

# **Estate Planning Current Developments and Hot Topics**

**December 2023**

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## Introduction

The 57th Annual Heckerling Institute on Estate Planning™ was held January 8-13, 2023, in Orlando, Florida. This summary includes some observations from that seminar, as well as other observations about various current developments in 2022 - 2023 and interesting estate planning issues.

### 1. Summary of Top Developments in 2023 and 2022

Although Ron Aucutt (Lakewood Ranch, Florida) will not be writing a separate “Top Ten” report this year, he lists the following as his top ten developments in 2023:

- (1) Thorough discussion of valuation approaches, tax affecting, and appropriate lack-of-marketability and lack-of-control discounts regarding the famous, closely-held, Biltmore Company (*Estate of Cecil*) (see Item 28 below);
- (2) “Substantial compliance” analysis for gift tax adequate disclosure requirements (*Schlapfer*) (see Item 14 below);
- (3) Corporate Transparency Act explanations and filing extensions (see Item 3 below);
- (4) Consent to judicial modification adding trustee discretionary reimbursement power for grantor’s payment of income tax on grantor trust income treated as gift by trust beneficiaries (CCA 202352018) (see Item 19.c below);
- (5) Estate tax treatment of life insurance owned by a closely-held company, and a buy-sell agreement that failed the §2703(b) tests (*Connelly v. United States*, cert granted 12/13/2023) (see Item 29 below);
- (6) Updated actuarial tables, with full election back to May 1, 2019 (T.D. 9974) (see Item 8 below);
- (7) Creative, but questionable and troublesome, extension of personal estate tax liability to beneficiaries and a successor trustee of a revocable trust who received trust assets and trust distributions after the decedent’s death (*United States v. Paulson* 9th Cir.) (see Item 26 below);
- (8) Basis of assets in a grantor trust at the grantor’s death (Rev. Rul. 2023-2) (see Item 5.c below);
- (9) IRS rejects decanting of QTIP trusts to permit charitable distributions at the spouse’s death, but folds when Tax Court pushes back (*Estate of Horvitz*) (see Item 25 below); and
- (10) Gift to charity followed quickly by a sale triggers the anticipatory assignment of income doctrine to deny a charitable deduction (*Hoensheid*) (see Item 27.b below).

Ron listed the following top ten developments for 2022 in his report, “Top Ten” Estate Planning and Estate Tax Developments of 2022 (January 2023) found [here](#) and available at [www.bessemerttrust.com/for-professional-partners/advisor-insights](http://www.bessemerttrust.com/for-professional-partners/advisor-insights):

- (1) Estate Tax Deduction: Present Value Concepts (Prop. Regs.) (see Item 7 below);
- (2) Clarification of SECURE Act RMD Rules (Prop. Reg. §1.401(a)(9)-4, Notice 2022-53) (see Item 4.f(4) below);
- (3) IRS Funding in the “Inflation Reduction Act”: Public and Political Perceptions (see Item 2.c below);
- (4) Other Changes and Challenges in the Components of Valuation (Interest Rates, Actuarial Tables [see Item 8 below], *Wandry Settlement-Sorensen* [see Item 13 below];
- (5) Disqualification of a GRAT Over Valuation Process (CCA 202152018, *Baty*) (see Items 18.a and 18.b below);
- (6) Courts Back Off from Allowing Arbitration (*Boyle (Va)*, *Hekemian (NJ)*);
- (7) IRS Rulemaking and the Example of Syndicated Conservation Easements (see Item 21 below);
- (8) Proposed Exceptions from Anti-Clawback Rules (Prop. Reg. §20.2010-1(c)(3)) (see Item 6 below);
- (9) “Sprinkling” CRUTs (CCA 202233014) (see Item 24 below); and
- (10) Intergenerational split-dollar life insurance (*Estate of Levine*) (see Item 17.c(4) below).

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## 2. Legislative Developments

- a. **FY 2024 and FY 2023 Greenbooks.** Tax legislative proposals from the Biden administration were summarized in “General Explanations of the Administration’s Fiscal Year 2024 Revenue Proposals” (popularly called the “Greenbook”), released March 9, 2023. Many of its provisions are similar to items in the FY 2023 and FY 2022 Greenbooks, but the FY 2024 (FY24) Greenbook include some rather surprising new transfer tax and trust proposals. For a brief description of some of the business, individual, and transfer tax provisions in the FY23 Greenbook, see Item 2.e of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found [here](#), and for a much more detailed discussion of the FY23 and FY24 Greenbooks, see Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (April 2023) found [here](#), both available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). The following is a brief overview of highlights of the FY24 and FY23 Greenbooks (the new proposals in the FY24 Greenbook are noted).

The FY24 Greenbook proposals have precious **little chance of being enacted** into law with a split Congress. Ron Aucutt warns “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.”

### (1) Selected Business Taxation Provisions.

- Increase the corporate income tax rate from 21% to 28%
- Increase the corporate stock repurchase excise tax from 1% to 4% (in FY24 Greenbook)
- Reduce basis shifting using partnerships

### (2) Taxation of Individuals.

- Increase the top marginal income tax rate from 37% to 39.6%
- Tax the capital income for high-income earners (taxable income over \$1 million, \$500,000 for married filing separately, both indexed) at ordinary rates
- The net investment income tax rate would increase from 3.8% to 5.0% for taxpayers with more than \$400,000 of earnings (indexed) (new in FY24 Greenbook) and the net investment income tax would be applied to pass-through business income for high income taxpayers (in the FY23 and FY24 Greenbooks)
- The 39.6% top marginal income tax rate and the 5% net investment income tax rate bring the top marginal rate to 44.6%
- The Medicare tax would increase from 3.8% to 5.0% for taxpayers with more than \$400,000 of earnings (indexed) (new in FY24 Greenbook)
- Treat transfers of appreciated property by gift or on death as realization events; gain on unrealized appreciation also would be recognized by every trust, partnership or other non-corporate entity if the property has been held on or after January 1, 1942 and has not been the subject of a recognition event within 90 years; the FY24 Greenbook clarifies that the first such deemed recognition event would occur on December 31, 2032
- Impose a 25% (up from 20% in the FY23 Greenbook) minimum tax on the income (generally including unrealized gains) on wealthiest taxpayers (similar to what has been referred to as the “Billionaire Income Tax” proposals; Senator Wyden introduced the “Billionaires Income Tax Act” (S. 3367, weighing in at 116 pages!) on November 30, 2023, which would annually tax the value of unrealized gains on assets using mark-to-market taxation for taxpayers with adjusted gross incomes of more than \$100 million or assets valued at more than \$1 billion, see Sword & Wallace, *Mark-to-Market Bill Would End ‘Buy, Borrow, Die,’ Senator Says*, 181 TAX NOTES FEDERAL 1861 (Dec. 4, 2023)); for a

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discussion of these similar proposals see Item 2.1 and 2.m of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found [here](https://www.bessemertrust.com/for-professional-partners/advisor-insights) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](https://www.bessemertrust.com/for-professional-partners/advisor-insights).

- Taxing “carried interests” as ordinary income
- Eliminating real estate like-kind exchanges for gains in excess of \$500,000 (\$1 million for joint returns) (not indexed)

**(3) Transfer Tax and Trust Proposals in FY23 Greenbook.**

- Add additional restrictions on GRATs (including a 10-year minimum term and a 25% remainder interest-which would effectively kill the use of GRATs going forward)
- Recognize gain on sale transactions with grantor trusts (with an effective date for *transactions* after the date of enactment)
- Treat the payment of income tax by the grantor on grantor trust income as a gift (effective for trusts created after the date of enactment)
- Provide consistent valuation of promissory notes at death
- Limit the duration of GST exemption (distributions to generations younger than grandchildren or persons alive on the date of creation would be subject to the GST tax, and existing trusts would be treated as being created on the date of enactment)
- Expand the definition of executor for all tax purposes (an example of the significance of this proposal is *Sander v. Commissioner*, T.C. Memo. 2022-103, which held that the trustee of the decedent’s revocable trust was not a proper party to contest assessed income tax deficiencies of the decedent)
- Increase the special use valuation value reduction from \$750,000 (indexed) to \$11.7 million (\$13 million in the FY24 Greenbook)
- Extend the 10-year estate and gift tax lien
- Require reporting (not specified as to how detailed the reporting will be) of the estimated value of trust assets for trusts valued over \$300,000 or with gross income over \$10,000 (the FY24 Greenbook adds that both of these amounts are indexed after 2024); The FY24 Greenbook adds the each trust would have to report on its annual income tax return “the inclusion ratio of the trust at the time of any trust distribution to a non-skip person, as well as information regarding any trust modification or transaction with another trust that occurred during that year”; this information is described as providing information for a comprehensive statistical data base about trusts rather than for targeting trust audits, but the reporting could be very burdensome and, for many, quite ominous; applicable to taxable years ending after the date of enactment
- Not included: reducing the estate and gift tax exclusion amount prior to 2026 or including grantor trust assets in the grantor’s gross estate under §2901

**(4) Additional Transfer Tax and Trust Proposals in FY24 Greenbook.** Some startling new transfer tax and trust proposals are included in the FY24 Greenbook.

- Defined value formula clauses to determine the value of gifts or bequests that depend on some activity of the IRS will not be recognized, other than a formula clause defining a marital or exemption equivalent bequest at death based on the decedent’s remaining transfer tax exclusion amount.
  - Reasons given for the proposal are (i) the clauses allow donors to escape gift taxes for undervaluing transfers, (ii) the clauses make gift tax return examinations and litigation cost-ineffective, (iii) transferred property must be reallocated among donees long after the gift, and (iv) the property rights of donees are determined in a tax valuation process in which they cannot participate.

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- The proposal literally says “the value of such gift or bequest will be deemed to be the value as reported on the corresponding gift or estate tax return”; wouldn’t donors love having the reported value being automatically accepted as the final value? – that obviously is not intended but presumably the quantity of the transfer (number or percentage of shares or units) would be deemed to be the quantity estimated on the return.
  - Clauses with a formula based on an appraisal within a reasonably short period of time (as in *Nelson v. Commissioner*) would be recognized (even if the appraisal is “after the due date of the return”).
  - This proposal also appears to target inter vivos or testamentary charitable lead annuity trusts (CLATs) that define the charitable annuity amount by a formula to reduce the remainder to zero or some specified value.
  - The proposal is effective for transfers by gift or at death after 2023.
  - “Simplify” the exclusion from gift tax for annual gifts; this proposal would limit the annual exclusion for many types of gifts to \$50,000 per donor; this is similar to prior proposals from the Clinton and Obama administrations as well as a proposal in section 10 of Senator Sanders’ “For the 99.5 Percent Act”; the proposal is effective for gifts after 2023.
  - Several proposals impact GST tax issues:
    - A purchase of assets from a GST non-exempt trust or any other property subject to GST tax would be treated as an addition to trust principal requiring a redetermination of the purchasing trust’s inclusion ratio (by adding the purchased assets to the denominator of the applicable fraction); the proposal would also apply to a decanting transaction (presumably from a non-exempt trust); effective for transactions occurring after the date of enactment;
    - Under current law, charitable entities are treated as assigned to the transferor’s generation under §2651(f)(3) and §501(c)(3) charities are not counted as having an interest in the trust for purposes of delaying a taxable termination (§2652(c)(1)(B)); the proposal is also to exclude §501(c)(4)s (and other designated exempt organizations) as having an interest in the trust for that purpose; and
    - Loans from a trust to a beneficiary will be treated as a distribution for GST tax purposes and a refund of GST tax paid as a result of such deemed distribution can be requested within one year after the loan is repaid in full; furthermore repayment of a loan to the grantor or deemed owner of a trust would be treated as a new contribution to the trust for GST tax purposes; the proposal applies to loans made, renegotiated, or renewed by trusts after the year of enactment
  - As part of the loan proposal described immediately above, loans from a trust to a beneficiary would be treated as a distribution for purposes of carrying out DNI to the borrowing beneficiary; the loan provision (including the GST tax provisions described above) apparently apply to loans of property as well as cash loans because the proposal says the IRS may by regulations except certain loans such as short-term loans or the use of real or tangible property for a minimal number of days.
  - Section 2704(b) would be repealed (the good news), to be replaced (the bad news) by a provision generally treating the value of transfers of a partial interest in non-publicly traded property to or for a family member as a pro rata portion of the collective FMV of all interests held by the transferor and family members (with a broad definition of family including the transferor’s ancestors and descendants and their spouses).
    - For transfers involving a trade or business, passive assets would be segregated and “the FMV of the family’s collective interest would be the sum of the FMV of the

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interest allocable to a trade or business (not including its passive assets), and the FMV of the passive assets allocable to the family's collective interest determined as if the passive assets were held directly by a sole individual."

- This special valuation rule would apply only if the family collectively owns at least 25% of the whole (and a special rule in footnote 41 applies for making that determination).
- Despite a statement in the FY24 Greenbook that "discounts for lack of marketability and lack of control ... are not appropriate when families are acting in concert to maximize their economic benefits," under the proposal, a lack of marketability discount presumably would apply in valuing the family's collective interest in a trade or business (even if the family owns a majority interest) and a lack of control discount would apply if the family's collective interest is not a controlling interest.
- The valuation proposal would apply to valuations as of a valuation date on or after the date of enactment.
- Charitable lead annuity trusts (CLATs) would have to include a fixed level annuity amount over the trust term, and the remainder interest at the creation of the CLAT would have to be at least 10% of the value of the property used to fund the CLAT (no more "zeroed-out" CLATs); effective for all CLATs created after date of enactment.

**(5) Private Nonoperating Foundation Annual Distribution Issues.**

- Limit the use of donor advised funds (DAFs) to avoid the private foundation annual 5% payout requirement (i.e., distributions from a private foundation to a DAF would not be a qualifying distribution unless the DAF makes a qualifying distribution of those funds by the end of the following taxable year, and the FY24 Greenbook adds that a qualifying distribution under this exception does not include a distribution to another DAF); this is different from additional restrictions that would be imposed on DAFs and private foundations generally under the Accelerating Charitable Efforts (ACE) Act introduced in the House and Senate (H.R. 6595 and S. 1981) in 2021 and 2022
- Private foundation payments to disqualified persons (other than a foundation manager who is not a family member of any substantial contributor) for compensation or expense reimbursement would not satisfy the annual 5% payout requirement for foundations, but they would still qualify for the exception from self-dealing if the payments are reasonable and necessary to carry out the foundation's exempt purposes (new in FY24 Greenbook)

**(6) Retirement Plan Issues.**

- Retirement accounts (including IRAs) owned by high-income taxpayers (\$450,000 for married filing jointly, indexed) with an account balance exceeding \$10 million on the last day of the preceding calendar year would be required to distribute at least 50% of the excess (with additional requirements for accounts exceeding \$20 million), subject to the 25% penalty (10% if corrected within a specified period) for failing to take required minimum distributions (RMDs)
- High-income taxpayers (\$450,000 for married filing jointly, indexed) could not roll over a retirement account that is not a Roth IRA or a Roth account to a Roth IRA

b. **H.R. 5376 Inflation Reduction Act of 2022.** Key elements of the Inflation Reduction Act of 2022 ("weighing in" at 730 pages), passed under the reconciliation budgetary procedures requiring only a majority vote in the Senate (and it passed on a 50-50 party-line vote with Vice President Harris casting the tie-breaking vote), are very briefly summarized.

- Medicare would be allowed to negotiate drug prices on some drugs over a period of years; out-of-pocket drug costs of seniors enrolled in Part D of Medicare would be capped at \$2,000 per year; a provision imposing an inflation cap on prescription drug prices was dropped from the reconciliation package by the Senate parliamentarian (which eliminated about \$100 billion

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of potential savings and deficit reduction, paid for by extending pass-through loss limitations for two years). Medicare savings will be used to pay for three years of subsidized Obamacare premiums.

- Various climate change and energy provisions include about \$369 billion spending (including expanded tax credits) with requirements that electric vehicles must be built in North America to qualify for tax credits. These provisions are estimated to lower energy costs and reduce carbon emissions by roughly 40 percent from a 2005 baseline by 2030.
- Over \$300 billion of deficit reduction would result over ten years.
- Revenue raisers include (1) a 15% corporate minimum tax on companies with average financial statement income (i.e., book income) over \$1 billion (which was modified to allow applicable companies to include accelerated tax depreciation, including bonus depreciation, in computing book income and to eliminate certain common control aggregation rules for portfolio companies (which generally benefits many private-equity owned businesses); (2) a 1% stock buyback tax for §317(b) stock redemptions or similar transactions for publicly traded corporations (applicable for stock repurchases after December 31, 2022); and (3) an \$80 billion boost to the IRS for enforcement and operations enhancements. The Joint Committee on Taxation projects that corporations will pay an additional \$222.2 billion over ten years from the new corporate minimum tax and will pay \$73.7 billion over ten years from the 1% excise tax on stock buybacks. Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions of Title I – Committee On Finance, Of An Amendment In The Nature Of A Substitute To H.R. 5376, “An Act To Provide For Reconciliation Pursuant To Title II Of S. Con. Res. 14,” As Passed By The Senate On August 7, 2022, And Scheduled For Consideration by the House of Representatives on August 12, 2022, JCX-18-22 (August 9, 2022).*
- **The Act does not otherwise reverse the 2017 tax cuts (including the lower corporate rate), impose additional taxes on high earners (such as the 5% and 8% surtax), eliminate the carried interest tax break, or include any provisions affecting transfer taxes or taxing unrecognized gains.**
- Notice 2023-7, issued December 27, 2022, announces the IRS’s intention to issue proposed regulations addressing the new 15% corporate minimum tax, and provides interim guidance regarding various time-sensitive issues that will be addressed in the proposed regulations. Notice 2023-20, issued on February 17, 2023, provides additional interim guidance “to help avoid substantial unintended adverse consequences to the insurance industry.”
- Notice 2023-2, issued December 27, 2022, provides guidance regarding the 1% excise tax on stock redemptions, including an exclusive list of §317(b) redemption transactions that are not treated as repurchases and guidelines for determining the fair market value of stock that is repurchased.
- The \$80 billion of additional IRS funding for enforcement, taxpayer services, operations support and modernization has been controversial. The additional IRS funding is discussed in Item 2.c immediately below.
- A collateral effect of the legislation is that extending the qualified business income deduction past 2025 is made more difficult. A provision that had been considered as a revenue offset to extend the §199A QBI deduction was an extension of the cap on excess business losses, but that provision was used to offset the cost of modifications in the Senate to the 15% tax on book income of large corporations. Doug Sword, *Section 199A Extension Just Got Tougher to Cover*, TAX NOTES TODAY FEDERAL (August 9, 2022).
- Democrats have been praising the legislation as the most significant legislation ever impacting climate change, as legislation to reduce drug prices and extend Obamacare subsidies, and as providing much needed additional resources to the IRS to increase tax collections.

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- For a discussion of the 15% corporate minimum tax on book income, see Michael Geeraerts & Jim Magner, *What Advisors Need to Know About the New Book Income AMT, Including COLI's Impact on EBITDA and E&P*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #255 (August 23, 2022).

- c. **Additional IRS Funding from Inflation Reduction Act.** The Inflation Reduction Act includes \$79.6 billion of additional long-term IRS funding available until September 30, 2031. Included amounts are \$3.18 billion for taxpayer services, \$45.64 billion for enforcement, \$25.33 billion for operations support, \$4.75 billion for business services modernization, and about \$700,000 for various other purposes. In addition, another \$15 million is included for a task force to design an efile tax return system that would not be run by the IRS.

The administration estimated that the additional funding for enforcement would increase tax collections by possibly over \$400 billion (by \$240 billion according to the Congressional Budget Office), and as reducing the deficit by over \$300 billion over a decade (a Penn Wharton analysis estimates a reduction of non-interest cumulative deficits by \$265 billion over the budget window).

A significant drop in the audit rate of high-income taxpayers is cited as evidence of the need for more enforcement IRS resources.

The IRS has a lot of ground to make up on audits. The agency scaled back audits of all taxpayers between 2010 and 2019, with the total audit rate falling to 0.25% from 0.9%. The largest drop has been among those reporting \$5 million or more, who have a 2.35% chance of being audited, down from more than 16% a decade ago, according to a May watchdog report from the Government Accountability Office.

...

IRS Commissioner Chuck Rettig said in a **letter** to Congress on Thursday that the agency has fewer auditors in the field at any time since World War II, underscoring the need for the additional money. Rettig told a House panel earlier this year that his agency is "outgunned" in examinations of large companies that have teams of corporate accountants and lawyers. Laura Davison, *Wealthy Americans Escape Tax Hikes But Would Face Beefed-Up IRS*, BLOOMBERG DAILY TAX REPORT (August 5, 2022).

Treasury Secretary Yellen directed the IRS to develop an operational plan for the additional funding by mid-February (that the plan was released April 6, 2023, as discussed below). She has summarized the need for additional enforcement resources.

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.

Remarks available at [https://home.treasury.gov/news/press-releases/jy0952#\\_ftnref10](https://home.treasury.gov/news/press-releases/jy0952#_ftnref10).

Republicans decry the legislation as a reckless threat to the economy. Senator Rick Scott (R-Fla) says the additional \$80 billion for the IRS will allow it to hire 87,000 more agents and "Joe Biden's federal government is coming after every penny you have with more audits," Alexander Rifaat, *Biden, Democrats Relish Passage of Reconciliation Bill*, TAX NOTES TODAY FEDERAL (August 9, 2022).

Hiring large numbers of additional IRS personnel, though, will likely prove difficult. For example, a report by the Treasury Inspector General for Tax Administration points out that the IRS hired only 41% of those it sent tentative offers in 2022 through October 9 (and only 31% in 2021). The report highlights the hiring difficulties.

The IRS has a goal of filling approximately 19,000 positions in FY 2023. However, representatives from the Human Capital workstream indicated that realistically the net gain of employees will be closer to 5,000 to 10,000 as these new hires will be offset by separations. A continued challenge the IRS faces is having to evaluate a high number of applicants in order to find successful candidates both willing to accept the job offer and also be able to pass the required background checks....

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When the IRA legislation was being drafted, it included language to allow the IRS to have critical pay and direct hire authority. However, the language giving the IRS expanded hiring authority was removed from the bill. Subsequent to the passage of the IRA, the IRS requested direct hire authority to hire up to 10,000 positions annually through the end of FY 2027 for the Services and Enforcement organizations. This authority would enable the IRS to satisfy mission-critical hiring needs and support significant changes in tax law, customer outreach, and other highly complex tax compliance efforts.

In addition, the IRS also requested approval of direct hire authority to fill up to 4,500 positions throughout the Operations Support organizations through the end of FY 2024 ....

As mentioned previously, IRA legislation did not provide the IRS with critical pay authority. Critical pay authority would have allowed the IRS to increase the basic pay for certain positions in order to recruit and retain experts. IRS officials indicated that because the IRS does not know what positions could have been filled using critical pay authority, it is difficult to determine the impact of not having this authority.

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... However, IRS officials do not believe there is an immediate risk of violating the Secretary's commitment [not to use IRS funding to increase audits of taxpayers making under \$400,000 a year] **because employee attrition and hiring challenges will limit its ability to conduct more audits.**

Treasury Inspector General for Tax Administration, *Inflation Reduction Act: Assessment of the Internal Service Implementation Efforts*, Report Number: 2023-IE-R003 at 9-12 (January 12, 2023) (emphasis added).

On April 6, 2023, the IRS released its 150-page "Internal Revenue Service Inflation Reduction Act Strategic Operating Plan" (available at <https://www.irs.gov/pub/irs-pdf/p3744.pdf>). The Plan presents 42 objectives organized in five categories: improving taxpayer services, resolving taxpayer issues, expanded enforcement for complex filings and large dollar amounts of non-compliance (the majority of the funds will be spent on this category), technology updates, and attracting and retaining a skilled workforce. A new Transformation and Strategy Office will oversee implementation of the Plan.

The additional IRS funding (especially funding allocated to enforcement) has been very controversial, in particular with House Republicans. In fact, the Fiscal Responsibility Act of 2023 (the debt-ceiling legislation that President Biden signed on June 3, 2023) rescinded \$1.39 billion of the IRA's long-term funding, and reportedly one condition of its dramatic negotiation was a commitment to repurpose an additional \$10 billion of that funding in each of Fiscal Years 2024 and 2025, raising serious concerns about the durability and trustworthiness of the funding. Interestingly, a new study titled "A Welfare Analysis of Tax Audits Across the Income Distribution" finds that IRS audits of high-income taxpayers provides an estimated 12-to-1 return of each dollar spent on an audit of the taxpayer. Their estimated returns are vastly higher than the roughly 2.5-to-1 return estimated by the Congressional Budget Office in its analysis of the effects of the additional IRS funding under the Inflation Reduction Act. See Jonathan Curry, *IRS Sitting on Gold Mine of Potential Revenue, Study Suggests*, TAX NOTES (June 16, 2023) (for each dollar spent, audits of taxpayers in the 70<sup>th</sup> to 80<sup>th</sup> percentiles produce a return of \$9.06, and audits of taxpayers in the 90<sup>th</sup> to 99<sup>th</sup> percentiles yield \$12.48, including the deterrent effect on the audited taxpayers in future years).

- d. **Effect of 2022 Midterms; Likelihood of Tax Legislation; What Will Happen to the Estate and Gift Tax Basic Exclusion Amount?** Midterms are historically tough on the president's party, but the November 8, 2022, election was quite surprising in leaving the Democrats in control in the Senate with 50 Democratic senators (and Vice President Harris breaking any tie votes), and a run-off election in Georgia on December 6, 2022, resulted in the Democrats picking up a 51st vote in the Senate. Republicans will hold a 4-vote majority in the House, resulting in a split Congress.

The 2022 midterm election suggests that the country is very evenly divided politically. The split Congress means that a major tax legislative package is very unlikely and the likelihood of any significant transfer tax legislation (or legislative changes regarding grantor trusts) is also very unlikely for the next several years. Among other things, Democrats want a restoration of the 2021 version of the child tax credit and approval of a global minimum tax, and Republicans would like to make

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permanent the individual income tax provisions in the 2017 Tax Act. Tax matters that were discussed as part of the FY 2023 omnibus spending bill (ultimately passed as the Consolidated Appropriations Act, 2023) included extending the expanded child tax credit desired by Democrats and several business tax breaks (including the research and development deduction, net interest expensing, and bonus depreciation) desired by Republicans, but no agreement could be reached as to those tax issues. Reaching such an agreement in 2023 will also be difficult.

None of that will happen in a divided Congress. Still, lawmakers may try to address several important, but smaller, tax law changes. They include new retirement savings incentives, a modest expansion of the [child tax credit], and some important business tax breaks that expired this year.

The question is whether either party will pursue legislation that can become law or spend time trying to advance their partisan agendas....

...

**The Inflation Reduction Act (IRA)** Democratic control of the Senate ends Republican dreams of rolling back the two major corporate tax hikes in the bill passed last summer—a minimum tax on book income and a 1 percent tax on stock buybacks.

**Extending the TCJA.** Even if the House passes a bill to extend the individual income tax provisions of the 2017 tax cut, which are due to expire at the end of 2025, the measure will die in the Senate.

**Individual income tax cuts.** This could be a sleeper. If the economy slumps, Congress could enact some temporary tax cuts. But lawmakers of both parties will have to decide whether they want a political message or a compromise bill that becomes law.

**Retirement savings.** There is broad bipartisan support in the current Congress to increase tax subsidies for retirement savings. Lawmakers could agree to a consensus measure in a lame duck session. If not, it could come up again next year.

...

**The best bet:** Expect nasty partisan wrangling over the debt limit and a possible government shutdown as well as deep ideological divisions among the Republicans. The result will be little or no major tax legislation in 2023. But some narrow bills could pass, as both parties start to jockey over their tax agendas for the 2024 campaign.

Howard Gleckman, *What Will the Midterm Elections Mean For Tax Policy?*, FORBES (November 16, 2022).

The likelihood of the \$10 million (indexed) estate and gift basic exclusion amount being reduced before it is scheduled to be reduced to \$5 million (indexed) in 2026 is very unlikely. Even if the Democrats win control of the administration and Congress in 2024 elections, the new Congress would not be seated until 2025, so a change in the exclusion amount before 2026 would occur mid-year in 2025 (or perhaps retroactive to January 1, 2025), both of which are extremely unlikely. Whether the \$10 million (indexed) exclusion amount is extended beyond 2025 will depend in part on whether compromises can be reached to achieve some tax legislative changes in the 2023-2024 Congress (which is unlikely, as discussed above). If not, the 2024 elections could have some impact on that issue. However, even if the Democrats should win control of the Administration, Senate and House for 2025, do not assume the exclusion amount will necessarily be allowed to revert back to \$5 million (indexed) (likely something in excess of \$7 million in 2025). Remember that late in the second year of the Obama administration, when Democrats controlled the Administration, Senate and House, legislation was passed that increased the gift exclusion amount from \$1 million to \$5 million (effective 1-1-11), increased the estate exclusion amount and GST exemption from \$3.5 million to \$5.0 million (effective 1-1-10), decreased the transfer tax top rate from 40% to 35% (effective 1-1-10 for estate tax and 1-1-11 for gift and GST tax), began indexing the exemption in 2012, and added portability of the unified credit. Who would have thought the Democratic controlled Congress and Presidency would have agreed to such massive advantageous transfer tax changes? They did – as a result of **negotiation**, and it could happen again.

A common misbelief is that the exemption amount has never gone down, so we could anticipate that it will not go down in 2026. That is not exactly true. While the estate tax exemption amount has rarely decreased from 1916 when the estate tax was enacted, it did go down from \$100,000 to

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\$50,000 in 1932-1933, and decreased again from \$50,000 to \$40,000 in 1935-1941. But after increasing to \$60,000 in 1942, the estate tax exemption amount has never decreased.

At this point, the “bottom line” for planners is that at least a significant possibility exists that the exemption amount will decrease in 2026 (from about \$14 million to about \$7 million), and planners should advise their clients of that possibility so that clients can make an informed decision as to whether to make use of the large \$10 million (indexed) exclusion amount while it exists.

Looking forward, planners can anticipate that the decision about whether the exclusion amount (and many other tax cuts under the 2017 Tax Cuts and Jobs Act) will expire at the end of 2025 will not be resolved until December 2025 (or even later). Planners will be very busy in the fall of 2025 advising clients about possible alternatives for making use of the large exclusion amount while it exists, in case it should be decreased in 2026. For example, transfers to QTIP trusts could leave open the option of whether the transfer will be a taxable transfer making use of the exemption amount, based on whether the QTIP election is made on the gift tax return that would not be due until October 2026, if the gift tax return due date is extended. And clients who make large gifts in 2025, only to find out that Congress later keeps the exclusion from going down, may be upset with having made the large gifts and look for ways to “undo” the gifts.

In any event, we’ve been there before, and the fall of 2025 could be a very busy season for planners.

- e. **FY 2023 Omnibus Spending Bill – Consolidated Appropriations Act, 2023.** The Consolidated Appropriations Act, 2023, signed by the President on December 29, 2022, is an omnibus spending package that calls for \$1.7 trillion in discretionary resources across the fiscal year 2023 appropriations bills, funding the federal government through September 30, 2023. In addition to allocating spending levels for federal agencies, the Act also provides \$45 billion in emergency funding for Ukraine and includes retirement provisions in Division T of the Act titled the “SECURE 2.0 Act of 2022” (described in Item 4.i below). Negotiations about the omnibus spending package included discussions about some major tax provisions, with Democrats wanting the expanded child tax credit and Republicans wanting extensions of some of the business provisions in the 2017 Tax Act, but no agreement could be reached regarding those tax provisions. See Item 2.d above.
- f. **Accelerating Charitable Efforts (ACE) Act Proposal.** Sen. Angus King (I-ME) and Sen Chuck Grassley (R-IA) on June 9, 2021, introduced bipartisan legislation, the Accelerating Charitable Efforts (ACE) Act, to cause philanthropic funds to be made available to working charities within a reasonable time period by tightening restrictions on donor advised funds (DAFs) and private foundations. An essentially identical proposal, H.R. 6595, was introduced in the House on February 3, 2022, by Representative Chellie Pingree (D-ME). A similar proposal will likely be introduced in 2023.

These changes are introduced in response to coalitions of philanthropic and nonprofit leaders and academics urging reforms to unlock hundreds of billions of dollars in DAFs and foundation endowments. A statement from Senator King’s office observes that DAFs currently have more than \$140 billion set aside for future charitable gifts with no requirement to ever distribute these resources to working charities. However, the proposal is strongly opposed by the Council of Foundations and others in the charitable sector. If the proposal advances to a committee or Senate floor vote, Council on Foundations president and chief executive officer Kathleen Enright has said “we expect a big, pitched battle over it.” *Philanthropy Divided Over Legislation to Accelerate DAF Grants*, Philanthropy News Digest website (posted June 11, 2021).

This proposal includes –

- Additional restrictions on DAFs with differing restrictions depending on whether the donor’s advisory privilege ends within 15 years;
- Administration expenses and distributions to DAFs would not count toward the 5% minimum distribution requirement for private foundations; and
- Exemptions from the investment income excise tax would apply for foundations that (1) make qualifying distributions in excess of 7% of the foundation’s asset value (other than

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direct use assets) or (2) have a specified duration of not more than 25 years and do not make distributions to other private foundations having a common disqualified person.

For a more detailed discussion of the ACE Act, see Item 2.n of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- g. **Extending (or Making Permanent) the TCJA 2017 Tax Cuts.** Extending the key features of the 2017 Tax Cuts and Jobs Act (TCJA) was at the core of recommendations of the Republican caucus's Jobs and Economy Task Force in the fall of 2022.

The "TCJA Permanency Act" (H.R. 8913) filed September 20, 2022, by Rep. Vern Buchanan (R-Fla) would make permanent tax cuts for individuals and small businesses in the TCJA (including the estate and gift tax increased exclusion), but whether the bill would permanently extend all 23 of the expiring tax provisions is not clear. A similar bill will likely be filed in 2023.

The Congressional Budget Office estimated in May 2022 that an extension of the tax provisions in the TCJA beyond 2025 would cost more than \$350 billion per year beginning in 2027. If Republicans had gained majorities in both the House and Senate for 2023, the issue would have been whether President Biden would veto an extension of the 2017 tax cuts. But with the Democrats retaining control of the Senate, any measure to extend the individual income tax provisions of the 2017 Tax Act will die in the Senate (unless some major compromise could be achieved, which is very unlikely).

- h. **Focus by Ways & Means Committee in 2023 on Preserving Basis Step-Up and Other Measures Benefitting Rural Taxpayers.** The change of the composition of the House Ways and Means Committee to give more representation by members representing rural districts may result in a shifting focus in priorities. Chairman Jason Smith (R-Mo.) presents himself as a champion for working families, small businesses, and farmers, "not the people on K Street." As an example of the shift in focus, Chairman Smith has said that providing more exceptions to the book minimum tax is not his first priority. One of the new committee members, Rep. Randy Feenstra (R-Iowa), intends to introduce legislation shielding the stepped-up basis and like-kind exchanges. Rep. Michelle Fischbach (R-Minn.), who moved from the Agriculture Committee to Ways and Means this year, wants to bolster tax policies that bolster farmers and, and preserving the stepped-up basis is a top priority for her to protect farmers who want to pass their land to a family member. See Samantha Handler, *Rural Tilt on Ways and Means Puts Focus on Stepped-Up Basis*, BLOOMBERG DAILY TAX REPORT (February 2, 2023).
- i. **"For the 99.5 Percent Act."** On April 18, 2023, Senator Bernie Sanders (I-Vermont) introduced S. 1178 titled "For the 99.5 Percent Act," similar to bills Senator Sanders has introduced in every Congress since 2010 making far-reaching changes to estate, gift and generation-skipping transfer tax provisions. For a brief overview of the version introduced in 2021, see Item 2.n of Estate Planning Current Developments (December 2021) found [here](#), and for a much more detailed summary of the bill introduced in 2023 (and his prior similar bills), see Item 1.b of Aucutt, Washington Update: Pending and Potential Administrative and Legislative Changes (June 7, 2023) found [here](#), both available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

### 3. Corporate Transparency Act Overview

- a. **Brief Summary.** The Corporate Transparency Act (CTA) was enacted on January 1, 2021, effectively creating a national beneficial ownership registry for law enforcement purposes. This is an outgrowth of the efforts of the international community, through the Financial Action Task Force (FATF), to combat the use of anonymous entities for money laundering, tax evasion, and the financing of terrorism. The U.S. has been viewed internationally as being vulnerable to money laundering and tax evasion because of a perceived lack of corporate transparency and reporting of beneficial ownership.

The CTA requires that certain entities must disclose to the Financial Crimes Enforcement Network ("FinCEN") identifying information about individual owners and those who control the entity ("Beneficial Owners") and "Applicants" applying to form an entity. A national registry of entities and their applicants and owners will be created. FinCEN estimates that 32,556,929 entities will submit

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reports in 2024, and in subsequent years it estimates that about five million reports will be filed each year. (See the Comment Request available at <https://www.federalregister.gov/documents/2023/09/29/2023-21293/agency-information-collection-activities-submission-for-omb-review-comment-request-beneficial>.)

Following is a brief overview of highlights of the beneficial ownership reporting requirements. For a more detailed summary of the reporting requirements under the CTA see Item 3 of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). A 50-page guide from FinCEN, titled “Small Entity Compliance Guide” (Version 1.1, dated December 2023), is available from the FinCEN webpage, available at <https://www.fincen.gov/news/news-releases/fincen-issues-compliance-guide-help-small-businesses-report-beneficial-ownership>. A 33-page Beneficial Ownership Information Reporting Frequently Asked Questions document, updated December 12, 2023, is available on the FinCEN website at <https://fincen.gov/boi/beneficial-ownership-information-frequently-asked-questions>.

FinCEN conducted a virtual information session on December 13, 2023. Some of the information gleaned from that session is summarized by John Strohmeyer (Houston, Texas) in Strohmeyer, *FinCEN’s Beneficial Ownership Information Reporting Requirements: “What You Need to Know” Webinar*, LEIMBERG BUSINESS ENTITIES NEWSLETTER # 287 (December 19, 2023). Some highlights:

- There is no upper limit on the number of beneficial owners;
  - There should be at least one beneficial owner for every entity (even if no individual has 25% or more of the ownership interests, at least one person should have “substantial control”);
  - Entities that have always been exempt are not required to report to claim their exempt status (speakers did not explain how to deal with the fact that a new entity created after 2024 must report within 30 days, and the entity will likely not have its exempt letter within 30 days after being created);
  - Company “Applicant” information, which must be provided for entities created after 2023, needs to be updated only if it was wrong, but not just because information about the Applicant changes; and
  - Speakers did not provide specific guidance about what a Reporting Company should do if Beneficial Owners refuse to provide their information.
- (1) **Reporting Companies.** “Reporting Companies” that must report are corporations, LLCs, and other “similar entities” that are created by filing a document with a secretary of state or similar office or foreign entities registered to do business in the U.S. At this point, private trusts are not included among the entities that must report, and charitable organizations, including private foundations, are specifically exempt from the reporting requirements. Various other exceptions apply including an exception for companies that employ more than 20 people, have gross receipts exceeding \$5 million, and have a physical operating presence in the U.S. Estimates are that about **32 million** partnerships, limited liability corporations and other legal entities will be subject to the reporting requirements. **Most of the corporations, limited partnerships, and LLCs that estate planning professionals create for their clients will NOT be exempt.**
  - (2) **Beneficial Owners.** A “Beneficial Owner” (who must be reported) is any individual who directly or indirectly (i) exercises substantial control over a Reporting Company or (ii) owns or controls at least 25% of the Reporting Company. An individual “exercises substantial control” if the individual has (i) a senior officer position, (ii) appointment/removal powers over any senior officers, (iii) direction or substantial influence over important matters, or (iv) any other form of substantial control. If a trust exercises substantial control or owns at least 25% of the Reporting Company, the regulations generally treat as Beneficial Owners (i) trustees “or other individual (if any) with the authority to dispose of trust assets” (query, would that include investment advisors or distribution advisors for directed trusts or someone who holds a power of appointment or someone who holds a veto power over distributions?), (ii) a trust beneficiary who “is the sole

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permissible recipient of income and principal from the trust” or who can demand distribution of or withdraw substantially all of the trust assets, and (iii) the trust grantor or settlor who has the right to revoke the trust or otherwise withdraw all of its assets. 31 C.F.R. §1010.380(d)(2)(ii)(C). The regulations do not address how this applies to corporate trustees; the CTA generally requires reporting about **individuals**, so will individuals who are primarily responsible for decisions on behalf of the corporate trustee for the trust have to be identified?

- (3) **Applicants.** “Applicants” (who create a company) must also be reported. The final regulations clarify this means “the individual who directly files the document to create or register the reporting company and the individual who is primarily responsible for directing or controlling such filing if more than one individual is involved in the filing.” 31 CFR §1010.380(e). Final regulations also provide that Applicants do not have to be reported for companies that are created before the effective date of the regulations (January 1, 2024), and information about Applicants will not have to be updated.
- (4) **Beneficial Ownership Information Reports.** “Beneficial Ownership Information Reports” (sometimes referred to as “BOI Reports”) must be filed by Reporting Companies. The Reporting Company must identify itself (full legal name, any trade name or doing business name, current address, state of formation, and IRS taxpayer identification number) and report four pieces of information about beneficial owners (and, for companies created after January 1, 2024, about applicants who created the entity): (1) name, (2) birthdate, (3) address, and (4) a unique identifying number and issuing jurisdiction from an acceptable identification document (passport, state identification document, or driver’s license) and an image of the document. If an individual provides the four pieces of information to FinCEN directly, the individual may obtain a “FinCEN Identifier,” which can then be provided to FinCEN in a Beneficial Information Report in lieu of the required information about the individual. (Attorneys who form a substantial number of reporting entities may wish to obtain a FinCEN Identifier.)

The Beneficial Ownership Information Report (BOIR) is available (beginning January 1, 2024) on the FinCEN Beneficial Ownership Information website (at <https://fincen.gov/boi>). Filing BOIRs is free of charge. The Report can be completed online by typing information into the BOIR webpage or with a fillable PDF (which can be uploaded to the FinCEN portal). The online version consists of five pages. In addition, a FinCEN ID can be prepared from that same website.

On September 29, 2023, FinCEN published a notice seeking comments regarding certain issues about the BOI rules, including how to deal with the requirement of reporting certain information about beneficial owners of applicants that is unknown to the Reporting Company. The BOIR does not have an alternative for merely stating that information is not available.

- (5) **Reporting Due Dates; Extension of Due Dates.** Reports will be required within 30 days after the company is created, but companies created before January 1, 2024, have one year to file the report – by January 1, 2025. Updated and corrected reports to report any change to information previously reported concerning a reporting company or its beneficial owners must be filed within 30 days of when the change occurred. A corrected report must also be filed to report any inaccuracies in a report within 30 days of becoming aware of the inaccuracy.

FinCEN on August 14, 2023, filed a proposed deadline extension, titled “Beneficial Ownership Information Reporting Deadline Extension for Reporting Companies Created or Registered in 2024” with the Office of Information and Regulatory Affairs proposing that the deadline for filing beneficial ownership reports be extended beyond the current 30-day due date after an entity is formed in 2024. The formal proposal was filed September 27, 2023, proposing to extend the deadline from 30 days to 90 days for companies created in 2024 (RIN 1506-AB62). The preamble to the proposed extension states that the extension to 90 days will give companies more time to understand the new reporting obligations (FinCEN will be publishing additional informational materials), more time to obtain the information needed to complete the reports, and more time to resolve questions that may arise in the process of completing their reports. The January 1, 2025, due date for entities created before January 1, 2024, would not be affected. The reporting

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deadline extension was finalized with the release of its revised rule on November 29, 2023, (RIN 1506-AB62).

Rep. Patrick McHenry (R-NC), chair of the House Financial Services Committee, on June 12, 2023, introduced H.R. 4035, the “Protecting Small Business Information Act of 2023,” to delay the due date for beneficial ownership reports until the access rules and revised customer due diligence rules are finalized. Rep. McHenry has been emphasizing that FinCEN should not institute an overly burdensome compliance regime on small businesses or infringe on Americans’ privacy rights.

Rep. Joyce Beatty (D-OH) and Rep. Zach Nunn (R-IA) on August 2, 2023, introduced H.R. 5119, the “Protect Small Business and Prevent Illicit Financial Activity Act,” which would, among other things, extend the due date for filing reports by entities created before 2024 to January 1, 2026 (rather than January 1, 2025) and extend the time for filing reports for companies created in 2024 or later to 90 days (rather than 30 days) after the creation of the entity. This is the first bipartisan bill to extend the filing deadlines. It would also bar Reporting Companies from responding “unknown” or “unable to identify” (or similar responses) in beneficial ownership reports, which the sponsors believe would close a loophole that would otherwise allow criminals to avoid the reporting requirements. H.R. 5119 passed the House on December 12, 2023, by a vote of 420-1.

- (6) **Penalties.** Willful failure to file a timely required report or willfully providing false information with FinCEN may result in civil penalties of \$500/day the report is outstanding and criminal fines up to \$10,000 and up to two years imprisonment. 31 USC §5336(h)(3)(A).
- (7) **Lawsuit Contesting Constitutionality of CTA.** The National Small Business Association filed a lawsuit in November 2022, challenging the CTA as unconstitutional (including violations of right to privacy from unreasonable searches and seizures without probable cause, privilege against self-incrimination, First Amendment rights, and due process, and exceeding Congress’s Article I powers under the Commerce Clause). *National Small Business United et al. v. Janet Yellen et al.*, Docket No. 5:22-CV-01448 (N.D. Ala. Filed Nov. 15, 2022). See Geeraerts & Magner, *NASB v. Yellen: Is the Corporate Transparency Act Constitutional?*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #284 (December 4, 2023). However, disclosure provisions in the Bank Secrecy Act were held to be constitutional in *California Bankers Ass. v. Shultz*, 416 U.S. 21 (1974). See also *United States v. Miller*, 425 U.S. 435 (1976).
- (8) **Who Will Be Filing Reports?; Massive Effort as We Approach 2025.** There are some indications informally that accountants may not want to file these reports (because they have nothing to do with tax.) If that is the case, attorneys may end up filing many of these reports for entities they have created (or will create) for their clients. Reports for the hundreds (or thousands) of entities that an attorney may have created in the past will be due January 1, 2025. That is a long time out, but the filing process could be a massive effort as we approach 2025.

Attorneys who create entities for clients may wish to put clients on notice of the filing requirements (and of the looming January 1, 2025, due date). Consider having clients sign an acknowledgement as to the responsibility for filing reports, and revise engagement letters to make the scope of the engagement clear regarding who has responsibility for filing reports for an entity involved in the engagement. Fiduciaries making distributions of interests in an entity from an estate or trust must be on notice that the entity will need to file reports reporting the change of ownership.

- b. **Regulations; Beneficial Ownership Reporting; January 1, 2024, Effective Date of Beneficial Ownership Reporting Requirements.** Final regulations regarding beneficial ownership, reporting requirements, and exemptions from reporting were released on September 29, 2022, with an effective date of January 1, 2024. The delayed effective date gives FinCEN time to design and build the Beneficial Ownership Secure System (BOSS) as the national registry of the reported information (and to seek appropriated funds to implement the new rules).
- c. **Access to Beneficial Ownership Information; Additional Guidance.** FinCEN issued proposed regulations on December 15, 2022, governing the disclosure, access, and safeguarding of beneficial

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ownership information (referred to as BOI). Those final rules were released December 21, 2023 (RIN 1545-AB59). A Fact Sheet summarizing those final rules is available on the FinCEN website at <https://fincen.gov/news/news-releases/fact-sheet-beneficial-ownership-information-access-and-safeguards-final-rule>.

A third rulemaking guidance dealing with revised customer due diligence rules is anticipated by January 1, 2025.

- d. **More to Come?; ENABLERS Act.** This required reporting under the CTA may just be the beginning. For example, the rules may be expanded at some point to treat trusts as Reporting Companies (private trusts are viewed very suspiciously throughout much of the world, and FATF may put pressure on the U.S. to require reporting about private trusts).

Over the last decade, bar groups and ACTEC have fought against a requirement that attorneys must file “suspicious activity reports” on their clients (without notice to their clients), **but that may come at some point.** The “Establishing New Authorities for Business Laundering and Enabling Risks to Security Act,” or ENABLERS Act, would expand the list of “gatekeepers” who are required under the Bank Secrecy Act to conduct due diligence on clients and file suspicious activity reports, and the expanded list would include attorneys who assist in financial-related transactions such as the formation of companies and trusts. The ENABLERS Act passed the House of Representatives on July 14, 2022, on a 329 to 101 vote (obviously with broad bipartisan support), but that proposed legislation has not been acted on in the current Congress.

The proposed legislation would bring lawyers and accountants within the scope of “financial institutions” who must report under the Bank Secrecy Act if they provide the following services that “involve financial activities that facilitate” and not “direct payments or compensation for civil or criminal defense matters:” (i) corporate or other legal entity arrangement, association, or formation services; (ii) trust services; or (iii) third party payment services. The legislation directs Treasury to issue regulations within one year of enactment to provide details about persons who will be subject to the new rules and to provide “appropriate requirements” for such persons. Treasury is directed to include lawyers who engage in the following activities as being subject to the new rules: “the formation or registration of a corporation, limited liability company, trust, foundation, limited liability partnership, or other similar entity” or the “acquisition or disposition of an interest” in one of those entities.

Similar legislation was not introduced in 2023.

- e. **Preparatory Planning.** Planners may be very busy complying with the reporting requirements of the CTA beginning in 2024 for new entities and in 2025 was the multitude of previously existing entities. The following is an excellent summary of preparatory steps that planners can be taking **now** to prepare for the coming reporting onslaught.

Recommended best practices will include: (1) developing an appropriate process to identify reporting requirements; (2) gathering required information and documentation from impacted individuals; (3) documenting exception decisions; and (4) monitoring for necessary updates to CTA reporting. Appointing a dedicated reporting individual to adopt this practice is recommended. A common approach being adopted by family offices is to have the job responsibility of the person handling financial KYC regulatory reporting to also include responsibility for CTA reporting. Reporting companies must submit reports within 30 days of corporate formation and update reports with any changes within 30 days. This will be a shortfused timeline in many circumstances involving complex ownership structures or ambiguous application of the rules.

Even when exemptions apply, decision makers should carefully document decisions regarding the application of exemptions to the reporting requirements to be positioned to address potential future regulatory inquiries regarding failure to report. Relatedly, given that these reports will be filed with federal regulators, internal procedures should include robust processes for vetting the fulsomeness and accuracy of all disclosures made under the rule to avoid future claims regarding willful false statements (or false statements or omissions made with willful blindness).

After an initial report is made, companies will also need a process to monitor changes to ensure that updates to CTA reports are made as required, which may be a daunting task if there are many individuals associated with an entity, for instance, as senior officers.

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Thinking ahead to the Jan. 1, 2025 reporting requirements for entities formed prior to Jan. 1, 2024, compliance will require a process for identifying and inventorying these historical entities and gathering information and documentation to make required reports.

Jan. 1, 2024 may seem far away today, but for many there will be complicated issues to address, guidance to be sought from FinCEN and significant amounts of information and documentation to gather to identify beneficial owners under FinCEN's broad definition.

Domingo P. Such III & Jamie A. Schafer, *Prepare to Comply With Upcoming Corporate Transparency Act Reporting Rules*, TRUSTS & ESTATES 55, at 58 (July/August 2023).

