to do is to eliminate taxes," that would not add very much. Acting while the parent is competent and engaged may reduce the likelihood, although it can never eliminate the possibility, of the parent's imminent death, or even death within three years, thereby potentially taking some issues off the table.

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

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

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

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

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

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

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

(6) **Fund the entity.**

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

> There are compelling reasons to question whether a valid partnership was ever formed here. In comparison with the $10 million in cash and securities that the decedent relinquished for her alleged

partnership interest, the other two supposed partners – her sons and heirs – contributed nothing more than unsecured promissory notes.

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

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

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

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

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

(b) Many of these questions would have been eliminated or diminished if there had been no borrowing. And compare the borrowing in *Levine* discussed in paragraph f(4)(c) above.

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

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

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

(c) Even if all interests cannot be divested, transferring some of the decedent's interests could mitigate the bad impression of owing fiduciary duties solely to oneself, discussed in paragraph (4) above.

(9) **Make all partners irrevocable trusts with independent trustees.**

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

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

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

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

(b) But there can appear to be gamesmanship, even hypocrisy, and risk, with such a strategy.

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

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

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

(1) **Basic Facts**

a. Background. The core business involved in the 2009 gifts was Seneca Sawmill Co. (SSC) of Eugene, Oregon. Mr. Jones founded SSC in 1954 as a lumber manufacturing business; in 1986 it elected to be an S corporation. The Tax Court opinion describes the significant growth of the business since 1954 and includes considerable detail about the operation and business environment of the lumber business. At the time of the gifts in 2009, SJTC (introduced and described in the next paragraph) held approximately 1.45 billion board feet of timber over 165,000 acres in western Oregon. Originally relying on timber from federal lands, SSC began purchasing its own land in 1989 when environmental regulations had reduced the access to federal lands.

In 1992 Mr. Jones formed Seneca Jones Timber Co. (SJTC), an Oregon limited partnership, to hold timberlands intended to be SSC's inventory and to obtain debt financing secured by the timberlands. SSC was the 10 percent general partner of SJTC and contributed to SJTC the timberland it had recently acquired. SSC and SJTC share a management team and share their headquarters in Eugene, which was built in 1996.

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

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

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

Ownership of SSC Before and After the 2009 Gifts				
	Voting Shares		Nonvoting Shares	
Shareholder	**Before**	**After**	**Before**	**After**
Aaron Jones	4,900	3,600	39,468	8,700
Voting Trust		1,300		
Family Trust	600	600		
Rebecca Jones*	1,500	1,500	544	10,800
Kathleen Jones Hall*	1,500	1,500	544	10,800
Jody Jones*	1,500	1,500	544	10,800

* Aaron Jones's three daughters. Numbers for the nonvoting shares for each daughter include trusts for her and her family. After the gifts, Aaron and his daughters (or trusts for them and their families) each owned 12,300 total shares (voting and nonvoting).

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

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

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

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

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

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

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

(2) **The Tax Court Opinion**

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

In the court's view:

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

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

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

The court concluded that:

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

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

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

> As of the valuation date SSC's dimension and stud lumber were used primarily to build houses and, therefore, its lumber sales were almost completely dependent on housing starts.
>
> …
>
> As of the valuation date the United States was experiencing severe economic turmoil amidst the subprime mortgage crisis, especially in the housing market. Housing starts, which measure new residential construction projects during a given period, declined in the United States from 2.3 million units in early 2006 to 490,000 units in early 2009. The crisis required SSC to reduce production. It also reduced the hours that its employees worked so that it could avoid layoffs.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(3) **Analysis**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> Valuing closely held stock incorporates a number of alternative methods of valuation, and the appellate courts have afforded the tax court broad discretion in determining what method of valuation most fairly represents the fair market value of the stock in light of the facts presented at trial. See *Palmer v. Comm'r of Internal Rev.*, 523 F.2d 1308 (8th

Cir. 1975). Moreover, "complex factual inquiries such as valuation require the trial judge to evaluate a number of facts: whether an expert appraiser's experience and testimony entitle his opinion to more or less weight; whether an alleged comparable sale fairly approximates the subject property's market value; and the overall cogency of each expert's analysis." *Ebben v. Comm'r of Internal Rev.*, 783 F.2d 906, 909 (9th Cir. 1986).

…

Valuation is a fact specific task exercise; tax affecting is but one tool in accomplishing that task. The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction. The Tax Court did that and determined that tax affecting was not appropriate in this case. I do not find its conclusions clearly erroneous.

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

v. Further Tax Court Litigation. The Tax Court largely went along with the IRS. For example, in *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148 (corrected, T.C. Memo. 2011-244), Judge Halpern, again, wrote (emphasis added):

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

In *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141, *rev'd on other grounds*, 586 Fed. Appx. 417 (9th Cir. 2014), *on remand*, T.C. Memo. 2019-114, Mr. Reilly had reduced each year's predicted cashflows by 25 percent to account for the income taxes that would be owed by the owner of the partnership interest on that owner's share of the partnership's income. With very little discussion, but citing *Gross*, the Tax Court disallowed that adjustment. The Court of Appeals for the Ninth Circuit agreed with the Tax Court, stating that "[t]he Estate itself admits in its brief that 'tax-affecting is ... an unsettled matter of law.' We therefore cannot say that the Tax Court clearly erred.…

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

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

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

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

viii. IRS Reaction. It might be thought that the IRS would be embarrassed by a case in which it was caught ignoring the consensus of the appraisal community and keeping its "experts … notably silent," and would take pains to avoid such a risk in the future. But it cannot be so easily assumed that the IRS will now give up its hostility to tax-affecting. One Tax Court loss (making the IRS's Tax Court record, in effect, 3-1) may encourage some in the IRS to work even harder to uphold its position in the next case, perhaps by choosing to litigate a case in which the facts provide less justification for tax-affecting or where (as apparently in *Gross*) the taxpayer's appraiser has taken a less thorough and balanced approach than the appraiser in *Jones*.