#### 4. Planning for IRA and Retirement Plan Distributions Under the SECURE Act; New Life Expectancy Tables for Calculating Required Minimum Distributions; SECURE 2.0

- a. **Overview.** The SECURE Act made various changes regarding retirement benefits including (i) changing the required beginning date (RBD) for required minimum distributions (RMDs) (April 1 of the following year) from age 70½ to 72 (and SECURE 2.0 changes it to age 73 beginning in 2023 and to age 75 beginning in 2033), (ii) eliminating the prohibition on contributions to an IRA after age 70½ (but if an individual both contributes to an IRA and takes a qualified charitable deduction (QCD) between ages 70½ and 72, the IRA contribution will reduce the portion of the QCD that would otherwise be treated as tax-free), and (most important) (iii) substantially limiting “stretch” planning for distributions from defined contribution plans and IRAs over a “designated beneficiary’s” (DB’s) lifetime (with several exceptions). (A DB is an individual; for example, an estate or a charity would be a non-designated beneficiary (non-DB).) Generally, much more favorable rules (allowing slower payouts) apply if a plan has DBs than if it doesn’t. The SECURE Act mandates that distributions to a DB be made within 10 years following the death of the participant, with exceptions for five categories of “eligible designated beneficiaries” (EDBs). The anti-stretch provisions of the SECURE Act generally apply to owners who die after 2019.

These rules apply to distributions from qualified retirement plans that are defined contribution plans as well as to IRAs. This summary refers to any of these as a “plan.”

- b. **ACTEC Comments; Proposed Regulations; Timing of Final Regulations.** These provisions of the SECURE Act create many uncertainties, and ACTEC has filed various comments with the IRS with detailed observations and recommendations for guidance regarding the implementation of the statutory provisions. See Item 6.e of Estate Planning Current Developments (December 2021) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

The IRS issued proposed regulations (275 pages, no less!) to update the minimum distribution rules, including guidance regarding the SECURE Act, on February 23, 2022. REG-105954-20 (published in the Federal Register on February 24, 2022). The proposed regulations reflect statutory amendments since the required minimum distribution regulations were last issued, clarify issues that have been raised in public comments and private ruling requests, and replace the question-and-answer format of the existing regulations. Among other clarifications, the regulations “clarify and simplify” the minimum distribution rules where trusts are beneficiaries. ACTEC filed extensive comments with the IRS regarding the proposed regulations on May 24, 2022 (available at <https://www.actec.org/resources/government-relations/>).

The proposed regulations regarding required minimum distributions are proposed to apply for calendar years beginning in 2022, and for 2021 “taxpayers must apply the existing regulations, but taking into account a reasonable, good faith interpretation of the amendments made by sections 114 and 401 of the SECURE Act. Compliance with these proposed regulations will satisfy that requirement.” Preamble at 77-78.

As to the timing of final regulations, in January 2023, William Evans (Treasury Office of Benefits Tax Counsel) said the IRS is considering whether to delay the issuance of final RMD regulations until the provisions impacted by SECURE 2.0 could be revised. See Caitlin Mullaney, *Treasury Reconsidering Retirement Guidance in Wake of SECURE 2.0*, TAX NOTES TODAY FEDERAL (Jan. 27, 2023). Indeed, that delay has occurred. Notice 2023-54, issued in July 2023, provided transition relief related to the RMD age increases in SECURE 2.0 and announced that the final RMD regulations would not apply

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until calendar years beginning in 2024. Laura Warshawsky, IRS deputy associate chief counsel (employee benefits, exempt organizations, and employment taxes), said at a recent American Bar Association Tax Section meeting that the RMD final regulations were well on their way to being completed before the enactment of SECURE 2.0. She reported that the IRS is actively working on the RMD regulations, which will include final regulations as well as additional proposed regulations regarding relevant SECURE 2.0 provisions. As to the timing of the final regulations, Warshawsky quipped, "I expect I'm not the only person in the presentation today who would love to know when the final regulations will be published. But I don't know. And unfortunately, I couldn't say even if I did." See Caitlin Mulaney, *RMD Final Regs Were Halted by SECURE 2.0 Passage*, 181 TAX NOTES FEDERAL 751 (Oct. 23, 2023). Guidance in the form of questions and answers regarding certain provisions in SECURE 2.0 was released December 20, 2023, in Notice 2024-02, IRB 2024-2 (dated January 8, 2023).

For a fairly detailed summary of highlights of the proposed regulations, see Item 4.d of Estate Planning and Hot Topics 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). For a much more detailed discussion of planning issues in light of the SECURE Act, see Item 3 of Estate Planning Current Developments and Hot Topics (December 2020) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- c. **Eligible Designated Beneficiaries.** The five categories of EDBs are (i) the surviving spouse, (ii) a participant's child who "has not reached majority" (specified in the proposed regulations to be age 21), (iii) a disabled individual, (iv) a chronically ill individual, and (v) an individual not described above who is not more than 10 years younger than the participant. These beneficiaries qualify for a modified life expectancy payout.

Status as an EDB is determined at the participant's death. A DB who later satisfies one of the five categories of EDBs does not become an EDB for purposes of being able to use an adjusted lifetime payout rather than being subject to the 10-year rule. Planners had thought that a special rule applied for minors – that if the minor is disabled upon reaching majority, the minor exception continues through the period of disability – but the proposed regulations say that is not the case. A modified life expectancy payout is allowed for EDBs, but the plan must be distributed within 10 years after such EDB's death or cessation as an EDB (even if the next successor beneficiary has become an EDB at that time).

- d. **Brief Overview of Planning for Trusts as Beneficiaries.** A big change for planners comes into play if the owner wants to use a trust as a beneficiary of a qualified plan or IRA. In a dramatic improvement, the proposed regulations restate and substantially improve the minimum distribution rules when a trust is a beneficiary and for the first time use and describe the very commonly used terms see-through trust, conduit trust, and accumulation trust. Under the existing regulations, the IRS position has been that all potential trust beneficiaries other than "mere potential successor beneficiaries" are not considered, but significant uncertainty remains over how far that exception extends. The proposed regulations provide much more certainty (though some questions may remain).

- (1) **General Descriptions for Trusts as Beneficiaries.** A DB must be a **human individual** and a trust is not an individual, so what happens if a trust is the beneficiary of a plan? If a trust meets four requirements, the IRS has agreed that the beneficiaries of the trust could be treated as if they had been named directly as beneficiaries of the plan. See Item 4.e(2) below. The proposed regulations eliminate the requirement of identifying the beneficiary with the shortest life expectancy. A trust that meets these requirements is referred to as a "**see-through trust**." (If the plan beneficiary is a trust of which all "countable" (more on that later) beneficiaries are individuals, the plan will have a DB (or multiple DBs).)

A **conduit trust** is a see-through trust requiring that all distributions from a plan to the trust "will, upon receipt by the trustee, be paid directly to, or for the benefit of, specified beneficiaries." Prop. Reg. §1.401(a)(9)-4(f)(1)(ii)(A). For the first time, the proposed regulations clarify that a conduit trust may have multiple beneficiaries.

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An **accumulation trust** is “any see-through trust that is not a conduit trust.” Prop. Reg. §1.401(a)(9)-4(f)(1)(ii)(B).

- (2) **Conduit Trusts Generally Not as Desirable.** A “conduit trust” is a trust that must immediately pay any distribution from a qualified plan or IRA to the trust beneficiary. They were often used because they do not have many complexities that apply to “accumulation trusts” (that permit plan or IRA distributions to be “accumulated” in the trust). They worked fine when plan or IRA distributions were made over the beneficiary’s lifetime because the distribution each year was relatively small. But when the entire plan benefits must be distributed within 10 years, they would have to be distributed from the trust to the beneficiary, and therefore would not serve the purposes for which the owner wanted to use a trust in the first place. Natalie Choate summarizes, “Almost invariably, conduit trusts will not work the way the client anticipated or wants.”
- (3) **Conduit Trusts Still Appropriate for Surviving Spouse (and a Beneficiary Not More Than 10 Years Younger).** A distribution to a trust for a surviving spouse (or for a beneficiary not more than 10 years younger than the participant) generally has to be made to a conduit trust, rather than an accumulation trust, to qualify as an EDB (a possible exception is if all other “countable” beneficiaries are EDBs). For example, a standard QTIP trust generally does not qualify as an EDB and the 10-year rule would apply after the participant’s death. A QTIP trust that also requires such distributions to the spouse of all plan distributions would constitute a conduit trust that is an EDB and would also qualify for the spousal special treatment (such as waiting until the decedent would have reached age 72 before distributions must begin and recalculating life expectancy each year).

Furthermore, under SECURE 2.0, after 2023 if a surviving spouse makes an election, conduit trusts for spouses will receive the same favorable income tax treatment as distributions directly to a surviving spouse. See Item 4.i(12) below.

Planners have believed that a trust for a minor would probably have to be a conduit trust in order to qualify for the minor child exception, but the proposed regulations allow using accumulation trusts for minor children. See Item 4.e(5)(b) below.

- (4) **Accumulation Trusts Generally Used.** Other than for surviving spouses (and not-more-than-10-years-younger beneficiaries), accumulation trusts will probably be used if the owner wants a trust to receive plan distributions. Accumulation trusts for minor children or for disabled or chronically ill individuals will qualify for the modified lifetime payout exception under the proposed regulations.
- e. **Natalie Choate Analysis for Testing a Trust Beneficiary.** Natalie Choate at the 57th Heckerling Institute on Estate Planning™ described a detailed 4-step analysis with 10 “disregard” rules for determining the countable beneficiaries of a trust and applying the RMD rules for the trust beneficiaries. (Natalie’s written materials are a fantastic resource for analyzing the RMD rules under the SECURE Act, including for trusts as beneficiaries.) For another outstanding discussion of the treatment of trusts as beneficiaries under the proposed regulations see Natalie Choate, *How to Test a Trust Under the New Proposed Minimum Distribution Rules*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #796 (November 15, 2022).
- (1) **Overview of Four-Step Analysis.** The four steps of the trusts analysis are (1) determine if the trust meets the four requirements to be a “see-through” trust, (2) make a list of all potential beneficiaries who could ever conceivably receive money under the trust, (3) divide the potential beneficiaries into two tiers of beneficiaries, and (4) apply certain “disregard” rules to the potential beneficiaries to get the countable beneficiaries.
  - (2) **Step One—Does the Trust Pass the Four Rules to be a See-Through Trust?** The four rules that must be satisfied for a trust to be a see-through trust are: (1) the trust is valid under local law; (2) the trust is irrevocable or becomes so at the participant’s death; (3) the beneficiaries are identifiable; (4) certain documentation is provided to the plan administrator by October 31 after

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the year of the participant's death. Prop. Reg. §1.401(a)(9)-4(f)(2). (Natalie suggests that a trust for which beneficiaries cannot be identified is likely not a valid trust under local law.)

- (3) **Step Two–List ALL Potential Beneficiaries.** Identify all beneficiaries that could conceivably receive distributions, including under the “wipe-out” clause and as appointees under a power of appointment, but with some special exceptions. The following three disregard rules apply to all trusts.
- (a) **Predeceased Individual.** Exclude anyone who predeceased the plan owner.
  - (b) **Nonexistent Individuals.** Exclude anyone who does not exist at the plan owner's death. (Do not include future offspring who may become trust beneficiaries in the future.)
  - (c) **Appointees Under Power of Appointment.** Exclude appointees under a power of appointment. Only the takers in default of exercise of the power of appointment are included as potential beneficiaries. However, after a power of appointment is exercised, going forward any actual appointee is included as a potential beneficiary. (A testamentary power of appointment cannot be exercised until the powerholder has died.)

The following four rules may or may not apply based on whether certain events occur after the owner's death and before the “beneficiary finalization date” (BFD), which is September 30 of the year after the year of the owner's death. These post-death rules are generous and very helpful. These changes are given retroactive effect to the date of the owner's death for minimum distribution purposes; prior to the proposed regulations, post-death changes were not given any effect at all for minimum distribution purposes. These post-death rules under the proposed regulations apply only for RMD purposes; for example, they cannot be used to assist in causing a trust to qualify for an estate tax marital or charitable deduction.

- (d) **Disclaimer.** Disregard any beneficiary who disclaims his interest in a qualified disclaimer before the BFD. Prop. Reg. §1.401(a)(9)-4(c)(3)(i).
- (e) **Distributions.** Disregard any beneficiary who is distributed all of his interest in the plan before the BFD. Prop. Reg. §1.401(a)(9)-4(c)(3)(iv).
- (f) **Reformation or Decanting.** Disregard any beneficiary who is removed as a beneficiary pursuant to a reformation or decanting action prior to the BFD that is permissible under state law. The reformation exception only applies to post-death reformation of a trust, not the post-death reformation of a beneficiary designation form.

*Example: If an older person is a permissible beneficiary, the payout period may have to be over the older person's life expectancy. If the older person could be removed as a beneficiary by reformation or decanting prior to the BFD, the life expectancy of much younger persons may possibly apply to determine the payout period.*

- (g) **ADD Any Beneficiary Added by Reformation or Decanting.** Add any beneficiary who is added as a trust beneficiary in a reformation or decanting action prior to the BFD in a manner permissible under state law. Prop. Reg. §1.401(a)(9)-4(f)(5)(ii)(A), 4(f)(5)(iii)(C). (This would be unusual.)

If a post-death change occurs after the BFD, the change will cause the trust to be “retested” as of the date of the change, Prop. Reg. §1.401(a)(9)-4(f)(5)(iv), but the retesting cannot improve the RMD results. For example, if the change results in a *shorter* distribution period, the trust's RMDs will be recalculated as of that time going forward (but a 100% required distribution cannot be imposed until the following calendar year). *Id.*

- (4) **Step Three–Divide the Possible Beneficiaries into Two Tiers.** The designation of two “tiers” comes from Natalie and is not in the proposed regulations. (For example, the proposed regulations refer to “first-tier” beneficiaries as “beneficiaries described in paragraph 1.401(a)(9)-4(f)(3)(i)(A).”)

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- (a) **First-Tier.** Generally speaking, a first-tier beneficiary is anyone who must or might be entitled to receive money from the trust following the death of the plan owner without having to wait on someone else to die. More specifically, a first-tier beneficiary is any beneficiary who could receive amounts in the trust attributable to the plan that are “neither contingent upon, nor delayed until, the death of another trust beneficiary who did not predecease (and is not treated as having predeceased)” the participant.

*Example: “income to spouse for life and remainder to children.” The spouse is a first-tier beneficiary (i.e., a current beneficiary) but the children are not because their interest is delayed until the death of the spouse.*

- (b) **Second-Tier.** A second-tier beneficiary (referred to in the title of Prop. Reg. §1.401(a)(9)-4(f)(ii)(A) as a “secondary beneficiary”) is a beneficiary who could receive amounts attributable to the plan that were not distributed to first-tier beneficiaries.

*Example: “income to spouse for life, then to issue, per stirpes, but if all issue are deceased, to Charity.” At the IRA owner’s death, she has three children and four grandchildren surviving. Potential beneficiaries are the spouse, the three children and four grandchildren. One might think of Charity as a third-tier beneficiary because Charity receives only if other second-tier beneficiaries are deceased, but there are no third-tier beneficiaries under the proposed regulations; they merely provide that some second-tier beneficiaries are not countable beneficiaries.*

Some or all second-tier beneficiaries are not counted as beneficiaries pursuant to the disregard rules described below.

(5) **Step Four—Apply Three More Disregard Rules.**

- (a) **For Conduit Trusts, Disregard All Second-Tier Beneficiaries.** All second-tier beneficiaries are disregarded for conduit trusts. Prop. Reg. §1.401(a)(9)-4(f)(1)(ii)(A), (3)(i)(B), (6)(i), Example (1)(B). Conduit trusts are useful for disregarding any beneficiaries following the death of the conduit beneficiary.

- i. **Conduit QTIP Trust.** For example, a conduit trust for a surviving spouse is treated as passing to the surviving spouse. This means that the spousal EDB exception applies for the outer limit, the start of distributions may be delayed until the owner would have reached age 72, and life expectancy is recalculated annually. (SECURE 2.0 makes a change in this regard – beginning in 2024, distributions may be delayed only if an appropriate election is made; in addition, if the spouse makes that election, the spouse (or, importantly, a conduit trust for the spouse), may use the uniform life table (rather than the single life table) and may recalculate life expectancy annually for determining the amount of distributions over the spouse’s life expectancy. See Item 4.i(12) below.

The trust would have standard QTIP terms (including the required marital deduction provision that the trustee must at a minimum withdraw all income from the plan each year), require that the RMD amount be withdrawn each year, AND require that the trustee distribute to or for the benefit of the spouse all amounts received from the plan (to qualify as a conduit trust). Natalie strongly suggests that (unless the IRA owner really want to limit distributions to the surviving spouse) the trust also provide that additional distributions may be made as the trustee determines advisable for support in her accustomed standard of living because the RMD and income from the plan may both be very low.

- ii. **Standard QTIP Trust/Not a Conduit Trust.** If a standard QTIP trust that is named as the plan beneficiary does not require the trustee to distribute to the spouse all amounts withdrawn from the plan, the trust does not qualify as an EDB, so the outer limit on distributions is 10 years after the owner’s death if the owner dies after the owner’s RBD.

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- (b) **First-Tier Inherits by Age 31 Rule.** If a first-tier beneficiary who is under age 31 will receive an outright distribution by age 31 (or younger), disregard any second-tier beneficiary who will receive trust assets if the child dies before age 31. Prop. Reg. §1.401(a)(9)-4(f)(1)(ii)(A).

*Example: "income or principal distributions to child for HESM; terminate and distribute to child at age 31; if child dies before age 31, all assets to Charity." The Charity would be disregarded as a beneficiary because it would receive only if the child dies before age 31. If the termination date was at age 40, the Charity would be counted as a beneficiary.*

This rule does not help if the termination date of the trust is after age 31 or if the trust is perpetual for the beneficiary's life.

This exception is very useful for minor children who are trust beneficiaries; such trusts need not be conduit trusts for the child to qualify for the "minor child" EDB exception. The trust could provide that the trustee could make distributions for the child's HESM and distribute all assets to the child by age 31. That trust would qualify for the EDB minor child exception (and RMDs could be made based on the child's life expectancy, with all of the assets being distributed by age 31). See generally Sara A. Nicholson, *Minor Children and IRAs After the SECURE Act*, TRUSTS & ESTATES 20 (July/August 2023).

Also, this exception applies for grandchildren or minor beneficiaries other than children of the plan owner.

- (c) **Disregard the "Second Choice-Second-Tier Guy."** Disregard any second-tier beneficiary who will receive only if some other second-tier beneficiary (who was supposed to take outright on the death of a first-tier beneficiary) fails to survive such first-tier beneficiary. This is the clarification of the "mere potential successor beneficiary" rule that applies under the current regulations. Natalie describes the rule: "Both the 'first choice guy who failed to survive' and the 'second choice guy who actually did survive' must be second tier beneficiaries who inherit the property outright ... upon death of a first-tier beneficiary."

*Example: "income to spouse for life, then to issue, per stirpes, but if all issue are deceased, to Charity." Charity can be disregarded as a beneficiary under this rule. Issue and Charity are both second-tier beneficiaries, but Charity will not get anything unless all other second-tier beneficiaries predecease the plan owner.*

But the exception may not apply if the trust is a "spray trust" for multiple first-tier beneficiaries (or if it is a perpetual family trust for issue of the owner).

*Example: "income to spouse and issue the spouse's life, then to issue, per stirpes, but if all issue are deceased, to Charity." The spouse and issue are all first-tier beneficiaries. This is no longer a situation in which Charity is the "second choice-second-tier guy," because Charity is the only second-tier beneficiary.*

Also, the exception may not apply if "secondary" beneficiaries may receive assets outright upon contingencies other than death of a first-tier beneficiary; that may cause them actually to be first-tier beneficiaries.

*Example: "income to spouse for life, but if he remarries, to owner's niece, but if she is not alive, to Charity." The niece is a first-tier beneficiary because she may take other than following death of a first-tier beneficiary. Charity is the only second-tier beneficiary, so the "second choice-second-tier guy" rule does not apply.*

- (6) **Step Five—Determine the Distribution Period.** Once you know the countable beneficiaries, apply the following rules to determine the distribution period. The distribution period is generally (i) over some period of time (the life expectancy of some individual if there are DBs) but (ii) with an outer limit year (for example, it may be 10 years after the owner's death if there is no EDB or 10 years after an EDB ceases to be an EDB). The proposed regulations state the general rule that minimum distributions are determined by dividing the account balance by an "applicable

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denominator” (if there are DBs). Prop. Reg. §1.401(a)(9)-5(a)(1). Special rules are described below.

- (a) **No DB.** If any of the countable beneficiaries is not an individual (e.g., an estate or a charity), the trust, or if the trust flunked Step One, the trust is not a DB. The distribution period is (i) the owner’s “ghost life expectancy” at the owner’s death (his life expectancy if still living) if death occurs after the owner reached his RBD and (ii) five years if the owner died before his RBD.
- (b) **Conduit Trust.** For a conduit trust, the distribution period is the same as if the conduit beneficiary had been named directly as the plan beneficiary. For example, it would be 10-years if the beneficiary is not an EDB and it would be the modified life expectancy if the beneficiary is an EDB (if the beneficiary is a spouse, life expectancy can be redetermined annually, but special rules apply after 2023 under SECURE 2.0, see Item 4.i(12) below).
- (c) **Type II AMBT.** A Type II “Applicable Multi-Beneficiary Trust” (AMBT) is a trust having a disabled or chronically ill (“D/CI”) beneficiary (or beneficiaries) for which no distributions may be made to anyone other than the D/CI beneficiary during his lifetime. The general rule for a Type II AMBT is that the benefits are distributed over the life expectancy of the oldest D/CI beneficiary, and the outer limit year is 10 years after the death of the D/CI beneficiary (or the last D/CI beneficiary to die if there are more than one). But exceptions to this general rule apply. For a general discussion of planning for D/CI beneficiaries see Nancy Welber, *RMD Rules for Disabled and Chronically Ill Beneficiaries of Retirement Accounts*, TRUSTS & ESTATES 66 (June 2023). SECURE 2.0 adds that at the death of the D/CI beneficiary, the assets of a Type II AMBT can pass to charity (other than a private foundation or donor advised fund). See Ed Morrow & Nancy Welber, *Secure 2.0 Act Enhances Special Needs-See Through Trust Planning*, LEIMBERG ESTATE PLANNING NEWSLETTER #3028 (March 30, 2023).
- (d) **Trust With Any Minor Child EDB.** If the trust has any minor child EDB as a beneficiary, a life expectancy payout can be used, but surprisingly the oldest countable beneficiary’s life expectancy is used, even if he is not the minor child EDB.

*Example: The trust current beneficiaries are a child of the owner who is age 18 and three children of the owner who are over age 21. The 18-year-old minor child of the owner is an EDB so this rule applies.*

The life expectancy of the oldest child (not the 18-year-old in the prior example) is used to determine the payout period, Prop. Reg. §1.401(a)(9)- 5(f)(1)(i), and the outer limit year is 10 years after the oldest minor child EDB reaches age 21 (or earlier dies), Prop. Reg. §1.401(a)(9)-5(f)(2)(ii). Special exceptions can apply to these general rules.

- (e) **All Beneficiaries are EDBs.** If all the trust beneficiaries are EDBs and none of the prior rules apply, generally use the life expectancy of the oldest EDB. But there are exceptions and special rules.
  - i. **Greater of Rule.** If the owner dies after his RBD and if the owner’s ghost life expectancy is longer than the life expectancy of the oldest DB, the ghost life expectancy can be used, Prop. Reg. §1.401(a)(9)-2(a)(4), 5(d)(1)(ii), but the outer limit year is when the oldest EDBs life expectancy drops to one or below or, if earlier, 10 years after the death of such oldest EDB. Prop. Reg. §1.401(a)(9)-5(e)(3), (f)(1)(ii).
  - ii. **Other Exceptions.** Other exceptions can apply in special circumstances.
- (f) **Trust That Is DB Trust But None of Above Apply.** If all countable beneficiaries are (i) individuals, (ii) none are EDBs, and (iii) none of the conduit trust rule, Type II AMBT trust, and minor child EDB rules apply, the 10-year rule will apply.
  - i. **Death Before RBD.** If the owner died before the RBD, **no** distributions must be made during years 1-9 but all of the plan must be distributed by December 31 of the 10th year.

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- ii. **Death After RBD.** If the owner died after the RBD, the proposed regulations take the position that annual distributions are required in years 1-9 based on the oldest beneficiary's life expectancy, and the entire balance must be withdrawn in year 10. Prop. Reg. § 1.401(a)(9)-5(f)(1)(i).

(7) **Multiple Trusts and Subtrusts.**

- (a) **Multiple Trusts.** If the beneficiary of a plan is a trust that at some time will pass to another trust, the two trusts are tested as if they formed one combined trust. Prop. Reg. § 1.401(a)(9)-4(f)(4) ("Multiple trust arrangements").

*Example: IRA passes to a trust for the surviving spouse, and that trust says on the spouse's death, the remaining property will pass to the XYZ Trust for the owner's daughter dated 4.30.2015. Both trusts are tested together, so the countable beneficiaries of both trusts are considered.*

- (b) **Subtrusts.** If a trust divides into separate trusts at some point, those separate trusts are generally referred to as subtrusts (but that term is not used in the proposed regulations). If the beneficiary designation form leaves plan benefits to separate subtrusts, each subtrust is tested separately. This is often helpful; for example, if one subtrust has a charity as a beneficiary, that would not taint all subtrusts as not being a DB.

However, if the "funding" trust is named as the plan beneficiary, it and all of the subtrusts are tested collectively. Reg. § 1.401(a)(9)-4, A-5(c). This is a harsh rule for trusts (Natalie says "it stinks"), and planners had hoped that the IRS would change the rules in the SECURE Act proposed regulations. However, the proposed regulations provide just one exception – if the trust is a Type I AMBT (in which event the subtrusts are tested separately). An AMBT as a trust having only DBs as beneficiaries, at least one of which is a disabled or chronically ill (D/CI) individual. A Type I AMBT is one that, under the terms of the trust agreement, is to be divided immediately upon the death of the owner into separate trusts for each beneficiary. If any beneficiary of any subtrust is a D/CI individual, all the subtrusts get separate account treatment, even those that do not have a D/CI beneficiary.

- (8) **"Sponginess;" Continuing Trusts.** These rules in the proposed regulations are, as Natalie Choate puts it, "a bit spongy" and more guidance will be needed beyond the "simplistic scenarios in the examples in the Proposed Regulations."

Furthermore, the rules are not helpful if, as typically happens for trusts, assets remain in trust for the successor beneficiaries. Kathy Sherby (an attorney in St. Louis, explains that "you keep counting until you get to someone who can put it in their pocket." A beneficiary is a second-tier beneficiary (so beneficiaries who will receive something if that second-tier beneficiary is deceased are not counted) only if the asset passes out of the trust to that beneficiary – **not** if the assets remain in trust for the beneficiary's life.

- f. **Life Expectancy Payments Must be Made During the 10-Year Period for Making Distributions to Designated Beneficiaries If the Owner Dies on or After the RBD.** This was a rather shocking change made in the proposed regulations. Planners (and the IRS, as discussed below regarding positions in IRS Publication 590-B), have believed that if the 10-year rule applied (i.e., for DBs who are not EBDs), no distributions were required until the end of the 10-year period. Indeed, the IRS has taken that position in official IRS publications. The proposed regulations, however, provide that if the decedent dies after the RBD naming a DB, distributions must continue to be made over the greater of the life expectancy of the participant or of the DB during the 10-year period (Prop. Reg. § 1.401(a)(9)-5(d)(1)(ii)), and the full account must be distributed by December 31 of the tenth year (Prop. Reg. § 1.401(a)(9)-5(e)(2)). If the decedent dies before the RBD naming a DB, no distributions are required annually, but the full account must be distributed by December 31 of the tenth year. Prop. Regs. § 1.401(a)(9)-3(c)(3) & § 1.401(a)(9)-3(c)(5)(B).

Thus, whether the owner dies before the RBD or on or after the RBD is critically important under the proposed regulations as to whether distributions must be made during the 10-year period following

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the owner's death. (For a Roth IRA, the owner is deemed to have died before the RBD, so no annual payments are required during the 10-year period even if the owner actually died on or after the RBD, Prop. Reg. §1.408-8(b)(1)(ii).)

- (1) **IRS Rationale for Changed Position.** While the 10-year rule is based on a 5-year rule (that applies if a participant dies on or after the RBD with a non-DB), which does not require annual distributions, the SECURE Act did not repeal §401(a)(9)(B)(i), which requires that distributions be made "at least as rapidly" as of the date of death. (That is interpreted to require that distributions be made over the longer of the "ghost life expectancy" of the participant – as if she had not died – or of the DB.)

For a statutory construction argument suggesting that annual distributions should not be required throughout the 10-year period, see Item 4.d.2(a) of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- (2) **Dual Distribution Requirements; Annual Distributions and Outer Limit.** The effect is that two distribution rules apply, and **both** must be satisfied:

- certain **annual distributions** are required (generally based on the life expectancy of the beneficiary); and
- an **outer limit** on distributions applies (the 10-year rule, but if an EDB is named as beneficiary, the outer limit is generally 10 years after the EDB dies or ceases to be an EDB).

- (3) **Example of Application of Annual Distribution and Outer Limit Requirements.** The preamble to the proposed regulations gives this example:

For example, if an employee died after the required beginning date with a designated beneficiary who is not an eligible designated beneficiary, then the designated beneficiary would continue to have required minimum distributions calculated using the beneficiary's life expectancy as under the existing regulations for up to nine calendar years after the employee's death. In the tenth year following the calendar year of the employee's death, a full distribution of the employee's remaining interest would be required. Preamble at 46-47.

- (4) **Uncertainty for 2021 Minimum Distribution Requirements.** The changed position created uncertainty regarding 2021 required minimum distributions for beneficiaries of plans for which the owner died on or after January 1, 2020, (meaning that the SECURE Act rules apply) and after the owner's RBD. The proposed regulations are proposed to apply for calendar years beginning in 2022, and for 2021, "taxpayers must apply the existing regulations, but taking into account a reasonable, good faith interpretation of the amendments made by sections 114 and 401 of the SECURE Act. Compliance with these proposed regulations will satisfy that requirement." Preamble at 77-78. (There was no need to address minimum distribution requirements for 2020 because the CARES Act waived any minimum required distributions for 2020.)

In light of the position taken by the IRS in the May 13, 2021, version of IRS Publication 590-B and the Draft as of February 25, 2022, of Publication 590-B, a reasonable position should be that no distribution was required in 2021, as discussed in detail in Item 4.d.(2)(e) Heckerling Musings 2022 and Current Developments (June 7, 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). See Natalie Choate, *New Proposed RMD Regs: Effect on Beneficiaries Who Did Not Take an RMD in 2021*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #782 (April 4, 2022).

Uncertainty prevailed, however, until the IRS provided further guidance on October 7, 2022, in Notice 2022-53. It stated that the IRS intends "to issue final regulations related to required minimum distributions (RMDs) under section 401(a)(9) of the Internal Revenue Code (Code) that will apply no earlier than the 2023 distribution calendar year." See generally Denise Appleby, *IRS Waives 50% Excise Tax for 2021 and 2022 RMDs for Some Beneficiaries*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #793 (October 17, 2022).

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That relief was extended to 2024 in Notice 2023-54, which states that “[f]inal regulations regarding RMDs under § 401(a)(9) and related provisions will apply for calendar years beginning no earlier than 2024.”

Notice 2022-53 also provided further guidance for distribution requirements in 2021 and 2022. The Notice observed that commenters about the proposed regulations noted the uncertainty and problems created for 2021 and 2022.

Commenters in those situations who are heirs or beneficiaries of individuals who died in 2020 explained that they did not take an RMD in 2021 and are unsure of whether they would be required to take an RMD in 2022. Commenters asserted that, if final regulations adopt the interpretation of the 10-year rule set forth in the proposed regulations, the Treasury Department and the IRS should provide transition relief for failure to take distributions that are RMDs due in 2021 or 2022 pursuant to section 401(a)(9)(H) in the case of the death of an employee (or designated beneficiary) in 2020 or 2021.

Notice 2022-53 clarified that a plan will not be treated as having failed to make distributions required under §401(a)(9) merely because it failed to make distributions in 2021 or 2022. Also, the IRS will not impose an excise tax under §4974 because of the failure to make required minimum distributions in 2021 or 2022, and if the taxpayer has already paid an excise tax for a missed distribution in 2021, the taxpayer may request a refund.

The relief was extended to 2024 in Notice 2023-54, which states that “[f]inal regulations regarding RMDs under § 401(a)(9) and related provisions will apply for calendar years beginning no earlier than 2024.”

The Notices do not remove the distributions in 2021-2023 as being “required minimum distributions (RMDs),” but just says that the harsh 50% excise penalty will not be imposed for the failure to make the distributions in 2021-2023. This distinction may be important in some circumstances. For example, spouses wanting to do a spousal rollover or other beneficiaries wanting to roll a plan received from a decedent into an inherited IRA cannot roll over RMDs. Furthermore, for retirement plan interests payable to a trust, under §409 of the Uniform Principal and Income Act (but not the newer Uniform Fiduciary Income and Principal Act), the amount to be allocated to trust income may depend, to some extent, on “the part that is required to be made during the accounting period.” Also, the beneficiary’s creditors might be able to reach amounts that were required to be distributed.

Informal indications are that Treasury does not intend that “make-up” distributions will be required in future years for required distributions that were not made in 2021-2023. Despite the fact that question has been raised repeatedly following the issuance of Notice 2022-53, the IRS did not address the “make-up” issue in Notice 2023-54.

- g. **New Life Expectancy Tables for Retirement Plan Required Minimum Distributions.** The Single Life and Uniform Life tables for calculating required minimum distributions are in Reg. §1.401(a)(9)-9(b)-(c). The tables had not been modified for two decades, but final regulations were issued November 4, 2020 (T.D. 9930, published in the Federal Register on November 12, 2020), with an effective date of January 1, 2022. The final regulations (which include the new tables) are located at <https://www.regulations.gov/document/IRS-2019-0050-0057>. As an example, using the new tables, the life expectancy of a 72-year-old person under the single life table is 17.2 years (vs. 15.5 years under the old table) and under the uniform life table is 27.4 years (vs. 25.6 years under the old table). For a discussion of the new tables and the mechanics of applying the tables, see Item 4.g of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- h. **New Life Expectancy Tables for Pre-Age 59½ Distributions.** Notice 2022-6 updates the life expectancy tables used for calculating a series of substantially equal periodic payments (“SOSEPP”), a popular method of avoiding the 10% tax on pre-age 59½ distributions. Notice 2022-6 replaces Rev. Rul. 2002-62 for any series of payments beginning on or after January 1, 2023, and may be used for a series of payments commencing in 2022. For a discussion of planning considerations for planning SOSEPP distributions using the new tables, see Vanessa L. Kanga & Natalie B. Choate, *New Life*

- i. **SECURE 2.0.** The House of Representatives passed H.R. 2954, the Securing a Strong Retirement Act of 2022 (commonly referred to as “SECURE 2.0”) on March 29, 2022, by an overwhelming bipartisan vote of 414 to 5. Several similar versions were considered in the Senate, and an agreed version titled “SECURE 2.0 Act of 2022” was included in Division T of the FY 2023 omnibus spending bill, the Consolidated Appropriations Act, 2023, which was signed by the President on December 29, 2022 (i.e., the date of enactment). SECURE 2.0 is an expansive (130 pages of legislative text!) addition of a wide variety of retirement savings enhancement provisions. A very helpful Committee section by section summary of SECURE 2.0 is available at [https://www.finance.senate.gov/imo/media/doc/Secure%202.0\\_Section%20by%20Section%20Summary%2012-19-22%20FINAL.pdf](https://www.finance.senate.gov/imo/media/doc/Secure%202.0_Section%20by%20Section%20Summary%2012-19-22%20FINAL.pdf). Some of the added provisions are briefly summarized.
- (1) **Increased Age for Required Beginning Date for Mandatory Distributions.** One of the most notable changes in SECURE 2.0 is the increased age of the required beginning date for retirement plan distributions. The SECURE Act of 2019 increased the required beginning date (“RBD”) age from 70½ to 72. SECURE 2.0 increases the RBD to age 73 for those who reach age 72 after 2022 and increases it to age 75 for those who reach age 74 after 2032. Notice 2023-54 addresses several issues that have arisen as a result of the increase of the RBD to age 72 in 2023 (including that the beneficiary will have until September 30, 2023 to roll over the part of the distribution that was mischaracterized as an RMD). Legislative technical corrections may be needed to clarify several ambiguities. *Lawmakers Say SECURE 2.0 Act Requires Technical Changes*, TAX NOTES (May 23, 2023) (letter from Chairs and Ranking Members of House Ways and Means Committee and Senate Finance Committee to Secretary Yellen and IRS Commissioner Werfel describing reasons for technical changes and stating that technical corrections legislation will be introduced to correct erroneous statutory provisions).
  - (2) **Expanding Automatic Enrollment in Retirement Plans.** In plan years beginning after 2024 Section 401(k) and 403(b) plans will be required to automatically enroll participants upon becoming eligible (and the employees can opt out of coverage). The initial automatic enrollment amount is at least 3 percent but not more than 10 percent (and the amounts will increase in subsequent years). Existing plans, governmental plans, church retirement plans, and plans for new or small businesses are not subject to the new automatic enrollment requirement.
  - (3) **Saver’s Match.** For lower income taxpayers (for joint returns, phasing out between \$41,000 to \$71,000 of income), the current nonrefundable credit for contributions to IRAs will be replaced with a 50 percent match deposited into the IRA, up to \$2,000 per individual.
  - (4) **Catch-Up Contributions.** Under current law, individuals aged 50 and older may make catch-up contributions in excess of otherwise applicable limits. The limit is \$6,500 for 2022 and \$7,500 for 2023 (\$3,000 in 2022 and \$3,500 in 2023 for SIMPLE plans). Beginning in 2025, the limit will be increased for Individuals aged 60 to 63 to the greater of \$10,000 or 150 percent of the 2024 amount. (The increased amounts are indexed for inflation after 2025.)
  - (5) **Roth Treatment for Matching Contributions and Catch-Up Contributions.** SECURE 2.0 permits Roth treatment to be elected for employer matching contributions (effective on the date of enactment, December 29, 2022), and for catch-up contributions (for taxable years beginning after 2023).
  - (6) **Rollovers From 529 Plans to Roth IRAs.** A concern with 529 plans is that leftover funds no longer needed for educational purposes may be trapped in the account unless a penalty is paid when the account is withdrawn for a non-qualified purpose. SECURE 2.0 permits a beneficiary of 529 accounts to roll over up to \$35,000 over her lifetime from any 529 account into her Roth IRA. The rollovers are subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years. The new provision applies to distributions after 2023.
  - (7) **Qualifying Longevity Annuity Contracts (QLACs).** Qualifying longevity annuity contracts (QLACs) are deferred annuities that can delay payments until the individual reaches age 85.

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Because payments start so late, QLACs are an inexpensive way for individuals to hedge the risk of outliving savings. Limitations imposed under regulations, however, have reduced their usefulness. The statute addresses some of these limitations. It eliminates the requirement that premiums for QLACs be limited to 25% of the account balance, allows up to \$200,000 (indexed (up from \$125,000) to be used to purchase a QLAC, relaxes the effects of divorce on a QLAC with spousal survivor rights, and allows a 90-day free look-back period by permitting rescission of the QLAC purchase within 90 days.

- (8) **Reduction in Excise Tax and Statute of Limitations for Failure to Take Required Minimum Distributions.** The excise tax for failing to take required minimum distributions is reduced from 50 to 25 percent and is further reduced to 10 percent if the distribution failure is corrected in a timely manner. The new provision applies to taxable years beginning after the date of enactment (December 29, 2022). See Conner Watts, *SECURE 2.0 and Required Minimum Distribution Excise Tax Waivers*, TAX NOTES (Oct. 23, 2023). Effective on the date of enactment, the statute of limitations for excise taxes on the failure to make required minimum distributions will generally be three years from when the owner files an individual tax return (Form 1040) for the year of the violation (under prior law the limitations period ran from when a Form 5329 was filed for the violation).
- (9) **IRA Charitable Rollovers.** The \$100,000 limit for IRA charitable distributions for owners over age 70½ will be indexed for inflation (rounded to the nearest thousand) beginning in 2024. Also, a one-time distribution up to \$50,000 is allowed from an IRA (again, for owners over age 70½) to a charitable remainder trust or charitable gift annuity meeting certain requirements. (Such charitable gift annuity must commence fixed payments of 5% or more not later than one year from the date of funding; the 5% distribution requirement can be a problem for single life annuities if the annuitant is under age 61 and for joint annuities for a married couple if the younger spouse is younger than about age 64). The \$50,000 amount will be indexed for inflation after 2023. See generally Christopher R. Hoyt, *Tax-Free Transfers From IRAs to CRTs and CGAs*, TRUSTS & ESTATES 46 (June 2023); Ed Morrow, *New Qualified Charitable Distribution (QCD) Provisions in SECURE Act 2.0 – Some Welcome, Some Dubious*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #325 (February 6, 2023).

**Observation:** Who would go through the complexity of creating and operating a CRT with only \$50,000?? Why was this provision included in SECURE 2.0 for a one-time only opportunity at such a low level? The severe limitations were included because of revenue scoring. Reports from people involved with the efforts from the charitable sector to include this provision observe that similar proposals allowing annual distributions with \$100,000 and \$400,000 limits were scored by the Joint Committee on Taxation in 2016 at \$97 - \$357 million (relatively minor amounts for legislative matters). Similar bills were scored again in 2021 by the JCT and the scoring jumped to \$37 - \$768 billion (BILLION, not million). To include the provision in SECURE 2.0, congressional members supporting the bill said the revenue cost had to be lowered to \$2 to \$3 billion. Therefore, the severe limitations were imposed, knowing they were impractical, but at least they could “get the foot in the door,” and perhaps expand the provision later. Because the JCT scores revenue impact over a ten-year period, this provision scores badly because the upfront revenue loss is not offset by the revenue gains as the annuity payments are made beyond the ten-year window.

- (10) **Treatment of IRA Involved in a Prohibited Transaction.** If a person has multiple IRAs and engages in a prohibited transaction, only the IRA with respect to which the prohibited transaction occurred will be disqualified.
- (11) **Roth Plan Distribution Rules.** Required minimum distribution rules do not apply to Roth IRAs prior to the death of an IRA owner, but under prior law, pre-death distributions were required for Roth accounts of 401(k) plans. Under SECURE 2.0 the pre-death distribution requirement for 401(k) Roth accounts is eliminated, effective for taxable years beginning after 2023.
- (12) **Surviving Spouse Election; Use of Uniform Life Table for Conduit Trusts.** For calendar years beginning after 2023, surviving spouses may elect to be treated as the employee (i.e., as the plan

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participant) for purposes of the required minimum distribution rules. In addition, if the spouse makes that election, the spouse (or, importantly, a conduit trust for the spouse), may use the uniform life table (rather than the single life table) for determining the amount of distributions over the spouse's life expectancy.

(The uniform life table is based on the life expectancy of an individual and someone 10 years younger. Under current law, it may only be used while the account owner is living or for a spousal rollover IRA. Otherwise, the single life table must be used. The uniform life table allows taking withdrawals at a substantially slower rate. Not surprisingly, the combined life expectancy is about 10 years longer for a 72-year-old person.)

This provision is complicated but has important ramifications for surviving spouses as beneficiaries of plans. A few are summarized below.

- Under current law, the surviving spouse does not have to make an affirmative election to delay taking distributions until the deceased owner would have reached his or her RBD. Beginning in 2024, an affirmative election will be required by the spouse to make use of the delayed distribution option.
- Under current law, a surviving spouse beneficiary receiving plan benefits outright could roll the benefits into his or her own IRA or could treat the participant's IRA as the spouse's IRA and could then use the uniform life table to determine the RMD each year. These options continue under SECURE 2.0.
- Beginning in 2024, under SECURE 2.0 a surviving spouse can continue as the beneficiary of the participant's IRA (i.e., not treating the IRA as his or her own) and, if the spouse makes a special election under §327 of SECURE 2.0, use the uniform life table (and recalculate life expectancy annually) without rolling the proceeds into a spousal IRA. However, there is some controversy regarding the details of this option.
- Importantly, a conduit trust is treated as if the surviving spouse were the beneficiary, so a conduit trust can also use the uniform life table (and recalculate life expectancy annually) beginning in 2024 if the election is made. Under current law (and beginning in 2024 if the election is not made) a conduit trust for a surviving spouse had to use the single life table (but could recalculate life expectancy annually).

For an excellent discussion of these complicated new rules (beginning in 2024) see Edwin Morrow & Robert Kirkland, *New Rules for Inherited IRAs by Surviving Spouses*, TRUSTS & ESTATES 56 (June 2023); Natalie Choate, *The (B)(iv) Rule from Hell: SECURE 2.0 Section 327*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #807 (May 31, 2023) and Ed Morrow, *Secure 2.0 Offers Longer Stretch for Conduit Trusts, but Contains Traps for Surviving Spouses*, LEIMBERG EST. PL. NEWSLETTER #3010 (Jan. 24, 2023).

(13) **Special Needs Trusts.** The SECURE Act has an exception from the 10-year distribution requirement for disabled beneficiaries. There are two types of accumulation trusts for disable/chronically ill beneficiaries (Applicable Multi-Beneficiary Trusts, or AMBTs) that are not subject to the 10-year rule, A Type I AMBT separates at death into separate trusts, so a separate trust exists for the disabled beneficiary. A Type II AMBT includes multiple beneficiaries, but retirement benefits can only be used for the disabled beneficiary(ies) until the death of all disabled beneficiaries. Before SECURE 2.0, a charity could not be named as a beneficiary after the disabled beneficiary dies. SECURE 2.0 clarifies that a Type II AMBT may include a "qualified charitable organization" (not a donor advised fund or private foundation) as the remainder beneficiary and still qualify for the exception.

(14) **ESOPs for S Corporations.** Non-publicly traded C corporations that sell stock to an ESOP may elect to defer recognition of gain if the sale proceeds are reinvested in qualified replacement property and if the ESOP owns at least 30 percent of the corporation's stock. SECURE 2.0 expands the gain deferral provisions for up to 10 percent of the amount realized for S corporation ESOPs, effective for sales made after 2027.

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- (15) **Conservation Easements.** SECURE 2.0 is a legislative follow-up to Notice 2017-10 treating certain syndicated conservation easements as “listed transactions,” after the validity of Notice 2017-10 has come into question (see Item 21.c(3) below). The legislative provisions are described in Item 21.c(7) below.
- (16) **Error Regarding Catch-Up Contributions.** The provision allowing Roth treatment for catch-up contributions inadvertently omitted a subparagraph that has the effect of banning all catch-up contributions beginning in 2024. The mistake may be corrected legislatively, but if that is not done before 2024, the IRS may attempt a fix through regulatory action with the expectation of a future legislative correction. See Caitlin Mullaney, *Response to SECURE 2.0 Catch-Up Contribution Error in Limbo*, TAX NOTES TODAY FEDERAL (Feb. 16, 2023).
- (17) **Adjustments to RMD Calculation If Part of Account is Annuitized.** New rules, applicable in 2024, allow reducing the RMD if part of the retirement account has been annuitized, as compared to current law. The following is a description.

The issue addressed by section 204 can be explained as follows. Under the pre-SECURE 2.0 RMD rules, annuitizing a portion of one’s retirement savings generally produces a higher benefit payment for the individual than the RMD amount the individual would have been required to withdraw if they had not annuitized. This occurs naturally because annuity payments are generally higher than the required withdrawals under similar economic assumptions using the method the RMD rules apply to non-annuitized accounts.<sup>1</sup> The problem is that when computing the RMD amount that an individual must withdraw from her non-annuitized account, she does not get any credit under the RMD rules for the fact that the annuity payments from the annuitized portion are higher than the minimum withdrawals would have been. As illustrated below, SECURE 2.0 provides individuals with the option of taking credit for that higher payment.

Let’s assume that Ruth turns 75 years old in 2023 and her retirement savings consist entirely of a \$475,000 traditional (non-Roth) IRA. In December Ruth decides to purchase a single life annuity using a little less than half (\$200,000) of her traditional IRA to supplement her Social Security benefits. That annuity will pay Ruth \$18,500 per year as long as she lives, starting in January 2024. The new RMD rule for partial annuitizations in SECURE 2.0 comes into play beginning with Ruth’s RMD calculation for 2024:

**Old RMD Rule.** Under the old rule for partial annuitizations, which Ruth may still choose to use, Ruth’s RMD for 2024 would equal the sum of (1) her \$18,500 annuity payment that year, plus (2) a calculation based on the account balance of the non-annuitized portion of her IRA as of December 31, 2023. That balance was \$275,000, so Ruth’s RMD for her non-annuitized account in 2024 would be \$275,000 divided by 23.7 (her life expectancy factor from the IRS’s uniform lifetime table), or \$11,603. Thus, in 2024 Ruth would receive her \$18,500 annuity payment, and she must withdraw a minimum of \$11,603 from the non-annuitized portion of her IRA.

**New RMD Rule.** If Ruth instead elects to use the new rule in SECURE 2.0, her 2024 RMD is calculated differently. We explain this calculation in more detail below, but, in short, Ruth would first add the values of the annuitized and non-annuitized portions of her IRA as of December 31, 2023. On that date, the non-annuitized account was valued at \$275,000, and the annuity had a present value of \$200,000, for a total value of \$475,000. Next, a total RMD amount is calculated as her total value of \$475,000 divided by 23.7 (the same uniform lifetime table factor used above), or \$20,042. Finally, Ruth’s annual annuity payment of \$18,500 is subtracted from \$20,042, leaving a remainder of \$1,542. Based on this calculation, in 2024 Ruth would be required to withdraw only \$1,542 from her non-annuitized IRA, in addition to receiving her \$18,500 annuity payment.

As the example above illustrates, compared with the old RMD rule calculation, Ruth’s RMD calculation under the new rule in SECURE 2.0 represents a nearly 90 percent reduction in the RMD amount that Ruth must take from the non-annuitized portion of her IRA in 2024 — from \$11,603 to \$1,542. This lower amount of \$1,542, when added to her \$18,500 annuity payment, exactly equals what her RMD would have been if she had not annuitized — thereby achieving parity for partial annuitization under the RMD rules.

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The new rule is available now. Congress provided that taxpayers may immediately rely on their “reasonable good faith interpretations” of the new RMD rule for partial annuitizations until Treasury amends its regulations to incorporate it.

Kent A. Mason, Bryan W. Keene & Courtney A. Zinter, *SECURE 2.0 Offers a Powerful Retirement Income Planning Opportunity*, 180 TAX NOTES FEDERAL 721 (July 31, 2023).

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(18) **Notice 2024-2.** Guidance in the form of questions and answers regarding certain provisions in SECURE 2.0 was released December 20, 2023, in Notice 2024-02, IRB 2024-2 (dated January 8, 2023).

(19) **SECURE 2.0 Technical Corrections Act.** A draft of bipartisan legislation, titled the SECURE 2.0 Technical Corrections Act was released December 6, 2023. It makes various technical corrections to SECURE 2.0.

## 5. Miscellaneous Guidance From IRS; Overview of Treasury-IRS Priority Guidance Plan Projects

a. **2023-2024, 2022-2023 and 2021-2022 Treasury-IRS Priority Guidance Plans.** The 2023-2024 Treasury-IRS Priority Guidance Plan (released September 29, 2023) adds two new projects in the “Gifts and Estates and Trusts” section.

(1) Regulations under §645 pertaining to the duration of an election to treat certain revocable trusts as part of an estate (Number 1). Under Reg. §1.645-1(f)(2)(ii)(A), one of the measurements of the termination of an election under section 645 is the day before the date that is 12 months after the IRS issues an estate tax closing letter (unless a claim for refund has been filed within that 12 months). Because the IRS no longer routinely issues estate tax closing letters, this measurement may no longer be appropriate, and removing or replacing it may be one of the objectives of this regulation project.

(2) Regulations under §6011 identifying a transaction involving certain uses of charitable remainder annuity trusts as a listed transaction (Number 10). Cathy Hughes, an attorney advisor in the Office of Tax Policy at Treasury, recently said at an American Bar Association Tax Meeting that the proposed regulations on these trusts “are coming soon.” See Erin Slowey, *Charitable Remainder Annuity Trust Rules Expected, Treasury Says*, BLOOMBERG DAILY TAX REPORT (OCT. 19, 2023). This is part of the project of issuing proposed regulations regarding various “listed transactions” in light of the Tax Court’s holding that prior Notices describing listed transactions did not comply with the Administrative Procedure Act. See Item 21.c below.

A new item in the “Exempt Organizations” section is guidance addressing the SECURE 2.0 Act changes relating to §529 (Number 4). SECURE 2.0 permits a beneficiary of 529 accounts to roll over up to \$35,000 over her lifetime from any 529 account into her Roth IRA if the 529 account has been open more than 15 years; presumably the guidance is about that provision. See Section 4.i(6) above.

The 2023-2024 Plan deletes several projects in the “Gifts and Estates and Trusts” section that were finalized in the last fiscal year of the Plan: (1) basis adjustment under §1014 for grantor trusts not included in the grantor’s gross estate (Rev. Rul. 2023-2 was published, discussed in Item 5.c below); (2) guidance on portability regulatory elections (addressed in Rev. Proc. 2022-32, discussed in Item 5.e below); and (3) regulations under §7520 regarding actuarial tables (the final regulation was released June 1, 2023, discussed in Item 8 below).

The 2022-2023 Treasury-IRS Priority Guidance Plan (released November 4, 2022) added three new projects in the “Gifts and Estates and Trusts” section:

- (1) 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 (Number 2) (this project was completed with the issuance of Rev. Rul. 2023-2, discussed in Item 5.c below);
- (2) Regulations under §20.2056A-2 for qualified domestic trust elections on estate tax returns, updating obsolete references (Number 7); and
- (3) Guidance on portability regulatory elections under §2010(c)(5)(A) (Number 4) [already published as Rev. Proc. 2022-32 when the 2022-2023 Plan was released] (discussed in 5.e below).

The 2022-2023 Plan deleted one item in this section from the 2021-2022 Plan – the project about establishing a user fee for estate tax closing letters (Reg. §300.13 (T.D. 9957)) was finalized on September 27, 2021, effective October 28, 2021.

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The 2021-2022 Priority Guidance Plan released on September 9, 2021, contained a few changes from the 2020-2021 Plan regarding estate planning related issues.

For a general discussion of and commentary about the 2020-2021 Priority Guidance Plan, see Ronald D. Aucutt, *2020-2021 Treasury-IRS Priority Guidance Plan*, ACTEC CAPITAL LETTER NO. 50 (Nov. 25, 2020) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

The following are items regarding gifts and estates and trusts in the 2023-2024 Plan.

#### GIFTS AND ESTATES AND TRUSTS

1. Regulations under §645 pertaining to the duration of an election to treat certain revocable trusts as part of an estate.
2. 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.
3. 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.
4. 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.
5. 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.
6. Regulations under §20.2056A-2 for qualified domestic trust elections on estate tax returns, updating obsolete references.
7. 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.
8. 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.
9. 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.
10. Regulations under §6011 identifying a transaction involving certain uses of charitable remainder annuity trusts as a listed transaction.

Several of the items on the Plan are discussed in more detail below.

The 2023-2024 Plan sets the priority for guidance projects during the Plan year (from July 1, 2023, to June 30, 2024), but no deadline is provided for completing the projects.

Proposed regulations were issued in 2022 with respect to two of the items on the Plan (Numbers 3 [abuse exception to the anti-clawback regulation], and 5 [§2053]) and final regulations were issued for the actuarial tables project (Number 10 on the 2022-2023 Plan). Melissa Liquerman (IRS Office of Chief Counsel) in a presentation at a District of Columbia Bar tax conference said, "We're really putting a lot of time and effort into finalizing these regulations as soon as possible." Naomi Jagoda, *IRS Working to Issue Final Rules on Estate-Tax Projects*, BLOOMBERG DAILY TAX REPORT (January 25, 2023).

- b. **Basis Consistency (Number 1).** When the basis consistency regulations are finalized, among other things planners hope the final regulations will relax the requirement to file reports for subsequent transfers. Interestingly, the Form 8971 does not specifically address the reporting of subsequent transfers.

These regulations are reportedly a high priority with the IRS and Treasury. Informal comments since May 2022 indicate that the basis consistency final regulations "may be coming soon." "We haven't forgotten about...I'm hoping that we'll be able to get those out soon." See Jonathan Curry, *Treasury and IRS Teeing Up Proposed Regs on Personal Guarantees*, TAX NOTES TODAY FEDERAL (May 16,

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2022) (Comment by Cathy Hughes, Treasury Department Office of Tax Policy, at ABA Tax Section meeting in May 2022).

For a detailed discussion of this project, see Item 5.a of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (June 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- c. **Basis of Grantor Trust Assets at Death Under §1014 (Number 2); Rev. Rul. 2023-2.** The Priority Guidance Plan in various prior years have included a broad project about the basis of assets at death in grantor trusts. That broad project was omitted in the 2021-2022 Plan. For further discussion of that project from prior Plans, see Item 6.c of Estate Planning Current Developments and Hot Topics (December 2019) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

This much narrower topic, about grantor trusts for which the assets are not included in the grantor's gross estate was included for the first time as Number 2 of the Gifts Estates and Trusts issues on the 2022-2023 Plan. It apparently is the IRS's response to political pressure (see Item 5.c(3) below).

Beginning in 2015, the IRS no-ruling list includes whether "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 ..." *E.g.*, Rev. Proc. 2022-3, 5.01(11).

- (1) **Statutory Provisions.** Section 1014(a) provides generally that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent is adjusted to the fair market value at the date of death. Section 1014(b) describes seven categories of assets that "shall be considered to have been acquired from or passed from the decedent. (An eighth category applies for decedents dying before 2005.)
- (2) **Arguments.** Some planners maintain that assets in a grantor trust should receive a basis step-up at the grantor's death because until that time the assets were deemed owned by the grantor for income tax purposes (*See* Rev. Rul. 85-13, 1985-1 C.B. 184), and after the grantor's death they are "acquired from a decedent" by someone else. *See e.g.*, Gans & Blattmachr, *Grantor Trust Assets and Section 1014: New Ruling Doesn't Solve the Problem*, J. TAX'N (Sept. 2023); Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (Sept. 2002); Treas. Reg. §1.1001-2(c)Ex. 5 (grantor of grantor trust was considered the owner of all trust property in a grantor trust and when grantor renounced powers that caused trust to be a grantor trust, partnership interest owned by the trust was considered to have been transferred from grantor to trust for Federal income tax purposes). Many other planners are uncomfortable with that position. *See* Austin Bramwell & Stephanie Vera, *Basis of Grantor Trust Assets at Death: What Treasury Should Do*, 160 TAX NOTES FEDERAL 793 (Aug. 6, 2018) (suggesting that §1015(b) could provide a rationale for not adjusting basis of grantor trust assets at the grantor's death).
- (3) **Political Pressure.** This item in the 2022-2023 Plan is apparently the IRS's response to a statement by Secretary of the Treasury Janet Yellen's in a dialogue with Representative Bill Pascrell (D-New Jersey) at a June 8, 2022, House Ways and Means Committee hearing that the IRS would be implementing guidance on the "infamous stepped-up basis loophole" "Very soon. Very soon."

Representative Pascrell had written a letter to Secretary Yellen in March, 2022 about the issue. He followed up in the June hearing by pressing to find out when something would be done about the issue.

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

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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."

The IRS responded by adding the issue to the Priority Guidance Plan (released November 4, 2022) and on March 29, 2023, by releasing Rev. Rul. 2023-2.

- (4) **Revenue Ruling 2023-2.** Rev. Rul. 2023-2, 2023-16 IRB 658 (issued on March 29, 2023, and dated April 17, 2023) denies a basis adjustment under §1014(a) for assets gifted to an irrevocable grantor trust by completed gift that are not included in the deceased grantor's gross estate. This result was anticipated. The Ruling reasons in a very straightforward manner that such assets are not in any of the categories in §1014(b) that "shall be considered" to have been acquired from or passed from the decedent and therefore do not receive a basis adjustment under §1014(a). The ruling posits that assets in a grantor trust attributable to gifts that are not in the deceased grantor's gross estate are not properly acquired by bequest, devise, or inheritance under §1014(b)(1). Section 1014(b)(2), (3), or (4) do not apply where the grantor does not have the power to revoke or amend the trust or appoint the assets of the trust. Section 1014(b)(6) refers to community property, and §1014(b)(9) and (10) refer to assets included in the decedent's gross estate. "Because at [the grantor's] death [the trust asset] does not fall within any of the seven types of property listed in § 1014(b), [it] does not receive a basis adjustment under § 1014(a)."

The facts on which the Ruling is based, as stated at the beginning of the Ruling, have several important caveats: (1) liabilities of the trust did not exceed the basis of assets in the trust, i.e., no negative-basis property, and (2) neither the trust nor the grantor held a note on which the other was the obligor.

The complete holding of the Ruling is:

A creates T, an irrevocable trust, retaining a power which causes A to be the owner of the entire trust for income tax purposes under chapter 1 but does not cause the trust assets to be included in A's gross estate for purposes of chapter 11. If A funds T with Asset in a transaction that is a completed gift for gift tax purposes, the basis of Asset is not adjusted to its fair market value on the date of A's death under § 1014 because Asset was not acquired or passed from a decedent as defined in § 1014(b). Accordingly, under this revenue ruling's facts, the basis of Asset immediately after A's death is the same as the basis of Asset immediately prior to A's death.

The Ruling also confirms in a footnote that it does not alter the result of Rev. Rul. 84-139, which held that property from a non-resident non-citizen decedent that is not included in his or her gross estate may receive a basis adjustment if the property is acquired by bequest, devise, or inheritance as described in §1014(b)(1) "or is otherwise specifically described in § 1014(b)."

- (5) **Ruling Does Not Address Argument Regarding Change of Deemed Ownership For Income Tax Purposes at Death of Grantor.** Interestingly, the Ruling does not directly discuss whether assets in the grantor trust are "property passed from a decedent" in light of fact the grantor is viewed generally as the deemed owner of the trust assets until the grantor's death for income tax purposes (Rev. Rul. 85-13). That issue was mentioned, albeit briefly, however, in IRS Guidewire Issue Number RR-2023-02 (March 29, 2023) that described Rev. Rul. 2023-2. It states the result reached in the Ruling "even though the grantor trust's owner is liable for Federal income tax on the trust's income." Instead, the Ruling merely views the list of circumstances in §1014(b) as the only ways property can pass from a decedent. That might seem contrary to regulations that treat a grantor as having "transferred ownership" of assets from the grantor to the trust when a grantor trust ceases to be a grantor trust, Reg. §1.1001-2 (c) Ex.5, and a "transfer" from a grantor might seem analogous to "passing" from a decedent. See Mitchell Gans & Jonathan Blattmachr, *Grantor Trust Assets and Section 1014: New Ruling Doesn't Solve the Problem*, J. TAX'N (Sept. 2023).

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- (6) **Treatment of §1014(b) Categories as Exclusive Ways to be “Acquired From” or “Passed From” the Decedent.** Rev. Rul. 2023-2 says the **only way** an asset can be “acquired from a decedent” for purposes of getting a basis adjustment under section 1014(a) is to be in one of the categories listed in §1014(b), and none of the sub-sections in 1014(b) apply. From the Ruling: “For property to be acquired or passed from a decedent for purposes of § 1014(a), it **must** fall within one of the seven types of property listed in § 1014(b).” (emphasis added). The ruling does not cite any authority for the proposition that the seven types of situations listed in §1014(b) are the only ways property can be acquired from a decedent for purposes of §1014(a).

A possible alternate reading of section 1014(b) is that it is not an exclusive list, but the Code is effectively providing safe harbors—if you meet one of those situations, the property “shall be considered” to have been acquired from a decedent. Section 1014(b) does not explicitly say it is an exclusive list. It just says “the following property shall be considered to have been acquired... from the decedent”; it does not say “**only** the following property shall be considered ...”. If §1014(b) is read as a nonexclusive list of ways to acquire property from a decedent, one could argue that property in a general sense passes from the decedent for income tax purposes when the property ceases to be owned by that person for income tax purposes by reason of the person’s death.

In any event, the IRS has clearly stated its view (but without any kind of express discussion of why it is rejecting the possible view that §1014(b) is merely a non- exclusive list of ways property can be acquired from a decedent).

- (7) **Does Not Apply to Sale to Grantor Trust Situation Where Note Is Outstanding at Death.** The fact that the holding in the Ruling applies just to assets given to the trust and the existence of the second caveat in the facts of the Ruling (i.e., no notes exist between the parties at the grantor’s death) suggest that the Ruling does not apply to the classic sale to grantor trust situation (as least as to the assets sold to the trust) if a note from the trust is unpaid at the grantor’s death.
- (8) **Penalties.** If a taxpayer wants to take the position that the IRS’s position in Rev. Rul. 2023-2 is wrong, the recipient of the grantor trust asset might want to report capital gain upon the sale of the asset as if no basis adjustment applied, and then claim a refund, taking the position that a basis adjustment did apply at the death of the grantor of the grantor trust. That approach would avoid underpayment penalties if the taxpayer’s position is not upheld.

If the refund approach is not used, must the taxpayer disclose the position on Form 8275 to avoid accuracy related and understatement penalties if the position of Rev. Rul. 2023-2 is upheld? Section 6694(a) provides that such penalties can apply if the preparer knew of the position and either (a) the position is related to a tax shelter or reportable transaction, (b) the position is not disclosed and there was not substantial authority for the position, or (c) the position is disclosed but there was not a reasonable basis for the position. Whether there is substantial authority for the view that a basis adjustment applies for assets in grantor trusts at the grantor’s death is uncertain. Some commentators take the position that substantial authority exists and penalties would not apply even if the position is not reported on Form 8275. See Alan Gassman, Kenneth Crotty, Brandon Ketron, & Peter Farrell, *Revenue Ruling 2023-2 Got It Wrong? The Case for a Stepped-Up Basis When the Grantor Dies*, LEIMBERG INCOME TAX PLANNING NEWSLETTER #244 (April 3, 2023). The taxpayer could expect strong resistance from the IRS, though, in light of the priority it has placed on this issue and the clear position it has taken in Rev. Rul. 2023-2.

- (9) **Background Information.** For a more detailed discussion of this issue, see Item 6.c of Estate Planning Current Developments and Hot Topics (December 2019) found [here](#) and Item 5.b of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (June 2023) found [here](#), both available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

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- d. **Anti-Abuse Exceptions to Anti-Clawback (Number 3).** Number 3 addresses the anti-abuse exception to the clawback regulation. The IRS released proposed regulations on April 26, 2022, discussed in Item 6 below.
- e. **Portability Regulatory Election Extensions Increased from Two to Five Years, Rev. Proc. 2022-32 (Number 4).** In a project that was added as Number 4 of the 2022-2023 Priority Guidance Plan, the IRS announced in Rev. Proc. 2022-32 that it is extending from two to five years from the decedent's date of death the period for obtaining an extension to file a late estate tax return to make the portability election without going through the expensive and time-consuming process of requesting a private letter ruling (which also avoids the necessity of paying a hefty user fee for a ruling under §301.9100-3 to obtain an extension).

**Summary Discussion.** For a discussion of Rev. Proc. 2022-32 and the various regulatory extensions that have been granted, see Item 5.c of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found [here](#) and Item 5.d of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (June 2023) found [here](#), both available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

**Planning Implications.** Planners may wish to review their records for estates of decedents who have died less than five years ago and that did not file estate tax returns. Planners might inform those estates that they have a longer opportunity to make the portability election using this simplified procedure. Also, when a Form 706 is filed after the original due date under this simplified procedure, the statement that is included at the top of the return should refer to Rev. Proc. 2022-32 rather than 2017-34.

- f. **Alternate Valuation Period (Number 5).** This project has been on the Plan for a number of years. For further discussion of this project see Item 6.d of Estate Planning Current Developments and Hot Topics (December 2019) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- g. **Section 2053 Proposed Regulations (Number 6).** Proposed regulations were released on June 24, 2022, and published in the Federal Register on June 28, 2022. These regulations eventually could have a profound impact on planning and the deductibility of certain administrative expenses for estate tax purposes. The proposed regulation and planning implications are discussed in Item 7 below.
- h. **Qualified Domestic Trust Elections (Number 7).** The QDOT project apparently is merely "updating obsolete references."
- i. **GST Exemption Allocation (Numbers 8-9).** Number 8 first appeared in the 2021-2022 Plan, but it is related to Number 9, which has been in Plans for a number of years, first appearing in the 2007-2008 Plan. For a discussion of these projects, see Item 5.h of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (June 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- j. **Tax Under §2801 on Gifts from Expatriates (Number 10).** This item first appeared in the 2008-2009 Plan, and proposed regulations were issued in 2015. The item was dropped from the 2017-2018 Plan and has not been in the Plan since then. For a discussion of this issue, see Item 29.i of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (June 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- k. **New Actuarial Tables Under §7520 (Number 11).** The actuarial tables project, added in the 2019-2020 Plan, is to update the §7520 actuarial tables based on updated mortality information, which must be done every ten years and was last done effective May 1, 2009. Proposed regulations were published on May 5, 2022 (more than three years after the statutorily required date of May 1, 2019), and final regulations were released on June 1, 2023. The regulations and planning issues are discussed in Item 8 below.
- l. **Other Notable Omissions in 2021-2022 Plan.** Among new items added to the Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015, were the following.

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“3. Guidance on basis of grantor trust assets at death under §1014.

...

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

...

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

These all address issues that are central to often-used transfer planning alternatives involving gifts and sales to grantor trusts.

Number 3 remained in the Plan until the 2021-2022 Plan, and then, as noted in Item 5.c above, a refined version of it was restored as Number 2 in the 2022-2023 Plan.

Number 5, addressing the valuation of promissory notes, first appeared in the 2015-2016 Plan and was dropped from the 2019-2020 Plan. (It was moved to the “Financial Institutions and Products” section in 2017-2018 and 2018-2019 Plans). The Treasury dropped this project from the 2021-2022 Priority Guidance Plan, but it has been added to the legislative proposals in the Fiscal Year 2023 Greenbook (mentioned in Item 2.a(3) above).

Number 8, regarding defined value formula clauses, was added in 2015 and was dropped in the 2017-2018 Plan and has not been in the Plan since then.

For a detailed discussion of these important items that previously appeared in Plans, see Item 29.k(1)-(2) of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (June 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- m. **Letter to Treasury from Senators Asking for Regulatory Crackdown on GRATs and Grantor Trusts.** A letter dated March 20, 2023, from four prominent Senators (two members of the Senate Finance Committee (Elizabeth Warren, D-Mass, and Sheldon Whitehouse, D-R.I and Senators Chris Van Hollen, D-Md, and Bernard Sanders, I-Vt.) details what they view as a “blatant abuse of our tax system,” and requests Treasury to take *regulatory* steps to remove many of the transfer planning advantages of GRATs and grantor trusts. See Alan Gassman, *Bernie Sanders and Elizabeth Warren Win a Battle in the War on the Taxation of Grantor Trusts*, FORBES (April 5, 2023). This request for current *regulatory* action is in the face of unsuccessful legislative attempts over multiple years to address some of the advantages of GRATs and grantor trusts. Indeed, the 2023 and 2024 FY Greenbooks again make various legislative proposals to take away some of the transfer planning opportunities of GRATs and grantor trusts, as discussed in Item 2.a(3) above. With the Republicans having majority control of the House of Representatives, the only way some of the trust-limiting measures can proceed currently may be through administrative action.

The letter begins with explanations of its view that tax abuses are allowing wealthy Americans to avoid the estate tax. Some excerpts: “multi-millionaires use trusts to shift wealth to their heirs tax-free”; “they are doing this in the open”; “their wealth managers are bragging about ... their tax-dodging tricks”; “millionaires and billionaires engaging in increasingly complex tax planning that exploits trusts to avoid paying taxes”; and “a kind of shell game ... to pass assets back and forth.” In the last half of the 20th century an average of 2.2% of adult deaths resulted in taxable estates, with a high of 7.65% in 1976. See Doug Sword, *Senators Ask Treasury to Rein in ‘Tax Dodging’ Grantor Trusts*, TAX NOTES (March 22, 2023). The letter explains that “[t]oday, less than 0.1% of Americans pay estate tax,” and that the recent market downturn that presents undue hardships for many Americans poses for the “ultra-wealthy” a massive wealth-shift opportunity without paying gift tax as the values eventually rebound.

The letter urges that Treasury has the authority and should take various steps administratively to cut back on what it views as abusive wealthy shifting opportunities:

(1) Revoke Rev. Rul. 85-13 but instead follow *Rothstein v. United States*, 735 F.2d 704 (2nd Cir. 1984), which in their view treats transfers between grantors and grantor trusts as taxable events, but with appropriate exceptions “to prevent disruption of business operations conducted for legitimate non-tax reasons”;

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(2) Revoke Rev. Rul. 2004-64 and confirm that the grantor's payment of income tax attributable to grantor trust income results in taxable gifts;

(3) Require GRATs to have a minimum remainder value, reasoning that having a minimum remainder value (such as 25% of contributed assets) would better ensure that the GRAT will be able to make the statutorily required fixed annual annuity even if the assets should fall in value, and noting "[t]his action would make GRATs far less appealing as a tax avoidance tool" (Greenbooks over a number of years have included a similar legislative proposal for a 25% minimum remainder value for GRATs, and Greenbooks over the last several years have included legislative proposals addressing recommendations (1) and (2) above);

(4) Reissue the §2704(b) proposed regulations from the Obama administration "to address the abuse of valuation discounts through family limited partnerships";

(5) Confirm Chief Counsel Advice 200937028 that grantor trust assets not included in the grantor's gross estate do not receive a basis adjustment at the grantor's death (indeed, the IRS has already acted on this issue by issuing Rev. Rul. 2023-2 on March 29, 2023); and

(6) Issue regulations "clarifying" §2702 and its regulations to

(a) require that GRATs have a required minimum and maximum annuity term to eliminate "inappropriate" planning opportunities,

(b) treat assets sales and substitutions with GRATs as prohibited "additional contributions," and

(c) limit the ability to exclude the value of a grantor's retained interest when valuing a transferred remainder interest "to prevent an inappropriate reduction in the value."

The letter also asks Treasury to respond to various questions about the amount of revenue could be raised by adopting these measures to address "grantor trust abuse," and to itemize the revenue estimates for various ranges of estate values.

The same Senators sent a letter on October 2, 2023, to Treasury and IRS that does not address those detailed proposals, but requests (among other things) "Regulations and other guidance to address abuses for ultra-wealthy families and dynastic wealth, including to police valuation games, perpetual dynasty trusts, and transfers of foreign assets" (citing the prior letter in a footnote).

- n. **Future Bold Projects Suggested by Tax Law Center at NYU Law (or "What Far Reaching Projects Might We See in the Future?").** In response to Treasury's annual request for recommendations for future projects (in Notice 2021-2), the Tax Law Center at NYU Law (the "Center") submitted a broad range of far-reaching projects on June 2, 2022. Recommendations regarding gifts, estates, and trusts are discussed in Item 5.a(6) of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- o. **Inflation Adjustments.** Inflation adjustments based on the C-CPI-U numbers published by the Bureau of Labor Statistics based on information through August 31 (typically in mid-September of each year) for 2021, 2022, 2023, and 2024 were announced in Rev. Proc. 2020-45, Rev. Proc. 2021-45, Rev. Proc. 2022-38, and Rev. Proc. 2023-34, respectively. Some of the adjusted amounts are as follows:
- Basic exclusion amount and GST exemption-\$13,610,000 in 2024, \$12,920,000 in 2023, \$12,060,000 in 2022, \$11,700,000 in 2021 (observe, the \$860,000 and \$690,000 increases for 2023 and 2024 are much larger than prior year inflation adjustment increases and leave substantial additional gift exclusion for additional gifts by those donors who have previously utilized all of their gift exclusion);
  - Gift tax annual exclusion-\$18,000 in 2024, \$17,000 in 2023, \$16,000 in 2022, \$15,000 in 2018-2021 (observe that the annual exclusion was \$15,000 for four years [2018-2021], but it has increased by \$1,000 in each of 2022-2024, and likely will increase by another \$1,000 in 2025);

- Estates and trusts taxable income for top (37%) income tax bracket-\$15,200 in 2024, \$14,450 in 2023, \$13,450 in 2022, \$13,050 in 2021;
- Top income tax bracket for individuals-\$731,200/\$609,350 (married filing jointly/single) in 2024, \$693,750/\$578,125 in 2023, \$647,850/\$539,900 in 2022, \$628,300/\$523,600 in 2021;
- Taxable income threshold for §199A qualified business income-\$383,900/\$191,950 (married filing jointly/single) in 2024, \$364,200/\$182,100 in 2023, \$340,100/\$170,050 in 2022, \$329,800/\$164,900 in 2021;
- Standard deduction-\$29,200/\$14,600 (married filing jointly/single) in 2024, \$27,700/\$13,850 in 2023, \$25,900/\$12,950 in 2022, \$25,100/\$12,550 in 2021;
- Non-citizen spouse annual gift tax exclusion-\$185,000 in 2024, \$175,000 in 2023, \$164,000 in 2022, \$159,000 in 2021;
- Section 6166 “two percent amount”-\$1,850,000 in 2024, \$1,750,000 in 2023, \$1,640,000 in 2022, \$1,590,000 in 2021; and
- Special use valuation reduction limitation-\$1,390,000 in 2024, \$1,310,000 in 2023, \$1,230,000 in 2022, \$1,190,000 in 2021.

The estate and gift exclusion amount is estimated to increase about another \$500,000 in 2025 to \$14,110,000. This suggests that if the estate and gift exclusion amount decreases from \$10 million (indexed) to \$5 million (indexed) in 2026, it would be some amount over \$7 million in 2026.

- p. **Re-Emergence of Section 2704 Proposed Regulations Addressing Valuation?** Neither the FY 2022 Greenbook nor the FY 2023 Greenbook includes a regulatory project to restrict valuation discounts under §2704. Apparently, there is no intent by the Biden administration, at this point, to re-open the §2704 regulation project, but the March 20, 2023 letter to Treasury from four prominent Senators request that the proposed regulations be reissued, as summarized in Item 5.m above. (The highly controversial proposed regulations published August 4, 2016, were withdrawn on October 20, 2017, during the Trump administration. For a detailed discussion of the history of the §2704 proposed regulations, see Item 18 of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (June 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).)
- q. **End of OIRA Review of Tax Regulations.** A memorandum of agreement signed June 9, 2023, between Treasury and the Office of Management and Budget provides that regulations issued by the IRS will no longer be subject to review by the Office of Information and Regulatory Affairs (OIRA). The OIRA has generally had up to 45 days to review tax regulations, but that review will no longer occur, which could save some (generally small) time in the process of issuing tax regulations. For a history of the review of tax regulations by the OIRA, see Marie Sapirie, *News Analysis: A Finale for OIRA Tax Review*, 180 TAX NOTES FEDERAL 349 (July 17, 2023).

## 6. Limitation on Anti-Clawback Special Rule, Proposed Regulations

- a. **Background.** The IRS published proposed regulations in the Federal Register on April 27, 2022. REG-118913-21. The preamble to the anti-clawback final regulations, published on November 26, 2019, stated that further consideration would be given to the issue of whether gifts that are not “true inter vivos transfers,” but rather are includible in the gross estate would be excepted from the anti-clawback relief provisions. Two and a half years later, these proposed regulations answer that question affirmatively. This project is Number 3 on the 2022-2023 Priority Guidance Plan mentioned in Item 5.d above.
- b. **Rationale.** The preamble to the proposed regulations (referred to hereafter in this discussion as the “Preamble”) reasons that the Code and existing regulations distinguish between (i) gifts that are not included in the gross estate (and are “adjusted taxable gifts”) and (ii) “completed gifts that are treated as testamentary transfers for estate tax purposes and are included in the donor’s gross estate (includible gift).” Preamble, citing: §2001(b) (flush language) (excluding includible gifts as

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“adjusted taxable gifts” for purposes of the estate tax calculation); Reg. §25.2701-5 & §25.2702-6 (excluding from adjusted taxable gifts transfers includible in the gross estate that were subject to the special valuation rules of §2701 and §2702, respectively); Rev. Rul. 84-25 (excluding from adjusted taxable gifts completed transfers, such as an enforceable gift of a promissory note, that will be satisfied with assets includible in the gross estate). Similarly, the proposed regulations deny the benefit of the anti-clawback provision to includible gifts, reasoning that including the date of death value of the transfer in the gross estate, but not also including the gift as an adjusted taxable gift in the estate tax calculation, results in subjecting those transfers “to estate tax with the benefit of only the BEA [basic exclusion amount] available at the date of death.” Preamble. The general rationale of the “string” statutes (§2036, 2038, 2037, and 2042) is to treat certain transfers in which the donor retains “too much” interest or control as if the transferred assets are still subject to the estate tax, and the anti-abuse rule achieves that purpose.

- c. **General Anti-Clawback Rule.** If a client made a \$12 million gift in 2022 (when the gift exclusion amount was \$12.06 million) but dies in 2026 after the basic exclusion amount has sunsetted to \$5 million indexed (say \$6.8 million), the \$12 million is added into the estate tax calculation as an adjusted taxable gift, but the estate exclusion amount is only \$6.8 million. So, will estate tax be owed on the difference? The special anti-clawback rule in Reg. §20.2010-1(c)(1) allows the estate to compute its estate tax credit using the higher of the BEA applied to gifts made during life or the BEA applicable on the date of death. Therefore, in the example above, if the donor dies when the BEA is \$6.8 million, the \$12 million gift would be included in the estate tax calculation as an adjusted taxable gift, but the available exclusion amount would be the larger of the \$6.8 million BEA at the date of death or the \$12 million of BEA applied to gifts made during life, or \$12 million. For a detailed discussion of the estate tax calculation process and the operation of the anti-clawback special rule, see Item 4 of Estate Planning Current Developments and Hot Topics (December 2019) found [here](#), and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- d. **General Anti-Abuse Exception.** Proposed §20.2010-1(c)(3) provides that the special anti-clawback rule (which allows applying a BEA equal to the greater of the BEA at death or the BEA allowed against taxable gifts) does not apply to “transfers includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b)” including, without limitation:
- Transfers includible in the gross estate under §2035, 2036, 2037, 2038, or 2042 (whether or not any part of the transfer was allowed a gift tax marital or charitable deduction);
  - Transfers made by enforceable promise to the extent they remain unsatisfied at death;
  - Transfers described in Reg. §25.2701-5 and §25.2702-6; and
  - Transfers that would have been those types of transfers but for the elimination by any person of the interest, power, or property within 18 months of the decedent’s death.

**Exceptions to the Exception.** The anti-clawback special rule continues to apply, however, to: (i) includible gifts in which the value of the taxable portion of the transfer, at the date of the transfer, was 5% or less of the total value of the transfer (observe that this would protect most GRAT transactions); and (ii) eliminations occurring within 18 months of death that were effectuated by termination of the period described in the original instrument by the mere passage of time or the death of any person.

- e. **Example of Transfers Includible in Gross Estate.** The exception to the general anti-clawback rule applies if the donor retained the beneficial use of or the control of the transferred property, such as a transfer with a retained life estate or subject to other powers of interests as described in §2035-§2038 and §2042. Another example would appear to be a transfer of a small income interest in a QTIP trust, triggering a deemed gift of the entire remainder interest under §2519; the retention of the remaining (large) income interest in the balance of the QTIP trust would result in estate inclusion of a proportionate (large) portion of the QTIP trust under §2036, thus causing the anti-abuse rule to apply.

The following example is based on an example in Item 5.c(1)(a) of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes*, (June 2023) found [here](#) and available

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at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). Assume the donor makes a \$9 million gift to a trust of which the donor is the income beneficiary in 2022 (fully covered by the gift exclusion amount) and dies in 2026 with a taxable estate of \$20 million, except that the \$9 million in the income trust (assume no appreciation has occurred) is also included in the gross estate under §2036(a)(1), resulting in a total taxable estate of \$29 million. Assume the BEA in 2026 has dropped to \$ 5 million (indexed), or \$6.8 million. Section 2001(b) (flush language) provides that the \$9 million gift is not brought back into the estate tax calculation as an adjusted taxable gift (because it is included in the gross estate).

Under the general anti-clawback rule, the estate tax would have been calculated using a BEA of \$9 million (the greater of the BEA applied against gifts [\$9 million] or the BEA at the date of death [\$6.8 million]). The estate tax is 40% x (\$29 million - \$9 million BEA), or **\$8 million**. Under the proposed anti-abuse exception, though, the estate tax would be calculated using a BEA of \$6.8 million, and the estate tax would be 40% x (\$29 million - \$6.8 million), or **\$8,880,000**. Effectively, the donor would not get the benefit of having made use of the extra \$9 million less \$6.8 million, or \$2.2 million of “bonus” exclusion amount. That \$2.2 million times 40% is \$880,000.

Another example of a §2036 transfer that could be caught by this proposed anti-abuse rule is the creation of a qualified personal residence trust (QPRT) if the donor should die during the term of the retained interest in the residence. See Brad Dillon, *QPRTs Should Come with a New Warning Label*, LEIMBERG ESTATE PLANNING NEWSLETTER #2990 (NOVEMBER 3, 2022). **Another example where this rule could apply inadvertently is if an interest in a partnership or LLC is given and at the donor’s subsequent death (possibly years later) the gifted interest is included in the donor’s gross estate under §2036.**

- f. **Example of Gift of Enforceable Promissory Note.** Because the donor/promisor keeps the enjoyment of property until the promissory note is satisfied, there is a resemblance to §2036, and the general rationale is that such transfers should still be subject to the estate tax at the donor’s death. The following example is based on Example 1 in the proposed regulation. Prop. Reg. §20.2010-1(c)(3)(iii)(A) Ex. 1. The donor made a completed gift of a \$9 million enforceable promissory note, which remains unpaid until the donor’s death in 2026 with a taxable estate of \$29 million, when the BEA is \$6.8 million. The note is not deductible as a claim under §2053(c)(1)(A) because it was not contracted for a valuable consideration. However, because the note will be paid with assets in the gross estate, Revenue Ruling 84-25 reasons that the note is treated as being includible in the gross estate, so the \$9 million gift is not brought back into the estate tax calculation as an adjusted taxable gift.

Under the general anti-clawback rule, the estate tax would have been calculated using a BEA of \$9 million (the greater of the BEA applied against gifts [\$9 million] or the BEA at the date of death [\$6.8 million]). The estate tax would be 40% x (\$29 million - \$9 million BEA), or \$8 million. Under the proposed anti-abuse exception, the estate tax would be calculated using a BEA of \$6.8 million, and the estate tax would be 40% x (\$29 million - \$6.8 million), or \$8,880,000. Effectively, the donor would not get the benefit of having made use of the extra \$9 million - \$6.8 million, or \$2.2 million of “bonus” exclusion amount (\$2.2 million x 40% = \$880,000).

A planning alternative suggested by many, in light of the fact that a gift of a promissory note may not be enforceable in most states, is for a donor to make a completed gift of assets to a grantor trust, and after some period of time the donor might choose to repurchase the assets for a note. The net effect is that the donor then has use of the assets and owes a promissory note to the trust, the same as if the donor had given a promissory note in the first place. Whether that transaction would be caught by the anti-abuse rule is unclear. Literally, perhaps so. The gifted assets would be in the donor’s gross estate or, at the least, in the words of the proposed regulation, might be “treated as includible in the gross estate for purposes of section 2001(b).” However, the purchase of the assets from the trust arguably is just an investment decision. If the donor decides to sell the gifted assets and re-invest in other assets, would the “gifted assets” no longer be considered to be in the donor’s gross estate and therefore the anti-abuse rule would not apply? Obviously, if the IRS could treat the

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gift and the repurchase as an integrated (i.e., “step”) transaction, the IRS might be expected to maintain that the anti-abuse rule applied.

Comments filed with the IRS by the New York State Bar Association Tax Section on July 12, 2022, observes that the IRS “may wish to define a gift followed by a loan back to the donor as *per se* a targeted gift, if the loan occurs within [a] certain period (such as 18 months [or] three years) following the gift.”

- g. **Example of Gift Subject to Section 2701.** The following example is based on Example 2 in Reg. §25.2701-5(d) Ex. 2. An individual owns preferred stock with an aggregate value of \$7.5 million and makes a gift of all of the common stock in 2022, which has a value of \$2.5 million. The total value of the individual’s interest in the corporation is \$10.0 million. The preferred stock is treated as having a value of zero under §2701, so the donor made a taxable gift of \$10 million. The individual dies in 2026, when the BEA is \$6.8 million, owning \$15 million of other assets in addition to the preferred stock (or the proceeds of selling the preferred stock to someone other than an “applicable family member”), and the preferred stock still has a value of \$7.5 million at the date of death. In computing the estate tax, the value of the preferred stock is reduced by \$7.5 million, so it is valued at zero for estate tax purposes, under Reg. §25.2701-5(a)(4). In calculating the estate tax, the \$10 million gift is included as an adjusted taxable gift, but the preferred stock is treated as having a value of zero in the gross estate.

Under the general anti-clawback rule, the estate tax would have been calculated using a BEA of \$10 million (the greater of the BEA applied against gifts [\$10 million] or the BEA at the date of death [\$6.8 million]). The estate tax would be  $40\% \times (\$15 \text{ million} + \$10 \text{ million ATG} - \$7.5 \text{ million [2701 adjustment]} - \$10 \text{ million BEA})$ , or **\$3 million**. Under the proposed anti-abuse exception, the estate tax would be calculated using a BEA of \$6.8 million, and the estate tax would be  $40\% \times (\$15 \text{ million} + \$10 \text{ million ATG} - \$7.5 \text{ million [2701 adjustment]} - \$6.8 \text{ million})$ , or **\$4,280,000**. In effect, the deceased donor would be taxed on the \$15 million of assets other than the preferred stock and does not receive the benefit of a \$1.28 million windfall that would result under the general anti-clawback rule. The windfall would have been the bonus exclusion amount that was utilized (\$10 million - \$6.8 million) times 40%, or **\$1.28 million**.

- h. **Example of De Minimis Rule; Gift to a GRAT.** The special anti-clawback rule continues to apply if the taxable amount of a gift is 5% or less of the total amount of the transfer. The Preamble describes this as a bright-line exception “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.” In Example 4 of the proposed regulations, a donor transfers \$9 million to a GRAT. The retained annuity was valued at \$8,550,000, and the taxable gift was \$450,000. The donor died in 2026 (when the BEA is assumed to be \$6.8 million) during the term of the GRAT, and an amount equal to the full value of the GRAT corpus is included in the donor’s gross estate under Reg. §20.2036-1(c)(2). The taxable value of the transfer was 5% of the total transfer, so the 5% de minimis exception applies under the proposed regulation and the general anti-clawback rule applies. That makes no difference under these facts because the \$450,000 gift is less than the \$6.8 million BEA at the date of death, and the available BEA under the anti-clawback rule is the greater of the BEA applied against gifts (\$450,000) or the BEA at death (\$6.8 million). Prop. Reg. §20.2010-1(c)(iii)(D) Ex. 4. That will generally be the case for GRATs, because the taxable gift is typically a very low number.

Some advisors have questioned whether a de minimis exception is needed or is appropriate.

- i. **Example of Use of DSUE Amount.** The proposed regulation includes a detailed example of a gift by a donor who has DSUE from a predeceased spouse. The example walks through the mathematical details for determining the amount of the **donor’s** BEA that was applied against gifts. The example confirms the position in the anti-clawback final regulation that the DSUE must be applied to the gift before the donor’s BEA. Prop. Reg. §20.2010-1(c)(3)(iii)(C) Ex. 3.
- j. **Deathbed Planning.** The proposed regulations address deathbed planning alternatives to avoid the exception by removal of the donor’s beneficial use or control of the transferred property before death

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in a way that would avoid §2035 in order to prevent the transferred asset from being included in the gross estate (which is what generally causes the exception to apply). The proposed regulation specifically refers to actions taken by third parties, in contrast to §2035, which requires affirmative action by the transferor to relinquish interests or powers that would trigger estate inclusion. Examples in the proposed regulations include elimination by a third party of an interest or power that would trigger estate inclusion or payment of a gifted promissory note. The exception to the general anti-clawback rule would apply if such elimination occurs within 18 months of the date of death. Such “pre-death” planning to eliminate a problematic power in a way that would not trigger §2035 could still be attempted if an individual finds he is seriously ill but may survive 18 months after such elimination. Prof. Mitchell Gans describes this sort of planning as “nothing ventured, nothing lost.” See Jonathan Curry, *Proposed Regs Add Guardrails to Estate Tax Anti-Clawback Rules*, 175 TAX NOTES FEDERAL 769 (May 2, 2022).

The 18-month rule has been criticized in comments to the IRS. The American College of Trust and Estate Counsel, The Tax Law Center at NYU Law, and New York State Bar Tax Section all recommend applying a three-year test rather than an 18-month test, consistent with the approach of §2035. The Florida Bar, on the other hand, recommends that the 18-month test be reduced to a 12-month test, consistent with §1014(e). See Jonathan Curry, *Tax Orgs Split on Deathbed Planning in Anti-Clawback Regs*, 176 TAX NOTES FEDERAL 774 (Aug. 1, 2022). Comments have also sought clarification about whether the 18-month rule would apply to a bona fide sale of an interest.

Melissa Liquerman (IRS Office of Chief Counsel) has noted at a conference that the IRS received comments that the 18-month period is too long and should instead be 12 months. See Lauren Loricchio, *IRS Pushes to Wrap Up Work on Estate and Gift Tax Regs*, TAX NOTES TODAY FEDERAL (Jan. 26, 2023).

- k. **Durational Periods of Retained Interests or Controls.** If the donor is willing to retain the problematic interest or control for a limited period of time that would be stated in the trust agreement, the anti-abuse rule could be avoided if the period of time ends before the donor’s death, even if it is within 18 months of the donor’s death. Planners may consider increased use of such durational periods of retained interests or powers in drafting trust instruments, weighing the possible loss of flexibility such durational periods might create..
- l. **Effective Date.** Once the regulations have been published as final regulations, they are proposed to apply to estates of decedents dying on or after April 27, 2022 (the date of publication of the proposed regulations in the Federal Register). The rationale of this special effective date provision is that it is “the best way to ensure that all estates will be subject to the same rules” in case the BEA should be reduced before the regulations are finalized. Preamble. Accordingly, the proposed regulation would apply to gifts made at any time by a decedent who dies on or after April 27, 2022.
- m. **Comments by New York State Bar Association Tax Section.** Comments filed by the New York State Bar Association Tax Section with the IRS on July 12, 2022, make a number of recommendations regarding the proposed regulations. In a summary of their comments, the Tax Section writes that it recommends the following.
  1. Treasury and the Service consider whether the portability regulations should be revised so that targeted gifts may not be used to lock in deceased spousal unused exclusion (“DSUE”) before an individual remarries and survives a second spouse.
  2. The final regulations clarify whether a targeted gift can absorb the standard BEA, even if it cannot preserve bonus BEA.
  3. The final regulations clarify that some transfers are treated as targeted gifts, even if they are neither includible in the gross estate nor treated as includible.
  4. Treasury and the Service consider whether gifts that the donor later borrows back should, in some cases, be treated as targeted gifts.
  5. The final regulations clarify that the retention of a qualified payment right within the meaning of Section 2701(c)(3) does not cause a transfer to be treated as a targeted gift.

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6. The final regulations replace or supplement the 5% rule set forth in Prop. Reg. § 20.2010-1(c)(ii)(A) with a provision that that would permit application of the anti-clawback rule in cases where the donor retains no more than a qualified retained interest within the meaning of Section 2702(b).

7. The final regulations eliminate the disparities that would arise under the Proposed Regulations in the treatment of transfers, relinquishments, or eliminations of interests, powers or property prior to death, and instead adopt a uniform and consistent rule.

- n. **Planning Implications.** For a discussion of ways in which the proposed regulations could impact various planning alternatives, see Martin Shenkman & Jonathan Blattmachr, *Proposed Clawback Regs May Undermine Some Estate-Planning Strategies*, TRUSTS & ESTATES 30 (July/Aug. 2022).

## 7. Section 2053 Proposed Regulations

Proposed regulations were released on June 24, 2022, and published in the Federal Register on June 28, 2022 (REG-130975-08), addressing Number 5 on the list of estate related projects on the 2021-2022 Priority Guidance Plan and Number 6 on the 2022-2023 Plan mentioned in Item 5.a above.

- a. **Overview of Topics Addressed.** The proposed regulations address four general topics about deductions for claims and administration expenses under §2053: (1) applying present value concepts, (2) deductibility of interest, (3) deductibility of amounts paid under a decedent's personal guarantee, and (4) curing technical problems of references in existing regulations to a "qualified appraisal" for valuing claims by instead describing requirements for a "written appraisal document."
- b. **Applying Present Value Concepts to §2053 Deductions.** The general rationale of allowing deductions for claims and expenses is that such amounts "do not pass to the decedent's legatees, beneficiaries, or heirs and, therefore, are not subject to the estate tax." Proposed Regulations Preamble [REG-130975-08] ("Preamble"). Although assets in the gross estate are valued under a "snapshot" method at the date of death (or the alternate valuation date, if applicable), the Preamble reasons that limiting the deduction under §2053 for claims and expenses

to the discounted amount of a payment or payments made or to be made after an extended period following the decedent's death ... [is] a more accurate measure of the amounts not passing to the heirs and legatees ... [and] will more accurately reflect the economic realities of the transaction, the true economic cost of that expense or claim, and the amount not passing to the beneficiaries of the estate.

For claims and expenses paid (or to be paid) after a three-year "grace period" from the date of death, only the discounted present value of such post-grace-period payments may be deducted. The present value of each such payment made after the grace period, discounted from the date of payment to the date of death using the appropriate mid-term or long-term applicable federal rate in effect at the date of death will be deductible under §2053. Payments made during the three-year grace period are not discounted. The formula for calculating the discounted present value is given in Prop. Reg. §20.2053-1(d)(6)(ii).

For claims or expenses that may be deducted before they are actually paid (such as amounts ascertainable with reasonable certainty, claims regarding a particular asset, or claims totaling not more than \$500,000, Reg. §§20.2053-1(d)(4) & 20.2053-4(b) and (c)), the expected dates of payment (which will be used in making the present value calculations) "must be determined using all information reasonably available to the taxpayer... [and] must be identified in a written appraisal document." Prop. Reg. §20.2053-1(d)(6)(iii). The deductible present value amount will be adjusted if the actual date or dates of payment differ from the estimated payment dates. Prop. Reg. §20.2053-1(d)(6)(iii) & §20.2053-1(d)(6)(vi).

A statement must be filed with the estate tax return supporting the deduction under §2053 of any amounts paid after the three-year grace period. Prop. Reg. §20.2053-1(d)(6)(iv). The rule limiting the deduction to the discounted value of post-grace-period payment "does not apply to unpaid principal of mortgages and other indebtedness deductible under §20.2053-7." Prop. Reg. §20.2053-1(d)(6)(vii).

The Preamble explains that the rationale of requiring discounting of claims and expenses paid only after the three-year grace period is that most ordinary administration expenses are paid within three years of the date of death, three years takes into account a reasonable time for administering and

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closing the estate, and three years is a short enough period of time that the deduction of the full undiscounted amount of payments made within that grace period will not significantly distort the value of the net (distributable) estate. The Preamble concludes this rationale by stating that the three-year cutoff “strikes an appropriate balance between benefits and burdens.”

- c. **Deductibility of Interest as an Administration Expense.** General regulatory requirements for deducting administration expenses under §2053(a)(2) are that they are “actually and necessarily incurred in the administration of the decedent’s estate” (Reg. §20.2053-3(a)) and are “bona fide in nature” (Reg. §20.2053-1(b)(2)). Numerous cases and published guidance over the past half century have addressed the deductibility under §2053(a)(2) of interest on deferred tax and on loan obligations incurred by the estate under these “necessarily incurred” and “bona fide” regulatory requirements. The proposed regulations provide more detailed guidance as to the deductibility of interest expenses.

- (1) **Interest on Unpaid Tax and Penalties.** By statute, interest paid on estate tax deferred under §6166 is not deductible (instead a special low interest rate is applied). For other situations, the general rule is that interest payable under §6601 on federal taxes (including income taxes, estate and gift taxes, employment taxes, and miscellaneous excise taxes), other than §6166 interest, that accrues after the date of death on any unpaid tax (including additions to tax) or penalties is deductible to the extent permitted by Reg. §20.2053-1.

Interest on unpaid estate tax deferred under §6161 or §6163 is “actually and necessarily incurred in the administration of the estate ... because the extension was based on a demonstrated need to defer payment.”

Other interest on all unpaid tax or penalties “generally” is actually and necessarily incurred in the administration of the estate. Prop. Reg. §20.2053-3(d)(1)(ii). If an extension is not acquired under §6161 or §6163, an important exception to the general rule is that interest on unpaid tax and penalties is not actually and necessarily incurred in the administration of the estate, and therefore is not deductible, 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 §1.6662-3(b)(2) of this chapter, or fraud with intent to evade tax.” Prop. Reg. §20.2053-3(d)(1)(iii). Even if the underlying deferral, underpayment or deficiency is not attributable to such conduct by the executor, any interest accruing after such conduct occurs by the executor will not be deductible. *Id.*

This important exception applies even if there is no negligence or fraudulent intent to evade tax if “rules or regulations” are disregarded (which arguably is what happens whenever a tax payment is not made timely or if a position on a return results in an underpayment). The reference to Reg. §1.6662-3(b)(2) provides some guidance as to what is careless (the failure to exercise reasonable diligence), reckless (making little or no effort to determine a rule or regulation requirement), or intentional disregard (disregarding a rule that the taxpayer knows). With respect to making tax payments, the “careless” standard would often be relevant (in case the executor is unaware of a payment date or of an issue that results in an underpayment), but the “intentional” standard would likely be applicable if the executor knows that a payment date exists but does not make a timely payment or knowingly takes an incorrect position that results in an underpayment. The proposed regulations do not suggest that reasons explaining why a payment was made late or why a position was taken that resulted in an underpayment are not listed as factors to overcome disregard of the rule, in contrast to the various factors described in the proposed regulations that are considered in whether interest on a loan obligation will be deductible (discussed below). The potential broad reach of the exception is suggested by the Examples in the proposed regulations. (Prop. Reg. §20.2053-3(d)(iv).) In Example 2, the executor files the estate tax return and pays tax (presumably without a payment extension) a year after the due date. The executor pays the tax, assessed penalties, and interest on the tax and penalties. The Example states the failure to timely file and pay tax was “a result of [the executor’s] disregard of the rules for filing the return and paying the tax and any assessed penalties” without referring to any negligence or fraudulent intent to evade tax. Such “disregard of the rules” would seem to apply in almost any situation in which taxes and penalties are not paid timely. (In one sense, tax underpayments and penalties

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that are ultimately determined to apply literally result from the failure to follow correctly some tax “rule.”) The proposed regulations do not include any explicit kind of exception for reasonable cause or for some other reason for not correctly following some tax rule. The preamble provides some relief despite the language in the regulation itself, distinguishing “legitimate disagreements with the IRS, inadvertent errors, or reasonable reliance on a qualified professional.”