Moreover, the hostile view toward tax-affecting is not necessarily shared, or apparently even known and understood, uniformly within the IRS. There is informal anecdotal evidence of both the historical unevenness of resisting tax-affecting within the IRS and the survival of that resistance after *Jones*.

ix. *Cecil v. Commissioner*. On February 24-26, 2016, the Tax Court tried a case that includes tax-affecting for valuing S corporation stock as one of its issues. *Estate of William A. V. Cecil, Sr. v. Commissioner*, Docket No. 14639-14, and *Estate of Mary R. Cecil v. Commissioner*, Docket No. 14640-14. Briefs were filed in May and July 2016. As of January 3, 2022, over five years later, there was still no decision. In *Cecil*, as in *Kress*, both the taxpayer **and** the IRS's expert used tax-affecting in their analysis. This may be an example of the lack of uniformity or discipline within the IRS on this issue. Or it may mean simply that facts vary and facts matter and the presentation of facts matters. Also, tax-affecting is not the only issue in *Cecil*. But at a minimum the Tax Court may have a hard time rejecting tax-affecting as a matter of law in *Cecil* when both experts agree in its application, but it still depends both on the facts and on the presentation of the facts, as illustrated in *Jones*.

(4) **Observations**

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

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

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

- There was of course a legitimate 55-year-old family-owned operating business.
- There is no indication that Mr. Jones' actions were taken for him under a power of attorney or any other agency arrangement.
- Mr. Jones' gifts resulted in making his daughters and himself equal owners of the economic interests in both SSC and SJTC. There was no division like 99-1 to attract scrutiny.

- These were not "deathbed" gifts. Mr. Jones survived the gifts by more than five years. When a deathbed scenario is encountered, it is not possible to go back. But the point remains that often the best estate planning is the earliest estate planning. The counterpoint is that decisions irrevocably made can later become a source of regret and friction, and the desirability of flexibility should not be overlooked.
- Mr. Jones actually paid some gift tax with his return. The opinion tells us that in 1996 the Jones family built a new headquarters and began succession planning. The succession process was evidently deliberate and not hasty (and, as noted, not a "deathbed" scurry). Mr. Jones may have been advised to choose 2009 when business was down and a willing buyer would have paid less for the business, and there is nothing wrong with that. In 2010 the gift tax rate was scheduled to drop from 45 percent to 35 percent (with the exemption remaining $1 million), but there was uncertainty, especially after the 2008 election, about what the law in 2010 would be. Overall, Mr. Jones seems to have been very well served by his advisors.

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

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

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

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

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

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

i. Interesting Dicta in *Kress*. In *Kress*, the GBP Bylaws contained the following limitation on the transfer of Kress family shares:

> Transfer of shares of the Corporation by shareholders who are members of the Kress Family … is hereby restricted to transfers by gift, bequest or private sale to a member or members of the Kress family, provided, however, that the children of George and Marguerite Kress may transfer shares of the Corporation by gift to such child's spouse or trust therefor and further provided that in the event of any such transfer as above provided to issue and descendants or spouse of a child or trust therefor of George and Marguerite Kress, that all of the restrictions set forth herein shall continue to be applicable to the shares of common stock then held by such issue and descendants or spouse or trust therefor as transferee.

The Government argued that the restriction should be disregarded under section 2703(a). The taxpayers argued that section 2703(b) applied, which exempts from section 2703(a)

> any option, agreement, right, or restriction which meets each of the following requirements:
>
> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
>
> (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

The court determined, however that the requirement of section 2703(b)(3) **had not been met:**

> Though Plaintiffs contend restrictions like the Kress Family Restriction are common in the commercial world, they have not produced any evidence that unrelated parties dealing at arms' length would agree to such an arrangement.

But the court reduced the lack-of-marketability discounts in question only by 3 percent – from 30, 30, and 28 percent for the three respective years to 27, 27, and 25 percent. (In contrast, the Government's expert had determined lack-of-marketability discounts of only 10.8, 11.0, and 11.2 percent.)

Despite the fact that all three requirements of section 2703(b) had to be met to qualify for the exception, the court opined that the requirements of section 2703(b)(1) and (2) **had been met.** The court, in effect, found the "bona fide business arrangement" requirement of section 2703(b)(1) to be obvious in the context of GBP, which the court described as "unmistakably an operating business."

As to the requirement of section 2703(b)(2), the court reasoned simply that the restriction could not be "a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth" because the gifts were *inter vivos* and the Kresses were not "decedents." The court acknowledged that Reg. §25.2703-1(b)(1)(ii) substitutes "the natural objects of the transferor's bounty" for the statutory term "members of the decedent's family," which the Government argued resolves the ambiguity of "decedent" in the statutory context of chapter 14. Reviving a debate that seemed to have been dormant since the early 1990s, the District Court found the word "decedent" to be unambiguous and in effect declared the regulation invalid – all, however, totally dicta!

ii. Nothing in *Jones*. In *Jones*, although there were comparable and relevant restrictions on transfer of family interests in the SSC and SJTC Buy-Sell Agreements (described in paragraph (1)a above), the IRS evidently did not raise the issue of section 2703. (The *Jones* petition was filed in late 2013 and the IRS's answer was filed in early 2014, before the IRS successfully invoked section 2703, at least for purposes of summary judgment, in *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018), discussed in Part 6.d(2) above).

8. A Confusing Deathbed-Planning Taxpayer Loss: *Moore*

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

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

The decedent's revocable trust provided a formula bequest to a charitable lead trust in an amount to "result in the least possible federal estate tax." In addition, the Irrevocable Trust provided that the trustee would distribute to the revocable trust "the value of any asset of this trust which is includible in my gross estate." Following the decedent's death at the end of March 2005, the charitable lead trust apparently was funded with a substantial amount under the revocable trust's formula transfer. An IRS examination resulted in this case alleging additional gift and estate taxes.

Not surprisingly, the court determined that the farm was included in the gross estate under section 2036(a)(1). The bona fide sale for full consideration exception in section 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 section 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 section 2043 in *Estate of Powell v. Commissioner* with its own lengthy analysis, but on the facts of the case the application of section 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 section 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),** ***aff'd,*** **128 AFTR 2d 2021-6604 (9th Cir. Nov. 8, 2021).**

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 and Partnership**

(a) **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.

(b) **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.

(c) **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.

(d) **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.

(e) **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.

(f) **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 section 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.

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 section 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. **Court's Analysis**

(1) **Value of Farm is Included in Gross Estate Under Section 2036.** A three-part test is applied for determining whether section 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)).

(a) **Bona Fide Sale for Full Consideration Exception to Section 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 3 of the Basic Facts Section 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, see Estate of Mirowski …, 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.

(b) **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 section 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."

(c) **Conclusion as to Section 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 below regarding the application of section 2043, apparently the court is including 100% of the farm in the gross estate under section 2036, not just the 4/5ths transferred to the FLP.

Observation: Apparently, the court is combining two different transfers as triggering section 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 section 2033 or section 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 section 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 section 2035(a)(2).)

(3) **Application of Section 2043 Consideration Offset.** The court observed that prior to the *Powell* case in 2017, the analysis would end there regarding section 2036 inclusion. The proceeds from the farm's sale would be included in the gross estate under section 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 section 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 section 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 section 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 section 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**

(a) **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.

(b) **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 paragraph e(11)(b) 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.

(a) **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 paragraph e(11)(f) below.

(b) **Charitable Deduction Must be Ascertainable at Death.** What the court called "a second, 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.

(c) **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 section 2035(b) because the gifts had been made within three years of death.

(7) **Epilogue.** According to the court's decisions dated August 17, 2020, the IRS had been advised that the son of Mr. Moore who had served as executor and trustee had died. In the absence of any motion to appoint a successor, the court accepted the IRS's Rule 155 calculations and found deficiencies of $1,329,751 in gift tax and $6,384,073 in estate tax.

(8) **Affirmed on Appeal.** The estate appealed only the denial of charitable deductions to the Court of Appeals for the Ninth Circuit. In a short unpublished opinion, that court affirmed on the narrow ground of the "any asset of this trust" wording of the Irrevocable Trust (discussed in paragraph (5)(a) above), which it found unambiguous. ***Moore, et al. v. Commissioner*, 128 AFTR 2d 2021-6604 (9th Cir. Nov. 8, 2021).**

e. **Observations**

(1) **Long Delay.** This Tax Court memorandum decision (not a reviewed opinion involving negotiations with all Tax Court judges) was long delayed. The trial was held March 26, 2012, the last brief was filed February 13, 2013, and the docket sheet reflects no other actions until the memorandum opinion was filed April 7, 2020 – more than seven years later. Apparently, some of the issues in the case raised difficult issues for the court.

Altogether, the Moore family had to wait almost 11 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 learn that it owed an additional $7.7 million in taxes (and, as noted above, Mr. Moore's son who served as executor reportedly did not even survive the proceedings).

(2) **Deathbed 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."

This is the latest in a string of cases in which judges are understandably skeptical when planning is implemented on death's doorstep that would result in huge discounts (an approximately 53% discount in this case) for tax savings purposes and would not serve a legitimate and significant nontax purpose. The IRS viewed the decedent's estate plan "as nothing more than a last-minute, last-ditch effort to avoid paying tax." In that context, the section 2036 result of this case is not at all surprising.

(3) **Emphasis on Businesses Requiring Active Management to Satisfy "Legitimate and Significant Nontax Purpose" Requirement.** The opinion begins its analysis of the "bona fide" element of the bona fide sale for full consideration exception in section 2036(a) by saying that "whether a transfer was *bona fide* turns on motive" and reiterating the legitimate and significant nontax reason test announced fifteen years ago in *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005). (Some planners had believed that "bona fide" meant that a transfer occurred that was not a sham and represented something that really happened, but that position has been firmly rejected since 2005 in *Bongard*.) 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 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.") It is startling to read that. If, because of wealth, background, profession, profile, reputation, personality, lifestyle, family connections, political history, or any other characteristic, a person is especially exposed to the threat of questionable claims by opportunistic claimants, then for that person protection against that threat is surely significant. For such a person, it appears that "significant" means almost the same thing as "legitimate."

(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. The court observed:

> Ronnie [one of Mr. Moore's sons] also testified during trial that because the family was–as he put it–"dysfunctional," the FLP was supposed to bring the family together. But if so, the FLP flopped. It doesn't seem as if there has ever been a second meeting of the partners. An investment adviser handles all investment decisions according to a set of "investment objectives." And neither Ronnie nor his siblings have vetoed any of the adviser's decisions.