Accordingly, in some situations, interest on tax underpayments and penalties, other than interest accruing on taxes that are extended under §6161 or §6163, will not be deductible, even though there is no negligence or fraud and even though such amounts are not received by the estate beneficiaries.

- (2) **Interest on Loan Obligations of the Estate.** A considerable number of cases have addressed the deductibility of interest under §2053 on funds borrowed to pay estate taxes. For descriptions of many of these cases, see section IV.D.2 of Akers, *Post-Mortem Planning—It’s Not Too Late to Plan: A Review of Income, Gift and Estate Tax Planning Issues and Strategies and Disclaimer Planning Issues* (January 2022) (available from author). The Preamble observes that this issue “has been litigated often, with varying results” and that the proposed regulation will “provide guidance.”

Under the proposed regulation, if an estate obtains a loan to facilitate payment of estate tax or other liabilities in the administration of the estate, interest on the loan will be deductible if three requirements are met: (1) the interest expense arises “from an instrument or contractual arrangement that constitutes indebtedness under the applicable income tax regulations and principles of Federal tax law”; (2) the interest expense and loan must be “bona fide in nature based on all the facts and circumstances”; and (3) the loan and 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.” (Note that word “essential.”) The proposed regulations have a non-inclusive list of 11 “factors that collectively may support a finding” that those requirements are satisfied. Prop. Reg. §20.2053-3(d)(2). Some of those factors (none of which by themselves are presumably determinative) are:

- the interest rate and loan terms (including any prepayment penalties) are reasonable and comparable to arm’s-length transactions;
- the lender includes the interest in gross income for income tax purposes, especially if the lender is a family member, related entity, or beneficiary;
- the payment schedule corresponds to the estate’s ability to make payments and is not extended beyond what is reasonably necessary;
- the only practical alternatives to the loan are the sale of assets at significantly below-market prices, the forced liquidation of an entity that conducts an active trade or business, or “some similarly financially undesirable course of action”;
- the estate does not have liquidity to pay estate liabilities, the estate does not have control of an entity with liquid assets to satisfy estate liabilities, the estate has no power to compel an entity to sell liquid assets and make distributions, and the estate will have sufficient cash flow to make the loan payments [an example of these factors is *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) (an FLP in which the estate owned a substantial interest sold assets for \$98 million and made a \$71 million loan to the estate; court reasoned in part that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership)];
- the estate’s illiquidity does not occur as a result of a “testamentary estate plan to create illiquidity” or action or inaction by the executor when a reasonable alternative could have avoided or mitigated the illiquidity;
- the lender is not a beneficiary or entity over which the beneficiary has control; and

- the estate has no right to recover estate tax from the person loaning the funds.

The illiquidity factor has been addressed in several of the cases regarding the deductibility of interest on a loan obtained to pay estate taxes. For example, in *Estate of Murphy, Jr. v. U.S.*, 104 AFTR 2d 2009-7703 (W.D. Ark. 2009), the estate borrowed \$11,040,000 from an FLP on a 9-year *Graegin* note (i.e., which had a fixed term and interest rate and which prohibited prepayment). The estate also borrowed an additional \$41.8 million from a prior trust on a “regular” note (i.e., that had a floating interest rate and that permitted prepayment). The Government argued that the interest should not be deductible for two reasons. (1) The interest was not necessarily incurred “because it was the result of an unnecessary estate-tax avoidance transfer” that drained decedent’s estate of liquid assets. The court rejected this reasoning, because the FLP was created “in good faith and for legitimate and significant non-tax purposes,” and because decedent retained sufficient assets (\$130 million) at the time the FLP was created to pay his living expenses and anticipated estate taxes. (2) The FLP could have sold some of its assets and made a distribution of cash to the estate to pay taxes. The court also rejected this argument, reasoning that “[i]f the executor acted in the best interest of the estate, the courts will not second guess the executor’s business judgment.” (Citing *McKee v. Commissioner*, 72 T.C.M. 324, 333 (1996).)

The net effect is that “*Graegin* loans” (see *Estate of Graegin v. Commissioner*, T.C. Memo, 1988-477) will be significantly restricted under the proposed regulations. Even if a deduction is allowed for post-death interest accruing on the loan, the deduction for interest paid after three years following date of death (which may be all of the interest) will be discounted as discussed above. Proposed Reg. §20.2053-1(d)(6). Furthermore, an interest deduction may be denied totally for some loans after applying the 11 factors listed in the proposed regulations. **Those factors generally reflect issues that have been addressed in various cases involving loans obtained to pay estate taxes, but some cases have not been as restrictive as is suggested by the listed factors.** For example, one of the negative factors listed in the proposed regulations is whether the lender is a beneficiary or entity in which the beneficiary has control, but various cases have permitted a deduction for interest paid to a beneficiary or family entity. *E.g.*, *Beat v. U.S.*, 107 AFTR 2d 2011-1804 (D. Kan. 2011); *Estate of Murphy v. U.S.*, 104 AFTR 2d 2009-7703 (W.D. Ark. 2009); *Keller v. U.S.*, 697 F.3d 238, 110 AFTR 2d 2012-6061 (5th Cir. 2012) (\$114 million borrowed after death from FLP on a 9-year note; deduction allowed; “we refuse to collapse the Estate and FLP to functionally the same entity simply because they share substantial (though not complete) common control”), *aff’g* 104 AFTR 2d 2009-6015 (2009) and 106 AFTR 2d 2010-6309 (2010). Also, some courts have refused to second guess the business judgments of executors by not requiring “that an estate totally deplete its liquid assets before an interest expense can be considered necessary,” *Estate of Thompson v. Commissioner*, T.C. Memo 1998-325, or requiring an estate to qualify to defer estate taxes under §6166 rather than borrowing funds to pay the estate taxes, *McKee v. Commissioner*, T.C. Memo. 1996-362.

- (3) **Illustrative Cases Regarding Interest on Loan Obligations.** The Preamble cited only two cases – one that allowed the deduction (*Graegin*, discussed above) and another that didn’t (*Black*).

In *Estate of Black v. Commissioner*, 133 T.C. 340 (2009), an FLP sold about one-third of its very large block of stock in a public company in a secondary offering, generating about \$98 million to the FLP, and the FLP loaned \$71 million to the estate to pay various taxes, expenses, and a charitable bequest. The estate argued four reasons for allowing an interest deduction. (1) The executor exercised reasonable business judgment when he borrowed funds, (2) the FLP was not required to make a distribution or redeem a partnership interest from the estate, (3) the son was the managing partner and executor and owed fiduciary duties to both the estate and the partnership, and (4) the loan itself was a bona fide loan. The IRS argued that the loan was (1) unnecessary and (2) not bona fide (because the transaction had no economic effect other than to generate an estate tax deduction). The court found that the loan was not necessary, basing its analysis primarily on the “no economic effect” rationale that the IRS gave in its “no bona fide loan” argument. The court noted that the partnership agreement allowed modifications, and a modification permitting a distribution of stock to the partners or a partial redemption of the

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estate's interest would not have violated the son's fiduciary duties, as managing partner, to any of the partners. The court reasoned further that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership in return for the stock, which it would then use to discharge the debt. Instead, the partnerships sold the stock and loaned the sale proceeds to the estate. Under the court's analysis, the key factor in denying any deduction for loans obtained to pay debts and expenses seems to be that the loan was not necessary to avoid selling assets. The other cases cited by the taxpayer in which an interest deduction was allowed involved situations where the estate avoided a forced sale of illiquid assets or company stock. In this case, the company stock that was owned by the FLP was in fact sold by the FLP. *See generally* Liss, Estate of Black: *When Is It 'Necessary' to Pay Estate Taxes With Borrowed Funds?*, 112 J. TAX'N (June 2010).

Various other cases have allowed interest deductions for loans from family entities with interesting discussions of some of the 11 factors mentioned in the proposed regulations. One of these is *Estate of Duncan v. Commissioner*, T.C. Memo. 2011-255. In that case, the decedent had transferred a substantial part of his estate, including oil and gas businesses to a revocable trust. The decedent at his death exercised a power of appointment over an irrevocable trust that had been created by decedent's father to appoint the assets into trusts almost identical to trusts created under the revocable trust. The irrevocable trust and the revocable trust had the same trustees and beneficiaries. Following decedent's death in January 2006, the revocable trust borrowed about \$6.5 million from the irrevocable trust to cover the estate's shortfall in being able to pay federal and state estate taxes and various administration expenses and debts. The loan was evidenced by a 6.7% 15-year balloon note that prohibited prepayment. A 15-year term was used because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict. The 6.7% interest rate was the rate quoted by the banking department of the corporate co-trustee for a 15-year balloon loan. (At the time of the loan, the long term AFR was 5.02% and the prime rate was 8.25%.) In fact, the revocable trust ended up being able to generate over \$16 million in cash within the first three years, but the note prohibited prepayment. The revocable trust did not expect to generate sufficient cash to repay the loan within three years.

In *Estate of Duncan*, the estate claimed a deduction under § 2053 of about \$10.7 million for interest that would be payable at the end of the 15-year term of the loan. The IRS denied any deduction for the interest (although at trial it was willing to allow a deduction for three years of interest). The court determined that the interest was fully deductible. (1) The loan was bona fide debt. Even though the lender and borrower trusts had the same trustees and beneficiaries, the loan still had economic substance because the parties were separate entities that had to be respected under state law. (2) The loan was actually and reasonably necessary. The revocable trust could not meet its obligations without selling its illiquid assets at reduced prices. Because of the trustee's fiduciary duty, the irrevocable trust could not merely purchase assets from the revocable trust without requiring a discount that third parties would apply. The terms of the loan were reasonable, and the court refused to second guess the business judgment of the fiduciary acting in the best interests of the trust. The 15-year term was reasonable because of the volatile nature of the anticipated income. The interest rate was reasonable; using the AFR as the interest rate would have been unfair to the irrevocable trust because the AFR represents the appropriate interest rate for extremely low risk U.S. government obligations. The IRS complained that there were no negotiations over the rate, but the court said that the trustees had made a good-faith effort to select a reasonable interest rate and that "formal negotiations would have amounted to nothing more than playacting." (3) The amount of the interest was ascertainable with reasonable certainty. The IRS argued that the loan might be prepaid and that there is no economic interest to enforce the clause prohibiting prepayment. The court found that prepayment would not occur because the two trusts had to look out for their own respective economic interests. If a prepayment benefited one trust it would be a financial detriment to the other. *See generally* Stephen Liss, *In Estate of Duncan, the Tax Court Returns to Traditional Graegin Loan Principles*, 116 J. TAX'N 193 (April 2012).

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In the future, a case with facts similar to *Estate of Duncan* would be impacted significantly by the positions taken in the proposed regulation (after it is finalized). The interest payments after three years from the date of death would be discounted to the date of death present value using the mid-term AFR (at the date of death) for interest payments in years 4-9 and the long-term AFR for interest payments in years 10-15 as the discount rates. Whether a deduction for the interest payments would be disallowed entirely as a result of applying the 11 factors in Prop. Reg. §20.2053-3(d)(2) is not clear, but the IRS likely anticipates that the explicit reference to those factors in the regulation would bolster its argument that a deduction for the interest payments should be disallowed.

In a pending case, the IRS is taking the position that a deduction is not available under §2053 for \$4.61 million of interest on four promissory notes from family trusts that held limited partnership interests holding shares of the family business. The loans were incurred to obtain funds to pay estate tax. (Other issues are contested as well.) *Estate of Wells v. Commissioner*, Nos. 16564-22, 16567-22 (T.C. 2023). See Erin McManus, *Estate Says It Lacked Liquidity to Pay Taxes Without Loans*, 179 TAX NOTES FEDERAL 898 (May 1, 2023).

- d. **Deductibility of Amounts Paid Pursuant to Decedent's Personal Guarantee.** The proposed regulations treat a claim against the estate based on the decedent's personal guaranty as a "claim founded upon a promise" that is governed by Reg. §20.2053-4(d)(5), which requires that the promise or agreement was **bona fide** and **in exchange for adequate and full consideration in money or money's worth**; that is, the promise or agreement must have been bargained for at arm's length and the price must have been an adequate and full equivalent reducible to a money value. (Emphasis added.)

The proposed regulations revise Reg. §20.2053-4(d)(5) by restating the existing provision as a new paragraph (i) titled "In general," and adding a new paragraph (ii) titled "Decedent's promise to guarantee a debt." Prop. Reg. §20.2053-4(d)(5)(ii).

- (1) **Bona Fide Requirement.** The bona fide requirement is that the agreement must have been bargained at arm's length and, in the case of a claim involving a family member, the decedent's agreement to guarantee the debt of a family member, a related entity, or a beneficiary must meet the requirements of Reg. §20.2053-1(b)(2)(ii). (This simply reiterates the "bona fide" requirement that applies to all deductions for claims under §2053.)
  - (2) **In Exchange for Full Consideration.** A safe harbor is provided for a decedent's guarantee of a debt of an entity in which the decedent had an interest when the guarantee was given. The guarantee will be treated as satisfying the requirement that the agreement be in exchange for adequate and full consideration if **either** of two tests are met:
    - At the time the guarantee was given, the decedent had control (within the meaning of §2701(b)(2)) of the entity; or
    - To the extent the maximum liability of the decedent under the guarantee did not exceed, at the time the guarantee was given, the fair market value of the decedent's interest in the entity.
  - (3) **Right of Reimbursement.** The amount of the deduction of payment of a guarantee is reduced to the extent of the estate's right of contribution or reimbursement.
  - (4) **Avoiding Double Counting.** Payments made pursuant to a decedent's guarantee of a debt are deductible as a claim only to the extent the guarantee has not been taken into account in valuing an asset of the gross estate under Reg. §20.2053-7 (by reducing the value of the asset by all or some of the amount of an unpaid mortgage or debt against the property) or otherwise.
- e. **Substantiation Requirements for Valuations of Certain Administration Expense Deductions.** The regulations permit a deduction for claims against the estate under §2053 before the claim is actually paid in three circumstances: (1) claims for certain ascertainable amounts (Reg. §20.2053-1(d)(4)); (2) claims and counterclaims in a related matter (Reg. §20.2053-4(b)); and (3) claims totaling not more than \$500,000 (Reg. §20.2053-4(c)). The new substantiation rules in the proposed regulations apply to situations (2) and (3). The existing regulations require a "qualified

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appraisal” (within the meaning of §170) to value such claims. The IRS has determined that certain elements of a qualified appraisal under §170 do not apply in the context of valuing a claim against the estate. The proposed regulations provide revised rules for a “written appraisal document” that must support the value of claims for purposes of Reg. §20.2053-4(b) and (c). Prop. Reg. §20.2053-4(b)(1)(iv) & Prop. Reg. §20.2053-4(c)(1)(iv).

The proposed regulations specify detailed information that must be included in the report. The report must be signed under **penalties of perjury**, which is a new requirement that does not apply to other requirements or appraisals in the Code or regulations, and likely will be controversial with appraisers. There are limitations on who can give the report; the person must be qualified to appraise the claim and cannot be a member of the decedent’s family, a related entity, a beneficiary, a family member of a beneficiary or a related entity as to a beneficiary, or an employee or owner of any of the above.

- f. **ACTEC Comments.** ACTEC filed comments with the IRS on September 22, 2022. The comments address (i) the illiquidity and “beneficiary as lender” issues as factors about whether interest is deductible, (ii) the penalties of perjury requirement for appraisals of claims, and (iii) the impact of receiving full consideration for personal guarantees. The ACTEC comments are available at [https://www.actec.org/assets/1/6/22.09.22\\_ACTEC\\_LTRComments\\_Section\\_2053.pdf?hssc=1](https://www.actec.org/assets/1/6/22.09.22_ACTEC_LTRComments_Section_2053.pdf?hssc=1).
- g. **Effective Date.** The regulations are proposed to apply to estates of decedents dying on or after the adoption of the rules as final regulations (i.e., the date of their publication in the Federal Register).

## 8. New Actuarial Tables

- a. **Background.** The actuarial tables project, added in the 2019-2020 Plan, is updating the §7520 actuarial tables (Number 11 on the 2022-2023 Priority Guidance Plan mentioned in Item 5.a above). By statute, the tables must be revised with updated mortality information by May 1 of the ninth year of every decade. The tables were updated May 1, 2009, but were not updated by May 1, 2019, as was required by §7520. Proposed regulations (REG-122770-18) were released on May 4, 2022, and published in the Federal Register on May 5, 2022, implementing new updated actuarial tables based on new Table 2010CM. (The tables effective beginning in 2009 were based on data from the 2000 census reflected in Table 2000CM.) ACTEC submitted comments on July 5, 2022, regarding the proposed regulations, available at <https://www.actec.org/resources/government-relations/>. Final regulations (T.D. 9974) were released June 1, 2023 and published in the Federal Register on June 7, 2023.
- b. **Updated Lx Table.** IRS officials informally indicated that the IRS had been waiting on data from another agency. That data became available on August 7, 2020, when the National Center for Health Statistics at the Centers for Disease Control and Prevention issued the decennial life table for 2009-2011, which apparently is the underlying data that the IRS uses for updating the actuarial tables. The new Lx table lists the number of individuals, out of a total of 100,000, who will be alive at each of ages 0-110, based on data from the 2010 census (which obviously is already more than 10 years old). The new data reflects a somewhat remarkable increase in life expectancies compared to the existing Lx table (based on 2000 census data). For example, at age 84 the number of individuals, out of the 100,000 starting pool, expected to be surviving has increased from 37,837 to 44,809, an 18.4% increase in just 10 years. Larry Katzenstein summarizes:

The improvements in longevity at older ages is truly remarkable. For example, the probability of survival from age 60 to age 90 went from 21.088% to 26.6021% in just ten years. No wonder the Today show stopped years ago highlighting viewers who attained age 100. There were just too many of them.

Larry Katzenstein, *New Actuarial Tables Are Coming*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #303 (Nov. 30, 2020).

The rather dramatic increase in life expectancy from the 2010 census data compared with the 2000 census data interestingly is contrasted with a CDC report showing a decline in life expectancy over the last several years (no doubt impacted by the COVID-19 pandemic). For 2020, life expectancy at birth for the U.S. population declined by 1.5 years compared to 2019 (and declined 2.9 years for the non-Hispanic black population and 3.0 years for Hispanic individuals). National Center for Health

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Statistics Vital Statistics Rapid Release, Rept. No. 15 (July 2021). In 2021, life expectancy declined even further, by another 0.9 years at birth for the total population. For the period from 2019 through 2021, the life expectancy at birth declined by 2.7 years for the total population (3.1 years for males and 2.3 years for females). National Center for Health Statistics Vital Statistics Rapid Release, Rept. No. 23 (August 2022). The decreasing life expectancy of Americans is attributable to various factors in addition to the pandemic, a primary factor being the increased mortality rates of children and teenagers attributable primarily to violence, substance abuse, and other accidents (not disease).

But increasingly the American mortality anomaly, which is still growing, is explained not by the middle-aged or elderly but by the deaths of children and teenagers. One in 25 American 5-year-olds now won't live to see 40, a death rate about four times as high as in other wealthy nations. And although the spike in death rates among the young has been dramatic since the beginning of the pandemic, little of the impact is from Covid-19. Over three pandemic years, Covid-19 was responsible for just 2 percent of American pediatric and juvenile deaths.

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... For the poorer half of the country, simply being an American is equivalent to about four full years of life lost compared with the average Brit. For the richer half, being an American is not quite as bad but is still the equivalent of losing, on average, about two years of life.

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... If you make it to retirement age, you can expect to live about as long as your counterparts in other wealthy countries.... The country's exceptionalism of violence is more striking among the young but extends into early adulthood; from age 25 to 34, Americans' chances of dying are, by some estimates, more than twice as high, on average, as their counterparts' in Britain and Japan.

...

The pandemic years look even grimmer when we examine pediatric mortality by cause. Guns were responsible for almost half of the increase from 2019 to 2020, as homicides among children age 10 to 19 grew more than 39 percent. Deaths from drug overdoses for that age cohort more than doubled. In 2021, as schools reopened, pediatric deaths from Covid nearly doubled but still accounted for only one-fifth of the increase in overall pediatric deaths — a large increase on top of the previous year's even larger one.

The disparities are remarkable and striking, as well. Most of the increase in pediatric mortality was among males, with female deaths making only a small jump. Almost two-thirds of the victims of homicide were non-Hispanic Black youths 10 to 19, who had a homicide rate six times as high as that of Hispanic children and teenagers, and more than 20 times as high as that of white children and teenagers.

David Wallace-Wells, *It's Not 'Deaths of Despair.' It's Deaths of Children*, NEW YORK TIMES (April 6, 2023). Early deaths of young people impact the overall life expectancy rates because of the large number of life-years lost compared to deaths of elder people.

- c. **Updated Tables, Effective Date.** The lengthy regulations update a wide variety of regulations impacted by actuarial factors. Those include regulations dealing with valuation issues for Sections 170, 642, 664, 2031, 2032, 2036, 2055, 2056 (QDOTs), 2512, 2522, and 7520. Examples throughout the regulations are updated to apply the new actuarial data from the 2010 census.

The updated actuarial valuations all flow from the revised Lx table, Life Table 2010CM, that is based on data compiled from the 2010 census. Table 2010CM is in Prop. Reg. §20.2031-7(d)(7)(ii). It is the same Lx table that was released by the Center for Disease Control almost two years earlier in August 2020.

As discussed above, the life expectancies are considerably longer than under Table 2000CM. For example, various examples throughout the proposed regulations provide the life estate factors from Table S for single life calculations. The table below lists the life estate factors from Table S for single life calculations from the old tables (based on Table 2000CM) and the new tables (based on Table 2010CM) for various ages and for a §7520 rate of 4.6% (the §7520 rate for February 2023).

Age	Life Estate Factor (based on Table 2000CM)	Life Estate Factor (based on Table 2010CM)	Percentage Increase
30	.85797	.86691	1.04%
40	.79122	.80445	1.67%
50	.69989	.71805	2.59%
60	.58110	.60745	4.53%
70	.44174	.46914	6.20%
80	.29484	.31435	6.62%

As evidenced by this table, the most dramatic impact of the new tables compared to the old tables is for actuarial factors based on the lives of older individuals.

The updated actuarial tables are available, at no charge, via the IRS website at <https://www.irs.gov/retirement-plans/actuarial-tables>. IRS Publications 1457 “Actuarial Valuations Version 4A” (Rev. 6-2023), 1458 “Actuarial Valuations Version 4B” (Rev. 6-2023), and 1459 “Actuarial Valuations Version 4C” (Rev. 6-2023) provide additional references and explanations to the actuarial tables that are published on the IRS website. These publications were issued in connection with the final regulations. Of course, actuarial tables for a fixed term of years are not dependent on mortality factors, and they have not changed.

- (1) **Effective Date.** The new actuarial tables generally apply for annuities, interests for life or a term of years, and remainder or reversionary interests that are valued as of a date on or after June 1, 2023.
- (2) **Transition Rules.** The proposed regulations provided transition rules. Although the new tables were supposed to be finished by May 2019, the proposed regulations allowed transition relief only back to January 1, 2021. Taxpayers who would have benefitted from the updated tables during the 20 months from May 2019 through December 2020 would have been out of luck; they would have been required to use the existing tables based on over 20-year-old census data (i.e., from the 2000 census). For example, for charitable lead annuity trusts lasting for the life of some individual, the longer life expectancies under the new tables would result in a longer assumed period of charitable payments and a larger charitable deduction. The decision to grant relief only back to January 1, 2021 was roundly criticized as being unfair, and it was “perhaps legally required under Code section 7520, that the proposed new tables be available, at the election of the taxpayer, for any transaction occurring on or after May 1, 2019.” Comments from ACTEC filed with Internal Revenue Service. The IRS relented, and the final regulations extended the transition relief to back to May 1, 2019. *E.g.*, Reg. §§20.2031-7(d)(3) and 25.2512-5(d)(3) (other specific regulations have similar provisions).

For gifts or estates of decedents dying on or after May 1, 2019, and on or before June 1, 2023, the donor or executor may choose to value the interest (including any applicable charitable deduction) based on either Table 2000CM or Table 2010CM. The donor or executor “must consistently use the same mortality basis with respect to each interest in the same property.”

The §7520 interest rate to be utilized is the appropriate rate for the month in which the valuation date occurs, but special rules apply for charitable transfers. For charitable transfers, §7520(a) allows using the rate for the month in which the transfer is made or either of the two months preceding the month in which the transfer is made, and if the donor or executor elects under §7520(a) to use the §7520 rate for a month prior to May 1, 2019 (i.e., March or April 2019), the donor or executor *must* use tables based on Table 2000CM. If the §7520 interest rate is elected for a date on or after May 1, 2019, and on or before June 1, 2023, the donor or executor *may* use tables based on either Table 2000CM or Table 2010CM.

The preamble to the final regulations resolved an issue regarding formula-based amounts that might have been raised for transactions during the transition period in which an option exists as to which set of tables would be used. For example, charitable lead annuity trusts (CLATs) sometime define the annuity payment as a percentage of the value of the property transferred to

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the CLAT that would “zero out” the remainder value of the CLAT. The percentage could change depending on which set of actuarial valuation tables would apply. Thus, it is very helpful that the preamble to the final regulations dispels such alarm in such cases by adding:

The availability of the option to use the revised actuarial tables based on Table 2010CM for valuation dates during the transition period, whether or not exercised, is not a condition subsequent and does not limit or otherwise affect the validity of any formula or other condition in a document (even if created before the transition period) that is intended to determine the amount, value, character, or tax treatment of a transfer.

For a further discussion of concern with formula issues and the necessity of filing appropriate amended returns within the relevant period of limitations, see Item 5.j.(4)(b) of Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes* (June 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- d. **Planning Implications.** The new tables result in a larger charitable deduction for CLATs for the life of an individual, but a lower deduction for a CRAT (and more difficulty in satisfying the 10% remainder test and 5% exhaustion test for a CRAT) and a lower value for the remainder in a personal residence after a retained life estate. See generally Michael Strauss & Jerome Hesch, *A Matter of (Estimated) Life and Death – Calculating the Effect of the Overstatement of Mortality Under §7520 on Split-Interest Charitable Trusts*, 47 BLOOMBERG TAX MGMT. ESTS., GIFTS & TRUSTS. J. No. 2 (March 10, 2022). Annuity payments for private annuity transactions and payment amounts for self-cancelling installment notes will be smaller with the new tables than with the old tables.

## 9. Estate Planning for Moderately Wealthy Clients

- a. **Small Percentage of Population Subject to Transfer Taxes; Paradigm Shift for Planners.** The \$10 million (indexed) gift tax exclusion amount means that many individuals need not be concerned that lifetime gifts will result in the payment of federal gift taxes or that federal estate tax will be payable at death.

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

Concepts that have been central to the thought processes of estate planning professionals for their entire careers are no longer relevant for most clients – even for “moderately wealthy” clients (with assets of over several million dollars). That said, every estate planning professional would be wise to consider the following issues when advising a client.

- b. **Important Planning Issues.**
- Do not ignore the GST tax. Without proper allocation (either automatically or manually) of the GST exemption (also \$10 million indexed), trusts created by clients generally will be subject to the GST tax (currently 40%) at the death of the first-generation beneficiary (children of the settlor) unless the trust assets are included in the beneficiary’s gross estate. Consider allocating the increased GST exemption to previously created non-exempt trusts.
  - Review formula clauses that are based on the available exclusion amount to confirm they still reflect the intended result.
  - Many moderately wealthy clients will want to rely on portability and leave assets at the first spouse’s death either outright to the surviving spouse (and rely on disclaimers if a trust is desirable) or to a QTIP trust with a Clayton provision (which allows the most flexibility). However, a credit shelter trust approach may be appropriate for some moderately wealthy clients.
  - Basis adjustment planning will be appropriate for many clients. They and their family members may not have estate tax concerns given the higher exclusion amounts even if trust assets are included in their estates, and basis adjustment planning may be appropriate for assets may qualify for a stepped-up basis at the person’s death under §1014 (assuming §1014 is not repealed). See Item 7 of Estate Planning: Current Developments and Hot Topics

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(December 2014) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- Including provisions to provide flexibility to accommodate changing circumstances or changing tax laws can be very helpful.
  - For planning in states with state estate taxes (about a fourth of the states), using multiple QTIP trusts may be helpful if the state recognizes QTIP trusts that are effective for state purposes only. In addition, the exclusion amount at the state level may not be portable, necessitating additional planning in states with state estate taxes.
- c. **Further Discussion.** For further discussion of these issues, see Item 4 of Estate Planning: Current Developments and Hot Topics (December 2014) found [here](#) and Item 7 of Estate Planning Current Development and Hot Topics (May 2021) found [here](#), both available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

## 10. Trust Planning—Selecting Trust Jurisdiction and Governing Law

- a. **Focus on Client’s Objectives.** The selection of the trust’s jurisdiction and governing law can assist or frustrate meeting the client’s objectives. A trust is about protecting someone from someone else. Who are you protecting and who (or what) are you protecting from (such as taxes, the beneficiaries themselves, other beneficiaries, creditors, or people the grantor does not like)? The purpose(s) can be documented in the trust agreement or in a separate “Letter of Wishes.” Start with the client’s own words and tweak as needed for clarity.
- b. **Merely Stating Governing Law in Trust Agreement Is Not Sufficient.** The trust agreement should absolutely state the governing law, and that statement could include the law that applies specifically as to validity, construction, and administration. But a simple statement of the governing law does not necessarily control. The governing law provision in the trust instrument generally controls “unless the designation of that jurisdiction’s law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue.” UNIF. TRUST CODE §107(1); RESTATEMENT (SECOND) OF CONFLICT OF LAWS §270 (addressing trust validity).

Under the Restatement (Second) of Conflict of Laws, the idea is that a trust document may not simply choose any law whatsoever but may apply the law of a jurisdiction that has a substantial relationship to the trust. In addition, the law selected cannot violate a strong public policy of the forum jurisdiction. The Restatement (Second) of Conflict of Laws provides the following factors in determining “substantial relationship” for inter vivos trusts of personal property: where the trust is administered, the place of business or domicile of the trustee at the time of the creation of the trust, the location of the trust assets at that time, the domicile of the settlor at that time, the domicile of the beneficiaries, or other unspecified contacts or groupings of contacts that may suffice. Restatement §270.

See generally Items 43-56 of ACTEC 2014 Annual Meeting Musings (March 2014) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- c. **Contacts.** If the governing law of another jurisdiction is selected, plan to have as many contacts as possible with that state, including location of the trustee, trust administration, and trust assets.
- d. **Strong Public Policy.** Section 107 of the Uniform Trust Code restricts the choice of law to one that is not “contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue.” (That same restriction applies under §270 of the Restatement (Second) of Conflicts of Laws for determining the validity of a trust—“does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in § 6.”) Therefore, a court must consider which jurisdiction in the entire world has the greatest ties to the trust. How is that determined? The Uniform Trust Code comments do not provide any standards to make that determination but leaves that issue to each locale. As a practical matter, a judge in the forum state will use the forum state’s law if the decision is close.

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Whether an issue is based on a strong public policy is ambiguous. The only examples given in the Restatement (Second) of Conflict of Laws are (i) "exculpation of the trustee for failure to exercise reasonable care, diligence and prudence," and (2) "unusually strict rules as to self-dealing." §271. The decision does not necessarily turn on whether the issue is addressed in the state's constitution. Legislatively prescribed issues may also be based on strong public policy particularly if there are no exceptions to the rule or any ability to draft around the issue.

The public policy issues tend to be much stronger in divorce cases than in traditional creditor cases, and in many situations, the law of the place of the divorce will control. For example, in *Dahl v. Dahl*, 345 P.3d 566 (Utah 2015), involving a Utah divorce in which the husband had created a DAPT under Nevada law, the Utah Supreme Court reasoned that Utah's choice of law rules would enforce a choice of law provision in a trust unless it would "undermine a strong public policy" of the state. The court concluded that it could not apply Nevada law without violating Utah public policy. *Id.* at 579.

- e. **Engage an Attorney in the Other Jurisdiction.** If a trust jurisdiction other than the settlor's (and attorney's) home state is selected, consult with an attorney in the selected jurisdiction. That might seem unnecessary, but if a problem arises, no one will care that the client did not want to hire an attorney in the other jurisdiction.
- f. **Examples of Issues for Which Governing Law May be Important.** Examples of issues for which the governing law may vary significantly and which may assist or frustrate satisfying the settlor's goals include:
  - Rule against perpetuities (if a state other than the settlor's home state is used, include a provision in the trust agreement that includes a perpetuities savings provision if the applicable law would otherwise be violated);
  - Directed trusts (states vary significantly regarding the trustee's liability for following directions and the duty to monitor the validity and prudence of directions);
  - Prudent investor rule (cases have held trustees liable for failing to diversify assets despite trust provisions saying the trustee is not liable or that the trustee has no duty to diversify assets; some jurisdictions give more protection than others regarding relaxation of the prudent investor rule);
  - Asset protection (many states have exceptions to spendthrift clause protections, but the states differ in the exceptions and some states allow no exceptions; the asset protection issue may arise not only in creditor-debtor situations but very importantly also in divorce matters);
  - Domestic asset protection trusts (DAPTs) (a primary issue that has arisen in cases addressing DAPTs is the conflict of laws issue as to whether the law of the DAPT state where the trust is situated or the laws of the debtor's state will apply; for example, *Waldron v. Huber (In re Huber)*, 2013 WL 2154218 (Bankr. W.D. Wash. 2013), was a bankruptcy case concluding that Washington (the debtor's state) had a strong public policy against asset protection for self-settled trusts and applied the law of Washington rather than Alaska);
  - Trust modification (some states, including Uniform Trust Code states, allow nonjudicial modifications as long as the modification does not violate a material purpose of the trust and is not something a court would not approve);
  - Decanting (some but not all states have decanting statutes, and they vary significantly);
  - State income taxation of trusts (the key factor in some states is where the trust is administered);
  - Quiet trusts;
  - No contest clause recognition; and
  - Recognition of binding arbitration clauses.

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- g. **Important Substantive Law Issues to Address in Trust Agreements.** The list immediately above is also a good list of substantive issues that the planner should address in trust agreements for situations in which the issues impact the primary goals of the settlor for the trust.

## 11. Trust Planning and Drafting Pointers

- a. **Authorize Changing Trust Situs but No Duty to Monitor.** Including specific authority and mechanics for changing the trust situs provides very helpful flexibility, but state explicitly that the trustee has no duty to monitor continually whether other jurisdictions might be more advantageous for the trust (which is totally impractical for a trustee to monitor continually).
- b. **Perpetuities.** Some states have abolished the rule against perpetuities (RAP) entirely (e.g., District of Columbia, New Hampshire, Maryland, Missouri, Rhode Island, South Dakota, and Virginia) while others have extended the vesting period for a very long time (e.g., Tennessee [365 years], Nevada [360 years], Florida, Texas [300 years, effective September 1, 2021], and Wyoming [1,000 years]). For a thorough discussion of “perpetual” trusts, see Fein, *A Defense of Perpetual Trusts*, 47 ACTEC L.J. 215 (Spring/Summer 2022).
- Whether a settlor living in a state with a traditional RAP can create a trust in a state with an extended RAP and not be subject to the shorter RAP in the home state is unclear. The issue will likely turn on whether the RAP is a “strong public policy” of the home state. and that may be particularly problematic in those states that have constitutional provision prohibiting “perpetuities” (though some of those states have statutes that have significantly extended the perpetuities period). See generally Steven Horowitz & Robert Sitkoff, *Unconstitutional Perpetual Trusts*, 67 VANDERBILT L. REV. 1769 (2014). The Restatement of Donative Transfers says that the rule against perpetuities is a matter of strong public policy. The Restatement (Second) of the Conflict of Laws (the trust provisions of which were drafted by Austin Scott) takes the position that the rule against perpetuities is not a strong public policy, but that the elective share is.
  - Include a perpetuities savings provision in case the trust is moved to a state with a limited perpetuities period, the state changes the RAP, or the trust receives assets from a trust created in a jurisdiction with a shorter RAP.
  - Segregate assets from separate trusts when a merger or other addition by modification occurs in case assets might be subject to different perpetuities periods.
  - Be cautious in moving trust jurisdiction and governing law to a “perpetual trust state” if the original state has a RAP; it may work, but there are no guarantees.
  - In very long-term trusts, building in flexibility for the trust is critical (for example, with decanting, trust modifications, powers of appointment, trust protector powers, etc.)
- c. **Directed Trusts.** Several key structuring pointers include –
- Does the state have a directed trust statute; if so, following the statutory requirements closely and if not, consider carefully whether directed trust provisions in the instrument can override traditional trust law concepts that might limit the enforceability of such provisions.
  - What level of nexus does the state require?
  - Address whether the advisor giving direction acts in a fiduciary capacity (generally they should in order to assure that someone has fiduciary responsibility for every decision affecting the trust).
  - Address the compensation of the direction advisors.
  - Carefully define the scope of issues for which advisors can give direction and for which trustees are not responsible.
  - Very carefully limit the responsibility and liability of trustees to review and monitor the activities of the direction advisor and for following directions from the advisor.

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- Provide successor advisors or procedures for appointing successors.

d. **Trustee Resignation, Removal, and Succession.**

- Include a trust provision allowing non-judicial resignation as well as removal and replacement of fiduciaries. See Item 34 of Heckerling Musings 2023 and Estate Planning Current Developments (April 12, 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- Especially for long-term trusts, create procedures to always provide for the designation of successor trustees as needed.

e. **Investments and Diversification.** Under the Uniform Prudent Investor Act (UPIA) (adopted in 46 states) the trustee generally must diversify investments unless “because of special circumstances, the purposes of the trust are better served without diversifying,” UPIA §3, but the settlor can “expand, restrict, eliminate or otherwise alter” that duty and a trust is not liable if acting in “reasonable reliance” on provisions in the trust agreement. UPIA §1(b). Nevertheless, some cases have found trustees liable despite language relieving the trustee from the diversification duty or even if the agreement required the trustee to retain a concentrated position in particular investments. (In that case, the trustee may be held to a duty to monitor the investment and petition the court for modification if the assets decline substantially in value.)

- If the settlor’s intent is that particular assets should be retained notwithstanding the lack of diversification, be as explicit as possible in negating a duty to diversify and relieving the trustee of liability for retaining assets.
- Some states have statutorily enhanced the protections for a trustee who does not diversify in accordance with the express terms of the trust agreement; other states recognize “purpose” trusts for holding non-diversified positions. See *generally* Schanzenbach and Sitkoff, *Risk Management and the Prudent Investor Rule*, 159 TR. & EST. 45 (Nov. 2020).

f. **Trust Protectors.** A trust protector may be given the authority to take “settlor-type” actions that the settlor cannot retain directly for tax reasons. A protector may be authorized to take actions to provide flexibility to accommodate future changed circumstances.

Trust protector powers related to the trustee include the power to remove and replace trustees, to appoint additional trustees, to act as a tiebreaker, to provide advice or direction regarding discretionary distributions or regarding management actions, or to veto trustee decisions.

Powers unrelated to the trustee include the power to change the trust situs or governing law, to terminate the trust under specified conditions, to amend the trust for any valid purpose such as to respond to changes in tax laws, or to alter the beneficial interests such as adding or removing beneficiaries.

- Very specifically describe the scope of the protector’s responsibilities and powers.
- Who to name as protector can be a difficult decision. The trustee is the most “trusted” person from the settlor’s point of view, and the settlor needs “an even smarter and even more trusted person” to override the trust with the trust protector powers.
- Finding someone willing to serve may be very difficult, particularly if the protector acts in a fiduciary capacity considering potential liability for making broad changes to the trust.
- Address very explicitly whether the protector serves in a fiduciary capacity. Most of the statutes addressing trust protectors provide they are considered to act as a fiduciary unless the trust instrument provides otherwise (Delaware is an example of that approach). Respected planners have varying views about this issue. Some would generally not name trust protectors as fiduciaries in order to reduce the risk to them (if we think of protectors as standing in the shoes of the settlor, it may not make sense to make them a fiduciary in that role). Others would generally name protectors as fiduciaries and rely on exoneration in a trust instrument to exonerate the protector from liability except in the case of willful misconduct.

- The trust protector’s standard of liability should be clearly stated in the trust agreement to avoid uncertainty.
- Address compensation of the protector.
- Having protectors who can “fix chaotic situations” can be critically useful.
- Having a protector with the flexibility to “fix chaotic situations” is not as important in a state that allows nonjudicial settlement agreements. They can permit an efficient alternative for making adjustments as needed.

For a general discussion of trust protectors see Items 34-47 of ACTEC 2021 Annual Meeting Musings found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- g. **Trust Modification Flexibilities.** Tools available for nonjudicial modification of trusts include: (1) nonjudicial settlement agreements; (2) nonjudicial consent modifications; (3) decanting; and (4) dividing trusts.
- (1) **Governing Law.** The governing law of a trust determines which tools are available and who are necessary parties to the modification. Changing the place of administration might be possible to change the governing law to a state that allows a tool that is particularly favorable in a given situation.
  - (2) **Necessary Parties.** The necessary parties to implement a modification under each of the tools vary depending on the tool but consist of some combination of (1) the settlor, (2) the trustee, and (3) beneficiaries (or under the Uniform Trust Code, qualified beneficiaries).
  - (3) **Representation.** Because the consent of beneficiaries is typically needed in nonjudicial modifications (other than decanting), having a way to represent minors or unborn beneficiaries is often the key required element to complete a nonjudicial modification.
    - The representative must not have a conflict of interest with respect to the particular question at issue in the modification.
    - In addition, a settlor may never represent a beneficiary in a nonjudicial consent modification.
  - (4) **Decanting.** About 30 states have enacted decanting statutes including 12 that have adopted the Uniform Trust Decanting Act. A few state courts have recognized a common law power to decant by the authority to make distributions for the benefit of a beneficiary (examples are Florida, New Jersey, and Massachusetts).
    - The decanting power is exercised in the trustee’s discretion, so is subject to the trustee’s fiduciary duties.
    - Consider adding explicit decanting powers in the trust agreement in case the trust is moved to a jurisdiction that does not have a decanting statute.
    - Can a beneficiary be removed by decanting? Can decanting eliminate a mandatory right? Can a power of appointment (general or limited) be added by decanting?
    - Is notice to beneficiaries allowed (or required)? Generally, do not require beneficiary consent (unless required by the applicable state statute) because beneficiary consent may result in undesired tax effects to the consenting beneficiary.
  - (5) **Resources.** For a discussion of substantive law effects of the various nonjudicial modification alternatives, see Items 66-75 of ACTEC 2012 Summer Meeting Musings found [here](#), and tax effects of trust modifications are discussed at Item 34 of Heckerling Musings 2023 (April 12, 2023) found [here](#), Item 18 of Heckerling Musings 2017 found [here](#) and Items 42-51 of ACTEC 2015 Annual Meeting Musings found [here](#), all available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

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h. **Beneficiaries and Distribution Standards.** For a discussion about discretionary distribution standard and the administration of trusts regarding distributions, see Items 32-39 of ACTEC 2013 Summer Meeting Musings found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). For a general discussion of the trust law principles and cases regarding support vs. discretionary distribution standards, see Richard Ausness, *Discretionary Trusts: An Update*, 43 ACTEC L.J. 231 (Winter 2018).

- Beneficiaries serving as trustee must be limited to a health, education, maintenance, and support (HEMS) distribution standard or the beneficiary will have a general power of appointment under §2041. See generally Christian Kelso, *But What's an Ascertainable Standard? Clarifying HEMS Distribution Standards and Other Fiduciary Considerations for Trustees*, 10 EST. PLAN. & COMMUNITY PROP. L.J. 1 (Fall 2017).
- Allowing "independent" trustees (at a minimum someone other than a beneficiary) to make distributions using a broader standard (even "in the discretion of the trustee") can add helpful flexibility in the administration of the trust.
- Naming a co-trustee to serve with the beneficiary can be very helpful if the trust instrument restricts the beneficiary/co-trustee from participating in any decision to make distributions to himself beyond an ascertainable HEMS standard. As long as the beneficiary has no right to succeed to the powers held by that co-trustee, the broad distribution powers of the co-trustee will not be imputed to the beneficiary (except perhaps in very unusual cases).
- Use a "savings clause" that automatically restricts the beneficiary from taking any actions that might possibly be construed as a personal benefit, unless those actions are limited by a HEMS standard, and to provide that any such actions would be taken only by the co-trustee. If no co-trustee is acting, the beneficiary/trustee could take steps to have the next successor trustee appointed as a co-trustee for the sole purpose of making that decision. (Some states automatically limit distributions by a beneficiary-trustee to a HEMS standard. *E.g.*, FLA STAT. §736.0814(2).)
- Specifically address whether outside resources reasonably available to a beneficiary should, should not, or "may but need not" be considered in distribution decisions. State laws vary on that issue, and the trust agreement can eliminate the uncertainty. The Comments and Reporter's Notes to Section 50 of the Restatement (Third) of Trusts summarizes the diversity of state law regarding the consideration of outside resources if the trust instrument is silent on the issue. The approach used should not affect whether a beneficiary has a general power of appointment. See Treas. Reg. §20.2041-1(c)(2) ("immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised"); §25.2514-1(c)(2). It is *very important* that settlors understand that requiring the trustee to consider outside resources has real economic consequences and may limit the ability to make distributions.
- Discourage pot trusts for multiple beneficiaries. Mandating that beneficiaries share a pot of money is a perfect recipe for family resentment and dysfunction. Everyone wants more to make sure they at least get their fair share.
- With every trust, discuss whether the trustee should have the discretion to make distributions to charities (or to a specified charity). A charitable income tax deduction is not available to the trust unless the distribution is made "pursuant to the terms of the governing instrument," §642(c)(1), and the IRS takes the position that a later trust modification to permit charitable distributions does not satisfy that requirement. (A possible way around that hurdle is that each partner of a partnership is entitled to an income tax charitable deduction equal to the partner's distributive share of a charitable gift by the partnership. Rev. Rul. 2004-5 provides that a trust which is a partner will benefit from such flow-through charitable deductions even if the trust itself has no charitable beneficiaries.)
- In appropriate circumstances, powers of withdrawal may be beneficial rather than relying on a trustee to make distributions under a distribution standard. For example, powers of withdrawal may assist in shifting taxable income to lower bracket beneficiaries under §678,

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obtaining a basis adjustment at the powerholder's death, or avoiding GST taxes by treating the powerholder as the new "transferor" for GST purposes (Treas. Reg. §26.2652-1(a)) and where the powerholder is in a lower generation or the powerholder allocates GST exemption to the trust. See Neal Nusholtz, *An Explanation as to Why Having Powers of Withdrawal as an Alternative to Distributions Should be Included in Your Trust Repair Toolkit*, LEIMBERG ESTATE PLANNING NEWSLETTER #3056 (July 21, 2023).

i. **Divorce Protection.** If one of the settlor's primary goals is to protect trust assets from claims of the ex-spouse of a trust beneficiary in a divorce proceeding, various steps can be taken in structuring the trust. See generally Items 1-7 of ACTEC 2020 Fall Meeting Musings (October 2020) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- Avoid mandatory distributions or withdrawal rights.
- Use a fully discretionary distribution standard in the sole and absolute discretion of a third-party trustee.
- Even with a fully discretionary standard, if the trustee follows a regular pattern of distributions, a court may view the distribution pattern as a marital property right or may consider future anticipated distributions in determining how other marital assets will be divided between the spouses.
- Including multiple beneficiaries (i.e., a "pot trust"), waiving the trustee's duty of impartiality among beneficiaries, and giving someone the authority to expand the class of potential beneficiaries all further distance the rights of a beneficiary (including a beneficiary going through a divorce) to trust assets.
- Various goals of settlors must be balanced. For example, using "pot" trusts for multiple beneficiaries may conflict with a goal generally of not forcing family members to "share" trusts in order to avoid family conflicts, and the client will need to weigh which approach to use.
- Negate property rights. A trust might specifically state that a beneficiary's interest in the fully discretionary trust is not a property right but a mere expectancy, in case applicable state law does not expressly provide that result.
- Include a spendthrift provision to make clear (and convince the divorce judge) that creditors have no access to trust assets (even if an exception from spendthrift protection may ultimately apply for certain spousal or child support rights).
- Using a disinterested trustee is more protective than using the beneficiary or beneficiary's spouse as trustee.
- A trust provision might terminate or suspend a beneficiary's interest and powers over a trust if the beneficiary is a defendant in a lawsuit or a party to a divorce proceeding. Alternatively, a trust protector acting in a non-fiduciary capacity may have the power to terminate or suspend a beneficiary's interest in the trust in such circumstances.
- The trust could give a disinterested trustee the power to terminate or suspend a beneficiary's right to receive information about the trust, such as trust accountings or reports, if the trustee determines that receiving that information would not be in the beneficiary's best interest.
- Powers of appointment add significant flexibility, such as the ability to appoint the assets to someone other than the beneficiary going through a divorce or to remove the beneficiary's interest in the trust.
- Flexibility can be achieved by (1) giving a power of appointment to someone to appoint trust assets to specified parties or (2) giving an independent trustee broad discretion to make distributions. An important distinction from a tax planning standpoint is that the holder of a power of appointment is not a fiduciary and the IRS could argue that repeated exercises (at the suggestion of the donor) results in estate inclusion as retained control over who can

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enjoy trust assets and income under §2036(a)(2). Cases have held that §2036(a)(2) does not apply to family direction from a donor or the donor's family to a trustee who is a *fiduciary*. *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1973-153.