(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 section 2036(a)(1) can be shown by an implied agreement. Planners have advised clients to retain assets outside the partnership for living expenses, so that no implication would arise that the decedent necessarily would be looking to use partnership assets for required living expenses. 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 Section 2036 Transfer; Use of Farm Property.** We are all very familiar with treating property contributed to an FLP or LLC as a section 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 section 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 section 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 section 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 section 2033 or section 2036, but the complete absence of any analysis of treating a sale of property to a third party as a section 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 section 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 section 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 section 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 section 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 section 2036 within three years of death (section 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 section 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 section 2036. Value attributable to interests that have been transferred at least three years earlier should not be subject to section 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 (S.D. Md. 2019) (ERISA case in which court looked to whether section 678 applied to beneficiary's ability to withdraw assets as needed for health, education, support, and maintenance, but trustees never questioned whether withdrawn amounts were actually needed for those purposes; court reasoned that a "HEMS provision that exists only on paper cannot be said to restrict the power exercisable" by the beneficiary); *SEC v. Wyly,* 2014 WL 4792229 (S.D.N.Y. 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**

(a) **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.

(b) **Reliance on *Powell* Section 2043 Analysis.** The opinion says that the Tax Court "discovered" and first analyzed section 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 section 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 section 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 section 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 section 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 section 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 the various FLP cases prior to *Powell* in which section 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 cases with significant appreciation of partnership assets.

(c) **Section 2043 Background.** The section 2043 analysis was not actually "discovered" in *Powell*. The plurality opinion's summary of how section 2043 applies in the context of section 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 section 2042 and under section 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 section 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 section 2042, however, is that section 2043(a) refers to transfers under sections 2035-2038 and 2041, but not transfers under section 2042.

Similarly, the regulations regarding GRATs state that if the GRAT assets are included under section 2036, the retained annuity interest payments that are payable after the decedent's death are not also included under section 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 section 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 section 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.

(d) **Major Practical Impact—Appreciation, Depreciation, Distributions.** Applying the double inclusion with a section 2043 consideration offset analysis (rather than simply including the section 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.

i. **Impact of Appreciation.** If the assets that were contributed to the entity have appreciated prior to the date of death, footnote 7 of the *Powell* plurality opinion acknowledged that "duplicative transfer tax" would apply because the date of death asset value is included in the gross estate under section 2036 offset only by the *date of contribution* discounted value of the partnership interest. The date of death value of the LP interest would also be included under section 2033, so all of the post-contribution appreciation of the assets would be included under section 2036 AND the discounted post-contribution appreciation also would be included under section 2033. The effects in different example situations are summarized in various scenarios:

(1) **No FLP.** Do nothing; continue owning assets directly

(2) **FLP/No §2036.** Create FLP and §2036 does not apply

(3) **FLP/Simple §2036.** Apply §2036 without double inclusion or §2043 analysis

(4) **FLP/Double Inclusion §2036.** Apply §2036 with double inclusion and §2043 adjustment

Example. $10 million contributed to FLP; Assets appreciate to $12 million, 25% discount.

Under the double inclusion with section 2043 adjustment approach: Inclusion

= FLP Interest (DOD)(§2033) + [§2036 Value (DOD) – FLP Interest (DOT)]

= ($12 million x 0.75) + [$12 million – ($10 million x 0.75)]

= $9 million + [$12 million – $7.5 million)]

= $13.5 million [**Observe:** $1.5 million more than if no FLP transfer.]

Inclusion Comparisons:

Scenario	Inclusion
(1) No FLP	$12 million
(2) FLP/No §2036	($12 million x 0.75) = $9 million
(3) FLP/Simple §2036	$12 million
(4) FLP/Double Inclusion §2036	$13.5 million

Observation: Double Inclusion Section 2036 vs. Simple Section 2036 (or No FLP) results in double taxation of $1.5 million of gross estate value.

As a result, more value would be included in the gross estate than if the decedent had never contributed assets to the FLP. Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument) is unclear, but the *Powell* and *Moore* opinions do not even hint that a court would refuse to tax the same appreciation twice in that situation.

ii. **Impact of Depreciation.** Footnote 7 of the *Powell* plurality opinion also stated that a "duplicative reduction" would result if the assets depreciated after being contributed to the FLP. The analysis is not that simple though. If the assets have depreciated in value, a net reduction in value likely does not occur by having section 2036 apply with the section 2043 adjustment as compared to section 2036 not applying. Section 2043(a) indicates that if section 2036 applies the excess of the fair market value at the time of death over the value of consideration received is included in the estate, indirectly saying that the net amount included under a string statute is merely reduced to zero (a negative number cannot be created).

Example. $10 million contributed to FLP; Assets depreciate to $6 million, 40% depreciation, 25% discount.

Under the double inclusion with section 2043 adjustment approach: Inclusion

= FLP Interest (DOD)(§2033) + [§2036 Value (DOD) – FLP Interest (DOT)]

= ($6 million x 0.75) + [$6 million – ($10 million x 0.75)] but not less than zero

= $4.5 million + 0

= $4.5 million [**Observe:** Applying section 2036 has no impact; discount still allowed.]

Inclusion Comparisons:

Scenario	Inclusion
(1) No FLP	$6 million
(2) FLP/No §2036	$4.5 million
(3) FLP/Simple §2036	$6 million
(4) FLP/Double Inclusion §2036	$4.5 million

Observation: Double Inclusion Section 2036 vs. Simple Section 2036 – Double Inclusion Section 2036 has the same result as if no section 2036 (25% discount is still permitted), but the Simple Section 2036 approach does not allow use of the 25% discount.

Thus, creating an FLP may result in lower estate inclusion than doing nothing, even if section 2036 applies, if the assets should experience significant subsequent depreciation (40% depreciation in this example).

If an FLP is created, if section 2036 applies under a double inclusion/section 2043 adjustment approach, and if depreciation occurs, the net inclusion amount is the same whether or not section 2036/2043 applies if the depreciation percentage is equal to or greater than the discount percentage in valuing the FLP interest. For example, using the example above, if the discount percentage for valuing a limited partnership interest is 25% and if the assets depreciate by 25% from $10 million to $7.5 million, the net inclusion under the double inclusion section 2036/2043 approach is ($7.5 million) minus ($10 million x 0.75) or zero.

For an explanation (with examples) of the impact of appreciating and depreciating values, see Larry Katzenstein and Jeff Pennell, Estate of Moore v. Commissioner – *Discount Planning Debacle*, LEIMBERG INFORMATION SERVICES ESTATE PLANNING EMAIL NEWSLETTER #2790 (April 20, 2020).

iii. **Distributions.** The other practical impact occurs if distributions are made from the entity that are still owned by the decedent at death, illustrated by Example 5 in the *Moore* opinion, discussed in Item 3 of the Opinion Section above. A brief summary of that example follows—

Example 5 in *Moore* opinion: $1,000 land contributed to FLP that is sold, 25% discount, but section 2036 applies, $400 distribution that is unspent. Inclusion:

= Unspent distribution + FLP interest (§2033) + [§2036 Value (DOD) - consideration (DOT)]

= $400 + (remaining $600 x .75) + [$1,000 (land value) – ($1,000 x .75)]

= $400 + $450 + [$1,000 - $750]

= $1,100 (compared to $1,000 if no distribution is made)

Observe: Additional amount = Unspent distribution x 25% discount ($400 x 0.25 = $100).

Inclusion Comparisons:

Scenario	Inclusion
(1) No FLP	$1,000
(2) FLP/No §2036	$850
(3) FLP/Simple §2036	$1,000
(4) FLP/Double Inclusion §2036	$1,100

(e) **Summary: Double Inclusion Analysis Going Forward in FLP Context.** Using the Double Inclusion section 2036 approach rather than the Simple Section 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 Simple Section 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 Section 2036(a)(2).** The IRS argued, in the alternative, that the FLP assets should be included in the gross estate under section 2036(a)(2). Footnote 17 of the opinion states that the court does not address the IRS's section 2036(a)(2) arguments in light of the fact that the FLP's assets are included in the gross estate under section 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.)

(a) **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.

(b) **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 section 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.

(c) **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 in the context of 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 section 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 INFORMATION SERVICES ESTATE PLANNING EMAIL NEWSLETTER #2790 (April 20, 2020).

(d) **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 paragraph (f) below.

(e) **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).

(f) **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 section 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, 313-14 (2012) (sometimes referred to as "*Turner II*") (footnote omitted):

> 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.

(g) **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.

(h) **Concern Diminished After Ninth Circuit's Affirmance.** As noted above, the estate appealed only the denial of the charitable deductions, which the Court of Appeals for the

Ninth Circuit affirmed on the narrow ground of the "any asset of this trust" wording of the Irrevocable Trust. It found that wording "unambiguous: the Irrevocable Trust, as a limited partner, had no 'interest in any of the assets of the Partnership.'" The Ninth Circuit did not even mention what the Tax Court had described as the "much more general problem … that charitable deductions … must be ascertainable at a decedent's date of death."

9. A Taxpayer Valuation Victory (Mostly): ***Nelson***

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 directly or indirectly 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 Tax 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 Tax 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.

The taxpayers appealed to the Court of Appeals for the Fifth Circuit, which affirmed. ***Nelson v. Commissioner*, T.C. Memo. 2020-81 (June 10, 2020, Judge Pugh), *aff'd*, 128 AFTR 2d 2021-6532 (5th Cir. Nov. 3, 2021).**

b. **Basic Facts**

(1) **Founding of WEC.** In 1971, Johnny Warren, Mrs. Nelson's father cofounded (with another family) a company providing gas compression equipment for the oil and gas industry. In 1975, Mr. Warren and his brother-in-law bought the other family's interest in that business. In 1985, Mr. Warren purchased the assets of a Caterpillar dealership. 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 Tax 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. The businesses were successful and acquired

other related businesses. Mr. Warren died in 1999, and by 2008 WEC was owned primarily by his four children (including his daughter, Mrs. Nelson).

(2) **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 Tax 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 section 2703 issue was raised).

(3) **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 provided:

> [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 provided:

> [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 * * *.

(4) **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.

(5) **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 e(3) of the Observations, 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?)

(6) **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.)

(7) **Texas Residents.** Mr. and Mrs. Nelson were residents of Texas when they filed their petitions.

c. **Tax Court's Analysis**

(1) **Burden of Proof.** The taxpayers argued that the burden of proof shifted to the IRS under section 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 (the Caterpillar dealership and two smaller subsidiaries also involved in heavy equipment dealer operations) were valued on a net asset value method, which Ms. Rayner 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, 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.

(a) **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."

(b) **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 Tax 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. **Affirmed on Appeal**

The Court of Appeals for the Fifth Circuit affirmed, noting that "[b]y its plain meaning, the language of this gift document and the nearly identical sales document transfers those interests that the qualified appraiser determined to have the stated fair market value – no more and no less." Regarding the taxpayers' citation of other cases, the court added that "the transfer documents in every other formula-clause case contained crucial language that the Nelsons' instruments lacked: specific language describing what should happen to any additional shares that were transferred should the valuation be successfully challenged."

e. **Observations**

(1) **Not a Rejection of Defined Value Clauses.** The courts' 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.