- j. **Powers of Appointment.** Including powers of appointment exercisable by a beneficiary or someone other than a beneficiary affords substantial flexibility to react to changing circumstances.
- The powerholder of a power of appointment is not a fiduciary, which allows more flexibility in making changes to the trust's dispositive plan. (However, frequent exercises of a power of appointment during the settlor's lifetime may create more of an appearance of the settlor acting through the powerholder (and keeping powers over the trust that could arguably cause estate inclusion).)
  - Another incredibly important feature of the power of appointment is that it is also a power of *disappointment*.
  - If there is any concern that it will be exercised by the particular powerholder in an improper way, require the consent of a non-adverse party to the exercise.
  - Be aware that giving someone other than an adverse party an inter vivos power of appointment (during the grantor's life) may cause the trust to be a grantor trust under §674.
  - For long-term dynasty trusts, giving beneficiaries a testamentary power of appointment to appoint assets among the settlor's descendants (other than to the beneficiary's estate) gives each generation the ability effectively to re-write or eliminate the trust, eliminating the settlor's "dead hand from the grave" control over the trust for generations to come.
  - What law and jurisdiction applies to state law issues regarding the power of appointment — the situs of the creator of the power, the situs of the powerholder, or for testamentary exercise, the jurisdiction in which the will is probated (which could be different than the domicile of the powerholder)? The instrument could specify the governing law and jurisdiction to avoid uncertainty.
  - The common law rule is that there is a presumption that a power of appointment is a general power of appointment. Consider clearly specifying in the trust instrument that a power is intended as a "limited (non-general) power of appointment" to overcome that presumption.
  - Under the relation back doctrine, the exercise of a power of appointment is treated as a transfer by the donor. The relation back doctrine was relied on in *Self v. U.S.*, 135 Ct. Cl. 371 (1956), to conclude that the exercise of a limited power of appointment did not result in a gift by the powerholder – it was a transfer by the original creator of the power under state law principles. *But see Estate of Regester v. Commissioner*, 83 T.C. 1 (1984).
  - Including spouses of beneficiaries as possible appointees of a power of appointment can be helpful. There may be a desire to be able to continue the trust for the benefit of a child's spouse after the child's death in a long-term marriage situation. If there is concern that this power might be abused, the settlor could specify that the power could be exercised only with the consent of a non-adverse party. The trust could say that it can be exercised only to create an income interest, or perhaps also allowing invasions for limited purposes, such as health or maintenance.
  - Takers in default of the exercise of the power of appointment, to the extent that it is not exercised, should be listed. For a general power of appointment, if no takers in default are listed, the general rule is that the assets would pass to the powerholder's estate, not to the estate of the creator of the power. However, for a non-general power of appointment, if there are no takers in default, and if the power is not exercised, the assets would pass to the potential appointees if they are a defined narrow class, or otherwise to the recipients of the estate of the creator of the power.
  - For a summary of an outstanding presentation by Jonathan Blattmachr at the 2012 Heckerling Institute on Estate Planning about a wide variety of important state property law and federal

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tax law concepts regarding powers of appointment and helpful planning recommendations in using powers of appointment, see Item 8 of Heckerling Musings 2012 and Other Current Developments (April 9, 2012) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

k. **Communication.**

- Trustees are not enthusiastic about silent trusts. Indeed, if no one can enforce the trust, is it even a trust?
- Some states allow “quiet trusts” that typically involve communicating major issues with a “designated representative” for some period of time. But quiet trusts should have an end date, when open communication with the beneficiary can begin. (Some states, such as Florida, that allow the appointment of a designated representative do not preclude the trustee from providing information to a beneficiary upon the beneficiary’s request.)
- The concept of a quiet trust, when beneficiaries do not know of the trust’s existence for some time, is inconsistent with the concept of a Crummey trust in which the beneficiaries can withdraw contributions for some period of time.
- Institutional trustees prefer open communication with beneficiaries whereas individual trustees may be more reluctant to involve beneficiaries in decisions. The *Allard* case is a 40-year-old case that held the trustee responsible for selling major trust assets at too low a value without obtaining the beneficiaries’ consent. *Allard v. Pacific National Bank*, 663 P.2d 104 (Wash. 1983).
- What does the trustee gain by not discussing issues with beneficiaries in advance and hearing their concerns? If the trustee is going to get sued, it is better to know that before the trustee takes the action (they then know to get a third appraisal, etc.).

l. **Fiduciary Relationship.** Especially if family members serve as trustee, the fiduciary obligations of the office must be impressed on the trustee.

- Clients are free to act whimsically with their own property. “They can buy crappy investments.” Trustees are held to a different standard.
- Clients are in the wealth growth business and trustees are in the wealth preservation business. Clients get wealthy by taking big risks. That is not the trustee’s role.

## 12. Transfer Planning, Defined Value Formula Transfer Issues

- a. **Window of Opportunity; Anti-Clawback Regulation.** The gift/estate exclusion amount is scheduled to revert from \$10 million (indexed) to \$5 million (indexed) in 2026, so an ever-decreasing window of opportunity is available for making use of the larger exclusion amounts with lifetime gifts. Late 2025 could be a very busy time for transfer planning as we wait to see whether legislation will be enacted to extend the \$10 million (indexed) exclusion amount. The anti-clawback regulation clarifies that the donor can benefit from using the increased gift exclusion amount even if the donor should die after the estate tax exclusion amount has been reduced.

The significance of transfers to take advantage of this window of opportunity is highlighted by the massive wealth transfer that is predicted over the next decade. See Talmon Joseph Smith, *The Greatest Wealth Transfer in History Is Here, With Familiar (Rich) Winners*, N.Y. Times (May 15, 2023) (“Of the \$84 trillion projected to be passed down from older Americans to millennial and Gen X heirs through 2045, \$16 trillion will be transferred within the next decade”).

- b. **Cushion Effect.** Perhaps the most important advantage of the increased gift tax exclusion amount for many individuals will be the “cushion” effect – the ability to make gifts in excess of \$5 million, but considerably less than \$12,920,000 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even for assets whose values are very uncertain).

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- c. **Formula Transfers.** In light of inherent valuation uncertainties, planners are now frequently using defined value formula transfers.
- (1) **Types of Value Formula Transfers.** Five basic types of these clauses exist.
- (a) **Allocation Based on Agreement** – The formula allocation clause allocates portions of a transferred asset between taxable and non-taxable transfers based on the subsequent agreement of the parties (*McCord, Hendrix*).
- (b) **Allocation Based on Finally Determined Value for Gift Tax Purposes** – The formula allocation clause allocates portions of a transferred asset between taxable and non-taxable transfers based on values as finally determined for federal gift tax purposes (*Christiansen, Petter*; both were full Tax Court cases approving these clauses and they were affirmed by the Eighth and Ninth Circuits, respectively) (Example: “I hereby transfer 100 shares of the Company to [taxable transferee] and [charity/QTIP/GRAT] to be allocated between the transferees as follows: (1) that number of shares with a fair market value as finally determined for federal gift tax purposes equal to \$ [specific dollar amount] to [taxable transferee]; and (2) the remainder of the shares to [charity/QTIP/GRAT]”).
- (c) **Assigned Value (Wandry)** – The clause defines the amount transferred based on values as finally determined for federal gift tax purposes (*Wandry*) (Example: “I hereby transfer to \_\_\_\_\_ that number of shares of the Company with a fair market value as finally determined for federal gift tax purposes equal to \$ [specific dollar amount]”).
- (d) **Price Adjustment** – Price adjustment clauses adjust the price rather than the amount transferred in a sale transaction (*King*; but *McLendon* and *Harwood* did not recognize price adjustment clauses; an advantage of price adjustment clauses is that a “re-transfer/re-titling” of assets is not required after the correct value is determined) (Example: “I hereby sell 100 shares of the Company in exchange for a promissory note with a principal amount of \$[X] (which the parties believe to be equal to the fair market value of the shares). The term of the promissory note shall be [add note terms/interest]. If the fair market value of the shares as finally determined for federal gift tax purposes is greater or less than \$[X], the principal amount of the note shall be adjusted to the finally determined value effective as of the date of the transfer. The parties intend for the sale to be at fair market value and that no gift result from the sale.”).
- (e) **Reversion** – Reversions to donor of excess over a specified value (*Procter*) is a condition subsequent approach that does NOT work. The clause in *Procter* provided that any amount transferred that was deemed to be subject to a gift tax was returned to the donor. It trifles with the judicial system, because any attempt to challenge the gift or raise gift tax defeats the gift. That said, the *Procter* doctrine does not invalidate all formula transfers. Since the 1944 *Procter* case, many other types of formula clauses have been blessed by the IRS and the courts (marital deduction clauses, GST formula allocations, split interest charitable trust clauses, GRAT annuity payments, and formula disclaimers, to name a few).
- (2) **Potential Donees of “Excess Amount” Under Formula Allocation Clauses.** Potential donees of the “excess amount” under a formula allocation clause are:
- Public Charity/Donor Advised Fund – This approach is more conservative than other alternatives; the recipient of the excess amount has a fiduciary obligation; this type of donee was blessed in *McCord, Hendrix, Petter, and Christiansen*;
  - Private Foundation – This is more cumbersome because the self-dealing and excess benefit rules apply;
  - Lifetime QTIPs – A gift tax return will have to be filed making the QTIP election before knowing what assets are in the QTIP trust; and
  - GRAT (for both lifetime QTIPs and GRATs, consider having different trustees and some differences in the beneficiaries than of the trust that is the initial recipient of the formula

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transfer so that independent fiduciary obligations exist; it is not clear how a GRAT could meet the requirement to make annuity payments within 120 days of the due date for annuity payments during the period of uncertainty as to what assets have been conveyed to the GRAT).

- Spouse – The excess amount could pass outright to the donor’s spouse.

Significant Value – Some significant value should pass to the “excess amount” back-end beneficiary. That helps contravene an IRS argument made in *Petter* and *Christiansen* that the charitable gift was subject to a condition precedent. In *McCord, Hendrix, Petter* and *Christiansen*, the charities received 6-figure values. The charity should have “skin in the game” to review the transaction closely.

- (3) **Wandry Clause.** The *Wandry* approach is simpler because it does not involve a third-party recipient, but it loses the benefit of a third-party trustee with independent fiduciary obligations, and it could result in fewer shares being transferred. See Item 13 below for a discussion of IRS arguments made against a *Wandry* transfer in *Sorensen v. Commissioner*.
- (4) **Wandry Transfer Combined with Formula Disclaimer.** Some planners using a *Wandry* formula transfer approach recommend that the trust agreement specify that any disclaimed assets will remain with the donor, and that the trustee or donee(s) immediately following the transfer execute a formula *disclaimer* of any portion of the gift in excess of the value that the donor intends to transfer. (Statutes in some states specifically authorize the validity of such a provision allowing the trustee to disclaim.) The rationale is that the regulations have always recognized formula disclaimers as being valid (Treas. Reg. § 25.2518-3(d), Ex. 20.) and the *Christiansen* case upheld a formula disclaimer, 586 F.3d 1061 (8th Cir. 2009). Even if the *Wandry* formula transfer for some reason fails to limit the gift, the formula disclaimer will prevent an excess gift. This is a strategy that may provide additional comfort for clients who are very averse to paying gift taxes when making transfers of hard-to-value assets.

If the formula disclaimer approach is used and the trust agreement refers to a disclaimer by the trustee, consider adding a provision in the trust agreement expressing the settlor’s wish that the trustee would disclaim by a formula in order to benefit the beneficiaries indirectly by minimizing the gift tax impact to the settlor’s family, and perhaps make the transfer to the trust as a net gift so that if gift tax consequences arise they would be borne by the trust. That may give the trustee comfort in being able to disclaim, even though doing so could decrease the amount of assets in the trust. In addition, the formula transfer to the trust in the first place may help give the trustee comfort in making the formula disclaimer despite potential fiduciary concerns; the formula disclaimer is given in order to effectuate the settlor’s intent as much as possible in making the formula transfer to the trust.

One planner suggests that the formula disclaimer by the trustee be combined with provisions in the trust document stating (i) that if an excess value is inadvertently transferred compared to the specified dollar value, the trustee holds the excess as agent for the donor, and (ii) that the trustee may commingle the excess assets that are held as agent with the trust assets to buttress the argument that the disclaimed property has not been accepted prior to the disclaimer.

An alternative approach is to provide that if the primary beneficiary disclaims, the disclaimed asset would remain with the donor. That avoids the practical problem of obtaining disclaimers by minors and remote beneficiaries. One commentator, however, takes the position that while a beneficiary may be authorized to disclaim on behalf of other beneficiaries, that disclaimer of the interests of other beneficiaries may not be recognized as a qualified disclaimer under §2518 based on the theory that a person “cannot disclaim more than what she receives.” Ed Morrow, *How Donees Can Hit the Undo Button on Taxable Gifts*, LEIMBERG ESTATE PLANNING NEWSLETTER #2831 (Oct. 19, 2020). Even if the disclaimed asset passes to another person pursuant to the terms of the document, he reasons that for purposes of §2518, only the disclaiming person’s interest in the trust would be treated as having been disclaimed.

- (5) **Consideration Adjustment Clause.** The *King* approach can also be used for a sale.

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- (6) **Combined Wadry/King Approach.** In addition, a combined *Wadry*/consideration adjustment approach could be used (sometimes referred to as a two-tiered *Wadry* transfer). The client would make a traditional *Wadry* transfer of that number of units that is anticipated to be worth the desired transfer amount (which could either be a gift or a sale), but with a provision that if those units are finally determined for federal gift tax purposes to be worth a higher value, the shares that were not transferred because of the *Wadry* provision would be sold for a note as of the same date as the *Wadry* gift, with the price being determined by the finally determined gift tax value. See Joy Matak, Steven Gorin & Martin Shenkman, *2020 Planning Means a Busy 2021 Gift Tax Return Season*, LEIMBERG ESTATE PLANNING NEWSLETTER #2858 (February 2, 2021) (includes excellent suggested detailed disclosures for reporting a two-tiered *Wadry* transfer on a gift tax return and income tax return, including Schedule K-1 disclosures).

That approach was used in *True v. Commissioner* (Tax Court Docket Nos. 21896-16 & No. 21897-16), which cases were settled on a basis that, as reported in Tax Court filings, appears favorable for the taxpayer. The father made transfers of assets worth well over \$160 million under these clauses (any gifts were deemed to be made equally by the spouses under the split gift election). The IRS determined that the transfers resulted in additional gifts by the parents collectively of \$94,808,104 resulting in additional combined gift taxes of 35% of that amount, or \$33,182,836. The taxpayers avoided that horror show and ended up paying only an additional \$4,008,642 (combined) of gift tax under stipulated decisions filed in both cases in July 2018. The taxpayers no doubt viewed an additional current outlay of about \$4 million rather than \$33 million as a huge victory (even if the audit may have resulted in additional value being included in the parents' estates under revised face amounts of notes). For a discussion of *True v. Commissioner*, see Item 8.c(17) of Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts* (July 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- (7) **Impact of Large Exclusion Amount.** Because of the substantial cushion effect of the very large gift tax exclusion amount, clients making transfers significantly less than the full exclusion amount will have much less incentive to add the complexity of defined value transfers to gift transactions. However, clients wanting to use most of the \$10 million (indexed) exclusion amount are more likely to consider a defined value transfer to minimize the risk of having to pay gift tax.
- (8) **Some Planning Issues.**
- The IRS looks at these cases closely, but largely to determine whether the clause was implemented properly. No pre-arrangements should exist.
  - Documentation should be consistent in all respects with the formula transfer. (See the discussion in Item 13.c(1)(a) below about documentation tips based arguments raised in *Sorensen v. Commissioner*.)
  - With a *Petter* or *Wadry* type of formula (based on values as finally determined for gift tax purposes) it is essential that a gift tax return be filed.
  - The recipient trusts should be grantor trusts; if adjustments are made following an audit, no income tax return amendments should be necessary because all of the income is taxed to the grantor in any event.
- (9) **Resources.** For a more detailed discussion of defined value clauses, see Item 14 of the Current Developments and Hot Topics Summary (October 2017) found [here](#) and Item 8.c. of Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts* (July 2020) found [here](#), both available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- d. **Transfer Planning with Trusts.** The key in transfer planning engagements with clients who are hesitant about making significant gifts will simply be to START the planning process. Create a grantor trust and start to make gifts to it. One planner calls this generically a "Test Trust." For the client who

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wants a beneficiary-advised plan, the child could serve as trustee and the client can observe how the child operates or have the child serve with a co-trustee. Parents can start giving away assets and feel what that's like. Also, having an "old and cold" trust can help for later planning.

The backbone of transfer planning for clients will be to start making gifts to a grantor trust. Subsequently, assets could be sold to the trust by the grantor. Future appreciation is removed from the estate. (Clients think their assets will go up in value or else they would get rid of those assets.) Because this will be the backbone of a long-term transfer plan, carefully think through the dispositive and governance provisions of the trust, and build in flexibility for someone to make adjustments as necessary.

Clients often will want to keep (1) control and (2) income.

(1) **Control.** Control can often be maintained by giving non-voting stock while keeping the voting stock. See Rev. Rul. 81-15, 1981-1 C.B. 457 (revoking Rev. Rul. 67-54, which had held that transferring nonvoting stock, while retaining voting stock, would result in the transferred nonvoting stock being included in the estate under §2036(a)(2)). However, for noncorporate entities, cases such as *Strangi* and *Powell* have suggested that the ability to control distributions or to cause dissolution of the entity (or make amendments to the entity agreement regarding those issues) may trigger estate inclusion. For this reason, the planner may want to start with the client having control of at least investment and possibly distribution decisions for entities owned by the trust, but eventually over time give up control over distribution decisions (hopefully more than three years before death).

(2) **Income.** Having access to income of the trust may be accomplished by the simplicity of the client continually swapping hard assets into the trust each year (with a non-fiduciary substitution power) in return for income and liquidity produced by the trust. The hard assets may be valued with discounts, producing a further value shift of underlying values.

Alternatively, hard assets could be sold to the trust with an amortized note, with the anticipation that income and other liquidity of the trust would service the note payments.

With either of these approaches, if the settlor effectively always accesses the trust's income, consider whether the facts could give rise to an argument of an "indirect agreement" to retain income that could cause estate inclusion under §2036.

Another approach may be to name the donor's spouse as a potential discretionary beneficiary (or to give someone the ability to add the spouse as a potential beneficiary in the future). (This is referred to as spousal lifetime access trust – or SLAT – planning.) See Item 12.h below.

e. **GRAT Planning and Audits.** Several planning issues for GRATs for consideration –

- One of the major advantages of GRATs is that a formula, based on the finally determined value of contributed assets, can be used to set the retained annuity payments, thereby "eliminating" the risk of a surprise gift upon the creation of a GRAT. (But see 18.a(2)(a) below regarding CCA 202152018.)
- A GRAT can be structured so that no taxable gift results from its creation, so GRATs can be used by donors who have no gift tax exclusion remaining.
- When the GRAT funding is reported on a gift tax return, elect out of automatic GST allocation. (The estate tax inclusion period (ETIP) does not end until the GRAT term ends.)

The IRS is increasingly auditing GRATs and is raising the following issues.

- Do terms of the GRAT agreement comply with the §2702 regulations?
- Has the GRAT been operated in accordance with its terms?
- Are the assets contributed to the GRAT properly valued? (See *Grieve v. Commissioner*, T.C. Memo. 2020-58, CCA 202152018 in Item 18.a below, and *Baty v. Commissioner* in Item 18.b below).

- Is a consistent valuation methodology being used for the initial valuation and for annuity payment valuations or exercises of substitution powers? (Consider using a *Wandry* type formula approach for annuity payments or exercises of substitution powers, although the use of a *Wandry* clause will require the filing of a gift tax return.)
- Have all annuity payments been made timely?
- The IRS is taking a hard line on operational issues. IRS representatives in some cases have argued that the GRAT was not a qualified interest under an *Atkinson* analysis, similar to the position publicized in CCA 202152018 (which is discussed in Item 18.a below).

f. **Sales to Grantor Trusts.**

(1) **Gift Tax Issues.**

- Value of Transferred Asset.
- Value of Consideration Received. The IRS may argue that the note received in the sale is not worth the face value of the note. The IRS has submitted that the applicable federal rate under §7872 is not a safe harbor rate for sales, and that other factors should be considered such as the lack of covenants, restrictions, adequacy of security, and timing of payments (i.e., balloon all at maturity). In effect, the IRS is trying to re-litigate the *Frazee* and *True* cases. That direction is coming from the IRS national office. To minimize that IRS argument, the note should have commercial-like terms (adequate security, periodic payments, etc.).

(2) **Estate Tax Issues.** The IRS has argued that §2036/§2038 apply to the interest that is sold.

- **Sufficient Seeding.** The IRS should lose this argument if the trust is seeded with significant value or if the trust has a guarantee backed by a guarantor who can pay the guarantee if necessary. *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), was a private annuity case which did not result in estate inclusion where the promise to pay the annuity was a personal obligation, not just payable out of earnings, and the size of payments was not based on the amount of income from transferred assets. The government made similar arguments in the *Woelbing* and *Beyer* cases. For a discussion of *Woelbing*, see Item 8.c(16) of Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts* (July 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- **Collapsing Gift and Sale.** If the gift and sale happen the same day (or are deemed to be part of an integrated transaction) the IRS may argue that all the transferred assets have some gift element, so the bona fide sale for full consideration exception in §2036 and §2038 is inapplicable.

(3) **Sales Between Trusts; Triangular Structure.** If sales will occur between trusts that would be a taxable transaction, consider creating or modifying a third trust that would have the right to withdraw all of the income (including capital gain income) from both trusts. The third trust would be treated as the deemed owner of the other two trusts pursuant to the reasoning of Letter Ruling 201633021, based on §678(a)(1).

Trusts that are treated as deemed owned trusts under §678 because of the deemed owner's right to withdraw all of the income (including capital gain income) of the trust are sometimes referred to a BDOTs. For a detailed discussion of the use of BDOTs, see Item 16 of the Estate Planning Current Developments Summary (December 2018) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). See also Edwin Morrow, *Using Powers Over Income and Beneficiary Deemed Owner Trust (BDOT) Provisions to Reduce Trust Income Tax Burdens*, 47 TAX MGMT. ESTS., GIFTS & TRTS. J. No. 1 (Jan. 13, 2022); Edwin Morrow, *IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)* (October 2022) (very detailed 195-page excellent resource) available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3165592](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3165592). However, it is not clear that

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transactions between the deemed owner and the trust will be treated as nonrecognition events under Rev. Rul. 85-13.

In Letter Ruling 202022002, a beneficiary of a trust had the right to withdraw *all* the assets of the trust (not just the income). The ruling concluded that a sale from the trust that was deemed owned by the beneficiary and a grantor trust of the beneficiary was not a taxable transaction. The ruling concluded that “the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A.” That ruling approves the concept of a triangular approach in which one party is the deemed owner under §678 or under §671-677 of two other trusts, and sales between the two trusts were given non-recognition treatment under Rev. Rul. 85-13. However, the reasoning of Letter Ruling 202022002 does not necessarily extend to BDOTs in which another party has the right to withdraw all *income* (including capital gains) from a trust, rather than having the ability to withdraw all *trust assets* (as was the case under the facts of Letter Ruling 202022002).

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

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

(1) **Marital Wealth Shift.** SLATs result in a significant shift of marital wealth between the spouses. There is a shift of *double* the amount transferred to a SLAT – the donor’s share of marital wealth goes down by that amount and the donee spouse’s potential access to the marital wealth goes up by that amount, resulting in a double whammy effect. Furthermore, the donor must pay income tax on the trust income as a result of the repeal of §682 unless the spouses make other arrangements.

The planner should talk very frankly with the spouses about the effect of a divorce on SLATs (or the spouses should have separate counsel) and whether each spouse is comfortable with the SLAT planning in the event of a divorce.

(2) **Donor Access If Donee Spouse Predeceases; Deferred Contingent Annuity.** The donee spouse (or someone else) may have the authority to appoint assets following the donee spouse’s death that would be broad enough to appoint assets to a trust of which the donor spouse is a discretionary beneficiary. That raises potential “implied agreement” §2036(a)(1) issues as well as potential §2036(a)(2) and §2038 issues if the donor’s creditors can reach the trust under the “relation back” doctrine. References to additional resources in Item 12.h(3) below include discussions of the “relation back” doctrine in the context of SLAT planning.

An alternative approach may be for the donor-spouse to purchase a commercial annuity (or to purchase an annuity from the SLAT while the donee spouse is alive) that would pay a monthly amount beginning with the death of the donee spouse. Such a deferred contingent annuity can be relatively inexpensive (for example, to purchase a \$350,000 annuity for the life of a spouse to begin at the death of the other spouse might cost about \$1 million for 62-year-old spouses.)

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(3) **Resources.** For a detailed discussion of SLATs and “non-reciprocal” SLATs, including a discussion of the §2036 and §2038 issues and creditor issues, see Items 78 and 80 of the ACTEC 2020 Annual Meeting Musings (March 2020) found [here](#), Item 10.i. of Estate Planning Current Developments and Hot Topics (December 2019) found [here](#), and Item 16 of the Current Developments and Hot Topics Summary (December 2013) found [here](#), all available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). For a discussion of potential conflicts of interest between spouses and creditor concerns with SLATs, see Item 10.e of Estate Planning Current Developments (December 2021) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). See generally George Karibjanian, *Exploring the “Back-End SLAT” – Mining Valuable Estate Planning Riches or Merely Mining Fool’s Gold?*, 47 TAX MGMT. ESTS., GIFTS & TRTS. J. NO. 6 (Nov. 10, 2022).

i. **Grantor Trust Planning to Provide Flexibility if Grantor Wants to Stop Having to Paying Income Tax on Trust Income.** One of the advantages of grantor trusts is that the trust can grow income tax free because the grantor has the legal obligation to pay income taxes attributable to the grantor trust income. At some point, however, the grantor may feel financially threatened by that financial burden; “too much of a good thing.” Planning alternatives include structuring the trust to give the grantor or someone the flexibility to toggle off grantor trust status, making loans to the grantor to pay the tax, structuring automatic expiration of grantor trust status in some circumstances, making distributions to the grantor’s spouse if the spouse is named as beneficiary, having the grantor retain sufficient assets to pay the income tax, including powers of appointment giving a holder the power to appoint the assets to a non-grantor trust, decanting to a non-grantor trust, or leaving the trustee with the flexibility to reimburse the grantor for such income taxes (but possible adverse transfer tax consequences with tax reimbursement must be navigated carefully). These alternatives (and more) are discussed in Kristen A. Curatolo & Jennifer E. Smith, *Strategies for Mitigating the ‘Burn’ of Grantor Trust Status*, 48 BLOOMBERG TAX MGMT. ESTS., GIFTS & TRUSTS. J. No. 3 (May 11, 2023). See also Jerome M. Hesch & Paul Lee, *The Financial Danger of Maximizing Taxable Gifts*, LEIMBERG ESTATE PLANNING NEWSLETTER #2035 (Dec. 5, 2012).

j. **Section 2036; FLP and LLC Cases.** Whether §2036 applies to assets transferred to entities is the most litigated issue in the transfer tax area. The bona fide sale for full consideration defense is the best defense to any §2036 attack. Planners should accordingly consider documenting the purposes of transfers to entities at the time of the creation of the entities.

Section 2036(a)(2) and the “alone or in conjunction with” analysis has been the focus in the last several years following the *Powell* case. For a discussion of *Powell*, *Cahill*, *Morrisette*, and *Levine* regarding the §2036(a)(2) issue and for a table of discounts allowed in recent FLP/LLC cases, see Item 17 below.

k. **Valuation Penalties; *Morrisette*.** *Morrisette* (discussed in Item 17.c(3) and Item 20 below) applied undervaluation penalties even though the taxpayer secured appraisals from a reputable appraiser. The court did not question the credentials of the appraiser but said that the taxpayer was unreasonable in relying on the appraisal. The “legal advice defense” was waived by asserting attorney-client privilege. The court observed that the intergenerational split-dollar transaction was marketed as a way to undervalue rights and noted that the taxpayer recommended changes to the appraiser’s report.

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

m. **Reverse “Upstream” Estate Planning.** Consider making use of otherwise unused exclusion amounts of parents or other elderly relatives by giving them a formula testamentary general power of appointment over assets in the client’s grantor trust (that perhaps has been leveraged by sales to the

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trust), but only up to the unused exclusion amount in the parent's estate. That would allow a basis adjustment at the parent's death and would allow the parent to allocate GST exemption to the trust to the extent it is not fully exempt. To limit the risk of an "inappropriate" exercise of the general power, the general power of appointment would be (1) a testamentary power to appoint to the parent's creditors, (2) subject to the approval of a nonadverse party ("use Uncle Fred; he's a grouch and he says no to everything"), (3) of an amount that when added to all other assets does not exceed the powerholder's unused exclusion amount (4) without considering the marital or charitable deduction of the appointee's estate, but (5) only to the extent of assets with a fair market value in excess of basis (and perhaps with an ordering provision so that assets with the most appreciation would first be subject to the general power). Before using this approach, make sure the powerholder does not have creditor concerns and that the existence of the power will not cause a loss of access to government benefits. Melissa Willms refers to this as the "Accidentally Perfect Grantor Trust." For a detailed discussion, see Item 7.c of Estate Planning Current Developments and Hot Topics (December 2015) found [here](#) and Item 19.c of Estate Planning Current Developments and Hot Topics (December 2019) found [here](#), both available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). See also Turney P. Berry, *Powers of Appointment from Snoozy to Sexy*, ACTEC ANNUAL MEETING, 23-26 (March 2018); Paul S. Lee, *Putting it On & Taking it Off: Managing Tax Basis Today (For Tomorrow)*, ALI-CLE COURSE MATERIALS, 52-54 (April 30, 2020).

A similar formula general power of appointment could be used for other trust beneficiaries as well. See Item 19 below.

- n. **Report Transactions on Gift Tax Returns with Adequate Disclosure.** See Item 14 below regarding the summary of *Schlapfer v. Commissioner*, T.C. Memo. 2023-65, for a discussion of the adequate disclosure rules and approaches for satisfying those rules.
- o. **Gift Tax Return Preparation, Reporting Charitable Gifts.** Consider reviewing the instructions to Form 709 with each gift tax return that is prepared. Form 709 appears deceptively simple, but it's not at all simple. In particular, pay attention to the adequate disclosure rules (as discussed immediately above).

Unless all gifts are under the annual exclusion threshold, charitable gifts are required to be reported on Form 709. The danger of not doing so is that if gifts that are not reported are in excess of 25% of gifts that are reported, the limitations period on assessment is extended from three to six years. §6501(e)(2).

- p. **KISS Principle.** "We can take care of most of our clients most of the time using well understood commonplace type things and leave the esoteric for special situations. Do not be afraid of doing that."
- q. **Planning to Avoid Substance Over Form Attacks, Including *Smaldino v. Commissioner*.** For a discussion of substance over form and related attacks (i.e., step transaction, sham transaction, economic substance, business purpose, etc.) on transfer planning transactions, see Item 15 of Heckerling Musings 2023 and Estate Planning Current Developments (April 12, 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights), which is a summary of an excellent presentation by Carol Harrington (Chicago, Illinois) at the 57th Annual Heckerling Institute on Estate Planning™. Also, see Item 22 of Heckerling Musings 2023 and Estate Planning Current Developments (April 12, 2023) for a detailed discussion of *Smaldino v. Commissioner*, T.C. Memo. 2021-127, a 2021 case involving a step transaction/indirect gift transaction in which a husband tried (unsuccessfully) to make use of his wife's unused gift exclusion amount by a gift from husband to wife followed by an immediate re-transfer of those assets from wife to a trust for children.

The following are some practice pointers for avoiding substance over form attacks from Carol Harrington's presentation at the 2023 Heckerling Institute.

- (1) **Time.** A recurring theme is to allow time between many of the transactions. The longer the better. Some cases have said 12-15 days is enough to avoid the step transaction doctrine

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(*Holman, Gross*), but that is really pushing it. Clients will want to do it as soon as possible – “but he may change his mind,” yes, but that’s precisely the reason it works.

- (2) **Formalities.** In the substance vs. form test, at least get the “form” right – for example, with actual signed trust documents, actual transfers, maintained capital accounts, bank accounts owned by the entity, etc. Do things in the right order (e.g., sign the trust before transferring assets to the trust).
  - (3) **Compliance and Reporting.** Compliance and reporting should be consistent throughout. The IRS often looks for glitches in reporting (including tax reporting) of the transaction.
  - (4) **Play Fair.** You must follow the rules – no side agreements.
  - (5) **No Prearrangements.** Don’t have a prearranged plan, especially avoid prearranged “re-transfers.” Avoid even the appearance of a prearrangement to the extent possible.
  - (6) **Coercion.** No threats or intimidation. (For example, in *Griffin, Jr. v. U.S.*, 42 F. Supp.2d 700 (W.D. Tex. 1998), the husband spoke with his wife “every night for one month” to encourage her to re-transfer shares.)
  - (7) **“Steps.”** Do not say “Step 1, Step 2” in a flowchart.
  - (8) **Disclosure.** The planner must balance the desire to have written documentation of full exposure of risks of the transaction with not providing a roadmap to the IRS of how to attack the transaction. At the planning stage, proceed with the mindset that the IRS or a judge will someday see everything you put in writing. But, as Carol puts it: “We don’t go to jail for anyone.”
  - (9) **Follow-Up.** The client must be willing to have periodic follow-up to make sure the proper formalities and reporting are being carried out.
  - (10) **Pattern.** No pattern of consistently taking actions that suggest an implied agreement or prearrangement.
- r. **Further Discussion.** For further discussion of these transfer planning alternatives, see Item 8 of Estate Planning Current Developments and Hot Topics (May 2021) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

### 13. **Wandry Clause Gift Tax Case Settled, *Sorensen v. Commissioner*, T.C. Docket 24797-18, 24798-18, 20284-19, 20285-19 (Decision Entered Aug. 22, 2022)**

- a. **Basic Facts.** Chris and Robin Sorensen grew up in a firefighter family. Their father was a firefighter. They loved joining in communal meals at the firehouse, and Robin decided at a young age that one day he would open a restaurant. Eventually, the brothers scrounged \$28,000 in loans from family members and in 1994 started a sandwich shop (because it required the least capital investment compared to other restaurants). They had only one employee and the family (parents, sisters, spouses, even children) volunteered to provide other labor for the restaurant. Their single sandwich shop eventually turned into a number of Firehouse Subs franchises across the country. Their motto: “Big picture, we love to cook, we love to serve people, we love the hospitality industry. We make sandwiches for a living.”

The company succeeded and grew substantially. By 2014, the company owned 27 restaurants, had 823 franchisees, and had over \$550 million of sales system wide. In late 2014 they decided to make gifts to use their \$5.34 million gift exclusion amounts for fear that the gift exclusion might be reduced in the future. On December 31, 2014, each brother created a grantor trust and made a gift to the trust of nonvoting shares of Firehouse stock having a value of \$5,000,000 as finally determined for federal gift tax purposes. [**Observation:** This approach had been approved two years earlier in *Wandry v. Commissioner*, T.C. Memo. 2012-88.] They signed Irrevocable Stock Powers transferring

[a] specific number of nonvoting shares in FIREHOUSE RESTAURANT GROUP, INC., a Florida corporation (the “Company”), that have a fair market value as finally determined for federal gift tax purposes equal to exactly \$5,000,000. The precise number of shares transferred in accordance with the preceding sentence shall be determined based on all relevant information as of the date of transfer in accordance with a valuation report that

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will be prepared by the Dixon Hughes Goodman, LLP (“DHG”), Jacksonville, Florida, an independent third-party professional organization that is experienced in such matters and appropriately qualified to make such a determination. However, the determination of fair market value is subject to challenge by the Internal Revenue Service (“IRS”). While the parties intend to initially rely upon and be bound by the valuation report prepared by DHG, if the IRS challenges the valuation and a final determination of a different fair market value is made by the IRS or a court of law, the number shares [sic] transferred from the transferor to the transferee shall be adjusted accordingly so that the transferred shares have a value exactly equal to \$5,000,000, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or court of law.

An appraisal valued the nonvoting shares at \$532.79 per share as of December 31, 2014, and \$5.0 million worth of shares was 9,384.56 shares. The attorney recommended transferring that amount exactly, but the parties rounded the number of initially transferred shares to 9,385, which represented about 30% of each brother’s nonvoting shares. They later decided to transfer a total of up to about 50% of their shares, and on March 31, 2015, each brother sold to his respective trust 5,365 nonvoting shares in exchange for a \$2,858,418 secured promissory note (using the \$532.79 per share value in the appraisal as of December 31, 2014). (The sales were not *Wandry* defined value transfers.)

The 2014 gift tax returns reported the defined value formula transfers, described the number of shares determined to have a value of \$5.0 million based on an appraisal (attached on one brother’s gift tax return but not on the other brother’s return), and further explained:

Therefore based on the formula set forth above and the value as determined by the Valuation Report, the donor transferred 9,385 non-voting shares in Firehouses stock ... with a value equal to \$5,000,000, and the precise number of shares transferred cannot be finally determined until the value of such shares are finally determined for federal gift tax purposes.

The 2015 gift tax returns did not report the sale of shares in 2015 as a non-gift transaction.

In a gift tax audit, the IRS’s expert appraised the shares at \$1,923.56/share, later adjusted to \$2,076.86/share. The Notices of Deficiency were confusing because of confusion by the IRS as to how many shares had been transferred in 2014 and 2015, but the amount of gift tax ultimately in dispute for each brother (according to their pretrial memorandum) was about \$8.95 million for 2014 and \$4.62 million for 2015, totaling about \$13.57 million. In addition, penalties in dispute for each brother were about \$3.58 million for 2014 and \$1.85 million for 2015, or a total of \$5.43 million.

Jumping ahead seven years, the entire company was sold on November 15, 2021, for \$1 billion cash, which was allocated among the shareholders. Each of the trusts received about \$153 million.

- b. **Issues.** Three issues were in contention. (1) Are the defined value formula gifts respected? At issue is whether the defined value approach approved in *Wandry v. Commissioner*, T.C. Memo. 2012-88 would be respected. (2) What is the appropriate fair market value of the shares on the dates of the 2014 gift and the 2015 sale? (3) Are penalties appropriate or should they be waived for reasonable cause?
- c. **IRS Arguments for Refusing to Respect the Defined Value Transfers.**
  - (1) **The Donors Relinquished Dominion and Control of 9,385 Shares on 12/31/14.**
    - (a) **Facts Supporting.**
      - i. **Company Reporting.** The company reported that each trust owned 9,385 shares on its stock ledgers and on income tax returns. **[Planning Observation:** Include an “asterisked” explanation on the stock ledger and tax returns. Using “uncertificated shares” may facilitate this reporting.]
      - ii. **Distributions.** The trusts received pro rata distributions based on owning 9,385 shares. **[Planning Observation:** Document in company records that distributions are based on the initially determined amount of shares, which could be adjusted based on finally determined gift tax values, and that the brothers and their trusts will make appropriate adjustments between themselves if the shares are changed.]

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- iii. **No Agreement with Trusts.** The trusts never agreed to transfer shares based on the defined value formula and did not countersign the stock powers, which described the transfers as defined value formula transfers. **[Planning Observation:** Have the trusts countersign the stock powers to specifically acknowledge the conditions under which they are receiving the stock transfers.]
- iv. **Third-Party Buyer.** The trusts transferred 9,385 shares each to the third-party purchaser, who paid the trusts for those shares. **[Planning Observation:** Have the buyer acknowledge that the ownership of shares is based on the defined value formula transfers, but that the trusts and donors agree that collectively they own the 9,385 shares and transfer them to the buyer; if adjustments are made in the ownership of the shares, the donors and trusts will adjust the sales proceeds appropriately but acknowledge that the buyer can pay the purchase price attributable to the 9,385 shares to the respective trusts.]
- (b) **Cow Analogy.** The IRS's Pretrial Memorandum includes this analogy to a defined value gift of cows.

Consider that if a farmer agrees to transfer his son [sic] several cows worth \$1,000 as finally determined for federal gift tax purposes, and the farmer's appraiser determines that five cows equal that value, then the transfer is for five cows. The son is now the owner of five cows. Years pass. The son breeds the cows and opens a barbeque stand. If a later gift tax examination finds that each cow was actually worth more, and that two extra cows had been included in the transfer, **nothing in the agreement would allow the farmer to take the two cows back. They were sold as barbeque.** The parties might be held to their agreement—a transfer of the number of cows as finally determined to equal \$1,000 coupled with the possibility of the farmer getting something (barbeque?) in the event of a redetermination of value. But whatever it is, it won't be the cows transferred. And it might be nothing; the farmer may not pursue his claim, and if he does, he is now just a general creditor who must stand in line with all the other unsecured creditors of the barbecue operation.

The farmer's use of a transfer clause that contemplates subsequent events does not change the fact that the transfer of the five cows was complete on the execution of the documents. This is the case even though the number of cows was indefinite until the initial appraisal was completed. [Citations omitted.] The transfer was of five cows, regardless of whether the transfer is structured as a gift or a sale.

Under the farmer's transfer document, however, a redetermination of the value of a cow might give rise to a right of recovery against the son. But a right that is dependent upon the occurrence of an event beyond the donor's control, such as a later redetermination of value by federal authorities or the courts, does not alter the fact that the transfer is complete for gift tax purposes upon the execution of the documents. [Citations omitted.] The possibility that the farmer might get something back does not change the fact that he transferred five cows upon the execution of the documents, regardless of whether the transfer is structured as a gift or a sale. (Emphasis added.)

**[Observation:** The IRS reportedly often uses this folksy analogy in audits involving *Wandry* transfers. The Fifth Circuit in *Nelson v. Commissioner*, 128 AFTR 2d 2021-6532, Cause No. 20-61068 (5th Cir. November 3, 2021), *aff'g*, T.C. Memo. 2020-81, referred to this analogy presented by the IRS in that case. The emphasis on not being able to adjust the transfer of cows because they have been turned into barbeque ignores that we are in a society with a monetary system and can make appropriate adjustments to determine that the proper value is transferred.]

- (c) **Procter Argument.** The language in the stock power attempting to "adjust" the number of shares transferred is a condition subsequent and violates public policy, based on *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). That language precludes the IRS from enforcing the gift or making efforts to collect gift tax and precludes enforcing valuation misstatement penalties.

The taxpayers reside in Florida so the case would be appealable to the Eleventh Circuit Court of Appeals. The IRS cited an Eleventh Circuit case that referred to *Procter. TOT Property Holdings, LLC v. Commissioner*, 1 F.4th 1354 (11th Cir. 2021) (language in a conservation easement deed purporting to bring the easement in compliance with regulations held to be

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an unenforceable savings clause; clause presented “the same sort of catch-22 situation that leads to the trifling with the judicial process”).

The IRS distinguished formula allocation clauses in which the transferor clearly transferred all of a specific block of shares or interests, and the formula clause allocates the block between two recipients (and the transfer to one of those recipients would not result in a taxable gift). Those types of clauses have been approved in various cases (*Petter, Christiansen, McCord, Hendrix*). **[Planning Observation:** This argument by the IRS clearly suggests that those types of defined value clauses are more likely to be respected by the IRS.]

(2) **Wandry Was Wrongly Decided.** *Wandry* reasoned (referring to *Estate of Petter v. Commissioner*) that a savings clause is void because it creates a donor that tries to “take property back,” but the transfer document in question reflected the intent to transfer “a predefined ... percentage interest expressed through a formula” to each donee, and the transfer document does not allow taxpayers to “take property back,” but only to correct the allocations. The IRS suggested several reasons why that analysis is faulty.

- The formula transfer created a condition subsequent that could not change the fact the gift was complete as of the date the donors gave up control of LLC units.
- The adjustment to capital accounts to reflect the values as finally determined for gift tax purposes was not merely an internal accounting adjustment as discussed in *Wandry* but affected each member’s economics in the LLC.
- *Wandry* referred to competing interests, but unlike a situation involving a transfer to a third party, there are no real competing interests where the donor is gifting property to a spouse and/or children and both the donor and donee want to maximize the number of units transferred.
- The *Wandry* approach subverts Congressional intent regarding valuation misstatement penalties in gift tax matters. The court would not be deciding the amount of gift tax on property transferred but would just be determining the property that should be returned to the donor. In that scenario, there could never be a valuation misstatement penalty.
- The IRS’s Pretrial Memorandum summarized its criticism of *Wandry*:

The *Wandry* opinion improperly focused on the donors’ intent rather than the donors’ relinquishment of dominion and control over gifted property, as required by the statutes and regulations thereunder. Therefore, to the extent necessary to resolve this issue, this Court should find *Wandry* was wrongly decided, and petitioners owe additional gift tax to the extent that the value of 9,385 nonvoting shares of FRG exceeds petitioner’s annual exclusions and lifetime exemption equivalents.

(3) **Facts Are Distinguishable from *Wandry*.** In *Wandry*, the court noted that the number of LLC units initially transferred was unclear from the record before the court. In this case, specific shares were gifted and the benefits attributable to those shares were shifted.

Furthermore, unlike the donors in *Wandry*, the Sorensen donors failed to follow their own transfer clauses. Based on the appraised value, \$5.0 million worth of shares would have been 9,384.56 shares, but (contrary to their attorney’s advice) the donors for administrative simplicity rounded that to 9,385 shares, which resulted in transferring shares worth \$5,000,234.15. Thus, the facts align more with *Knight v. Commissioner*, 115 T.C. 515-16 (2000) (in which the donors did not report the transfer as a formula transfer on the gift tax return) than with *Wandry*.

**[Observation:** The IRS made this argument over \$234.15 in a transfer of \$5.0 million worth of hard-to-value assets. Really??]

A transfer of shares in an S corporation (by the Sorensens) is different than the transfer of units in an LLC in *Wandry* (where there is broader flexibility to determine the economic rights of members).

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(4) **Other Arguments.** The IRS also argued that the shares transferred could not be adjusted because of the sale of all shares to a third party and because the taxpayers had stipulated that each brother had gifted 9,385 shares.

- d. **Valuation.** The parties obviously had substantial differences in their valuations of the nonvoting shares. The experts used similar valuation approaches but applied significantly different risk adjustments and comparables. Also, the IRS disputed the use of “tax affecting” for valuing S corporation shares. **[Observation:** the IRS Pretrial Memorandum cited several cases that rejected tax affecting but did not cite the more recent *Estate of Jones v. Commissioner* case (T.C. Memo. 2019-101) that accepted a tax affecting analysis under the facts of that case.]
- e. **Penalties.** The taxpayers argued that penalties should not apply because a three-prong test (described in *Neonatology Associates v. Commissioner*, 115 T.C. 43, 99 (2000), *aff’d*, (3rd Cir. 2002)) for the reasonable cause exception was satisfied: (1) the adviser was a professional with expertise to justify reliance, (2) the taxpayer provided accurate and necessary information to the adviser, and (3) the taxpayer actually relied on the adviser’s judgment in good faith.

The IRS maintained that the valuation understatements were attributable to negligence and disregard of rules and regulations.

As to the 2014 gifts, the brothers knew they gifted 9,385 shares as shown by their reporting on 2015-2020 income tax returns, stock ledgers, and their gift tax returns, as well as the receipt by each of the trusts of about \$153 million from the sale of the company. Also, they knew the 9,385 shares were worth far more than \$5.0 million because of the company’s “prior five years of distributions, revenue, and operating income growth, and store expansion.”

As to the 2015 sales, the brothers “failed to report a transaction in which they transferred stock ... for far less than its value.” Also, they relied on an appraisal with a December 31, 2014, valuation date to determine the value of shares transferred in 2015.

- f. **Settlement.** A Stipulation of Settled Issues reached the following conclusions:
- A defined value formula clause does not apply to or control the donor’s transfer of nonvoting shares on December 31, 2014.
  - Each brother gave 9,385 shares on December 31, 2014.
  - Each gifted nonvoting share was valued at \$1,640, for a total gift from each brother of \$15,391,400 (a difference of \$10,391,400 from the reported value of \$5,000,000, which had resulted in a gift tax of zero).
  - No penalties applied as a result of the 2014 gifts.
  - Each brother sold 5,365 shares on March 31, 2015.
  - Each sold nonvoting share was valued at \$1,722, for a total transferred value of \$9,238,530, less the \$2,858,418 consideration received, resulting in a gift by each brother of \$6,380,112.
  - The 10% accuracy related penalty under §6662(a) applies to the 2015 transfer.

A Decision for the 2015 transaction reported a gift tax deficiency of \$2,516,045 and a penalty under §6662(a) of \$251,605.

The Stipulation regarding the 2014 gift of \$15,391,400 would have resulted in a gift tax of a little over \$4.0 million (assuming few taxable gifts had been made previously).

Therefore, the total gift tax deficiency for each brother for 2014 and 2015 was \$4,000,000+ plus \$2,516,045, or a total of \$6,516,045+. The total penalty was \$251,605.

#### **Observations:**

- (1) Because of the huge appreciation resulting from the sale in 2021, the brothers were probably highly motivated to be treated as having transferred 9,385 shares in 2014, and not have some of those shares treated as having been owned by the donors. Applying the defined value formula,

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based on the stipulated value of \$1,640 per share, would have resulted in each trust receiving only about \$87 million from the sale in 2021 rather than about \$153 million.

[Each brother was treated as giving 9,385 shares and selling 5,365 shares to his grantor trust. That is a total of 14,750 shares (9,385 + 5,365). In the 2021 sale, each trust received \$153 million. That is about \$10,372.88 per share (153,000,000 ÷ 14,750).

Under the settlement, the gift tax value was stipulated to be \$1,640 per share. If the defined value clause were given effect, that would reduce the number of shares given to about 3,049 (5,000,000 ÷ 1,640). The total shares held by each grantor trust would then be about 8,414 (3,049 + 5,365). Then upon sale in 2021, each trust would have received about \$87,277,412 (8,414 × 10,372.88).]

- (2) The values resulting from the settlement (\$1,640 per share for the gift and \$1,722 per share for the sale) were much closer to the IRS's position that the shares were worth about \$2,000 per share than the donors' appraised value of about \$500 per share. Query how much of that added value was attributable to not allowing tax affecting of the S corporation shares?
- (3) The 10% negligence penalty under §6662(a) was applied to the 2015 transaction but not the 2014 transaction. Was this because the 2015 transfer was not reported on a gift tax return? Or perhaps it was because the sale price was based on an appraisal as of three months earlier if significant financial changes occurred during those three months (the stipulated per share value was increased by five percent from December 31, 2014, to March 31, 2015, representing a 20% annualized increase if that growth was extrapolated over a full year).
- (4) By any measure, the transfer transactions were wildly successful from a transfer planning standpoint (unless the parents were concerned they had transferred too much!). For a gift tax of about \$6.5 million, as of seven years later each brother had transferred \$153 million minus the \$2.9 million (approximately) note from the 2015 sale, or \$150.1 million – reflecting an effective tax rate of less than 5%.
- (5) Do not use the *Wandry* formula in the stock power in *Sorensen* as a template for drafting *Wandry* assignments. The assignment began with assigning that number of shares equal to a particular value as finally determined for federal gift tax purposes, but then continued on with language that arguably could be closer to a *Procter* transfer. Stick closer to the assignment language used in *Wandry*.
- (6) As discussed in Item 13.c(1)(a) above, planning tips can be gleaned from the IRS arguments in *Sorensen* for structuring and documenting the transfer of shares in satisfaction of the formula assignment before the time that a final determination of gift tax value is made, including documentation regarding the stock ledger, distributions, and the sale to the third party as well as having the donee specifically acknowledge the formula transfer on the stock power.
- (7) The treatment of *Wandry* transfers varies among IRS estate and gift tax attorneys, but the national office of the IRS does not like *Wandry* clauses.
- (8) Be wary of using *Wandry* transfers if the transferred assets could explode in value. A change in the finally determined gift tax value could result in many of the transferred assets remaining with the donor – and all the appreciation attributable those assets remaining in the donor's gross estate.
- (9) An alternative to assure that all of a particular block of assets is transferred is to use a combined *Wandry/King* approach as discussed in Item 12.c(6) 12 above.

#### 14. Disclosures Substantially Complied With Gift Tax Adequate Disclosure Requirement, *Schlapfer v. Commissioner*, T.C. Memo. 2023-65

- a. **Synopsis.** This is the **first reported case** with a detailed discussion of the adequate disclosure requirements under the gift tax adequate disclosure regulations (Reg. §301.6501(c)-1(f)), and it

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applies a lenient “substantial compliance” approach (in contrast to some informal guidance from IRS attorneys that has applied a stricter approach).

Mr. Schlapfer (Donor) in 2006 (or possibly in 2007) gave to his mother, aunt, and uncle a universal variable life insurance policy funded by \$50,000 and all the stock of a closely held company (EMG) that managed investments (marketable securities and cash). In 2013 Donor filed a large package of various tax returns (including a 2006 gift tax return but not a 2007 gift tax return) as part of the Offshore Voluntary Disclosure Program (OVDP) (which is no longer available). The IRS eventually assessed gift tax liability and penalties of over \$8.7 million.

The court held that whether the gift was completed in 2006 or 2007 made no difference because the adequate disclosure regulations explicitly provide that disclosure of a gift as a completed gift on a gift tax return for a particular year can constitute adequate disclosure even if the gift is later determined to be incomplete in that year.