(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* Tax 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 Tax 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 about $60.7 million) by 26.24%, or a reduction of the Trust's value by about $15.9 million, without counting subsequent appreciation and income. It might have been thought that the family in retrospect would be delighted that they "lost" their argument that the assignments were defined value transfers. They might have been happy to pay an additional $2 million of gift tax in order to keep in the Trust an additional $15.9 million (effectively, at a 45% gift tax rate, locking in an initial valuation discount of about 72%), 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. Even so, the taxpayers appealed. But they apparently did not contest on appeal, and the court of appeals did not address, the Tax Court's rather favorable valuation.

(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 section 2703.

(7) **Sale for Note Using AFR 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 section 7872, as the interest rate on notes for intra-family installment sales. Section 7872 addresses the gift tax effects of "below-market" loans, and section 7872(f)(1) defines "present value" with reference to the "applicable Federal rate." Using section 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 section 7872 (rather than the interest rate under section 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 section 7520 rate or some other market rate should apply was not strictly before the court, because the IRS proposed using the lower section 7872 rate. However, the court analyzed section 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 section 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 section 7872 are objective and do not burden the court with the need for evidence, argument, and judgment.

The use of the section 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 section 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 was allowed in *Astleford v. Commissioner*, T.C. Memo. 2008-12. 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, cases 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*). 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 section 2036(a)(1) and Mr. Nelson could serve as trustee without risking estate inclusion for him under section 2036(a)(2) or section 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).

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 section 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.

10. Different Values for Gross Estate and for Charitable Deductions: *Warne*

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. ***Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (February 18, 2021, Judge Buch).**

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.

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 Royal Gardens LLC, and (v) whether a failure to file penalty under section 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 have been appealable to the Ninth Circuit Court of Appeals if it were appealed).

c. **Court's 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).

(2) **Lack of Control Discount for Majority LLC Interests.** The estate and the IRS each used an appraiser 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 different from the appraiser who had valued the underlying leased fee interests.

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) had 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 section 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 appoint a manager who could 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 of 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, 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 have passed from the estate to a single charity.

(5) **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.

(6) **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 section 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 section 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 IRS'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 section 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 section 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 section 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 Tax Court did not have to address the marital deduction mismatch issue in *Black* and *Shurtz* because the court held that section 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 a section 2036 FLP case. A tax fiction deems the value of the assets that were transferred in the section 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 section 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 section 2036. Again, the very asset that gives rise to section 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 section 2036, however, is that no particular disadvantage exists for having section 2036 apply at the first spouse's death regarding assets contributed to the FLP by that spouse (and section 2036 would not apply at the surviving spouse's subsequent death as to assets contributed to the FLP by the first-decedent spouse).

11. Failure of Improvised Unequal Gift-Splitting: *Smaldino*

a. The Plan. Mr. Smaldino owned 100 percent of the voting and nonvoting interests in an LLC that in turn owned several parcels of California real estate. In early 2013, he decided to give a substantial nonvoting interest to a Dynasty Trust for the benefit of his children and grandchildren, but he did not want to transfer an interest greater than 50 percent because that would have triggered reassessment of California property taxes on the real estate. He chose 49 percent. He also wanted to use both his and his wife's basic exclusion amount, which in 2013 was $5,250,000. His wife was not the mother of his children (they had married in 2006) or a beneficiary of the Dynasty Trust, but she fully supported his plan. She had her entire $5,250,000 exclusion amount available, but he did not, apparently because he had used some of it before marrying her.

b. The Execution. Mr. Smaldino hired, probably in April, an appraiser to determine the value of a 49 percent nonvoting interest in the LLC as of April 15. The appraiser's report, dated August 22, determined the value of a 49 percent interest to be $6,281,000. Then Mr. Smaldino executed an assignment to his wife of a "sufficient number" of nonvoting units in the LLC "so that the fair market value of such nonvoting units as determined for federal gift tax purposes shall be Five Million Two Hundred Forty Nine Thousand One Hundred Eighteen and 42/100ths Dollars ($5,249,118.42)" – $881.58 less than the 2013 basic exclusion amount. The assignment was not dated but recited that it was "Effective April 14, 2013." Mrs. Smaldino executed the same formula assignment to the Dynasty Trust, not dated but "Effective April 15, 2013." And Mr. Smaldino made a similar formula assignment to the Dynasty Trust of nonvoting units with a value of $1,031,881.58, not dated but "Effective April 15, 2013."

And $5,249,118.42 plus $1,031,881.58 happens to be exactly $6,281,000, the amount in the appraiser's August 22 report, which Judge Thornton pointed to in his opinion as evidence that those assignments could not have been signed in April but had to have been drafted and signed after receipt of the appraiser's August 22 report. ***Smaldino v. Commissioner*, T.C. Memo. 2021-127 (Nov. 10, 2021).**

c. Collapse of the Purported Transfers by the Court. But ultimately the timing of the execution of the documents was not dispositive. In the first paragraph of his opinion, Judge Thornton foreshadowed his conclusion by summarizing (emphasis added) that "petitioner **<u>purportedly</u>** transferred about 41% of the LLC class B member interests to his wife, Agustina Smaldino, who **<u>purportedly</u>** retransferred them to the Dynasty Trust the next day." Consistently, he concluded:

> On the basis of all the evidence in the record, we conclude that petitioner never effectively transferred any membership interest in the LLC to Mrs. Smaldino and consequently that the Dynasty Trust received its entire 49% of the class B membership interests as a gift from petitioner.

That evidence included Mrs. Smaldino's own testimony about her role as a conduit in the transaction, which Judge Thornton described as follows:

> Mrs. Smaldino testified that before the purported transfer in question she had already made "a commitment, promise" to her husband and family that she would transfer the LLC units to the Dynasty Trust. When asked on direct examination whether she could have changed her mind if she had wanted to, she responded: "No, because I believe in fairness."

Further evidence was that no operating agreement amendment or income tax return of the LLC ever showed Mrs. Smaldino as a member, the Smaldinos never followed the formalities required by the LLC operating agreement to make someone who was not a descendant of Mr. Smaldino a full member in contrast to just an assignee, and on April 15 Mr. Smaldino signed an amendment to the operating agreement as the LLC's "SOLE MEMBER."

d. The Result. The result was that none of Mrs. Smaldino's basic exclusion amount was available for the gift and thus more of the gift was taxable to Mr. Smaldino. And the court increased the gift tax value of a 49 percent interest from $6,281,000 to $7,820,008. In determining that value, the court dealt with amendments of the operating agreement to replace Donor's management fees with guaranteed payments (the April 15 "SOLE MEMBER" amendment) and then switch back (on December 31). And that gave Judge Thornton the opportunity to provide a first-ever substantive discussion of section 2701, which Mr. Smaldino had cited to support the treatment of guaranteed payments in the valuation of the LLC interest, even though section 2701 itself did not apply in this case.

e. Observations. The idea that spouses who are U.S. citizens can generally make unlimited outright gifts to each other without even a gift tax reporting requirement probably encourages transfers-of-convenience like this quite frequently. And to many it might seem very intuitive and natural. But the *Smaldino* case shows that it doesn't always work.

What the Smaldinos tried to do, in effect, was to "split" Mr. Smaldino's gift, just as section 2513 allows. But, because she had more of her exclusion amount available than he did, they tried to "split" that gift on a basis other than half and half, as section 2513 requires. If Mr. Smaldino had simply reported the entire gift himself and they elected gift-splitting, he would have avoided gift tax on half of the court-determined value of $7,820,008. By trying to shift more than half of the gift to his wife, he ended up shifting none.

12. Ominous Challenges to GRATs by the IRS

a. **Chief Counsel Advice 201939002**

(1) Chief Counsel Advice (CCA) 201939002 (issued May 28, 2019; released Sept. 27, 2019) concluded that stock on a listed exchange transferred to a GRAT by the co-founder and chairman of the board of the corporation had to be valued for gift tax purposes by taking into consideration an anticipated merger of the underlying company that was expected to increase the value of the stock.

(a) On his gift tax return, the donor had valued the shares under Reg. §25.2512-2(b)(1) at the mean between the highest and lowest quoted selling prices on the date of the gift. Reg. §25.2512-2(e) states that if the value determined from the mean between the high and the low selling prices does not represent the fair market value of the shares, then some reasonable modification of the value shall be considered in determining fair market value.

(b) The CCA reasoned:

> The principle that the hypothetical willing buyer and seller are presumed to have "reasonable knowledge of relevant facts" affecting the value of property at issue applies even if the relevant facts at issue were unknown to the actual owner of the property. Estate of Kollsman v. Commissioner, T.C. Memo. 2017-40, [*aff'd*, 123 AFTR 2d 2019-2296 (9th Cir. June 21, 2019)]. Moreover, both parties are presumed to have made a reasonable investigation of the relevant facts. Id. Thus, in addition to facts that are publicly available, reasonable knowledge includes those facts that a reasonable buyer or seller would uncover during the course of negotiations over the purchase price of the property. Id. Moreover, a hypothetical willing buyer is presumed to be "reasonably informed" and "prudent" and to have asked the hypothetical willing seller for information that is not publicly available. Estate of Kollsman, supra.

…

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

(c) The CCA failed to even mention that federal securities laws may have prohibited the donor from disclosing confidential information regarding the merger because he was the chairman of the board of the publicly traded corporation.

(2) The case addressed by the CCA was *Baty v. Commissioner* (Tax Court Docket No. 12216-21, petition filed June 23, 2021). On June 15, 2022, after the petitioner had filed a motion for summary judgment and a memorandum in support (arguing, among other things, the application of the restrictive securities laws) and 12 days before the IRS's response was due, the parties filed a proposed stipulated decision. On June 17, the court entered the stipulated decision and denied the motion for summary judgment as moot.

b. **Chief Counsel Advice 202152018**

(1) Chief Counsel Advice 202152018 (issued Oct. 4, 2021; released Dec. 30, 2021) involved the founder of what the CCA described as a "very successful company, Company," who transferred shares of the Company to a two-year GRAT. The required annuity payments, as the CCA described them, were "a fixed percentage of the initial fair market value of the trust property." The CCA did not specifically state that that was the fair market value **as finally determined for federal tax purposes**, as described in Reg. §25.2702-3(b)(1)(ii)(B), but it is hard to believe that it wasn't, when that description of the annuity payments in the CCA immediately follows the description of the GRAT (emphasis added) as "a two-year grantor retained annuity trust (GRAT), **the terms of which appeared to satisfy the requirements for a qualified interest under § 2702 and the corresponding regulations**."