The court considered various documents in the package of returns and information submitted under the OVDP including the 2006 gift tax return, a protective filing statement attached to the return, a schedule on Form 5471 for Donor’s 2006 federal income tax return, and an Offshore Entity Statement. The opinion reasons that substantial compliance, rather than strict compliance, with the adequate disclosure regulations will suffice. Donor did not strictly comply with the adequate disclosure regulations: (i) the gift was described as a gift of EMG stock rather than of the life insurance policy (which consisted primarily of the EMG stock), (ii) Donor’s mother (and not also his aunt and uncle) were listed as the recipient of the gift, and (iii) there was not a statement describing how the gift was valued and the disclosure did not provide all the detailed financial information listed in Reg. §301.6501(c)-1(f)(2)(iv) (but did provide all financial documents listed in the instructions to Form 709 for close corporations). The court concluded that the disclosed information was sufficient to constitute adequate disclosure, and the assessment of additional gift taxes was barred by limitations.

Some planners view the adequate disclosure regulations as stating a general rule (the information apprises the IRS of the nature and basis of valuation of the gift) and two safe harbors – a “description safe harbor” and an “appraisal safe harbor.” The court did not analyze the regulations as stating a general rule and safe harbors but analyzed whether the disclosure substantially complied with the elements of the description safe harbor. However, the opinion specifically recognized that the statement in the regulations that is viewed as the general rule is in a sentence stating that disclosure is adequate “only if” the sentence is satisfied, while the various listed “requirements” are in a sentence stating that disclosure of the listed elements “will be considered” adequate disclosure. The court viewed those elements as “not mandatory, but ... as guidance to inform them on a way to satisfy adequate disclosure.” That sounds like a general rule and safe harbor analysis, but the court did not use those terms.

In summary, important holdings in this first reported case that has a detailed discussion of the gift tax adequate disclosure requirements are that the requirements:

- Can be satisfied by substantial compliance; and
- Are not mandatory, but act as guidance to inform donors on a way to satisfy adequate disclosure.

The time for appealing the case has lapsed, and this Tax Court case will not be appealed. We will wait to see if the IRS files an acquiescence or nonacquiescence.

*Schlapfer v. Commissioner*, T.C. Memo. 2023-65 (Judge Buch).

- b. **Basic Facts.** For various years, ending in 2018, the IRS offered an Offshore Voluntary Disclosure Program (OVDP) that provided taxpayers an opportunity to disclose previously unreported offshore income, assets, investments, and accounts to the IRS and resolve their foreign and U.S. tax matters. The IRS would evaluate the taxpayer’s facts and circumstances and determine which penalties should apply. In exchange, the U.S. government typically would refrain from pursuing criminal prosecution.

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In 2006, Mr. Schlapfer (Donor) acquired a universal variable life (UVL) insurance policy on the lives of his mother, aunt, and uncle, funded by \$50,000 and all the stock of a closely held company (EMG) that managed investments (marketable securities and cash). On September 22, 2006, EMG issued a share certificate showing the policy's brokerage account as the owner of the EMG stock. The stock and cash had been fully funded to the policy's account by November 8, 2006. On January 23, 2007, Donor requested the insurance company to assign the policy to his mother, and on April 23, 2007, Donor and his mother jointly requested that the policy be assigned jointly to Donor's mother, aunt, and uncle. These changes were made on May 31, 2007.

In 2012, Donor decided to enter the OVDP, and in 2013 he submitted a disclosure packet to the OVDP that attached many documents, including various tax returns for 2004-2009. In particular, the packet included various items reporting information about the gift:

- Form 709 for 2006 reporting a gift of the EMG stock to Donor's mother;
- Attached to the Form 709 was a protective filing stating that on July 6, 2006, Donor made a gift of controlled foreign company stock valued at \$6,056,686, and that Donor was "not subject to U.S. gift tax as he did not intend to reside permanently in the United States until citizenship was obtained in 2008";
- Donor reported the gift as a gift of stock rather than the policy because the 2012 OVDP instructions required taxpayers to disregard certain entities that hold underlying assets, and he thought the reporting was "in accordance with the investor control doctrine";
- Amended income tax returns for 2004-2006 that included Forms 5471 for EMG, which "provided information regarding the number and type of issued and outstanding shares, the number of shares held by [Donor], and EMG's income statement, balance sheet, and earnings and profits for the respective tax years"; and
- An Offshore Entity Statement describing the EMG gift.

After the IRS requested additional documentation, Donor submitted various documents, including a brokerage "statement showing EMG's portfolio valuation as of September 22, 2006." He also explained that he took the position that the gift was made on July 6, 2006 "when he instructed [the insurance company] to transfer ownership of the UVL policy to his mother, aunt, and uncle as soon as the policy was issued." After agreeing to a revised gift date of September 22, 2006, Donor explained that listing him as the initial owner of the policy was a scrivener's error and the transfer requests in January and April 2007 "were merely intended to correct that error."

After receiving those responses in June-July 2014, the IRS had little contact with Donor until 2016 when it opened an examination of his gift tax return. Donor agreed to extend the time to assess gift tax to November 30, **2017**.

After Donor refused to concede that the gift was made in 2007, the IRS said he could not continue in the OVDP, and he withdrew from the program. The IRS prepared a substitute gift tax return for 2007 pursuant to §6020(b) and on October 17, **2019**, issued a notice of deficiency for 2007 asserting gift tax liability of \$4,429,949 and penalties under §6651(a)(2) and (f) of \$4,319,200 (thus presenting Donor with an **\$8.7 million** issue, **plus interest** for over 11 years).

Donor filed a petition with the Tax Court challenging the IRS's determinations. The IRS filed a motion for summary judgment finding that as a matter of law the gift was made in 2007, and Donor was liable for penalties. Donor filed a cross motion for summary judgment requesting the court to find that the period of limitations to assess gift tax expired before the notice of deficiency was issued because Donor had adequately disclosed the gift on his 2006 gift tax return.

- c. **Holding.** Donor adequately disclosed the gift on his 2006 gift tax return, as the Tax Court summarized:

The documents he attached to, and referenced in, his return provided the Commissioner with enough information to satisfy adequate disclosure. Therefore, the period of limitations to assess the gift tax commenced when the

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return was filed; and because the Commissioner issued the notice of deficiency more than three years after the filing, the Commissioner is barred from assessing gift tax.

Whether the gift was completed in 2006 or 2007 is immaterial because “disclosure of the gift on [the] 2006 return would suffice to commence the three-year period of limitations upon the filing of that return. See Treas. Reg. §301.6501(c)-1(f)(5).”

The court therefore granted Donor’s cross-motion for summary judgment and, the next day, entered an order and decision that there was no gift tax deficiency and no additions to tax.

d. **Court Analysis of Adequate Disclosure.**

- (1) **Reporting of Gift Ultimately Determined To Be Incomplete in That Year.** The IRS and Donor had a big disagreement over whether the gift was made in 2006 or 2007 (because the gift was reported on a 2006 Form 709 but not a 2007 return), which resulted in Donor eventually withdrawing from the OVDP. The court determined that difference was immaterial because of explicit provisions in the Treasury Regulations providing that

[a]dequate disclosure of a transfer that is reported as a completed gift on the gift tax return will commence the running of the period of limitations for assessment of gift tax on the transfer, even if the transfer is ultimately determined to be an incomplete gift for purposes of § 25.2511-2 . . . For example, if an incomplete gift is reported as a completed gift on the gift tax return and is adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed . . .

Reg. §301.6501(c)-1(f)(5) (as quoted in the opinion; emphasis is the court’s).

If a gift is reported as complete and is adequately disclosed on a gift tax return, the period of limitations on assessment of additional taxes commences with the filing of that return even if the transfer is ultimately determined to be an incomplete gift.

- (2) **Statute.** If a gift is not reported on a gift tax return, gift taxes may be assessed at any time. The statute provides an exception for “any item which is disclosed in [a gift tax return], or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item.” §6501(c)(9). A similar statement is in the statute for the six-year limitations period that applies if omitted gifts exceed 25 percent of the gifts reported on a gift tax return. The six-year limitations period does not apply to any item “disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the [IRS] of the nature and amount of such item.” §6501(e)(2). The court summarized the “essence” of the statute as providing the IRS “with a viable way to identify gift tax returns that should be examined with minimum expenditure of resources. T.D. 8845, 1999-2 C.B. 683.”
- (3) **Cases.** Cases generally have looked to the purpose of disclosure, and whether disclosure is sufficient to alert the IRS whether to select a return for examination. See *Thiessen v. Commissioner*, 146 T.C. 100, 114 (2016) (quoting *Estate of Fry v. Commissioner*, 88 T.C. 1020, 1023 (1987) (cited in the *Schlapfer* opinion). **Observation:** These are income tax cases addressing the application of the adequate disclosure exception in §6501(e)(1)(B)(iii) for purposes of the six-year limitations period where there is an omission of more than 25% of gross income. Both cases found that the taxpayer had not adequately disclosed omitted income. See Item 14.e(4) below regarding case discussions.]
- (4) **Regulations.** Regulations, finalized in November 1999, are effective for gifts made after December 31, 1996.
- (a) **First Sentence – General Rule.** The first sentence of the regulation, tracking the statute, states a general rule: “A transfer will be adequately disclosed on the return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported.” Reg. §301.6501(c)-1(f)(2).
- (b) **Second Sentence – Information So Gift “Considered Adequately Disclosed.”** The next sentence provides information describing the gift and its valuation that, if disclosed, will result in a gift being “considered adequately disclosed.” The opinion lists five items of information

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and subsequently analyzes whether those five items were supplied. The five elements in the regulation, as excerpted in the opinion, are:

- (i) A description of the transferred property and any consideration received by the transferor;
- (ii) The identity of, and relationship between, the transferor and each transferee;
- (iii) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;
- (iv) Except as provided in §301.6501(c)-1(f)(3), a detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property....; and
- (v) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer ....

Reg. §301.6501(c)-1(f)(2).

- (c) **Second Sentence "Requirements" Are Not Mandatory but Act as Guidance.** The opinion's introduction of the adequate disclosure regulation unfortunately does not refer to a general rule and a safe harbor. Some planners view the regulations as providing a general rule (apprising the IRS of the nature of the gift and the basis for its valuation) and two safe harbors: (1) a "description safe harbor," and (2) an "appraisal safe harbor." The opinion analyzes in some detail whether the elements in the "description safe harbor" are satisfied. The discussion of one of those elements, however, clearly recognizes the first sentence as a required rule and the listed elements in the second sentence as "not mandatory, but ... as guidance to taxpayers to inform them on a way to satisfy adequate disclosure":

Furthermore, the Treasury Regulations provide that *[First Sentence]* "[a] transfer will be adequately disclosed . . . only if it is reported in a manner adequate to apprise the [IRS] of the nature of the gift . . . *[Second Sentence]* Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed . . . if the return . . . provides the following information." Treas. Reg. § 301.6501(c)-1(f)(2) (emphasis added). The difference between the wording used in these two sentences informs us that the requirements are not mandatory, but act as guidance to taxpayers to inform them on a way to satisfy adequate disclosure. (Emphasis in original.)

**[Observation:** The court's description of the first sentence of the regulation (with its "only if" statement) sounds like the description of a general rule, and the description of the second sentence (with its "will be considered adequately disclosed" statement) sounds like a safe harbor, although the court did not use those precise terms. Indeed, the court refers to the elements of what many regard as a safe harbor in the second sentence as "requirements," albeit "requirements" that it views as "not mandatory" but only as guidance of what is "sufficient to alert the [IRS] to the nature of the gift." The opinion makes no reference to the appraisal safe harbor, which is an objective way of supplying the information required in subparagraph (iv) of Reg. §301.6590(c)-1(f)(2) about the method used to value the property.]

- (5) **Disclosure Contents That Can Be Considered.** In this case, the gift tax return was submitted in a package with various other documents. Donor pointed to four documents, in particular, that support his claim of adequate disclosure: (1) the 2006 gift tax return; (2) a protective filing statement attached to the gift tax return; (3) Schedule F of Form 5471 for his 2006 federal income tax return; and (4) the Offshore Entity Statement. The court concluded that all these could be considered.

The court observed that "[w]hen deciding whether an item has been adequately disclosed, we may consider not only a return, but also documents attached to the return plus information documents referenced in the return." The court reasoned that the gift tax return was part of the OVDP disclosure packet with this information and the protective filing attached to the gift tax return referenced controlled foreign company (CFC) stock, "which alerted the IRS to look to the Offshore Entity Statement for information on the gift referred to in the gift tax return."

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- (6) **Strict Versus Substantial Compliance.** The opinion concludes that substantial compliance will suffice. In the preamble to the adequate disclosure final regulations, the IRS rejected a recommendation that the regulations should expressly allow substantial compliance because of the difficulty in defining and illustrating what would constitute substantial compliance. T.D. 8845, 1999-2 C.B. at 685. However, the preamble said its rejection of that recommendation did not mean “that the absence of any particular item or items would necessarily preclude satisfaction of the regulatory requirements, depending on the nature of the item omitted and the overall adequacy of the information provided.”

The court viewed that statement as acceptance by the Department of Treasury of “the very essence of substantial compliance. Therefore, we conclude that the adequate disclosure requirements can be satisfied by substantial compliance.”

(7) **Substantial Compliance with Elements of the Description “Requirements.”**

- (a) **Description of Property and Consideration Received.** Donor actually gave the UVL policy, but the gift tax return, protective filing, Offshore Entity Statement, and Form 5471 for the 2006 income tax return described the gift of EMG shares valued at \$6,056,686 to his mother on July 6, 2006, and described the number and type of EMG shares. Donor did not strictly comply with the description “requirement” because he did not reference or describe a transfer of a life insurance policy. However, Donor substantially complied sufficient to alert the IRS to the nature of the gift.

As previously mentioned, disclosure is adequate if it is sufficiently detailed to alert the Commissioner to the nature of the transaction so that the decision to select a return for audit is reasonably informed. *Thiessen*, 146 T.C. at 114. ...

Mr. Schlapfer provided enough information to satisfy this requirement through substantial compliance. While he may have failed to describe the gift in the correct way (assuming the gift is the UVL Policy), he did provide information to describe the underlying property that was transferred. Mr. Schlapfer asserts that he chose to disclose the assets held in the insurance policy instead of the actual policy because the OVDP required him to disregard entities holding foreign assets. The UVL Policy’s value comes primarily from EMG stock, so Mr. Schlapfer’s describing the transferred property as EMG stock goes to the nature of the gift. Because this description was sufficient to alert the Commissioner to the nature of the gift, Mr. Schlapfer substantially complied with this requirement.

- (b) **Identity of Parties.** Donor did not strictly comply with the “requirement” of identifying the identity of, and his relationship to, each transferee. The Offshore Entity Statement stated that the gift was made to Donor’s mother, with no mention of his aunt or uncle. Nevertheless, Donor substantially complied with this “requirement.” The statement listing Donor’s mother as the transferee provided the IRS with enough information to understand the donee was a “member of his family,” and failing to provide the names of his aunt and uncle “does not make a meaningful difference in understanding the nature of the transfer.”
- (c) **Method to Determine Value of Gift.** The regulation refers to providing “a detailed description of the method used to determine the fair market value of property transferred, including” considerable detailed information for different types of property. Donor did not provide any statement describing how he valued the fair market value of the gift. Also, he did not provide all the detailed financial information listed in the regulation, but he did provide all documents listed in the instructions to Form 709 for stock of close corporations (“attach balances sheets, particularly the one nearest the date of the gift, and statements of net earnings or operating results and dividends paid for each of the 5 preceding years”). That was enough to show the IRS how he valued the EMG stock, and the UVL policy value stems primarily from the EMG stock, so he substantially complied with this “requirement”:

Although Mr. Schlapfer did not provide all the financial documentation listed in the regulation, he provided the information identified in the 2006 Form 709 instructions, which was enough to show the IRS how he determined the fair market value of the EMG stock. Therefore, he substantially complied with this requirement.

Furthermore, Mr. Schlapfer substantially complied even if the gift is the UVL Policy. The UVL Policy’s principal asset is the EMG stock, and the documents we considered above were enough to apprise the

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Commissioner of the method used to determine the fair market value of the EMG stock. Because the UVL Policy's value stems primarily from the EMG stock, those same documents can be used to illustrate the method used to determine the fair market value of the UVL Policy.

e. **Observations.**

- (1) **Most Attractive Aspect of Opinion (From Taxpayer Perspective).** The IRS has been aggressive in applying the adequate disclosure requirements strictly, to prevent the running of the gift tax statute of limitations. IRS notices and informal guidance have generally been very strict (and sometimes harsh) in applying the requirements, including treating the elements of the safe harbors in the regulations as mandatory requirements. This case is the **first case** to address in any detail what constitutes substantial compliance with the adequate disclosure regulations. The case takes a **very reasonable approach** to finding that substantial compliance exists despite various instances of failing to comply with the guidelines in the regulations. There have been few cases discussing the gift tax adequate disclosure regulation.

The case also recognizes that the various elements of what is known as the "description safe harbor" are not mandatory requirements but merely "guidance to taxpayers to inform them on a way to satisfy adequate disclosure."

- (2) **Most Concerning Aspect of Opinion (From Taxpayer Perspective).** Unfortunately, the case does not clearly analyze the adequate disclosure regulations as stating a general rule (apprising the IRS of the nature of the gift and the basis for its valuation) and two safe harbors: (1) a "description safe harbor," and (2) an "appraisal safe harbor." All the detailed elements of either safe harbor would not necessarily have to be satisfied in order to satisfy the general rule. Even though the court does not use the terms general rule and safe harbors, the court's analysis has the same general effect. It recognizes that the detailed "requirements" of the "description safe harbor" are not mandatory but merely "guidance [of] a way to satisfy adequate disclosure."

In any event, the court did not discuss directly whether the disclosure was sufficient to "apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported" aside from other "requirements."

- (3) **A Little History; Taxpayer Relief Act of 1997.** The Taxpayer Relief Act of 1997 made substantial changes to the statute of limitations applicable for gift taxes and for determining the amount of adjustable taxable gifts for estate tax purposes.
- (a) **Unlimited Period of Assessment for Gifts Not Adequately Disclosed.** The Omnibus Budget Reconciliation Act of 1990, while adding Chapter 14 to the Code, also added §6501(c)(9), providing an unlimited period for assessment of gift tax for gifts valued under §2701 or §2702 that were not adequately disclosed on a gift tax return. The 1997 Act amended §6501(c)(9), effective for all gifts after 1996, to extend the unlimited period of assessment for gift taxes to all gifts that are not adequately disclosed on a gift tax return, even if a return was filed for the year but did not adequately disclose such particular gifts.
- (b) **No Requirement To Pay Gift Tax To Commence Period of Limitations.** Prior to the 1997 Act, the three-year statute of limitations, for assessment of gift tax and for determining the amount of gifts in preceding calendar quarters, would begin to run on gifts in a year in which a gift tax return was filed *and gift tax was paid*. §2504(c). Effective for gifts made after August 5, 1997, the requirement of paying gift tax for limitations to begin running was deleted.
- (c) **No Revaluation for Estate Tax Purposes.** Prior to the 1997 Act, gifts could be revalued at the donor's death for purposes of determining the amount of adjusted taxable gifts added into the estate tax calculation, but the effect was merely possibly to push the estate into higher estate tax brackets. *Estate of Smith v. Commissioner*, 94 T.C. 872 (1990), *acq.* 1990-2 C.B. 1. The 1997 Act changed that and provides that gifts adequately disclosed on a gift tax return and for which the period of limitations on assessment of gift tax has run cannot be revalued for estate tax purposes. §2001(f) (effective for gifts made after August 5, 1997).

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- (d) **Regulations.** Regulations were proposed to implement the changes under the 1997 Act on December 21, 1998, and were finalized on November 18, 1999. The proposed regulation had stated that a gift would be adequately disclosed “only if” specified information is included in the return. This was changed in the final regulations, which require that a gift be reported “in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and basis for the value so reported.” Reg. §301.6501(c)-1(f)(2). The next sentence says that gifts “will be considered adequately disclosed” if the return provides the information listed in five subparagraphs.
- (e) **Resource.** For a detailed discussion of the history of the Taxpayer Relief Act of 1997 and the adequate disclosure regulations, see Ronald Aucutt, *The Statute of Limitations and Disclosure Rules for Gifts* (July 2022), found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights)).
- (4) **Prior Cases.** This is the **first reported case** with a detailed analysis of the requirements for adequate disclosure under Reg. §301.6501(c)-1(f)(2). Many cases, though, have discussed the six-year statutes for substantial omissions of gross income (now §6501(e)(1)(B)(iii) or of gross estate assets or gifts (§6501(e)(2)) with their similar exception for adequate disclosures.
- (a) **Income Tax Cases.** The Supreme Court, in addressing a situation governed by the predecessor of §6501, referred to the fact that “the return on its face provides **no clue** to the existence of the omitted item.” *The Colony, Inc. v. Commissioner*, 357 U.S. 28, 36 (1958) (emphasis added).

An oft-quoted case is *George Edward Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), *aff'd on other grounds*, 444 F.2d 90 (8th Cir. 1971). That case held that a partnership’s receivables for services constituted income in respect of a decedent, and a §754 election for the partnership did not result in a basis increase for the receivables attributable to the estate’s interest in the partnership. A second issue was whether a deficiency was time barred by the three-year period of limitations or open to adjustment under the six-year period of limitations for substantial omissions of gross income if the income was not adequately disclosed. The court held that the estate’s and partnership’s income tax returns could both be considered. The court reasoned that a schedule on the partnership return revealed distributions of ordinary income of \$1,561.13 (which the partnership had calculated incorrectly assuming a basis increase had occurred for the receivables) and also reported withdrawals by, and distributions to, the estate of \$32,587.50. The difference between those numbers exceeded the additional amount of asserted income that should have been reported.

Under these circumstances, we think that the “amount” of the omitted income was sufficiently disclosed. Nothing in the statute requires disclosure of the exact amount. See *Cardinal Life Insurance Co. v. United States*, 300 F. Supp. 387, 393 (N.D. Tex. 1969) [footnote omitted]. **The touchstone in cases of this type is whether respondent has been furnished with a “clue” to the existence of the error.** See *Benderoff v. United States*, 398 F. 2d 132, 136 (C.A. 8, 1968); *Louis Lesser*, 47 T.C. 564, 590 (1967); see also *Colony, Inc. v. Commissioner*, 357 U.S. 28, 36 (1958). **Concededly, this does not mean simply a “clue” which would be sufficient to intrigue a Sherlock Holmes. But neither does it mean a detailed revelation of each and every underlying fact.**

The respondent had clear notice that the estate received from the partnership an amount far in excess of the amount reported on the estate’s return. We think that this, together with the information revealed by the balance sheet on the partnership return, constituted compliance with the statutory requirement. Consequently, we hold that the year 1961 is barred. *Colony, Inc. v. Commissioner*, *supra*; *Benderoff v. United States*, *supra*; *Genevieve B. Walker*, 46 T.C. 630 (1966). (Emphasis added.)

The *Schlapfer* opinion cites *Thiessen v. Commissioner*, 146 T.C. 100 (2016), and *Fry v. Commissioner*, 88 T.C. 1020 (1987). Both of those cases also involved the income tax six-year period of limitations adequate disclosure exception. *Thiessen* concluded that the income tax return “offers not even a clue as to the existence, nature, or amount of any omitted income.” The *Thiessen* court described the standard for testing adequate disclosure as follows.

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A disclosure is “adequate” if it is “sufficiently detailed to alert the Commissioner and his agents as to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one.” *Estate of Fry v. Commissioner*, 88 T.C. 1020, 1023 (1987); see also *Colony, Inc. v. Commissioner*, 357 U.S. 28, 36 (1958). The disclosure need not detail every underlying fact but must be more substantial than simply providing a clue that would intrigue the likes of Sherlock Holmes. See *Quick’s Tr. v. Commissioner*, 54 T.C. 1336, 1347 (1970), *aff’d*, 444 F.2d 90 (8th Cir. 1971); see also *White v. Commissioner*, 991 F.2d 657, 661-662 (10th Cir. 1993), *aff’g* T.C. Memo. 1991-552. The test is whether a reasonable person would discern from the return that the disputed gross income is omitted. See *Univ. Country Club, Inc. v. Commissioner*, 64 T.C. 460, 471 (1975).

In *Fry*, the return included a statement describing a sale of stock, presumably to an unrelated party, without disclosing that it was a redemption transaction (which involves possible dividend consequences and warrants “special scrutiny” as a transaction between a corporation and one of its two equal shareholders). If the transaction had been described as a redemption, “the clue would have been fully sufficient to invoke the [adequate disclosure] exception.” The *Fry* court stated this as its standard for adequate disclosure:

The statement must be sufficiently detailed to alert the Commissioner and his agents as to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one. *Benderoff v. United States*, [398 F.2d 132 (8th Cir. 1968)].

- (b) **Estate Tax Case.** Section 6501(e)(2) provides a six-year limitations period for assessing estate or gift tax if there have been substantial omissions of more than 25 percent of the reported gross estate or gifts, and it includes an adequate disclosure exception similar to the six-year income tax statute discussed above. *Estate of Williamson v. Commissioner*, T.C. Memo. 1996-426, analyzed §6501(e)(2) by looking to the standards described in the parallel six-year limitations period for substantial omissions of income in §6501(e)(1):

Although no estate tax cases have been found interpreting section 6501(e)(2) of the code [footnote omitted], an examination of section 6501(e)(1) and (2) shows that the two are in *pari materia* in dealing with the same subject — the application of the statute of limitations — and, accordingly, we may give due consideration to income tax cases in deciding estate tax cases on this same subject.

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This Court has interpreted the Supreme Court's “clue” standard to mean not “a detailed revelation of each and every underlying fact”, but also that it “does not simply mean a clue which would be sufficient to intrigue a Sherlock Holmes.” *Quick Trust v. Commissioner*, 54 T.C. 1336, 1347 (1970), *aff’d*, 444 F.2d 90 (8th Cir. 1971). Furthermore, in interpreting this statutory language (common to both income and estate tax provisions) in section 6501(e), relating to the omission as “disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item”, we have held that disclosure of the omitted material is adequate, even without disclosing exact dollar amounts. *Quick Trust v. Commissioner*, *supra*; *University Country Club, Inc. v. Commissioner*, 64 T.C. 460, 470 (1975); *Morris v. Commissioner*, T.C. Memo. 1966-245. The disclosure statement however must be sufficiently detailed so that a decision whether to select the return for audit may be a reasonably informed one. *Estate of Frane v. Commissioner*, 98 T.C. 341, 355 (1992), *aff’d*, in part and *rev’d*, in part 998 F.2d 567 (8th Cir. 1993).

*Estate of Williamson* pointed to a statement in the extension request for filing the estate tax return that a reason for the delay was the inability to list and value items in the estate because of a dispute between the estate and the surviving husband. That statement was attached to the estate tax return when filed. The court concluded that gave “adequate notification” to the IRS of the reasons for failing to itemize and value specific items, and therefore the six-year statute did not apply.

- (c) **Gift Tax Cases.** Several gift tax cases have addressed the six-year limitations period for substantial omissions of more than 25% of gifts reported on a gift tax return in §6501(e)(2), but without any detailed discussion of the standard for adequate disclosure. *Daniels v. Commissioner*, T.C. Memo. 1994-591 (no gift was omitted but the dispute was merely over the value of gift arising from the reported transaction); *Estate of Robinson v. Commissioner*, 101 T.C. 499, 516 (1993) (incorrectly claiming excess annual exclusions is not the omission of a gift, so the six-year limitations period did not apply).

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Other cases have touched on §6501(c)(9) (as amended in 1997), but without any detailed discussion of the standards for adequate disclosure. *Estate of Sanders v. Commissioner*, T.C. Memo. 2014-100 (denied executor's motion for summary judgment that assessment of additional gift tax for gifts made by the deceased donor was time barred; a genuine dispute of material fact existed as to whether gift tax returns adequately disclosed the nature of gifted stock and the basis of its valuation; IRS contended that the returns failed to disclose the company's ownership of another closely-held entity); *Estate of Brown v. Commissioner*, T.C. Memo. 2013-50 (decendent as trustee of marital trust reported related-party installment sales on the trust's income tax return but did not report the transaction on a gift tax return; court cited §6501(c)(9) and Reg. §301.6501(c)-1(f)(4) but without any significant discussion of the adequate disclosure standards).

- (5) **IRS Guidance.** Informal IRS guidance from the IRS Chief Counsel's office or from IRS field attorneys have viewed the safe harbors in the adequate disclosure regulations as if they were substantive requirements rather than safe harbors for satisfying the general rule.
- Chief Counsel Advice 200221010 (gift was made before the effective date of the adequate disclosure regulation but "the principles upon which [the regulations] are based are implicit in section 6501(c)(9) itself"; return did not have an adequate description of the gifts because it did not describe the number of units of the LLC that were transferred, the percentage of ownership those units represented, or the nature of the Class B interests; the Advice was issued less than a month after the three-year statute ran, suggesting that the gift must have been under examination before that time, so apparently there was enough information on the return to alert the IRS it should be selected for examination, which is the general purpose of the adequate disclosure exception).
  - Chief Counsel Advice 201024059 (referencing §6501(c)(9) but with little analysis of the requirements for adequate disclosure).
  - Legal Advice Issued by Field Attorneys (LAFA) 20152201F (description safe harbor "requirements" not satisfied; names of partnerships were abbreviated, "LP" and "LLP" designations were omitted from the names of the partnerships, the return describes the transfer of "partnership interests" without explaining whether they were general, limited, or limited liability interests, employer identification number of one partnership was missing a digit, appraisals attached to the return valued the land held by each partnership but not the partnership interests themselves; acknowledged that IRS bears burden of proving that an exception to the three-year state of limitations applies).
  - Legal Advice Issued by Field Attorneys (LAFA) 20172801F (no gift tax returns filed for years 1-6 and return for year 7 did not describe property transferred or a description of the method used to determine the value of that property).

These Advice documents are all described in more detail in Ronald Aucutt, *The Statute of Limitations and Disclosure Rules for Gifts* (July 2022), found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights)).

(6) **Safe Harbors in Adequate Disclosure Regulation.**

- (a) **Description Safe Harbor.** The five elements of the description safe harbor are listed in Item 14.d(4)(b) above, as summarized in the *Schlapfer* opinion.
- (b) **Appraisal Safe Harbor.** The appraisal safe harbor is a way of satisfying the fourth subparagraph (the method to determine fair market value). Reg. §301.6501(c)-1(f)(3). The remaining elements of the description safe harbor (in Reg. §301.6501(c)-1(f)(2) (i)-(iii), (v)) are also applicable. The Appraisal Safe Harbor regulation provides details about who are qualified appraisers and the appraisal contents. The appraisal safe harbor may be a more objective way of supplying information about the method to determine the fair market value of property than the more generic information about fair market value listed in the description safe harbor.

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(c) **Approaches for Satisfying the Appraisal Safe Harbor.** The appraisal safe harbor specifies that the appraisal, among other things, contain “[t]he date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.” Reg. §301.6501(c)-1(f)(3)(ii)(A). But if a donor wants to make a gift of a certain value (or approximate value), how does the donor proceed? As a practical matter, the appraisal cannot possibly appraise the asset as of the date of the gift and be written and delivered on the same day prior to the gift later in the day. Alternatives include:

- Use an appraisal dated as close in time to the gift as possible (assuming economic conditions have not changed) and be ready to argue that the information is sufficient to satisfy the general rule of the adequate disclosure regulations (apprising the IRS of the nature and basis of valuation of the gift), or that the disclosure substantially complies with the appraisal safe harbor.
- Financial information may be available only through the end of some prior month or quarter preceding the transfer. As a practical matter, the appraiser cannot do anything other than to rely on the recently available data but note whether the financial conditions are generally the same. Hopefully, the appraisal can refer to interviews with management representing that no material changes in operations have occurred from the date of the financial data until the date of the transfer.
- Use a *Wandry* transfer on the date of the gift and obtain an appraisal later appraising the asset as of that date (to determine an estimate of the number of units transferred to include on the gift tax return before the value is finally determined for gift tax purposes). See *Wandry v. Commissioner*, T.C. Memo. 2012-88.
- Use a *Nelson* formula transfer, transferring assets having a specific value as determined by an appraisal by a designated appraisal firm to be completed within, say, 90 days after the transfer. See *Nelson v. Commissioner*, 128 AFTR 2d 2021-6532, Cause No. 20-61068 (5th Cir. November 3, 2021), *aff’g*, T.C. Memo. 2020-81. The IRS does not find that abusive. By the time the gift tax return is filed, the appraisal report will have been delivered and the precise number of shares that were transferred will be known and reported on the gift tax return. Obviously, that approach provides no protection against additional gift taxes in the event of an examination. The key distinction from a classic defined value type of transfer is that the formula number of units being transferred is determined by an appraisal within 90 days of the gift, not by values as finally determined for federal gift tax purposes. For a summary of *Nelson*, see Item 11 of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- Obtain an appraisal before the gift is made, transfer the number of assets required to equal the targeted gift amount based on the value in that appraisal, and negotiate with the appraiser to update the appraisal as of the actual date of the transfer. Most appraisers will do that for a small additional fee (assuming major economic changes have not occurred in the meantime).
- Alternatively, negotiate for the appraiser to simply re-issue the appraisal and add a sentence stating the date of the transaction. The safe harbor regulation does not require that the appraisal be prepared as of the transaction date but merely that the appraisal state “[t]he date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.” However, if economic conditions have changed in the meantime, reliance on the appraisal prepared as of the prior date may not be deemed to be reasonable.

(7) **Non-Gift Transactions.** Many planners encourage clients to file gift tax returns to report non-gift transactions (e.g., sales) to start the statute of limitations. Otherwise, the possibility of owing gift tax on an old transaction is always present.

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The adequate disclosure regulations expressly permit reporting non-gift completed transfers to start the statute of limitations in case the IRS were to later assert that the transaction had a gift element. That is permitted even if a gift tax return would not otherwise be required. Examples include sales purportedly for full value, transfers qualifying for the annual exclusion (Reg. §301.6501(c)-1(f)(7), Ex.2), transfers made in the ordinary course of business (Reg. §301.6501(c)-1(f)(7), Ex. 6), or transfers reported as complete but that are determined to be incomplete because of a retained power or interest (Reg. §301.6501(c)-1(f)(5)).

The regulation for non-gift transactions states that the transfer will be considered adequately disclosed “only if” (1) information in four of the five items in the second sentence of Reg. §301.6501(c)-1(f)(2) are provided (the items other than valuation information) and (2) an explanation states why the transfer is not a gift. Reg. §301.6501(c)-1(f)(4). Thus, under the regulations the four items are not merely a safe harbor but must be provided to constitute adequate disclosure of a non-gift transaction. They are (i) description of the transferred property and any consideration received, (ii) identity and relationship of the transferee, (iii) specified information about the trust recipient if the transfer is made to a trust, and (iv) a statement describing any position contrary to regulations or rulings published before the transfer. Interestingly, valuation information is not required, even though it would seem to be very relevant in determining whether a sale was for full consideration so that the transfer was a non-gift transaction.

- (8) **Split Gifts.** For split gifts under §2513, compliance with the adequate disclosure requirements by the donor spouse will be treated as adequate disclosure by the consenting spouse. §301.6501(c)-1(f)(6).
- (9) **Late Disclosure.** Disclosure to start the gift tax statute of limitations must be made “on a gift tax return ... or a statement attached to the return.” §301.6501(c)-1(f)(1). If a gift tax return does not make adequate disclosure, how can that be corrected since the gift tax rules do not specifically authorize amended gift tax returns? Rev. Proc. 2000-34, 2000-2 C.B. 186, provides the answer. An amended return may be filed (i) with a special caption at the top of the return, (ii) identifying the transfer in question, and (iii) supplying the additional information to constitute adequate disclosure. The amended return procedures do not apply to fraudulent returns or to willful attempts to evade tax. Rev. Proc. 2000-34 applies to amended returns filed beginning August 22, 2000.

## 15. Ethics and Privilege Landmines with Transfer Planning, Gifts, and Form 709

This is a summary of some observations from a presentation by Stephanie-Loomis Price (Seattle, Washington) and Christine Wakeman (Dallas, Texas) at the 57th Annual Heckerling Institute on Estate Planning™.

- a. **Potential Conflicts of Interest with Joint Representation of Clients Making Gifts.** Potential conflicts of interest between spouses could arise in various situations involving gifts by clients, including (i) SLAT by one spouse to another (resulting in substantial wealth-shift of marital property, (ii) SLAT by both spouses because differences to make the SLATs non-reciprocal result in differences favoring one spouse over the other, (iii) partitions and exchanges between spouses, (iii) split gift election because if unexpected indirect gifts occur, both spouses have joint and several liability for the gift tax, and (iv) split gift election because if the transferred assets are included in the transferor’s gross estate there is no recovery of gift exemption used by the other spouse.

Under the ABA Model Rules of Professional Responsibility (Model Rules) §1.7, a lawyer “shall not” represent clients if a concurrent conflict of interest exists where the representation of one client would be directly adverse to the other client. Under Rule 1.7(b), though, an exception arises if the lawyer reasonably believes he or she can give competent and diligent representation to each client and each of the clients gives informed consent. Under Rule 1.0(e), informed consent requires that the attorney communicates material risks and reasonably available alternatives to the proposed course of conduct. That communication might include a discussion of material risks of conflicts and that the clients might be better served by having separate representation.

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If one spouse should tell the lawyer that he or she will separate from the other spouse but directs the lawyer not to tell the other spouse, the lawyer could not satisfy the obligation under Model Rule 1.4 including Rule 1.4(a)(3) to “keep the client reasonably informed about the status of the matter” and the lawyer may have to withdraw from the representation (so held by a Georgia Ethics Opinion).

b. **Privilege Issues.**

- (1) **“The Privilege.”** The attorney-client privilege is often referred to as “the privilege.” It is an evidentiary rule, not an ethics rule, protecting an attorney’s legal advice from disclosure in discovery.
- (2) **Client Waiver.** Only the client (not the attorney) has the authority to waive the privilege. However, an inadvertent disclosure by the attorney may waive the privilege (in which event the attorney would have to consider the attorney’s ethical duties to the client).
- (3) **Contrasting Ethical Rule of Confidentiality.** Model Rule 1.6 requires that attorneys not disclose confidential information, including the identity of clients. The lawyer’s duty to maintain confidences is an ethical duty, and violations can give rise to a cause of action against the attorney. The attorney-client privilege is an evidentiary doctrine, typically defined by statute. Communications subject to the confidentiality restriction are not necessarily privileged. Under certain circumstances, the duty of confidentiality may be waived.
- (4) **Waiver of Privilege Often Is Needed in Transfer Tax Cases.** The taxpayer has the burden of proof and burden of production in tax cases. Often the taxpayer needs evidence of advice from the attorney to establish needed elements of a defense. For example, establishing a defense to a §2036 attack based on the bona fide sale exception may be facilitated by the attorney’s contemporaneous records regarding the legitimate and significant nontax reasons for creating an entity. Also, the attorney’s tax opinion may be essential to establishing a reasonable cause exception to an undervaluation penalty. As a result, the planning attorney should operate under the assumption that everything said or written by the attorney will eventually be seen by an IRS attorney or a judge.
- (5) **Communications With Non-Client Family Members.** Disclosures to anyone other than the client can waive the privilege. If a family member arrives at the attorney’s office with a client, the attorney could ask the client to wait in the waiting room until needed, or the family member may be appointed as an agent to assist on the tax planning matters. (Use a power of attorney very narrowly limited to tax issues.)
- (6) **Other Matters Not Covered by the Privilege.** Other documents and communications not covered by the privilege include –
  - The attorney’s work papers (though they may be protected by the work product doctrine).
  - Correspondence or communications with third parties.
  - Attorney bills and invoices (disclose enough to convince the client to pay the bill but not problematic details; for example, “consider section 2036 issues” is ok, but do not add details about why section 2036 might apply).
  - Tax return preparation advice.
  - Dual purpose business and tax advice; if the business advice is not the primary purpose of the advice, the advice might not be protected.
  - Tax opinions arguably are not privileged.
  - Delivery method could be available to third parties (one court said that putting documents in a Drop Box account caused loss of the privilege; “the more you can meet and deliver advice in person, the better”).
- (7) **Kovel Letters.** The privilege may apply as to an outside person that has helpful information to assist the attorney representing the client if the person has a particular skill the attorney does not

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have. The attorney should send the individual a “Kovel letter” engaging the person to assist the attorney. Requirements include (i) hiring a consultant, (ii) at the attorney’s direction, (iii) not just for return preparation work, (iv) with an agreement that the work belongs to the attorney, (v) to assist in delivering legal advice. Pre-Kovel communications are likely not privileged.

Consider using a very broad Kovel letter, providing that everything the individual does and all of the individual’s work papers belong to the lawyer. That provision protects the client and the third person. The best practice is for the attorney actually to keep the work papers so they are not in the other party’s files at all. For example, if a CPA is assisting the attorney and the CPA receives a subpoena to produce all items in the CPA’s possession related to the matter, the work papers would not be produced.

Some believe that the lawyer must pay the third-party, but most believe that the client has the responsibility of paying the third-party, even though the third party is engaged by the attorney.

(8) **Appraisers.**

- Having the attorney hire the appraiser is a good idea, but do not create the impression that doing so causes all communications with the appraiser to be privileged.
- Once a report of an expert is attached to a return, it is not privileged.
- Advise the appraiser not to communicate with the attorney by emails, text messages, voice mail messages, or in writing. The attorney will call the appraiser and have oral conversations.

c. **Disclosing Risks to Clients.**

(1) **No Fiduciary Duty to Elevate Client’s Interest Above Attorney’s Interest.** The Model Rules in no place state that the attorney is in a fiduciary role for the client and must elevate the client’s interest above the attorney’s interest. Model Rule 16 suggests that attorneys cannot place their own interests above the interests of their clients, but they do not have to elevate their clients’ interests above their own interests.

(2) **Disclosing Tax Risks.** The attorney will have an interest in fully disclosing tax risks of transactions, but disclosure (if eventually disclosed because of an inadvertent waiver of the privilege or a knowing waiver of the privilege) could provide a roadmap to the IRS of tax attacks.

Disclosing tax effects of transactions can often be advantageous to the client as well as the attorney, even if the IRS sees the communication. Even if that is not the case, the attorney should make sure to disclose enough to protect against a later malpractice claim (and the selective memory of a client). Such disclosure is often an art. For example, advise that “having time lapse between possible transactions would be advisable” is better than “delay the second transaction by three days to you don’t tip off the IRS.”

(3) **Do Not Consider Likelihood of Audit.** Circular 230, §10.37(a)(2)(vi) states that in giving advice the tax practitioner “must ... [n]ot, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.” The attorney may think in the course of giving tax advice that the possibility that a return will not be audited is low “but never let it cross your lips.”

(4) **“Can’t We Just ...?”** When a client asks, “can’t we just ...,” the answer is probably no. It is not in the client’s best interest to cut corners.

d. **Adequate Disclosure.** In order to be assured that the 3-year statute of limitations has started for assessing additional gift tax, the gift tax return must meet the adequate disclosure requirements of §6501(c)(9) and Reg. §301.6501(c)-1(f)(1). The IRS has been aggressive in applying the requirements very strictly to prevent the running of the gift tax statute of limitations. Some return preparers include an adequate disclosure statement on the gift tax return, explaining in detail how all the requirements of the regulation are satisfied. Stephanie Loomis-Price recommends not including an adequate disclosure statement on Form 709. It is not required, and some of the requirements are not totally

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objective. She recommends complying with the regulation, “but let the IRS ask you about it if they think something is wrong.” See Item 14 above for a summary of *Schlapfer v. Commissioner*, T.C. Memo. 2023-65, and more discussion about the adequate disclosure requirements.

- e. **Amending Form 709.** If a planner discovers that a gift has not been properly reported on a gift tax return, should the return be amended? Under Circular 230 §10.21, the tax practitioner’s duty is to inform the client of noncompliance and that the return could be amended, but that decision is for the taxpayer. The return preparer does not have a duty to amend the return.

Rev. Proc. 2000-34 authorizes filing amended gift tax returns where the return as originally filed does not satisfy the adequate disclosure requirements and supplies “magic language” for the top of the amended Form 709: “Amended Form 709 for gift(s) made in [insert the calendar year that the gift was made] – in accordance with Rev. Proc. 2000-34, 2000-34 I.R.B. 186.”

- f. **Form 2848, Power of Attorney.** A danger with having Form 2848 for taxpayers based on prior matters is that the Form stays on file until the attorney withdraws as the attorney of record, and communications from the IRS for the taxpayer may be sent to the attorney (and perhaps sent to an old address for the attorney). A CAF 77 listing is a complete listing of all clients for a given representative under that CAF number and may be obtained via a Freedom of Information Act (FOIA) request. The web address for a CAF 77 request is:

<https://www.irs.gov/privacydisclosure/freedom-of-informationact-foia-guidelines>. The practitioner should notify the CAF function in writing if there is a change of address. A request for withdrawing from representation must be in writing, list all tax matters and period, and contain the representative’s signature and date.

## 16. Installment Sales

This summary is an overview of a few of the comments by Paul Lee (New York, New York) and a panel discussion by Paul and Cassady V. Brewer (Atlanta, Georgia) at the 57th Annual Heckerling Institute on Estate Planning™.

In most estate planning transactions, sales in exchange for promissory notes are between the grantor and a grantor trust so that there are no income tax consequences to the sale. However, grantor trust status is never permanent, and estate planners should be familiar with the basic rules applicable to taxable installment obligations and the income tax ramifications when grantor trust status is lost. The terms “Taxable Installment Note” and “IDGT Installment Note” will be used to differentiate between the two different sale transactions.

- a. **Installment Method Basics.** The installment method for deferring income first appeared in the Revenue Act of 1926 and is currently addressed in §453, §453A, and §453B.
- (1) **Gains, Not Losses.** The installment method is only available for transactions that result in a gain to the seller; it is not available for transactions that result in a loss.
  - (2) **Payment Elements.** Under the installment method, each payment received by the seller is comprised of: (1) a nontaxable return of basis, (2) a portion of the realized gain, and (3) taxable interest.
  - (3) **Basis.** The buyer immediately receives cost basis in the property, notwithstanding the deferred payment obligation.
  - (4) **Deductibility of Interest.** If the buyer is related, the interest paid will likely be treated as nondeductible personal interest under §163(h). If the buyer is not related, the interest paid is deductible.
  - (5) **Interest Rate.** While there are no requirements related to deferring or varying principal payments, interest charged must be at least the applicable federal rate under §1274(d) to avoid a portion of each installment being treated as imputed interest under §1272-§1275.

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- (6) **Term of Note.** The IRS has ruled that if the duration of the note is equal to or greater than the seller's life expectancy, then the obligation will be taxed as an annuity under §72 instead of the preferred installment method. GCM 39503 (5/19/86).
- (7) **Types of Qualifying Transactions.** The installment method is not available in certain transactions, including but not limited to, sales of marketable securities, dispositions by dealers of property, or the sale of depreciable property to related buyers.
- b. **Electing Out.** Section 453(d)(1) says that if a transaction qualifies as an installment sale, it will be taxed pursuant to the installment method as a default unless the seller elects out. A seller may prefer to elect out of the installment method for several reasons, such as: (a) wanting to offset the gain with unused losses; (b) planning for an expected increase in capital gain tax rates; (c) reducing the taxable estate (by the tax liability paid); or (d) eliminating items of IRD from the estate.
- c. **The Interest Charge and Pledge Rules.** Section 453A outlines two special installment method rules applicable to nondealers for transactions where the sales price exceeds \$150,000:
- (1) **Interest Charge Rule.** The Interest Charge Rule applies if the "obligation is outstanding as of the close of such taxable year," and the face amount of "all such obligations held by the taxpayer which arose during, and are outstanding as of the close of, such taxable year exceeds \$5,000,000." §453A(b)(2). Important for planning purposes is the fact that the IRS has ruled that the Interest Charge Rule is applied at the owner level as opposed to the entity level for partnerships and other pass-through entities. IRS Notice 88-81, 1988-2 C.B. 397. In addition, TAM 9853002 ruled that spouses are treated as separate taxpayers for purposes of the \$5 million threshold. If the obligation is subject to the Interest Charge Rule an amount is added to the taxpayer's tax liability for that year that is calculated pursuant to §453A(c)(2) and reported on Line 15 of Schedule 2 of Form 1040. The amount due will decrease over time unless tax rates rise in the future, or the obligation is interest-only with a balloon payment of principal at the end of the term.
- (2) **Pledge Rule.** Section 453A(d)(1) provides that if a taxpayer pledges an installment obligation as security for a loan, then the net proceeds from such loan will be treated as a payment received on such installment obligation. As noted earlier, one reason a taxpayer may not wish to utilize the installment method is if the taxpayer anticipates that capital gains tax rates will go up in the future. If a taxpayer is holding an installment obligation and would like to accelerate the income for that same reason (and the buyer is unable or unwilling to pay off the note early), the taxpayer could intentionally trigger the Pledge Rule by borrowing funds and pledging the installment obligation as collateral.
- d. **Resale Rule.** Section 453(e) states that if a taxpayer sells property to a related person under the installment method (the "first disposition"), and the related person then disposes of the property (the "second disposition") within two years and before making all payments to the original seller, the amount received by the related party on the second disposition is treated as payment received by the original seller in the first disposition (with limitations). If the second disposition is not a sale, the fair market value of the transferred property is substituted for the amount realized. § 453(e)(4). Under §453(e)(5), if the second disposition results in a deemed payment to the original seller, future payments received by the original seller are not treated as amounts received until the total of such actual payments received surpasses the deemed receipt triggered by the second disposition.
- e. **Transfers at Death.** Generally, death-related transfers are not taxable dispositions. A Taxable Installment Note is IRD and no basis adjustment is allowed under §1014. One situation in which there is a taxable disposition at death is if the obligation is distributed to the obligor on the note. A transfer by way of a joint tenancy with rights of survivorship is not a taxable disposition. If the estate made the sale, however, in return for a note, a subsequent transfer of the note from the estate to beneficiaries generally would cause the transferor immediately to recognize any remaining gain that has been deferred by the installment reporting method. §453B(a).
- f. **Losing Grantor Trust Status.** What happens to outstanding IDGT Installment Notes when grantor trust status is lost? If grantor trust status is lost while the note is outstanding, the obligation

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transforms from an IDGT Installment Note into a Taxable Installment Note on the effective date of the status change, and the rules of §453, §453A, and §453B now apply.

- (1) **Grantor Trust Status Terminated While Grantor Living.** The basis of an IDGT Installment Note becomes important if grantor trust status is lost during the grantor's lifetime or if the grantor transfers the note. However, we have no guidance about whether an IDGT Installment Note has basis or what that basis might be. Paul concludes "that the only sensible answer is the IDGT Installment Note can only have an adjusted basis equal to the property that was exchanged in the installment sale to the IDGT." Paul's paper also walks through various examples analyzing the basis of an IDGT Installment Note in the event grantor trust status is turned off after the sale, the grantor gifts the IDGT Installment Note after the sale, and the grantor substitutes assets after the sale and thereafter terminates grantor trust status.
- (2) **Grantor Trust Status Terminated at Grantor's Death.** An IDGT Installment Note will not be considered IRD like a Taxable Installment Note upon the death of the grantor while the note is outstanding. It is not possible for an IDGT Installment Note to be IRD as long as Revenue Ruling 85-13 remains effective, since IRD can only include amounts that would have been taxable "in the hands of the decedent if the decedent had lived and received such an amount." Section 691(a)(3). Instead, the IDGT Installment Note should be entitled to a basis adjustment upon the death of the grantor under §1014. The beneficiaries receiving the note will therefore be shielded from recognizing gain as they receive payments on the now Taxable Installment Note. However, the interest will be taxable.
- (3) **Other Issues.** Numerous other issues that arise upon the termination of grantor trust status and the conversion from an IDGT Installment Note to a Taxable Installment Note include:
  - (a) **Imputed Interest.** If interest on the IDGT Installment Note was at the AFR but AFR rates are higher at the time of the conversion, the holder of the obligation may have imputed interest at the higher AFR.
  - (b) **Interest Charge Rule.** The Interest Charge Rule likely applies to the Taxable Installment Note, requiring additional payments based on the deferred tax.
  - (c) **Pledge Rule.** The Pledge Rule likely applies as well.
  - (d) **Ineligible Transaction.** Immediate gain may be triggered if the assets sold were ineligible for installment method treatment, such as marketable securities.
  - (e) **Taxable Disposition.** The taxable dispositions rules in §453B will apply, and a gift of the Taxable Installment Note will result in a taxable payment to the holder of the note at the greater of face value or fair market value.
  - (f) **Basis Adjustment.** The Taxable Installment Note will be ineligible for the basis adjustment under §1014 and will instead be considered IRD at the death of the holder.
- g. **Planning with Partnerships.** Paul believes planning for installment obligations should be focused on the use of partnerships. His outline contains various techniques, including but not limited to:
  - As noted above, the \$5 million threshold for the Interest Charge Rule is applied at the partner level, as opposed to the partnership level. Therefore, a partnership can be used to multiply the threshold by the number of partners, enabling the partnership to reduce or avoid the additional charge when utilizing installment sales for high value property.
  - It may be possible to avoid triggering the Pledge Rule if the Taxable Installment Obligation is owned by a partnership, and the partnership interest is pledged as opposed to the obligation itself.

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## 17. Family Limited Partnership (FLP) and LLC Planning Developments; Planning in Light of *Powell, Cahill, Morrisette, Levine*

- a. **Overview of Section 2036 Issues.** For any overview discussion of §2036 issues for FLPs and LLCs, including the bona fide sale for full consideration defense and §2036(a)(1) retained interests, see Item 8 of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). About 35 reported cases have arisen. The cases seem to be decided largely on a “smell test” basis.

The most recent case applying §2036(a)(1) to an FLP was *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40 (April 7, 2020, Judge Holmes), *aff'd*, 128 AFTR 2d 2021-6604, Docket No. 20-73013 (9th Cir. Nov. 8, 2021). (It also had an interesting discussion of the application of §2043, following up on the discussion of §2043 in *Estate of Powell v. Commissioner*, with its own lengthy analysis, and the effect of a formula charitable transfer, which was the only subject of the appeal.) For a detailed discussion of *Estate of Moore*, see Item 20 of Estate Planning Current Developments and Hot Topics (March 2021) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- b. **Section 2036(a)(2).** In a few cases, the IRS has also made a §2036(a)(2) argument, that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the income or property contributed to the entity. Two cases have applied §2036(a)(2) where the decedent had some interest as a general partner (*Strangi* and *Turner*), and one case applied §2036(a)(2) when the decedent held merely a limited partnership interest (*Powell*, as discussed in Item 17.c(1) immediately below).

A possible defense to inclusion under §2036(a)(2) may apply if distributions are subject to cognizable limits. See *Estate of Cohen v. Commissioner*, 79 T.C. 1015 (1982). Traditionally, planners have relied on the *Byrum* Supreme Court case for the proposition that investment powers are not subject to §2036(a)(2) (though *Strangi* and *Morrisette* made arguments attempting to distinguish *Byrum*).

- c. **FLP Assets Includable under §2036(a)(2) – *Powell, Cahill, and Morrisette* – But Not *Levine*.**

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

For a brief overview summary of *Powell*, see Item 26.c(1) of Estate Planning Current Developments (December 2021) found [here](#) and for a more detailed discussion of the facts and court analysis in and planning implications of *Powell*, see Item 15.g. of the Current Developments and Hot Topics Summary (December 2017) found [here](#), both available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

(2) ***Synopsis of Estate of Cahill and Settlement.*** In *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (Judge Thornton), the decedent’s revocable trust had advanced \$10 million to an irrevocable trust under a split-dollar agreement for the trust to purchase life insurance policies on the lives of the decedent’s son and his wife; the estate valued its reimbursement at only \$183,700, because of the long period of time before the policies would mature at the insureds’ deaths. The IRS argued, among other things, that the reimbursement right should have a value equal to the full cash surrender value of the policies (about \$9.6 million) in part because of §§2036, 2038, and 2703. The court rejected the estate’s motion for a partial summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) did not apply and that Reg. §1.61-22 applied in valuing the decedent’s reimbursement rights. The estate tax audit was settled on August 16, 2018, with the estate conceding all the issues regarding the intergenerational split-dollar arrangement (agreeing that the value of the decedent’s reimbursement right was the \$9.6 million cash surrender value of the policies) and the imposition of a 20% accuracy-related penalty under

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§6662; the IRS conceded regarding the value of certain notes from family members unrelated to the split-dollar transaction. For a more detailed summary of the *Cahill* case (including ramifications of its §2703 analysis) see Item 13 of Estate Planning Current Developments and Hot Topics (December 2019) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- (3) **Tax Court Follows Same Position in *Estate of Morrisette v. Commissioner*.** The initial case in *Estate of Morrisette v. Commissioner*, 146 T.C. 171 (2016), determined that the economic-benefit regime applies to the split-dollar arrangement in that case. The IRS made arguments under §§2036, 2038, and 2703, similar to its arguments in *Cahill*. The court entered an Order dated February 19, 2019, denying the taxpayer's motions for summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) do not apply, reasoning merely that *Estate of Cahill* "is directly on point" regarding §§2036(a)(2) and 2038(a)(1).

The court ultimately held that the bona fide sale for full consideration exception to §2036 and §2038 and the §2703(b) safe harbor applied, and the court valued the estate's reimbursement right, T.C. Memo. 2021-60 (May 13, 2021), as discussed in Item 20.a of Heckerling Musings 2023 and Estate Planning Current Developments (April 12, 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights). For a much more detailed discussion of the *Morrisette* developments before the 2021 opinion, see Item 13 of Estate Planning Current Developments and Hot Topics (December 2019) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- (4) **Section 2036(a)(2) Not Applicable in *Estate of Levine*.** The Tax Court held that §2036(a)(2) and §2038 did not apply in *Estate of Levine v. Commissioner*, 158 T.C. No 2 (February 28, 2022). The gross estate includes the value of transferred property, except for a bona fide sale for full consideration, in which the decedent, alone *or in conjunction with any other person*, retained the right to designate who would possess or enjoy the property or income from the property (§2036(a)(2)) or at death held the power to alter, amend, revoke, or terminate the enjoyment of the property (§2038).

- (a) **Synopsis.** The fundamental background and issue in the case was summarized in the first paragraph of the opinion.

Marion Levine entered into a complex transaction in which her revocable trust paid premiums on life-insurance policies taken out on her daughter and son-in-law that were held by a separate and irrevocable life-insurance trust. Levine's revocable trust had the right to be repaid for those premiums. Levine has since died, and the question is what has to be included in her taxable estate because of this transaction—is it the value of her revocable trust's right to be repaid in the future, or is it the cash-surrender values of those life-insurance policies right now?

The revocable trust would receive the greater of the advance (\$6.5 million) and cash surrender value of the policies upon the death of the last to die of the insureds or upon the earlier termination of the agreement, which could be made solely by the life insurance trust. An investment committee, whose sole member was an unrelated long-time business associate, made investment decisions for the life insurance trust.

The issue was whether the gross estate included the approximately \$6.2 million cash surrender value of the policies at the decedent's death (by reason of §2036, §2038, or §2703) or the approximately \$2.2 million stipulated value of the reimbursement right.

The court determined that §2036(a)(1) did not apply because the decedent did not retain anything and could not surrender the policies or terminate the split-dollar arrangement. Sections 2036(a)(2) and 2038 also did not apply. Under the documents, the decedent had no right to the cash surrender values or to join with someone else in getting current access to the cash surrender values. But under general contract principles, all of the parties to a contract could amend it at any time; however, that was not sufficient to cause the decedent to have a right "in conjunction with" another to designate who could enjoy the property under §2036(a)(2) or to alter, amend, or terminate the arrangement under §2038. The court relied on *Helvering v. Helmholz* (U.S. Sup.Ct. 1935) and *Estate of Tully v. United States* (Ct.

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Cl. 1976) to conclude 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 §2036(a)(2) or §2038.

The specific facts of the case do not raise an “in conjunction with” §2036(a)(2) or §2038 power either. The powers of others who owed fiduciary duties to the decedent did not, in effect, give the decedent rights over the cash surrender values because they also had conflicting fiduciary duties to other beneficiaries. The court distinguished *Estate of Strangi* and *Estate of Powell*, which had held that a decedent’s powers held in conjunction with other partners triggered §2036(a)(2). Those cases both distinguished *United States v. Byrum* (U.S. Sup. Ct. 1972), which determined that the fiduciary duties of a donor-shareholder to minority shareholders meant that a decedent’s retained right to vote transferred stock did not cause estate inclusion under §2036(a)(2). The distinction is that in *Byrum* the decedent held fiduciary duties to other shareholders whereas in *Strangi* and *Powell*, the potential fiduciary duties were owed “essentially to himself.” In *Estate of Levine*, fiduciary duties were owed to grandchildren who were beneficiaries of the life insurance trust in addition to decedent’s children (who were also beneficiaries of the revocable trust).

Section 2703 did not apply to cause the reimbursement right to be valued at the current cash surrender value of the policies. Section 2703 determines the value of property without regard to certain restrictions. Section 2703 refers to restrictions on property held by the estate, which was the receivable, not the policies or cash surrender value under the policies. There were no restrictions on the receivable; it could be sold or transferred as desired by the revocable trust. The court did not view the inability to cause the immediate surrender of the policies and payment of the cash surrender value to the estate as a restriction on what was owned by the estate—the receivable itself. *Estate of Levine v. Commissioner*, 158 T.C. No. 2 (February 28, 2022, Judge Holmes).

For a more detailed summary of and observations about *Levine*, see Item 16.a of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

- (b) **Decedent Had No Right to Terminate Early, Even “In Conjunction With Others.”** A big distinction from *Morrisette* is that in *Levine* the life insurance trust that owned the policies had the sole right to decide whether to terminate the split-dollar agreement or surrender the policies prior to the deaths of the insureds. The court reasoned that the decedent did not have any right, whether by herself or in conjunction with anyone else, to terminate the policies and therefore to designate who could possess or enjoy the property or to alter, amend, revoke or terminate the transfer.

Under the documents, the decedent had no “sort of possession or rights to [the] cash-surrender values,” and “if confined to the tilyard defined by the transactional documents, we would have to conclude that section 2036(a) and 2038 do not tell us to include the policies’ cash surrender values in the Estate’s gross value.”

- (c) **Right to of All Parties Amend Agreement Not Enough to Invoke §2036(a)(2) or §2038.**

Also, the court reasoned that the mere ability of all the parties to the split-dollar agreement to revise the agreement to terminate it early would not trigger the “in conjunction with” language of §2036(a)(2), relying on the *Helmholz* and *Tully* cases that placed limits on such a broad interpretation of the “in conjunction with” phrase.

The fact that the decedent, under the terms of the split dollar agreement, could not participate in a decision to terminate the policy early does not necessarily mean the donor could not act in conjunction with others to terminate the agreement, because all the parties to a contract can always modify it. As a matter of law, though, the court states that the decedent does not hold a §2036(a)(2) or §2038 power merely because of the ability to amend the split-dollar agreement under general contract law principles.

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*Helvering v. Helmholtz*, 296 U.S. 93 (1935), involved a transfer of stock to a trust. The Government argued that under state law the settlors of a trust with the consent of its beneficiaries may terminate the trust and revest the transferred property in the donor. A “persnickety textualist” may say that is a power in conjunction with others that would trigger §2036(a)(2) or §2038, but the Supreme Court in *Helmholtz* held:

[t]his argument overlooks the essential difference between a power to revoke, alter or amend, and a *condition* which the law imposes. The general rule is that all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust.

In *Estate of Tully v. United States*, 528 F.2d 1401 (Ct. Cl. 1976), the decedent was a 50% shareholder. The corporation and decedent entered into a contract to pay a death benefit to the decedent’s widow. Even though the beneficiary designation was irrevocable, the IRS argued that it could be amended for several reasons, including that the decedent and the other 50% shareholder could cause the corporation to agree with the decedent to change the beneficiary. The court concluded that the “in conjunction” language of §2038 “does not extend to powers of persuasion.”

The court summarized, very strongly, that the mere power of parties to amend a contract under general default rules of contract is not enough to trigger §2036(a)(2) or §2038.

We therefore agree with *Helmholtz* and *Estate of Tully* that general default rules of contract—rules that might theoretically allow modification of just about any contract in ways that would benefit the IRS—are not what’s meant in phrases like section 2036’s “right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom,” or section 2038’s “power . . . by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power).” What’s meant are rights or powers created by specific instruments. A more extensive reading, as the old Court of Claims noted in *Estate of Tully*, would swing a broadax to fell large swaths of estate and retirement planning that Congress meant to allow to stand.

In other words, where authority under an instrument is the same as it would be under default state law, the taxpayer does not retain a power. This holding is extremely important.

- (d) **Powers of Others Did Not Give Decedent Powers Over the Policy Because of Fiduciary Duties of Others Who Held Powers.** The court addressed whether the powers of others in effect gave the decedent rights or powers over the cash surrender values under the specific facts involved. In particular, the unrelated business associate owed duties to the decedent under the power of attorney and also had fiduciary duties to beneficiaries of the insurance trust that owned the policies. In *Estate of Strangi* and *Estate of Powell* the court held that §2036(a)(2) triggered the inclusion of assets transferred to a limited partnership where the decedent could act with others. In *Strangi*, 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 partners could act unanimously to dissolve the partnership.

Both of those cases distinguished *United States v. Byrum* (U.S. Sup. Ct. 1972), which determined that the fiduciary duties of a majority shareholder to minority shareholders meant that a decedent’s retained right to vote transferred stock did not cause estate inclusion under §2036(a)(2). The Supreme Court also noted that an independent corporate trustee alone had the right to make trust distribution decisions. The distinction is that in *Byrum* the decedent held fiduciary duties to *other* shareholders whereas in *Strangi* the potential fiduciary duties were owed “essentially to himself” and in *Powell* duties were “owed almost exclusively to decedent herself.” In *Levine*, fiduciary duties were owed to grandchildren who were beneficiaries of the life insurance trust in addition to decedent’s children (who were also beneficiaries of the revocable trust).

The IRS also argued that the decedent, through her agents, “stood on both sides of these transactions and therefore could unwind the split-dollar transactions at will.” But the court

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noted that the unrelated business associate who held the power as the sole member of the investment committee of the insurance trust to terminate the agreement held fiduciary duties to beneficiaries (grandchildren) other than the beneficiaries of the revocable trust and those grandchildren would have received nothing if the business associate had terminated the arrangement early.

The court concluded with this analysis:

We therefore find it more likely than not that the fiduciary duties that limit [the business associate]'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 [the business associate], 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).

The court concluded that §2038 did not apply for the same reasons (which were not repeated by the court).

(e) **Observations from *Estate of Levine*.**

- i. **Significant Limitation of "In Conjunction With" Analysis.** The *Strangi*, *Powell*, and *Cahill* cases have applied a broad reach to the "in conjunction with" clause in §2036(a)(2) and §2038. Planners have noted that prior cases have placed some outer limits on how far the "in conjunction with" clause should be applied, and this court picks up on those cases. The court concludes from *Helmholz* and *Tully* that the ever-present right of parties to a contract to amend the contract will not by itself trigger estate inclusion.
- ii. **Fiduciary Duties to Others Is Critical, Different Beneficiaries of Insurance Trust and Revocable Trust.** *Strangi* and *Powell* distinguished the Supreme Court's fiduciary duty analysis in *Byrum* to find that the fiduciary duty of a party who acts in conjunction with the decedent does not shelter the estate from estate inclusion. In determining whether *Byrum* can be distinguished in a particular situation, *Levine* focuses on whether the fiduciary duty is illusory and in reality is just owed to the decedent and not to other parties. If so, the fiduciary duty is really no limitation at all on the fiduciary's ability to act in a way that would benefit the decedent.

For §2036 issues involving FLPs or LLCs, very important facts may be whether third parties are substantial owners of the entity and whether the third parties are different from the beneficiaries of the decedent's estate. For example, in *Levine*, the decedent's children were the beneficiaries of her revocable trust, but her grandchildren were also substantial beneficiaries of the life insurance trust. The court observed that as to the children, whether the insurance trust terminated the split-dollar arrangement early just determined whether the children would benefit as beneficiaries of the revocable trust or as beneficiaries of the insurance trust. The presence of the grandchildren as beneficiaries of the insurance trust helped the court conclude that the fiduciary duties were not illusory.

- iii. **Discounted Estate Tax Value May Just Represent a Tax Deferral, Income Tax Effects.** The taxpayer in *Estate of Levine* 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, but when the reimbursement right is satisfied, the difference between the amount paid and the basis of the reimbursement right would be income. The income probably would be ordinary income; for example, §§1271-1276 deal with original issue discount (OID) by requiring the debt holder to take any discount into income as ordinary income, not as capital gain. See *Hudson v. Commissioner*, 20 T.C. 734 (1953), *aff'd sub. nom. Ogilvie v. Commissioner*, 216 F.2d 748 (6th Cir. 1954).

A gift or bequest to the obligee in satisfaction of the obligation may not trigger discharge of indebtedness income. See *Helvering v. American Dental Co.*, 318 U.S. 322 (1943) (interpreting predecessors to §§102 and 61); *Bosse v. Commissioner*, T.C. Memo. 1970-355 (§102 applied because forgiveness was gratuitous); Letter Rul. 9240003 (cancellation of debt by lender in lender's will was not discharge of indebtedness income but was in the nature of a testamentary bequest excludable under §102). However, bequeathing the reimbursement claim to the obligee might impact the estate tax valuation of the reimbursement right.

- d. **What to Do? Planning After *Powell*.** For a discussion of planning alternatives to avoid the *Powell* broad application of §2036(a)(2) under the “in conjunction with” reasoning, see Item 8.c-e of Estate Planning Current Developments and Hot Topics for 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- e. **Summary of §2036 FLP/LLC Cases (14-23, with 2 Cases on Both Sides).** For a summary of the various FLP/LLC cases that the IRS has chosen to litigate under §2036, see Item 9.f of Estate Planning Current Developments (March 16, 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
- f. **Review of Court Cases Valuing Partnership/LLC Interests.** Despite the many cases that have addressed the applicability of §2036 to limited partnership or LLC interests, fewer cases have actually reached the point of valuing partnership interests. Observe that some cases have allowed discounts even for controlling interests in FLPs or LLCs. E.g., *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (4% lack of control discount for controlling majority interests in LLCs); *Estate of Streightoff v. Commissioner*, T.C. Memo. 2018-178, *aff'd*, 954 F.3d 713 (5th Cir. 2020) (18% lack of marketability discounts for estate's de facto controlling interest in LLC holding cash and marketable securities). John Porter summarizes discounts that have been allowed by the courts in FLP/LLC cases as follows (some additional cases and explanations have been added to the table):

Case	Assets	Court	Discount from NAV/ Proportionate Entity Value
<b>Strangi I</b>	Securities	Tax	31%
<b>Knight</b>	Securities/real estate	Tax	15%
<b>Jones</b>	Real estate	Tax	8%; 44%
<b>Dailey</b>	Securities	Tax	40%
<b>Adams</b>	Securities/real estate/minerals	Fed. Dist.	54%
<b>Church</b>	Securities/real estate	Fed. Dist.	63%
<b>McCord</b>	Securities/real estate	Tax	32%
<b>Lappo</b>	Securities/real estate	Tax	35.4%
<b>Peracchio</b>	Securities	Tax	29.5%
<b>Deputy</b>	Boat company	Tax	30%
<b>Green</b>	Bank stock	Tax	46%
<b>Thompson</b>	Publishing company	Tax	40.5%
<b>Kelley</b>	Cash	Tax	32%
<b>Temple</b>	Marketable securities	Fed. Dist.	21.25%
<b>Temple</b>	Ranch	Fed. Dist.	38%
<b>Temple</b>	Winery	Fed. Dist.	60%
<b>Astleford</b>	Real estate	Tax	30% (GP); 36% (LP)
<b>Holman</b>	Dell stock	Tax	22.5%
<b>Keller</b>	Securities	Fed. Dist.	47.5%
<b>Murphy</b>	Securities/real estate	Fed. Dist.	41%
<b>Pierre II</b>	Securities	Tax	35.6%

Case	Assets	Court	Discount from NAV/ Proportionate Entity Value
<b>Levy</b>	Undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
<b>Giustina</b>	Timberland; forestry	Tax	25% with respect to cash flow valuation (Tax Court applied 75% weight to cash flow factor and 25% weight to asset value method); BUT reversed by 9th Circuit and remanded to reconsider without giving 25% weight to asset value method)
<b>Koons</b>	Securities	Tax	7.5%; Estate owned 70.42% of voting interests and could remove limitation on distributions
<b>Gallagher</b>	Publishing company	Tax	47%
<b>Streightoff</b>	Securities	Tax	0% lack of control discount because the 88.99% LP interest could remove the general partner and terminate the partnership; 18% lack of marketability discount
<b>Kress</b>	Manufacturing	Tax	Lack of marketability discounts of 25% for 2007-2008 gifts & 27% for 2009 gifts (those numbers include 3% downward adjustment because a family transfer restriction was not taken into account); additional adjustment for minority interest in non-operating assets
<b>Jones</b>	Sawmill & timber	Tax	35% lack of marketability discount from value of noncontrolling interest
<b>Grieve</b>	Securities	Tax	35% for one LLC and 34.5% for another LLC (98.8% non-voting LLC interest)
<b>Nelson</b>	FLP owned 27% of holding company that owned various subsidiaries with operating businesses	Tax	FLP's interest in holding company valued with 15% lack of control discount and 30% lack of marketability discount (combined 40.5% discount); transferred limited partner interest in FLP valued with 5% lack of control discount and 28% lack of marketability discount (combined 31.6% discount)
<b>Warne</b>	Majority interests in five LLCs (each over 70%) owning real estate	Tax	Four majority LLC interests not passing to charity: 2% lack of control discount (court might have found no LOC discount but parties agreed some LOC discount was proper) and 5% lack of marketability discount; One wholly owned LLC interest passing to two charities: for charitable deduction, parties stipulated a 4% discount for a 75% LLC interest and 27.385% discount for a 25% LLC interest
<b>Smaldino</b>	Ten rental real estate properties	Tax	36% combined lack of control and marketability discount (accepting view of IRS expert) for transfers of minority nonvoting interests

Adapted from John Porter, *A View from the Trenches: Current Issues in Estate and Gift Tax Audits and Litigation*, 56th ANN. HECKERLING INST. ON EST. PL. (2022).

## 18. GRAT Issues in Recent Rulings and Cases

### a. Application of "Atkinson Rationale" to GRAT and Valuation Issue Regarding Anticipated Merger, CCA 202152018.

- (1) **Very Brief Fact Summary.** Donor transferred shares of the Company to a two-year grantor retained annuity trust (GRAT) that appeared to satisfy the requirements for a qualified interest

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under §2702. The required annuity payments were a fixed percentage of the initial fair market value of the trust (whether that was the fair market value as finally determined for federal tax purposes, as described in the GRAT regulations, is not specifically stated). Even though Donor had been in serious negotiations with other corporations about merger offers prior to the transfer to the GRAT, the value of the transferred shares was determined 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 §409A.

Donor eventually accepted one of the merger offers. 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) **Analysis.**

- (a) **Valuation Should Take into Consideration Pending Merger.** CCA 202152018 has analysis very similar to the reasoning in CCA 201939002 in a similar situation involving a transfer of pre-merger stock to a GRAT. Indeed, the following concluding language in CCA 202152018 is almost word for word the same as the corresponding conclusion in CCA 201939002:

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 created], 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...

For a critical discussion of CCA 201939002 and this part of the discussion in CCA 202152018, see Charles Redd, *Less Giddy About GRATs*, TRSTS. & ESTS. at 8 (July/August 2022).

- (b) **GRAT Treated as Not Being a Qualified Interest Under §2702 Because of Using Undervalued Appraisal (by Analogy to *Atkinson*).** The conclusion quoted above regarding the valuation issue goes a step further than CCA 201939002, however, by adding the following clause not found in CCA 201939002: "... and thereby casts more than just doubt upon the bona fides of the transfer to the GRAT."

This is a big further step that treats the GRAT annuity as not being a qualified interest because of the undervalued appraisal used to determine the annuity amounts that were paid by the GRAT over its two-year term. Accordingly, Donor was 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 Donor's retained annuity payments.

The CCA analogized to *Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002), which denied an income tax charitable deduction for the creation of a charitable remainder annuity trust because of the manner in which the trust was operated (no annuity payments were actually made), even though the agreement itself met the technical requirements for CRATs.

Similarly, the CCA reasons that basing the annuity payments on an undervalued appraisal was an "operational failure" that resulted in Donor not having retained a qualified annuity interest under §2702.

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*.

(Emphasis added).

## (3) **Planning Implications.**

- (a) **Draconian Result Seems Inappropriate.** A feature of GRATs that is especially attractive is the "savings clause" feature that is authorized in the GRAT regulations, which allows basing the annuity payments on a specified percentage of the initial fair market value of assets

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contributed to the GRAT, as finally determined for federal tax purposes. Reg. §25.2702-3(b)(1)(ii)(B). If the contributed assets are initially undervalued, the annuity amounts automatically readjust based on the finally determined fair market value of the assets so that the gift value of the remainder interest in the GRAT is still nominal.

Rather than merely adjusting the amount of the annuity payments, so that the donor received back annuity payments equal to (actually, on a non-discounted basis, somewhat greater than) the full value that was contributed to the GRAT, the IRS took the **unprecedented** position that the retained annuity payments should be valued at zero, resulting in a very large, unexpected gift. That result is not described in the regulation. The only authority for that Draconian result is a broad extension of the reasoning of the *Atkinson* case. But the *Atkinson* case is a very different situation.

- (b) **Potentially Horrendous Effect.** The result of the CCA may be to treat the entire contribution to the GRAT as a gift even though the donor may have expected that the taxable gift would be a nominal value (the value of the remainder interest). The CCA makes reference to the company having received offers “in the multi-**billion** dollar range.” The value of shares transferred to the GRAT might have been many millions of dollars. Furthermore, the IRS may allege that the 40% undervaluation penalty would apply.
- (c) **Hopefully Limit This Approach to Egregious Situations.** This approach of treating the entire amount transferred as a gift seems inappropriate in light of the regulations that specify how to merely adjust the annuity amount if the initial value transferred to the trust is adjusted. However, the CCA reasons that the result is appropriate because of the donor’s “**deliberately using an undervalued appraisal.**” Perhaps the IRS concern in this CCA was not so much with the appraised *amount* but with the *process*. The donor appeared 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).

- (4) **Resource.** For a more detailed discussion of CCA 202152018 and planning implications from the CCA, see Item 23 of Heckerling Musings 2023 and Estate Planning Current Developments (April 12, 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

b. **Settled Case Involving Refusal to Recognize GRAT Annuity Adjustment Where Valuation of Stock Reported on Gift Tax Return Did Not Consider Pending Merger Discussion, *Baty v. Commissioner*.**

- (1) **Brief Overview.** In this Tax Court case (the case addressed in CCA 201939002), the IRS maintained that because the taxpayer intentionally undervalued stock contributed to a GRAT (by not taking into account pending merger discussions), the taxpayer was not able to take advantage of the GRAT provisions. The IRS eventually conceded. *Baty v. Commissioner*, Tax Court Docket No. 12216-21 (Petition filed June 23, 2021, Stipulated Decision Entered June 17, 2022).
- (2) **Valuation Issue.** The Chief Counsel’s office was pushing a novel valuation position that the value should be determined not based on the mean between the high and low selling prices (see Reg. §25.2512-2(b)(1)) but by taking into consideration the anticipated merger. The donor filed a motion for summary judgment seeking a determination by the court that the stock should be valued as of the date of the contribution to the GRAT by the value from the public market. The shares were actively traded on the NYSE. Observers of the senior housing industry were aware that the market was relatively fragmented and that significant consolidation in the industry was likely to happen in the future, and the donor maintained that the public market prices reflected that realization.

The taxpayer made strong arguments in its Memorandum in Support of Petitioner’s Motion for Summary Judgment to support its view that the public market prices should be used to value the stock that was contributed to the GRAT.

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- (3) **Concession.** The IRS sought and was granted a two-month extension to respond to the motion for summary judgment. Before entering a response, the IRS conceded, and a stipulated decision was entered on June 17, 2022.
  - (4) **Resource.** For further discussion of *Baty* and a summary of the taxpayer's valuation arguments in its Memorandum brief, see Item 24 of Heckerling Musings 2023 and Estate Planning Current Developments (April 12, 2023) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

c. **Swap Transaction with GRAT Was a "Purchase" For Purposes of Section 16(b) Short-Swing Profits Rule, Settlor of GRAT Should be Trustee to Satisfy "Mere Change of Form of Beneficial Ownership" Exception, *Donoghue v. Smith*, 2022 U.S. Dist. LEXIS 76071; 2022 WL 1225338 (S.D. N.Y. April 26, 2022).**

- (1) **Case Synopsis.** Mr. Smith ("Smith") created various GRATs with shares of Class B common stock of a publicly-traded company (the "Company") (that is, the second largest television station operator in the U.S.) and exercised substitution powers various times to reacquire Class B shares from the GRATs. The Class B shares were convertible into Class A shares on a one-for-one basis at the holder's election. Within six months of the respective acquisitions under the substitution power, Smith transferred or sold Class A shares, allegedly making approximately \$5.5 million in short-swing profits through these transactions. Smith was an insider (an officer, director, and owner of more than ten percent of the common stock and was one of the sons of the founder of the company). In this shareholder derivative action, shareholders seek disgorgement of the \$5.5 million in alleged short-swing profits under §16(b) of the Securities Exchange Act of 1934.

Smith sought to dismiss the claims on the grounds (1) that his acquisitions of stock from the GRATs under the substitution powers were exempt from 16(b), and, alternatively, (2) that the acquisitions of stock under the substitution powers were not "purchases" within the meaning of §16(b). The court rejected both arguments and refused to dismiss the action. *Donoghue v. Smith*, 2022 U.S. Dist. LEXIS 76071; 2022 WL 1225338 (S.D. N.Y. April 26, 2022).

- (a) **Not Qualify for Exemption.** SEC Rule 16a-13 exempts "transaction[s] ... that effect[] only a change in the form of beneficial ownership without changing a person's pecuniary interest in the subject equity securities." 17 C.F.R. §240.16a-13. Smith argued that the acquisition "merely changed the form of his beneficial ownership of the stock from indirect to direct." The court disagreed because Smith did not maintain beneficial ownership of the shares after they were transferred to the GRATs. SEC Rule 16-b provides that for the settlor of a trust to have beneficial ownership of securities held by the trust, the settlor must "exercise or share investment control" over the shares. Smith was not the trustee of the GRATs, and the trustee held the authority to sell or otherwise dispose of all property comprising the trust estate. Smith countered that the substitution provisions in the GRAT agreements gave him the power to veto any sale proposed by the trustees. The court rejected this argument as well because the trustee was not required to propose sales to Smith for his approval, and the power of substitution was subject to the trustee's approval that the acquisition was for property of equivalent value. Also, the substitution power did not make Smith a "de facto" trustee because no facts or circumstances were alleged suggesting that Smith had "investment control over the trust." Smith pointed to an SEC No-Action Letter, *Peter J. Kight*, Fed. Sec. L. Rep. ¶77,403, 1997 WL 35393250 (Oct. 16, 1997), which held that the creation of a GRAT and subsequent return of stock to the grantor in satisfaction of annuity payments will "effect only a change in the form of beneficial ownership without changing a person's pecuniary interest in the subject equity securities." However, that case was distinguished.

Finally, the parties spill much ink on the applicability of a 1997 SEC No-Action letter, *Peter J. Kight*, Fed. Sec. L. Rep. ¶ 77,403, 1997 WL 35393250 (SEC No-Action Letter October 16, 1997) (the "Kight Letter"), and *Quintiles*, a 1998 decision by Judge Richard Owen.... Although both the Kight Letter and *Quintiles* addressed Section 16(b) liability with respect to transfers or substitutions either into or out of GRATs, they are distinguishable because, in both, the insider was not only the settlor of the GRAT, but also the trustee.... In fact, in the case of the Kight Letter, the insider-settlor was also "the beneficiary[]" of the proposed GRAT. *Id.* Indeed, as commentators have noted, the SEC "staff's position in the Kight [L]etter

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was based on the fact that the insider-[settlor], by virtue of being both the trustee and lifetime beneficiary of the GRAT, would be deemed under Rule 16a-8(b)(2) to be the indirect beneficial owner of the issuer securities contributed to the GRAT.” [Peter J. Romeo & Alan Dye, Section 16 Treatise and Reporting Guide], § 6.02[3][c], at 558 [(5th ed. 2019)] (emphasis added) (citing Kight Letter, 1997 WL 35393250). Thus, neither authority speaks to the situation here, where the insider, Smith, was merely the settlor, and not a trustee or beneficiary of the GRATs.

(Why Smith was not a “beneficiary” of the GRATs was not explained. At least two of the four substitution transactions were with GRATs that had been created within four months of the creation of the GRATs, so presumably before the settlor’s retained annuity interest had ended.)

- (b) **Exercises of Substitution Powers Were “Purchases.”** Smith argued in the alternative that his acquisitions of stock under the substitution power were not “purchases” under §16(b). The court found no ambiguity in treating the exchanges of property of an equivalent value as purchases, “especially given that the value of the substitute property matched ‘the range of prices at which ... Class A shares traded on the open market’ on the acquisition dates.” The court cited *Morales v. Quintiles Transnational Corp.*, 25 F. Supp. 2d 369 (S.D.N.Y. 1998), which had treated an acquisition of shares under the substitution power in a GRAT as a “purchase” for §16(b) purposes. Also, “Smith himself even used the term ‘purchase’ to describe the transactions in some of his SEC Forms 4.” Furthermore, the purpose of the statute is served by treating the acquisitions under the substitution powers as “purchases” because Smith could have used non-public information by virtue of his status as an officer and director to acquire shares “from the GRATs at market value just before a price increase.” Smith countered that treating an insider’s reacquisition of shares from a GRAT as a purchase does not serve the purpose of the statute because the insider “makes all of the investment decisions for the GRAT, and therefore the insider enjoys no informational advantage over the GRAT.” But the court again noted that Smith was not the trustee and exercised no investment control over the securities held by the GRATs. The court concluded that “his (re)acquisitions of the ... shares – through an exchange of assets of equal value – plainly qualified as ‘purchase[s]’ for purposes of Section 16(b).”

- (2) **Resources Regarding Planning Implications.** For further discussion of the securities law planning implications for GRATs and estate planning issues, see Item 25 of Heckerling Musings 2023 and Estate Planning Current Developments (April 12, 2023) found [here](https://www.bessemertrust.com/for-professional-partners/advisor-insights) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](https://www.bessemertrust.com/for-professional-partners/advisor-insights).

For excellent discussions of securities laws issues impacting estate planning issues, see Anna Pinedo, Jay Waxenberg, Daniel Hatten, *Securities Law Considerations for Estate Planners*, 48 ESTATE PLANNING 3 (Nov. 2021); Arlene Osterhoudt & Ivan Taback, *Securities Law Considerations for Estates and Estates Advisors: Part I (Accredited Investors and Qualified Purchasers)*, TRUSTS & ESTATES 19 (July 2016); Arlene Osterhoudt & Ivan Taback, *Securities Law Considerations for Estates and Estates Advisors: Part II (Reporting and Short-Swing Profit Rules Applicable to Insiders)*, TRUSTS & ESTATES 24 (March 2017).

## 19. Trust Modification to Add General Power of Appointment, PLR 202206008, or to Add Power to Reimburse Grantor of Grantor Trust for Income Tax (Which Results in Gifts by Trust Beneficiaries Who Consent), CCA 202352018

- a. **PLR 202206008 Analysis.** In PLR 202206008, a trust funded before September 25, 1985 (and therefore not subject to the GST tax) directed the trustee in clause (1) to distribute all income to the settlor’s sole surviving child and authorized the trustee in clause (5) to make corpus distributions in its sole and absolute discretion as it deems necessary for the maintenance, education, welfare and comfort of beneficiaries. Under clause (2), at the child’s death, the assets would pass to the child’s descendants, per stirpes, or if none, to the heirs of settlor’s wife. The trustee expressed a desire to exercise its discretion by granting the settlor’s sole surviving child a power of appointment over certain assets. Following a controversy over that decision, a settlement agreement was reached, which a court approved (subject to obtaining a favorable PLR), to modify clause (2) to grant the child a

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testamentary general power of appointment to appoint a “Defined Portion” of the trust corpus to child’s estate.

The term “Defined Portion” was described as “the largest portion of Trust B that could be included in Child’s federal estate without increasing the total amount of the “Transfer Taxes” actually payable at Child’s death over and above the amount that would have been actually payable in the absence of this provision.” The term “Transfer Taxes” was described as “all inheritance, estate, and other death taxes, plus all federal and state GST taxes, actually payable by reason of Child’s death.” In default of exercise of the general power of appointment, the remaining assets would be distributed to the child’s descendants, per stirpes, or if none, to the Settlor’s wife’s heirs. The taxpayer sought rulings that as a result of “the exercise by Trustee of its discretionary authority ... upon the terms of the Settlement Agreement” – (1) the trust would retain its GST “pre-effective date” exempt status, and (2) only trust property subject to the child’s testamentary general power of appointment would be included in the child’s gross estate under §2041(a)(2). Both rulings were granted. Also, not specifically discussed in the PLR, the ruling tacitly confirms that a trustee with discretionary authority to distribute principal for a beneficiary’s welfare may exercise the authority to grant a general power of appointment.

Ruling (1): Similar to many other rulings, the PLR easily concluded that the modification would satisfy the safe harbor in Reg. §26.2601-1(b)(4)(i)(D) and not impact the GST exempt status of the trust because it would not push assets to a lower generation and would not extend the time of vesting of any beneficial interest beyond the period for vesting in the trust instrument.

Ruling (2): After summarizing §2041(a)(2), the PLR also granted the second ruling, but in quite misleading language. The first two sentences of the concluding paragraph about Ruling (2) are just flat wrong (or at least are incomplete and misleading):

In this case, the modification of Trust B to grant Child a testamentary general power of appointment pursuant to the Court-approved Settlement Agreement will not cause Trust B property to be includible in Child’s gross estate. However, the exercise by Child of Child’s testamentary general power of appointment will result in the appointed property being includible in Child’s gross estate under § 2041(a)(2).

General powers of appointment created on or before October 21, 1942, must be exercised to be included in the gross estate under §2041(a)(1), but assets subject to general powers of appointment created after that date are includible in the powerholder’s gross estate under §2041(a)(2) even if the power is not exercised. Perhaps the first sentence was intended to convey that granting a general power of appointment would not necessarily cause *all* of the trust property to be in the gross estate under § 2041(a)(2) (but only the Defined Portion over which the power was granted). The second sentence could be interpreted to imply that if a general power is not exercised, property subject to the power is not includible under §2041(a)(2), which, of course, is wrong. Planners should not be misled into thinking that unexercised general powers of appointment are not includible in the gross estate under §2041(a)(2).

However, the last sentence of that conclusory paragraph correctly states the ultimate ruling:

Accordingly, based on the facts submitted and the representations made, we conclude that the exercise by Trustee of its discretionary authority over Trust B principal upon the terms of the Settlement Agreement will result in only the trust property subject to Child’s testamentary general power of appointment to be included in Child’s gross estate under § 2041(a)(2).

The ruling did not address potential income tax issues (if the modifications changed beneficial interests substantially enough to constitute a taxable exchange under §1001) or gift tax issues ([i] if the remainder beneficiaries’ consents to giving up their vested remainder interests and allowing them to be divested through exercise of the power of appointment constituted gifts and [ii] whether a holder of a general power of appointment who takes actions that reduce the pool of assets subject to the power makes a gift by releasing the general power of appointment to that extent).

- b. **Basis Adjustment Planning.** The purpose of the modification apparently was to trigger estate inclusion in the child’s gross estate, to the extent that doing so would not generate transfer taxes for

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the child. Therefore, the assets would receive a basis adjustment at the child's death under §1014(b)(9). However, planners should not view the language in the PLR as a drafting roadmap.

(1) **General Basis Adjustment Planning Approaches.** Four basic approaches can be used to cause estate inclusion of trust assets in a beneficiary's gross estate, and therefore a basis adjustment:

- (1) making distributions to the beneficiary (assuming the distribution standards are broad enough to justify the distribution);
- (2) having someone grant a general power of appointment to a beneficiary;
- (3) using a formula general power of appointment for the beneficiary (as was done in PLR 202206008); or
- (4) triggering the "Delaware tax trap."

For a general discussion of each of these planning approaches, see Item 7 of Estate Planning Current Development and Hot Topics (May 2021) found [here](#), and for a detailed discussion of various basis adjustment planning alternatives (including various form provisions), see Item 5 of the Estate Planning Current Developments Summary (December 2018) found [here](#), both available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

(2) **Drafting Considerations.**

- (a) **Manipulation; *Kurz v. Commissioner*.** Consider whether the beneficiary could manipulate the beneficiary's taxable estate (for example, by leaving the beneficiary's estate to a spouse or charity) to increase the amount of the trust over which the beneficiary would have a general power of appointment. If so, the IRS might argue that the beneficiary has a general power of appointment to that maximum extent. See *Kurz v. Commissioner*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995). However, *Kurz* makes clear that contingencies that have independent significant non-tax consequences are to be ignored. Those contingencies prevent the decedent from having realistic unfettered control to access the trust assets. As to the possibility of a marital or charitable bequest increasing the amount of the general power of appointment under the formula, such bequests would seem to have independent significance. However, to avoid that argument, the formula could refer to an amount "determined for this purpose without regard to any available charitable or marital deduction." For a more detailed discussion of the *Kurz* case and the possible implications for formula general powers of appointment, see Item 7.e of the Current Developments and Hot Topics Summary (December 2014) found [here](#) and available at [www.bessemer.com/professionalspartners](http://www.bessemer.com/professionalspartners).
- (b) **Specifying Assets Subject to the General Power.** Consider describing particular assets over which the power of appointment applies (for example to include only appreciated assets, or to provide an ordering of assets so that particular assets with high appreciation that are likely to be sold early or assets with the highest percentage appreciation would be first in order). Without such a provision, the general power may apply to a pro rata portion of all trust assets. See Ed Morrow, *PLR 202206008: Judicial Settlement Modification & Formula Testamentary General Powers of Appointment*, LEIMBERG ESTATE PLANNING NEWSLETTER #2946, at n.2 (March 17, 2022).
- (c) **Limiting "Inappropriate" Exercise.** To limit the possible "inappropriate" exercise of a power of appointment, (1) state that some independent person has the ability to remove the general power of appointment before the powerholder dies or to revise the power (for example, to adjust a formula general power of appointment), (2) specify that the power is exercisable only with the consent of some other non-adverse party (but not the grantor), see Reg. §20.2041-3(c)(2), Ex. 3, and (3) limit the permissible appointees of the power (such as to persons related by blood, marriage, or adoption or to creditors).
- (d) **Flexibility.** Beyond limiting "inappropriate exercise," giving a non-adverse party the ability to modify the general power of appointment (mentioned immediately above) adds significant

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flexibility to react to changing circumstances. An added advantage is that the holder of the general power of appointment would not have a vested interest if the power can be modified by a third party, so actions by the powerholder reducing the pool of assets subject to the power would not constitute a release of a general power of appointment resulting in a gift by the powerholder.

- (e) **Using Beneficiary's GST Exemption.** If another purpose of granting the general power is to utilize the powerholder's GST exemption, structure the formula to be based on the lesser of the individual's remaining GST exemption or applicable exclusion amount.
  - (f) **Avoiding Need for Powerholder to File Estate Tax Return.** Consider limiting the formula to \$10,000 less than the powerholder's applicable exclusion amount so that the existence of the general power of appointment will not require the powerholder's estate to file an estate tax return.
  - (g) **Sample Forms.** For examples of formula powers, see *Ed Morrow & the Optimal Basis Increase Trust (OBIT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2080 (March 20, 2013). An updated version is downloadable for free from [the ssrn.com website](https://www.ssrn.com). An excellent comprehensive form is in Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, at II.H.2.k (January 2022) (an extremely comprehensive resource available from the author). Various forms and references to other resources with form examples are also included in Item 5 of the Estate Planning Current Developments Summary (December 2018) found [here](#), and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).
  - (h) **Power to Appoint to Creditors.** A method of limiting the manner in which a general power could be exercised is to provide that the power may only be exercised in favor of creditors. For an excellent discussion of the effect of a general power to appoint to creditors, and whether the power could be exercised only up to the amount of debt to a particular creditor, and the impact of that decision on the amount included in the gross estate under §2041, see Robert J. Kolasa, *Creditor General Powers of Appointment, Trusts & Estates* 16 (Feb. 2020).
  - (i) **Creditor Effects.** Bear in mind that the existence of the general power may have creditor effects, but the actual exercise of a testamentary general power of appointment may be more likely to subject the assets to the decedent-beneficiary's creditors than if the general power is not exercised. Section 502 of the Uniform Power of Appointment Act provides that creditors of the holder of a general power may reach the assets subject to the power to the extent the powerholder's property (if the power is *presently exercisable*) or the powerholder's estate is insufficient. This is the biggest change from traditional law principles under the Uniform Power of Appointment Act, and this is the provision of the Uniform Act that states are most likely to consider changing.
  - (j) **Similar PLRs.** Other PLRs that have addressed formula general powers of appointment include PLRs 200604028 and 200403094.
- c. **CCA 202352018, Consent by Beneficiaries to Trust Modification (Adding a Trustee Power to Reimburse the Grantor For Income Taxes Attributable to Grantor Trust Income) Results in Gift by Beneficiaries.** CCA 202352018 concludes that the modification of an irrevocable grantor trust with beneficiaries' consent, to add a tax reimbursement clause providing the trustee with a discretionary power to make distributions of income or principal in an amount sufficient to reimburse the grantor for income tax attributable to inclusion of the trust's income in grantor's taxable income, would constitute a taxable gift by the beneficiaries of a portion of their respective interest in income and/or principal of the trust. Prior to the modification, neither State law nor the governing instrument of the trust required or provided such reimbursement authority. The CCA specifically states that the result would have been the same if the beneficiaries had not explicitly consented but if they had notice of the modification and a right to object but failed to exercise their right to object.

The CCA distinguished Rev. Rul. 2004-64, which holds that if the original governing instrument (rather than a modification with the beneficiaries' consent) provided for a mandatory or discretionary

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right to reimbursement for the grantor's payment of the income tax, such payment to the grantor would not constitute a gift by the trust beneficiaries.

The CCA acknowledges that PLR 201647001 reached a contrary conclusion, that a trust modification to add a discretionary reimbursement power "is administrative in nature and does not result in a change of beneficial interests in the trust." The 2023 CCA states: "These conclusions no longer reflect the position of this office."

The CCA does not address how to value the gift and acknowledges that "the determination of the values of the gifts requires complex calculations" (without addressing how to approach making such complex calculations). The CCA, in its statement of the law, summarizes several regulations relevant to this issue as follows:

Section 25.2511-1(e) provides that if a donor transfers by gift less than their entire interest in property, the gift tax is applicable to the interest transferred. Further, if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the *entire value* of the property subject to the gift.

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Section 25.2511-2(a) provides that the gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer. Rather, it is a tax upon the donor's act of making the transfer. The measure of the gift is the *value of the interest passing from the donor* with respect to which they have relinquished their rights without full and adequate consideration in money or money's worth. (Emphasis added)

One can imagine a situation in which the beneficiaries actually benefit from the modification. For example, the grantor may tell the trustee that she will take steps to relinquish rights or powers that cause the trust to be a grantor trust if the trust is not modified to give the trustee the discretion to consider reimbursing the grantor in some situations.

In certain situations (for example, with very large trusts), the likelihood that a trustee would make reimbursement payments or that making reimbursement payments to the grantor would reduce the amount of any discretionary distributions to any current beneficiaries may be infinitesimally small. At what point would any such theoretical gift, by reason of consenting to the modification, be incomplete? See generally Zeydel, *When Is a Gift to a Trust Complete: Did CCA 201208026 Get It Right?*, 117 J. TAX'N 3 (September 2012); Zeydel, *Developing Law on Changing Irrevocable Trusts: Staying Out of the Danger Zone*, 47 REAL PROP. TR. & EST. L.J. 1 (Spring 2012) (discussing tax effects of trust modification, rescission, reformation, or decanting transactions).

Authority exists for treating the failure to enforce one's legal rights as a gift by that individual in appropriate circumstances. See Rev. Rul 84-105 (surviving spouse's failure to object to underfunding of a general power of appointment marital deduction trust); Rev. Rul 81-264 (failing to enforce note payable). And consenting to trust modifications in appropriate circumstances can result in a gift. See Reg. §26.2601-1(b)(4)(i)(E) Ex.7 ("modification increasing A's share of trust income is a transfer by B and C to A for Federal gift tax purposes"). But treating the consent to judicial modification to add a trustee discretionary reimbursement power as a gift seems inappropriate in this situation. Rev. Rul 2004-64 confirms that the grantor's payment of income tax on grantor trust income is not a gift to trust beneficiaries. It would seem rather ironic to treat the return of that benefit to the grantor, in whole or in part, be a transfer for gift tax purposes.

## **20. Intergenerational Split-dollar Life Insurance, Estate Tax Treatment of Repayment Right, *Estate of Morrisette v. Commissioner*, T.C. Memo. 2021-60 and *Estate of Levine v. Commissioner*, 158 T.C. No. 2 (February 28, 2022)**

*Estate of Morrisette v. Commissioner*, T.C. Memo. 2021-60 and *Estate of Levine v. Commissioner*, 158 T.C. No. 2 (February 28, 2022) involve intergenerational split dollar transactions in which parents made large advances to trusts to make premium payments on policies on the lives of their children. Under the split dollar agreements, the advances would not be repaid until the insured children died (which could be many years in the future) unless the split dollar agreement was terminated earlier. The parents died and their estates greatly discounted the reimbursement rights because they may not be paid for years.

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In both cases, the courts eventually determined that §2036 and §2038 did not apply. The court in *Morrisette* valued the estate's reimbursement rights at a significantly higher value than the estates had reported them, resulting in large estate tax deficiencies and penalties. The *Levine* case merely determined that §2036, §2038, and §2703 did not apply. The reasoning in *Levine* has broad planning implications regarding §2036 and §2038 in other contexts as well, as summarized in Item 17.c.(4) above.

For further discussion of these cases, see Item 20 of Heckerling Musings 2023 and Estate Planning Current Developments (April 12, 2023) found [here](#) and available at [www.besemertrust.com/for-professional-partners/advisor-insights](http://www.besemertrust.com/for-professional-partners/advisor-insights).