(a) The value used for the transferred shares was based on an appraisal as of a date about seven months earlier that had been obtained to report the value of a nonqualified deferred compensation plan under section 409A. Prior to the transfer to the GRAT, however, the donor had been negotiating with several corporations about a possible merger and had received offers from five different corporations within two and a half weeks before the transfer to the GRAT. Within three months after the initial offers, four of the corporations had submitted higher offers, and, three months after that, the donor accepted one of the offers, an initial cash tender offer for some of the outstanding shares at an amount that was nearly three times greater than the value used for the GRAT, with an option to purchase the remaining shares under a formula valuation.

(b) Several weeks prior to closing the tender-offer purchase, the donor had given shares to a charitable remainder trust and valued the shares pursuant to a qualified appraisal (under section 170(f)(11)) at an amount equal to the tender-offer value. The charitable remainder trust also took advantage of the tender offer.

(c) About six months after the end of the GRAT's two-year term, the purchasing corporation purchased the balance of the Company's shares at a price per share almost four times the value used for the GRAT valuation.

(2) CCA 202152018 has analysis very similar to the reasoning in CCA 201939002. Indeed, the following conclusion in CCA 202152018 is almost word for word the same as the corresponding conclusion in CCA 201939002 quoted above, **except for the additional 17 words (emphasis added) at the end**:

Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of [the date the GRAT was funded], would be reasonably informed during the course of negotiations over the purchase and sale of the shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger undermines the basic tenets of fair market value and yields a baseless valuation**, and thereby casts more than just doubt upon the bona fides of the transfer to the GRAT**.

(a) That addition is a big further step, which treats the GRAT annuity as not being a qualified interest because of the undervalued appraisal used to determine the annuity amounts that were payable by the GRAT over its two-year term. Accordingly, the donor would be treated as making a gift equal to **the full finally determined value of the shares transferred to the GRAT, without any offset for the value of the retained annuity payments**.

(b) The CCA reasoned by analogy to *Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002). In *Atkinson*, no annuity payments were actually made from a charitable remainder annuity trust during the two years from the creation of the CRAT until the donor's death. Although the trust met the statutory requirements for five percent annual distributions, the trust did not operate in accordance with those terms, and the court denied an income tax charitable deduction. On appeal, the taxpayer argued that the deduction was denied because of a "foot fault," or a minor mistake, but the appellate court concluded that the trust had failed to comply with the rules governing CRATs throughout its existence and denied the deduction. The deduction was denied because of the manner in which the trust was operated, even though the agreement itself met the technical requirements for CRATs.

(c) Similarly, CCA 202152018 reasoned that basing the annuity payments on an undervalued appraisal was an "operational failure" that prevents the donor's interest in the GRAT from being a qualified annuity interest under section 2702, apparently even if the GRAT document included a formula, specifically authorized by Reg. §25.2702-3(b)(1)(ii)(B), to adjust the annuity payments to a specified percentage of the initial fair market value of assets contributed to the GRAT, as finally determined for federal tax purposes. Immediately following the conclusion quoted above, which echoes CCA 201939002, the CCA added (emphasis added):

> In addition, although the governing instrument of Trust appears to meet the requirements in § 2702 and the corresponding regulations, **intentionally** basing the fixed amount required by § 2702(b)(1) and § 25.2702-3(b)(1)(i) on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust. The trustee's failure to satisfy the "fixed amount" requirement under § 2702 and § 25.2702-3(b)(1)(ii)(B) is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust; instead, the amount was based on an outdated and **misleading** appraisal of Company, at a time when Company had received offers in the multi-billion dollar range. When asked about the use of the outdated appraisal, the company that conducted the appraisal stated only that business operations had not materially changed during the 6-month period. In contrast, in valuing the transfer to the charitable trust, the company that conducted the appraisal focused only on the tender offer, and accordingly gave little weight to the business operations for valuation purposes.
>
> The operational effect of **deliberately** using an undervalued appraisal is to **artificially** depress the required annual annuity. Thus, in the present case, the **artificial** annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under § 2702. See Atkinson.

(3) The nature of a CCA, and a frequent challenge in understanding a CCA, is that it arises from a specific audit of a specific case, and therefore possibly with a specific back-story, not revealed in the CCA itself, as well as the motivation of the Chief Counsel's Office to build the strongest possible case for potential litigation. Perhaps the IRS concern in this CCA was not so much with the appraised **value** but with the **process**. The donor appears to have used a valuation that the donor knew was seven months out of date, prepared for another purpose, and which substantially undervalued the shares because of intervening events (obviously unknown to the appraiser and perhaps at that time even to the donor), even though the same donor showed the necessary initiative and diligence to obtain a qualified appraisal for the subsequent gift to a charitable remainder trust when the higher value would be beneficial. In fairness to the donor and the appraiser, however, it should be noted, as the CCA noted, that, when asked to explain, the company that conducted the appraisal stated:

> The appraisal used for the GRAT transfer was only six months old, and business operations had not materially changed during the 6-month period … For the charitable gifts, under the rules for Form 8283, in order to substantiate a charitable deduction greater than $5,000, a qualified appraisal must be completed. Because of this requirement an appraisal was completed for the donations … to various charities.

(4) Although there are anecdotal reports of increasingly aggressive IRS audits of GRATs (*see* Jonathan Curry, "Estate Planners Ponder IRS's 'Overaggressive' GRAT Slapdown," 174 TAX NOTES FEDERAL 1142 (FEB. 21, 2022)), the IRS's extreme reaction in this case, seemingly ignoring even its own regulations about adjusting annuity payments to match redetermined values, may be explained by the perceived lack of any good faith effort whatsoever to determine the initial value, and perhaps by other facts in the case as well.