**21. Validity (or Invalidity) of Regulations under the Administrative Procedure Act, *Hewitt v. Commissioner*, 128 AFTR 2d 2021-7033 (11th Cir. December 29, 2021); *Oakbrook Land Holdings, LLC v. Comm'r*, 129 AFTR 2d 2022-1031 (6th Cir. March 14, 2022); *Mann Construction, Inc. v. United States*, 129 AFTR 2d 2022-885 (6th Cir. March 3, 2022); *CIC Services, LLC v. IRS*, 592 F. Supp.3d 677, 688, 129 AFTR 2d 2022-1119 (E.D. TN March 21, 2022); *Liberty Global, Inc. v. United States*, 27 F.4th 1138 (D. Colo. April 4, 2022); Similar Cases**

- a. **Some Twenty-Year-Old History; *Walton v. Commissioner*.** In the much celebrated (at least by taxpayers) case of *Walton v. Commissioner*, 115 T.C. 589 (2000), the Tax Court invalidated the notorious Example 5 in the GRAT regulations (Reg. §25.2702-3(e), Ex. 5) as being “an unreasonable interpretation and an invalid extension of section 2702.” The court said that it did not need to reach the issue of whether the regulation was adopted in violation of the Administrative Procedure Act (APA). That holding allows the full actuarial value of the retained annuity interest in a GRAT to be subtracted in determining the net value of the gift upon the creation of a GRAT.

Since that time over twenty years ago, few cases in the estate planning arena have addressed the validity of Treasury regulations and notices, and very few have addressed the invalidity of regulations for failure to comply with the APA. A number of recent cases in late 2021 and 2022, though, have addressed that issue, not only for final regulations but also temporary regulations and even subregulatory guidance.

- b. **Validity of the “Protected-in-Perpetuity” Conservation Easement Regulation (At Least Regarding Improvements).** While the IRS's main concern with many conservation easement deductions is over the value of the easement, the IRS has been most successful in its attacks on conservation easements by challenging whether easements violated the requirement in regulations that the easement last in perpetuity. A model easement deed that was being used widely (and that had been accepted by the IRS in various private letter rulings) provided that upon termination or extinguishment of the easement the grantee would receive from the proceeds an amount reduced by the increase in value attributable to improvements made after the grant of the easement, which is inconsistent with the regulations. *E.g.*, *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014). (Interestingly, no one ever found a single easement that had been condemned, but that has not slowed the government from its attempt in many cases to deny deductions in their entirety over this issue.) For a discussion of some of these many cases, see Item 37 of Estate Planning Current Developments and Hot Topics (December 2019) found [here](#), Item 39.b. of Heckerling Musings 2020 and Estate Planning Current Developments (August 2020) found [here](#), and Item 38 of Estate Planning Current Developments (December 2021) found [here](#), all available at [www.besemertrust.com/for-professional-partners/advisor-insights](http://www.besemertrust.com/for-professional-partners/advisor-insights). For a review of the status of the extensive case law developments regarding the “proceeds regulation,” see Nancy A. McLaughlin, *Conservation Easements and The Proceeds Regulation*, 56 REAL PROP., TRUST & EST. LAW J. (Summer 2021) and Ronald D. Aucutt, *The Top Ten Estate Planning and Estate Tax Developments of 2020* (January 2021) found [here](#) and available at [www.besemertrust.com/for-professional-partners/advisor-insights](http://www.besemertrust.com/for-professional-partners/advisor-insights)).

The latest development in the conservation easement “protected-in-perpetuity” requirement under the judicial extinguishment proceeds regulation (Treas. Reg. §1.170A-14(g)(6)(ii)), which is intended to assure that easement donations comply with the “protected-in-perpetuity” requirement in

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§170(h)(5)), is whether the regulation is valid (at least as to improvements). The Sixth and Eleventh Circuits have recently reached opposite results as to that issue.

- (1) **Hewitt v. Commissioner, Eleventh Circuit.** The Eleventh Circuit Court of Appeals held that the prohibition on subtracting the value of post-donation improvements in determining the portion of extinguishment proceeds attributable to the easement is arbitrary and capricious and violates the procedural requirements of the APA. *Hewitt v. Commissioner*, 21 F.4th 1336, 128 AFTR 2d 2021-7033 (11th Cir. December 29, 2021).

The analysis of whether the regulation (and the IRS's interpretation of the regulation to bar subtracting improvements from the reimbursement calculation) satisfies the requirements of the APA to be a valid regulation is very interesting. Whether a Treasury regulation satisfies the procedural requirements of the APA does not often arise in reported cases. The Supreme Court has interpreted Section 4 of the APA (5 U.S. Code §553) to prescribe a three-step procedure for "notice-and-comment" rulemaking. *Perez v. Mortg. Bankers Ass'n*, 575 U.S. 92, 96 (2015). First, the agency must issue a general notice of proposed rulemaking. Second, the agency must give interested persons an opportunity to participate through submission of views, and the Supreme Court has interpreted this requirement in *Perez* to include that the agency "must consider and respond to significant comments received during the period for public comment." Third, in promulgating the final rule, the agency must include in the rule's text "a concise statement of its basis and purpose." 5 U.S.C. §553(c).

Of 90 commenters on the conservation easement regulations, 13 offered comments about the proposed extinguishment proceeds regulation, and seven specifically expressed concern that the process under the proceeds regulations "was unworkable, did not reflect the reality of the donee's interest, or could result in an unfair loss to the property owner and a corresponding windfall for the donee." The most detailed comment by the New York Landmarks Conservancy (NYLC) specifically addressed inequities about applying the proposed regulation to post-donation improvements. The court observed that Treasury stated that it had "consider[ed] ... all comments regarding the proposed amendments," but in the "Summary of Comments" section "Treasury did not discuss or respond to the comments made by NYLC or the other six commenters concerning the extinguishment proceeds regulation." *Id.* Instead, the court observed that Treasury "simply stated that it had considered 'all comments.'"

Because Treasury, in promulgating the extinguishment proceeds regulation, failed to respond to NYLC's significant comment concerning the post-donation improvements issue as to proceeds, it violated the APA's procedural requirements. ... We thus conclude that the Commissioner's interpretation of § 1.170A-14(g)(6)(ii), to disallow the subtraction of the value of post-donation improvements to the easement property in the extinguishment proceeds allocated to the donee, is arbitrary and capricious and therefore invalid under the APA's procedural requirements.

The Tax Court had found that the regulation was procedurally valid, relying on its decision in *Oakbrook Land Holdings, LLC v. Comm'r*, 154 T.C. 180 (2020). *Oakbrook* is discussed in Item 21.b(2) below.

A concurring opinion in *Oakbrook* by Judge Toro reasoned that the regulation was procedurally invalid if it is interpreted to bar the subtraction of post-donation improvements. The *Hewitt* appellate opinion included with agreement a detailed summary of Judge Toro's concurring opinion in *Oakbrook*.

Judge Toro explained that the "Treasury received more than 700 pages of comments" during the comment period and that, in the final regulations, Treasury responded to those comments and other administrative matters in just two of the twelve pages—"six columns in the Federal Register"—consisting of the final regulations. *Id.* at 221. In his view, it was likely that Treasury "was simply following its historical position that the APA's procedural requirements did not apply to these types of regulations," noting that the final regulations referenced Treasury's belief that they did not require notice and comment and that this belief was mistaken. *Id.* at 222.

Judge Toro then found that the "Treasury failed to 'respond to "significant points" and consider "all relevant factors" raised by the public comments.'" *Id.* at 223 ... The proposed regulations' preamble explained that they reflected Congress's "major policy decisions," and NYLC "in effect countered that the proposed rule on

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future donor improvements was contrary to those policy decisions, would lead to inequitable results that were inconsistent with the statute, and would deter future contributions.” *Id.* at 225 (quoting 48 Fed. Reg. at 22,940). In other words, Judge Toro found that NYLC “offered comments that, ‘if adopted, would require a change in an agency’s proposed rule,’” and that “were both ‘relevant and significant,’ [as to] require[e] [sic] a response.” *Id.* ...

... Judge Toro also explained that the *Oakbrook* majority’s reasoning as to the issue was flawed for several reasons. He explained that courts were “not required to ‘take the agency’s word that it considered all relevant matters,’” as the majority asserted. *Id.* at 226–27 (quoting *PPG Indus., Inc. v. Costle*, 630 F.2d 462, 466 (6th Cir. 1980)). He further noted that “[a] ‘relevant and significant comment’ requires a response, regardless of whether the point is made by many, a few, or even a single commenter,” and “a comment does not lose its significance because it is presented succinctly.” *Id.* at 227 (quoting *Carlson*, 938 F.3d at 347). And, if the scope of the project “was too large to permit an appropriate response to all ‘relevant and significant comments,’ then Treasury could have broken the project down into smaller parts.” *Id.*

The *Hewitt* opinion also pointed with agreement to reasons given by a dissenting opinion in *Oakbrook*.

In his dissenting opinion, Judge Holmes reached a similar conclusion to Judge Toro on the regulation’s procedural invalidity under the APA. He concluded that comments from NYLC and other organizations “were significant and [were] entitled to an agency response.” See *id.* at 245 (Holmes, J., dissenting). Judge Holmes explained that Treasury’s statement that it considered “all comments” was not sufficient under the APA ... Treasury failed to “even acknowledge the relevant comments or expressly state its disagreement with them” such that there was not even “a minimal level of analysis.” *Id.* at 248 (quoting *Encino Motorcars*, 579 U.S. at 2120).

Commentators have emphasized the significance of this case as representing “one of the few successful challenges to a Treasury regulation on procedural grounds.” Miller & Chevalier Tax Alert, *In Case You Missed It: Hewitt v. Commissioner Has Broken New Ground in Disputes Over Conservation Easements* (January 19, 2022), available at

<https://www.millerchevalier.com/publication/case-you-missed-it-hewitt-v-commissioner-has-broken-new-ground-disputes-over>.

Treasury and the IRS were long considered immune from the APA’s requirements, but the trend has shifted in recent years. We expect that this trend could continue, and we may continue to see more challenges to Treasury and IRS agency determinations in appropriate cases. Miller & Chevalier Tax Alert (January 19, 2022).

The U.S. solicitor general decided not to appeal *Hewitt* to the Supreme Court, despite the circuit split in light of the Sixth Circuit’s contrary holding in *Oakbrook Land Holdings, LLC*, discussed immediately below. The taxpayer eventually reached a settlement with the IRS and reportedly kept most of the claimed deduction.

For a critical analysis of the *Hewitt* reasoning, see Jasper Cummings, *Syndicated Conservation Easement Transactions*, TAX NOTES TODAY FEDERAL (May 23, 2022).

- (2) ***Oakbrook Land Holdings, LLC v. Commissioner, Sixth Circuit***. The Tax Court held that the regulation was procedurally valid not only in *Hewitt* but also in *Oakbrook Land Holdings, LLC v. Comm’r*, 154 T.C. 180 (2020). The Tax Court opinion included a detailed analysis of why the regulation was procedurally valid regarding the requirement that a proportionate share of post-donation improvements be shared with the easement holder if the easement was extinguished. Included in that analysis was a statement that “[t]he APA ‘has never been interpreted to require the agency to respond to every comment, or to analy[z]e every issue or alternative raised by the comments, no matter how insubstantial.’” (quoting *Thompson v. Clark*, 741 F.2d 401, 408 (D.C. Cir. 1984)). The Tax Court majority opinion in *Oakbrook* also observed that “[o]nly one of the 90 commenters”—NYLC—“mentioned donor improvements, and it devoted exactly one paragraph to this subject.” The majority opinion in *Oakbrook* also refuted an objection to the regulation because the conservation easement regulations did not include a “basis and purpose” statement specifically regarding the judicial extinguishment provision of the regulations. It reasoned that a regulation does not need to include a statement of the basis and purpose “where the basis and purpose... [are] considered obvious.” Furthermore, the judicial extinguishment provision is a very small provision in the lengthy regulations and the APA did not “mandate that an agency explain the basis and purpose of each individual component of a regulation separately.”

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The Sixth Circuit Court of Appeals affirmed the Tax Court and upheld the validity of the “in perpetuity” regulation. 129 AFTR 2d 2022-1031 (6th Cir. March 14, 2022). A majority of the three-judge panel upheld the validity of the regulation, but the third judge in a concurring opinion reasoned that the regulation was invalid. The majority agreed with the Tax Court that the very concise statement of basis and purpose of the regulation was sufficient and that the comments, including the comment by the NYLC mentioning donor improvements, do not raise valid concerns about how the regulation served the policy of restricting the conservation easement deduction to where the easement’s purpose can be protected forever and “do not qualify as significant;” therefore, the comments do not require a response under the APA. The NYLC’s comment “left Treasury to guess at the connection, if any, between the organization’s problems and the proceeds regulation’s basis and purpose.” The Sixth Circuit specifically found the Eleventh’s Circuit’s reasoning in *Hewitt* “to be unpersuasive.”

A concurring opinion by Judge Guy concluded that the in-perpetuity regulation is procedurally invalid under the APA

for substantially the same reasons stated by the Eleventh Circuit in *Hewitt v. Commissioner of IRS*, 21 F.4th 1336 (11th Cir. 2021), and by the concurring and dissenting opinions in *Oakbrook Land Holdings, LLC v. Commissioner of IRS*, 154 T.C. 180, 200-30 (2020) (Toro, J., concurring in the judgment, joined in full by Urda, J., and joined in part by Gustafson and Jones, JJ.); *id.* at 230-259 (Holmes, J., dissenting).

But Judge Guy still joined the majority in affirming the Tax Court on the basis that Oakbrook’s deed violated the perpetuity requirement of the statute itself (Section 170(h)(2)(C)).

Oakbrook filed a petition for certiorari with the Supreme Court on October 4, 2022, which the Supreme Court denied on January 9, 2023. See Kristen A. Parillo, *Taxpayer Pushes for End to Circuit Split on Easement Reg Validity*, 177 TAX NOTES FEDERAL 300 (Oct. 10, 2022); Mitchell A. Kane, *The Dispute Over Perpetual Conservation Easements Just Got Worse*, 177 TAX NOTES FEDERAL 1211 (Nov. 28, 2022).

- (3) **Glade Creek Partners LLC v. Commissioner, Eleventh Circuit.** The Eleventh Circuit vacated for reconsideration the Tax Court’s denial of a \$17.5 million easement deduction in *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2020-148 based on its opinion in *Hewitt* but upheld the Tax Court’s application of the substantial valuation misstatement penalty. *Glade Creek Partners LLC v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021).
- (4) **Sparta Pink Property, LLC v. Commissioner, Tax Court (Appealable to Eleventh Circuit).** The Tax Court denied the IRS’s motion for partial summary judgment regarding the IRS’s denial of a conservation easement deduction for failure to comply with the “protected in perpetuity” regulation (because of “carve-outs for ‘donor improvements’”). The motion was denied in light of *Hewitt* because the case is appealable to the Eleventh Circuit. The motion was denied “without prejudice to [the IRS’s] submission of the arguments set forth therein should subsequent developments warrant that action.” *Sparta Pink Property, LLC v. Commissioner*, T.C. Memo. 2022-88 (August 29, 2022).
- (5) **Long Leaf Property Holdings LLC v. Commissioner, Tax Court (Appealable to Eleventh Circuit).** The Tax Court, in an Order dated August 31, 2022, has held in abeyance a Motion for Partial Summary Judgment based on alleged invalidity of the “judicial extinguishment” regulation until the Eleventh Circuit provides further guidance regarding the scope of its *Hewitt* opinion. Judge Lauber reasoned that it is unclear whether *Hewitt* invalidated the regulation in its entirety or only as to its disallowance of a deduction based on carve-outs for donor improvements. The issue in *Long Leaf* involved limiting the donee’s share of extinguishment proceeds to a fixed historical value (*i.e.*, the easement’s fair market value on the donation date), not donor improvements. *Long Leaf Property Holdings LLC v. Commissioner*, Dkt. No. 11982-16 (Petition filed May 19, 2016). See Kristen A. Parillo, *Clarity Needed on Scope of Court’s Easement Reg Opinion*, TAX NOTES TODAY FEDERAL (September 1, 2022).
- (6) **Battelle Glover Investments LLC v. Commissioner, Tax Court (Appealable to Eleventh Circuit).** Similarly, the Tax Court, in an Order dated September 12, 2022, vacated its earlier order

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sustaining the denial of an approximate \$150 million easement deduction based on the *Hewitt* decision invalidating the “judicial extinguishment” regulation under the Administrative Procedure Act. The case would be appealable to the Eleventh Circuit Court of Appeals. *Battelle Glover Investments LLC v. Commissioner*, Dkt. No. 6904-19 (Order dated Sept. 12, 2022).

- c. **IRS Notices of “Listed” Transactions.** Section 6707A permits the IRS to penalize the failure to provide information concerning “reportable” and “listed” transactions as a way of identifying potentially illegal tax avoidance schemes (i.e., “tax shelters”). The IRS has issued various Notices identifying specific transactions that fall into either of these categories. Several recent cases have attacked several of the specific Notices as failing to comply with the notice-and-comment procedures of the Administrative Procedure Act.

- (1) ***Mann Construction, Inc. v. United States, Sixth Circuit and District Court Order Vacating Notice.*** The Sixth Circuit reversed the district court and held that Notice 2007-83, which designates certain employee-benefit plans featuring cash-value life insurance policies as listed transactions, was not valid because it violated the notice-and-comment requirements of the Administrative Procedure Act. *Mann Construction, Inc. v. United States*, 129 AFTR 2d 2022-885 (6th Cir. March 3, 2022). It concluded that (1) the Notice was a legislative rule subject to the APA because it imposed new duties on taxpayers subject to penalties and criminal sanctions, and (2) Congress did not exempt the IRS from following the procedures of the APA when issuing the Notice.

Following the Sixth Circuit opinion, the district court on remand vacated Notice 2007-83. The IRS argued the effect would be an “impermissible nationwide injunction.” The court reasoned, in response, that “[t]he APA requires reviewing courts to ‘set aside’ or to vacate any unlawful regulation [citing 5 U.S.C. §706(2)] ... [and] this Court may not ignore the edict of Congress....” Injunctions are rooted in equity whereas “APA vacatur is an action at law.” An injunction “operates on the enjoined officials” to block them from enforcing a regulation, but “the vacatur of a regulation ‘unwinds the challenged agency action’ altogether.” Opinion and Order Granting Plaintiffs’ Motion to Enforce Mandate of Court of Appeals and Setting Aside IRS Notice 2007-83 (E.D. Mich. January 18, 2023).

The Sixth Circuit vacated the district court’s remand decision that had invalidated the regulation nationwide. The Sixth Circuit reasoned that the government’s refund of tax with interest “deprives the court of jurisdiction over the taxpayer’s dispute, even if he continues to object to other aspects of IRS policy.” In addition to the tax refund claim, the APA permits a taxpayer to seek an injunction preventing the IRS from enforcing rules unrelated to future tax collection (such as reporting requirements), but “the government fully mooted Mann’s claim for relief under the APA when it conceded that it would no longer enforce Notice 2007-83 against these taxpayers or even within the Sixth Circuit.” 86 F.4th 1159, 132 AFTR 2d 2023-6535 (6th Cir. Nov. 20, 2023).

- (2) ***CIC Services, LLC v. IRS, Eastern District Tennessee.*** A couple of weeks after the Sixth Circuit decided *Mann Construction*, a Tennessee federal district court followed the same approach to invalidate Notice 2016-66, which designates certain micro-captive transactions as “transactions of interest” subject to reporting obligations. *CIC Services, LLC v. IRS*, 592 F. Supp.3d 677, 688, 129 AFTR 2d 2022-1119 (E.D. Tenn. 2022). The court followed *Mann Construction* (which is binding on this district court located in the Sixth Circuit) and held that the Notice did not follow the notice-and-comment procedures of the APA. The court further concluded that the Notice must be invalidated under the APA because the IRS acted arbitrarily and capriciously in issuing the Notice.
- (3) ***Green Valley Investors, LLC v. Commissioner.*** Notice 2017-10 identifies as “listed transactions” what are commonly referred to as syndicated conservation easement transactions in which promotional materials offer prospective investors in a pass-through entity the possibility of a charitable contribution that equals or exceeds an amount that is two and one-half times the investor’s investment. In a **15-2 full Tax Court decision**, the court granted summary judgment for the taxpayer, holding that Notice 2010-7 is invalid under the Administrative Procedure Act. *Green Valley Investors, LLC v. Commissioner*, 159 T.C. No. 5 (November 9, 2022) (reviewed by

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the Court). The opinion reasoned that Notice 2017-10 is a legislative rule, that it was improperly issued by the IRS without notice and comment as required under the APA, that it will be set aside for this case, and that penalties under §6662A will not be imposed. The opinion relied heavily on *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. March 3, 2022), *rev'g* 539 F. Supp. 3d 745 (E.D. Mich. 2021).

A dissenting opinion by Judge Gale observed that a temporary regulation had authorized the IRS to identify listed transactions “by notice, regulation, or other form of published guidance.” It reasoned that the reference to “notice” is significant.

A “notice” is a long recognized species of written guidance published by the Internal Revenue Service ‘when the Service determines that a public concern requires a speedy response’ and is correspondingly “[i]ssued without public notice and comment.” Stephanie Hunter McMahon, *Classifying Tax Guidance According to End Users*, 73 TAX LAW. 245, 256-58 (2020). This type of ‘notice’ is to be distinguished from the notice entailed in notice-and-comment rulemaking enumerated in the APA. See 5 U.S.C. § 553(b).

The majority opinion, on the other hand, reasoned that neither the statute (§6707) nor regulations indicating that the IRS would identify listed transactions by “notice, regulation, or other form of published guidance” reflected an intent by Congress to exempt Notices identifying listed transactions from the notice-and-comment requirements of the APA.

Respondent contends that this regulation apprised Congress that it would operate outside of the APA by issuing future notices (such as Notice 2017-10) without notice and comment. Respondent further maintains that when Congress later defined reportable transaction in section 6707A(c)(1), it incorporated this procedure set forth in Treasury Regulation § 1.6011-4. We are not persuaded. As an initial matter, we are less confident that Congress understood that the IRS’s reference to the term “notice” within Treasury Regulation § 1.6011-4 was a clearly defined procedure for identifying listed transactions separate from traditional APA procedures, particularly since Congress’ statutory text in no way authorizes such a course. To the contrary, we believe that Congress operates under the expectation that administrative agencies respect their APA obligations except when Congress expressly chooses different procedures. 5 U.S.C. § 559.

Footnote 22, at the end of the majority opinion (**again, a 15-2 decision**), states: “Although this decision and subsequent order are applicable only to petitioner, the Court intends to apply this decision setting aside Notice 2017-10 to the benefit of all similarly situated taxpayers who come before us.” That reasoning could apply beyond syndicated conservation easements to many other listed transactions identified in IRS Notices. Judge Pugh’s concurring opinion cites an IRS on-line source that lists 35 types of listed transactions, identified since 1990, most by Notices.

The IRS filed a motion to reconsider on December 9, 2022, arguing that the majority opinion, two concurring opinions, and two dissents did not appear to consider arguments made in a “Supplement” that was filed by the IRS only one week before the reviewed opinion was issued, which raises concern about whether the Supplement had been circulated to the entire court during its consideration of the taxpayer’s motion for summary judgment. That motion was denied in an Order entered January 23, 2023.

- (4) **GBX Associates, LLC v. United States, Northern District Ohio.** A district court opinion filed five days after *Green Valley Investors* allowed relief against the IRS’s use of Notice 2017-10 on the basis that *Mann Construction, Inc. v. United States* had invalidated a different IRS Notice for failure to comply with the APA. (The Ohio case would have been appealable to the Sixth Circuit, which decided the *Mann* case.) The court refused, though, to grant the GBX’s request for a “universal vacatur,” by which Notice 2017-10 would be held unlawful – or “vacated” – in its entirety, not just as applied to GPX. The opinion observed that the Third, Ninth, and D.C. Circuits have agreed that the APA authorizes universal vacatur, but neither the Supreme Court nor the Sixth Circuit has. It also noted that the IRS is continuing to contest in other jurisdictions that IRS Notices are subject to the APA notice and comment requirements. *GBX Associates, LLC v. United States*, 130 AFTR 2d 2022-6440 (N.D. Ohio 2022).

In denying the universal vacatur, the district court in *GBX* seems consistent with the Tax Court in *Green Valley Investors*, which noted in footnote 22 that the decision applied only to the petitioner in that case, but that the Court intended to apply the vacating of Notice 2017-10 to similarly situated taxpayers who come before the Court.

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(5) **Green Rock, LLC v. IRS, Northern District Alabama, on appeal to Eleventh Circuit.** An Alabama federal district court similarly set aside Notice 2017-10, despite an argument by the IRS that such action was tantamount to a nationwide injunction. *Green Rock, LLC v. IRS*, 131 AFTR 2d 2023-562 (N.D. Ala. February 2, 2023). The case is on appeal to the Eleventh Circuit Court of Appeals.

(6) **Proposed Regulations Regarding Syndicated Conservation Easements and Other Listed Transactions.** In response to the Tax Court's decision in *Green Valley*, Announcement 2022-28, 2022-52 IRB 1 stated that the IRS and Treasury disagree with the *Mann Construction* and *Green Valley* decisions and will continue "to defend the validity of Notice 2017-10 and other notices identifying transactions as listed transactions in circuits other than the Sixth Circuit." But to eliminate confusion the IRS released proposed regulations on the same day to identify certain syndicated conservation easement transactions as listed transactions, and the IRS plans to finalize the regulations in 2023. Prop. Reg. §1.6011-9. After finalizing the syndicated conservation easement regulations, the IRS intends to issue proposed regulations addressing additional listed transactions.

The proposed regulation addressing syndicated conservation easements is Prop. Reg. §1.6011-9. See Kristen Parillo, *Proposed Regs Would Formalize Easement Listing Notice*, TAX NOTES TODAY FEDERAL (December 7, 2022).

Proposed regulations issued on April 10, 2023, identify certain micro-captive insurance transactions as listed transactions and certain other micro-captive insurance transactions as transactions of interest; both are types of reportable transactions. Prop. Reg. §1.6011-10 & §1.6011-11 (REG-109309-22).

(7) **Legislation in Consolidated Appropriations Act, 2022 Denying Charitable Deduction for Similarly Situated Conservation Easements.** Rules to tighten deductions for syndicated conservation easements are provided under Section 605 of SECURE 2.0 of 2022 (in Division T of the Consolidated Appropriations Act, 2023), effective for contributions made after the date of enactment (December 29, 2022).

(a) **No Deduction in Certain Situations.** No charitable deduction of a qualified conservation easement made by a pass-through entity will be allowed if the deduction claimed exceeds two and one-half times the sum of each partner's relevant basis in the contributing entity, unless the contribution meets a 3-year holding period test, substantially all the contributing partnership is owned by members of a family, or the contribution relates to the preservation of a certified historic structure and certain reporting requirements are met. The deduction limitation applies to pass-through entities (including S corporations) as well as partnerships. §170(h)(7).

(b) **Safe Harbor Language; Correction Period.** The statute also includes a provision requiring the IRS to publish safe harbor deed language for extinguishment clauses and boundary line adjustments and allowing donors the opportunity to correct certain defects in an easement deed (excluding abusive easements for which deductions are denied under this legislation or if the transaction is already a docketed case or a penalty has already been determined) within 90 days after the publication of the safe harbor guidance.

The IRS published the safe harbor deed language in Notice 2023-30. Easement donors have 90 days from April 24, 2023 (i.e., until July 24, 2023), the date the safe harbor language is published in the Internal Revenue Bulletin, to substitute the new safe harbor language in their original deeds. IRS Newswire Issue Number IR-2023-73 (April 10, 2023). See generally Nancy Ortmeyer Kuhn & Shuman Rogers, *Conservation Easements: The IRS Provides a Limited Safe Harbor*, 48 BLOOMBERG TAX MGMT. ESTS., GIFTS & TRUSTS. J. No. 3 (May 11, 2023).

(c) **Penalties.** In addition, the statute strengthens accuracy-related penalties for these transactions by (i) treating any disallowance under these rules as a "gross valuation misstatement," which doubles the penalty under §6662 from 20 percent to 40 percent, (2)

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eliminating any reasonable cause defense under §6664(c), and (3) eliminating the requirement for supervisory approval of penalty assessment under §6751(b).

(d) **Listed Transaction, Statute of Limitations.** Transactions covered by the legislation shall be treated as listed transactions under §6501(c)(10) and §6235(c)(6), meaning that the statute of limitations on assessments or partnership adjustments will not run until one year after information has been furnished to the IRS as required for listed transactions.

(8) **Summary: Applicability of APA to Subregulatory Guidance.** The IRS's claim that its subregulatory guidance is not subject to the APA requirements is clearly under attack.

The IRS and Treasury have long claimed that subregulatory published guidance is exempt from notice and comment requirements established by the Administrative Procedure Act. Two recent cases, *Mann Construction* in the Sixth Circuit and *CIC Services* on remand from the Supreme Court, however, rejected this claim in the context of two IRS notices, paving the way for taxpayers to wage similar successful attacks.

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As recent cases like *Mann Construction*, *CIC Services*, and *Liberty Global* show us, courts keep encouraging Treasury and the IRS to join the mainstream of administrative law principles. It is unclear how developments will evolve and to what extent other courts will follow suit. What is clear, however, is that momentum continues to build behind APA challenges, and the recent run of taxpayer wins suggests that the government's traditional defenses against these challenges are no longer tenable. We anticipate that more taxpayers will press APA claims, as is their right. The government has a lot of old guidance that may be vulnerable. The situation is not sustainable from a tax policy perspective.

Gregory Armstrong et. al., *No Notice: Why Unilateral IRS Rulemaking Is Obsolete*, TAX NOTES TODAY FEDERAL (May 2, 2022) (footnotes omitted).

d. **Temporary Regulations Invalidated for Failure to Comply with APA, *Liberty Global, Inc. v. United States*.** Those cases were followed up weeks later with a decision by the federal district court of Colorado invalidating temporary regulations implementing retroactive application of §245A (the foreign source dividends received deduction) because they were promulgated without notice and comments as required by the APA. *Liberty Global, Inc. v. United States*, 27 F.4th 1138 (D. Colo. April 4, 2022). The court reasoned that (1) the Treasury Department was required to comply with the APA notice-and-comment procedures in promulgating the temporary regulations (disagreeing with the IRS's argument that §7805(e) authorizes the issuance of temporary regulations, which must also be issued as proposed regulations, without complying with the APA procedures), (2) the Department did not have good cause to depart from the notice-and-comment procedures (because the Department had ample time to include a notice and comment period alerting taxpayers to the potential retroactive effect of the temporary regulations and the Department could have met an 18-month deadline required for regulations to have retroactive effect under §7805(b)(2)), and (3) the Department's failure to comply with notice and comment procedures was not harmless error.

Billions of tax dollars are at issue if the retroactive temporary regulations are not effective. The case is appealable to the Tenth Circuit. One advisor suggests that the Tenth Circuit might resolve differently "both the good cause and harmless error arguments," and Monte Jackal, who has served in various roles at the Treasury's Office of Tax Policy and the IRS Office of Chief Counsel views the chances of a successful appeal as "probably 50-50." See Aysha Bagchi, *Treasury Has Options After Court Loss on Corporate Deduction Fix*, BLOOMBERG DAILY TAX REPORT (April 15, 2022). Another issue, which was not addressed by the district court, is whether the Treasury had the authority to issue the "regulatory fix" because "[t]he statute says one thing and then the temp regs say something that's contrary to the text, so how are you going to meet the *Chevron* standard of ambiguity?" *Id.* (quoting Caitlin Tharp).

e. **Impact on Tax Regulations Generally; End of OIRA Review of Tax Regulations.** Will we see increasing attacks on the validity of tax regulations generally based on alleged non-compliance with the Administrative Procedure Act or under a general standard for determining whether regulations go beyond the IRS's authority to interpret Code provisions? Eric Solomon, a former Treasury Assistant Secretary for Tax Policy, believes attacks on tax regulations will increase.

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Taxpayers will be emboldened to challenge the IRS and Treasury's rulemaking authority because of the judiciary's growing suspicion of the exercise of administrative power by the executive branch, [Eric Solomon] predicted.

[He] ... explained that the courts have increasingly taken the view that the executive branch is overstepping its bounds regarding regulations and that Congress should be writing the rules instead.

Noting that Justice Neil M. Gorsuch has indicated that he would like to revisit the *Chevron* doctrine, which set forth that if the statute isn't clear, an IRS interpretation that is reasonable within the law will be allowed, Solomon said that "taxpayers are going to challenge exercises of regulatory authority by the IRS as exceeding the IRS authority."

"They're going to say, 'Congress should have done this. The IRS has gone beyond its limits and therefore the regulations violate the *Chevron* decision,'" said Solomon.... Or the Supreme Court might rewrite the *Chevron* rules to say that the IRS is entitled to less deference, he said.

Solomon said taxpayers are also asserting that regulations are running afoul of the Administrative Procedure Act, which requires regulations to go through a notice and comment procedure.

Lauren Loricchio, *IRS, Treasury Regulatory Authority Challenges Likely to Increase*, TAX NOTES TODAY FEDERAL (Jan. 24, 2023).

In any event, the time frame for finalizing regulations may increase, and the size of preambles to final regulations may expand as the IRS becomes more careful than ever to respond in writing to all significant comments made about proposed regulations.

In an unrelated move, a memorandum of agreement signed June 9, 2023, between Treasury and the Office of Management and Budget provides that regulations issued by the IRS will no longer be subject to review by the Office of Information and Regulatory Affairs (OIRA), which could save some (generally small) time in the process of issuing tax regulations. See Item 5.q above.

## **22. Checks Written Before but Cashed After Death Includable in Estate, *Estate of DeMuth v. Commissioner*, 132 AFTR 2d 2023-5122 (3d Cir. 2023), aff'g, T.C. Memo. 2022-72**

- a. **Case Synopsis.** Decedent's son, under a power of attorney that authorized him to make gifts, wrote 11 checks from decedent's investment account on September 6, 2015. Decedent died September 11, 2015, after one of the checks had been paid from the account. Of the remaining 10 checks, three of the checks were deposited in the donees' accounts (the "depository banks" were different than the institution that held the investment account) on September 11 prior to the time of decedent's death, but those three checks were not paid from decedent's investment account until after decedent's death. The remaining seven checks were all deposited and paid after decedent's death. The estate tax return included the value of the investment account on Schedule B, less the value of all 11 checks. A notice of deficiency determined that the investment account value should be increased by the value of the 10 checks that were not paid before death. The IRS eventually conceded in its brief that the three checks deposited before decedent's death (though not yet paid from the investment account before death) could be excluded from the estate.

The court reasoned that a gift is complete when the donor has "parted with dominion and control as to leave him no power to change its disposition." Reg. §25.2511-2(b). As long as the drawer of a check can stop payment of a check, the check is revocable under state law. A stop-payment order can be given until "the drawee bank accepts, certifies, or makes final payment of the check." That did not happen until after the date of death for any of the ten checks. The court would have included all ten checks in the estate, but because of the IRS's concession in its brief, held that the three checks that were deposited (though not yet paid) before decedent's death were excluded from the estate.

*Estate of DeMuth v. Commissioner*, T.C. Memo. 2022-72 (Filed July 12, 2022, Corrected opinion served Aug. 1, 2022, Judge Jones).

The Third Circuit Court of Appeals affirmed in response to an argument on appeal that gifts were completed "gifts in causa mortis" and therefore completed gifts under Pennsylvania law even though the checks were not paid until after the donor's death. The appellate court determined that the evidence did not support that the donor wrote checks as gifts in causa mortis. There is no

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evidence that the gifts were made in contemplation of the donor's death. *Estate of DeMuth v. Commissioner*, 132 AFTR 2d 2023-5122 (3d Cir. July 12, 2023).

b. **Planning Considerations.**

(1) **Charitable Gifts.** Various cases have held that a charitable gift made by the delivery of a check to a charity in one calendar year is deductible for that year even the check is not cashed until the following year. The cases have applied a "relation back" doctrine so that the actual payment of the check relates back to the date the check was either delivered or deposited by the donee in the donee's account. *E.g.*, *Estate of Gagliardi v. Commissioner*, 89 T.C. 1207, 1212 (1987); *Estate of Belcher v. Commissioner*, 83 T.C. 227, 235 (1984), *acq. in result*, 1982-2 C.B. 1, *acq. recommended*, AOD 1989-014 (Nov. 13, 1989).

(2) **End-of-Year Gifts.** Whether a gift is complete in the year in which a check is delivered or when it is paid by the drawee bank in the following year has been addressed in various cases. A 1994 case applied the relation back doctrine "where the taxpayer is able to establish: (1) the donor's intent to make a gift, (2) unconditional delivery of the check, and (3) presentment of the check within the year for which favorable tax treatment is sought and within a reasonable time of issuance." *Estate of Metzger v. Commissioner*, 100 T.C. 204, 215 (1993), *aff'd*, 38 F.3d 118 (4th Cir. 1994). The IRS accepted the rationale of *Metzger* in Revenue Ruling 96-56, 1996-2 CB 161, if the check is cashed, deposited or presented for payment within a reasonable time after the check was issued.

[T]he delivery of a check to a noncharitable donee will be deemed to be a completed gift for federal gift and estate tax purposes on the earlier of (i) the date on which the donor has so parted with dominion and control under local law as to leave in the donor no power to change its disposition, or (ii) the date on which the donee deposits the check (or cashes the check against available funds of the donee) or presents the check for payment, if it is established that: (1) the check was paid by the drawee bank when first presented to the drawee bank for payment; (2) the donor was alive when the check was paid by the drawee bank; (3) the donor intended to make a gift; (4) delivery of the check by the donor was unconditional; and (5) the check was deposited, cashed, or presented in the calendar year for which completed gift treatment is sought and within a reasonable time of issuance. *Id.*

(3) **End-of-Life Gifts.** The relation back doctrine has not been extended to end-of-life gifts by check if the check is not paid before the decedent's death. *E.g.*, *Estate of Newman v. Commissioner*, 111 T.C. 81 (1998), *aff'd per curiam*, 203 F.3d 53 (D.C. Cir. 1999) (distinguishing *Metzger* where the donor was not still alive when the checks were accepted and paid by the drawee bank); *Rosano v. U.S.*, 67 F. Supp.2d 113 (E.D. N.Y. 1999), *aff'd*, 245 F.3d 212 (2d Cir. 2001). Revenue Ruling 96-56 expressly conditions application of the relation back doctrine on the donor still being alive when the check is paid by the drawee bank.

(4) **Other Alternatives.** To avoid these timing problems, consider making the end-of-year or deathbed gifts by a cashier's check (which cannot be cancelled by the donor), by wiring funds, or by electronic transfer.

## 23. Pending Cases Regarding Valuation of Cryptocurrency and Life Insurance

a. **DeMatteo v. Commissioner, Gift Tax Valuation of Life Insurance Policies.** This case involving the gift tax valuation of life insurance policies raises a thorny issue that has been percolating for years about life insurance policy valuations.

Regulation §25.2512-6 says to value life insurance contracts by sale of comparable contracts, but often that is not readily ascertainable for policies that have been in existence for some time and for which further premium payments will be made. In that event "the value **may be** approximated by adding to the interpolated terminal reserve at the [amount of unexpired premiums]. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used." (Emphasis added.)

Interpolated terminal reserve values vary dramatically. They may be much larger or much lower than what one would think is a reasonable value of a policy. Forms 712 from insurance companies may even list several values.

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In *DeMatteo*, the donor hired an independent professional appraiser, the Ashar Group, to value the policies. (They have a great deal of experience with life insurance policies in the secondary market.) The IRS position, though, is that the regulations **mandate** using interpolated terminal reserve values plus unexpired premiums to value policies. The donor sought summary judgment that the regulations do not require that the life insurance policies be valued at the interpolated terminal reserve values plus unexpired premiums.

The court refused summary judgment in an Order dated July 21, 2022, refusing to decide “in the abstract a question of law that may become moot depending on the evidence of the nature of the policies and the quality of the respective valuations.” *M. Joseph DeMatteo v. Commissioner*, Tax Court Docket No. 3634-21 (Petition filed April 9, 2021).

If the court in this case ultimately decides the values of the policies, the case could be quite instructive as to the proper (or permissible) approach for valuing life insurance policies for transfer tax purposes.

- b. ***Estate of Matthey T. Mellon v. Commissioner, Estate Tax Valuation of Cryptocurrency (Including Effect of Contractual Liquidation Restrictions)***. The IRS increased the valuation of the estate’s cryptocurrency (530 million tokens of XRP, previously known as Ripple) from \$151 million to \$242 million. Ripple Labs, Inc. imposed contractual liquidation restrictions on some holders of XRP tokens, including Mellon and a former executive, and has sued employees to enforce those restrictions. An appraisal by Empire Valuation Consultants applied a 40 percent discount to value the tokens at \$151 million as of the alternate valuation date. In addition to the sale restrictions, Empire considered the extreme volatility of cryptocurrency in general, the inherent uniqueness of the XRP tokens and the unpredictability of their market, and blockage and other factors. The estate also claimed that the Empire valuation failed to give sufficient weight to the risk that XRP would be found to be a security and that further securities law restrictions would apply. The IRS rejected the entire discount. The IRS acknowledged in its answer that the Empire appraisal concluded it would take “3.91 years” to liquidate the remaining cryptocurrency but denies that the inherent volatility would support a valuation discount. The case may ultimately provide guidance regarding cryptocurrency valuation for estate tax purposes. *Estate of Matthew T. Mellon v. Commissioner*, Docket No. 18446-22 (Petition filed August 19, 2022). See Erin McManus, *Mellon Estate May Provide Preview, Path in Crypto Valuation*, TAX NOTES TODAY FEDERAL (August 31, 2022); Erin McManus, *IRS Sticks to Volatility Discount Denial in Mellon Estate Case*, TAX NOTES FEDERAL (Nov. 21, 2022).

## 24. IRS Reversal of Position Regarding Sprinkling CRUTs, CCA 202233014

- a. **Prior Rulings.** The IRS has previously allowed estate and gift tax marital deductions for transfers to a charitable remainder unitrust (CRUT) where some portion of the unitrust amount was payable to a spouse (§664(d)(2) requires that at least a 5 percent unitrust amount be paid at least annually “to one or more persons (at least one of which is not an organization described in section 170I),” so more than a de minimis amount had to be paid annually to someone other than a charity in order for trust to be a valid CRUT), and the remaining portion of the unitrust amount could be distributed each year between a charity and the spouse at the trustee’s discretion. PLRs 201845014, 201117005, 200832017, and 200813006. (PLR 201845014 differed from the prior rulings regarding the gift tax treatment of the transfer. In PLR 201845014, the donor reserved the right to change charitable beneficiaries until actual distribution and reserved a testamentary power to revoke the spouse’s unitrust interest, thus causing any gifts to charity to be incomplete until actual distribution and cause any gift to spouse to be incomplete until the donor’s death.) Those prior rulings pointed to the legislative history for §2056(b)(8), which provides that if the surviving spouse of a decedent is the only noncharitable beneficiary of a CRT, the terminable interest rule of §2056(b)(1) shall not apply to any interest that passes from the decedent to the surviving spouse. In the legislative history to the Economic Recovery Tax Act of 1981, the House Ways and Means Committee stated:

If an individual transfers property outright to charity, no transfer taxes generally are imposed. Similarly, under the unlimited marital deduction provided in the committee bill, no tax generally will be imposed on an outright gift to the decedent's spouse. As a result, the committee finds no justification for imposing transfer taxes on a transfer

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split between a spouse and a qualifying charity. Accordingly, the bill provides a special rule for transfers of interests in the same property to a spouse and a qualifying charity.

Under the bill, if an individual creates a qualified charitable remainder annuity trust or a qualified charitable remainder unitrust, and the only noncharitable beneficiaries are donor and his spouse, the disallowance rule for terminable interests does not apply. Therefore, the individual will receive a charitable deduction (under sec. 2055 or 2522) for the amount of the remainder interest and a marital deduction (under sec. 2056 or 2523) for the value of the annuity or unitrust interest; no transfer tax will be imposed. H.R. Rep. No. 97-201, at 162 (1981).

Even though the portion of the unitrust that would be paid to the spouse is uncertain, because some of the unitrust amount could be distributed either to the spouse or a charity in the trustee's discretion, an estate tax marital deduction for the full amount of the unitrust was allowed "[i]n light of the legislative history noted above." Here is the reasoning in these PLRs:

In light of the legislative history noted above and based on the facts provided and representations made, we conclude that where Taxpayer establishes a testamentary charitable remainder unitrust for one measuring life in which the surviving spouse is the only noncharitable beneficiary, the estate tax marital deduction under § 2056(a) will completely offset the value of the assets distributed to CRUT as of Taxpayer's date of death, after deducting the value of the remainder interest qualifying for a charitable deduction under § 2055(a).

The IRS has now changed its position.

- b. **CCA 202233014.** Chief Counsel Advice 202233014 (July 12, 2022; release date August 19, 2022), involved amounts passing from a decedent's estate to a CRUT providing that 25 percent of the 5 percent unitrust interest must be paid to the decedent's spouse, and the remaining 75 percent could be paid either to a designated charity or to the spouse in the trustee's complete discretion. The CCA reasons that no estate tax charitable deduction is allowed for any portion of the unitrust amount that might be distributed to the charity in the trustee's discretion "because Charity's interest is not in the form of a fixed unitrust amount to be distributed annually and no part of the unitrust interest is ascertainable or severable from Spouse's noncharitable interest. See § 2055(e)(2)(B) and § 20.2055-2(a)." Similarly, no estate tax marital deduction was allowed for that portion of the unitrust amount that could be distributed either to the spouse or charity:

... the extent of Spouse's interest in the remaining 75 percent portion of the unitrust amount cannot be established as of Decedent's date of death and, therefore, is not considered to pass from Decedent to Spouse as beneficial owner for purposes of § 2056(a). The extent of Spouse's interest cannot be established because the amount to be distributed to Spouse annually is within the sole and complete discretion of the trustee. It is not possible to ascertain as of the date of death whether spouse will receive any of the 75 percent portion of the unitrust amount each year since all of such portion of the unitrust interest may be distributed to charity. Because the interest is not treated as passing to Spouse for purposes of § 2056(a), Decedent's estate may not claim an estate tax marital deduction for the value of this interest under § 2056(a). See § 20.2056(c)-2(a). See also *Estate of Turner v. Commissioner*, 138 T.C. 306, 316 (2012) ("property that passed to a person other than a surviving spouse cannot also be considered as passing to the surviving spouse").

Because the amount passing to charity is not ascertainable no charitable deduction is allowed, and because the amount passing to the spouse is not ascertainable no marital deduction is allowed. Simple as that according to the CCA.

The CCA makes clear in a footnote that it is changing its position from the prior rulings.

<sup>1</sup> The analysis and conclusion would be the same under § 2523 for a completed gift transfer to a CRUT with similar terms. In PLR 200813006, PLR 200832017, PLR 201117005, and PLR 201845014, this office ruled that taxpayers were entitled to an estate tax marital deduction under § 2056 or a gift tax marital deduction under § 2523 for a unitrust interest in a CRUT that can be distributed between charity and spouse at the trustee's discretion. The position in these earlier rulings no longer reflects the position of this office.

Before the issuance of CCA 202233014, this issue was added to the IRS's 2022 no-ruling list of matters for which no rulings would be issued until the Service resolves the issue "through publication of a revenue ruling, a revenue procedure, regulations, **or otherwise.**" Sections 5.01(16) and 5.01(20) of Rev. Proc. 2022-3, 2022-1 I.R.B. 144, added whether estate or gift tax marital deductions would be allowed for sprinkling charitable remainder trusts. The 2023 no ruling list initially did not change that. But Rev. Proc. 2023-3 was re-issued on January 3, 2023, and one of the changes was to delete those items. Apparently, the IRS has determined that the issue has now been resolved, so CCA 202233014 may be the only IRS publication that we see about this topic.

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For an excellent discussion of CCA 202233014, see Lawrence Katzenstein, *The IRS Has Buyer's Remorse About Earlier Ruling on Sprinkling Charitable Remainder Trust: CCA 202233014 Revisits PLR 201845014*, 47 TAX MGMT. ESTS., GIFTS & TRTS. J. NO. 6 (Nov. 10, 2022).

## 25. IRS Position Refusing to Respect Decanting and Denying Estate Tax Charitable Deduction Even Though Assets Were Actually Appointed to Charity Rejected by Tax Court, *Estate of Horvitz v. Commissioner*, T.C. Dkt. No. 20409-19 (Order dated Feb. 7, 2023)

- a. **Synopsis and Basic Facts.** QTIP trusts, funded when the predeceased spouse died in 1992, were decanted in 2013 to trusts with a broadened testamentary power of appointment (that could be exercised by a signed written instrument taking effect at the surviving spouse's death) allowing the surviving spouse to appoint the assets to charity. The surviving spouse died in 2015 having appointed about \$20 million to charities and her estate claimed an estate tax charitable deduction. The IRS took the position that the decanting was not appropriate, that the assets did not properly pass to the charities, and that no estate tax charitable deduction was allowed.

The Ohio decanting statute allows decanting to another trust if the trust agreement gives the trustee "absolute" authority to make principal distributions, which is defined as distributions that are not subject to an ascertainable standard. OHIO REV. CODE §5808.18(A)(1) & (2)(a). The decanted trust can include a broadened power of appointment that includes additional potential appointees.

The original QTIP trusts had various clauses that supported the legitimacy of the decanting. The distribution standard permitted distributions for the beneficiary's "comfort or general welfare" and included within that standard were distributions that "serve estate or tax planning objectives" and transfers deemed to be in "the best interests of the beneficiary." The original trust agreement included a decanting authority, stating that any authority to make distributions to a beneficiary includes authority to "to pay principal to a trust for the benefit of the beneficiary." Despite those provisions, the IRS position was that the trustee of the original QTIP trusts had no authority to decant the assets to the second trusts.

Discovery disputes arose in the Tax Court litigation over whether certain requested information was relevant and whether it was protected from discovery by the attorney-client privilege and attorney work product doctrine. Eventually (on October 14, 2021), the estate filed a motion for summary judgment asking the court to determine that the estate tax charitable deduction was allowed, claiming that the validity of the applicability of the charitable deduction was a legal issue with no material facts in dispute. The IRS (on January 7, 2022) filed a motion to compel compliance with discovery requests and an opposition to the estate's motion for summary judgment.

Thirteen months later (on February 7, 2023) the court entered an Order generally agreeing with the estate's legal positions – factual testimony about whether the Trustee believed the decanting was permissible would not affect the outcome; even if the decanting was impermissible, no contest was asserted as to the decanting or the contributions to charities and the court knows of no authority permitting the IRS to collaterally attack the charitable contributions; the distribution standard was not an ascertainable standard; and the Order had no discussion suggesting uncertainty about whether the decanting transaction was permissible. The Order directed counsel for the parties to confer with one another within one week to consider settling the case in light of observations in the Order. *Estate of Horvitz v. Commissioner*, T.C. Dkt. No. 20409-19 (Petition filed Nov. 15, 2019; Order dated Feb. 7, 2023, Judge Gustafson).

Within that one-week period, the IRS agreed to allow a full estate tax charitable deduction for the assets that passed to charities pursuant to the exercise of the power of appointment under the decanted trust. A Stipulation of Settled Issues was filed within about two weeks, and a Stipulated Decision was entered almost two months later (on April 6, 2023) – 8 years after the decedent's death.

- b. **Estate's Brief.** The estate's brief in support of the motion for summary judgment explained fundamental concepts about decanting, common law decanting, codification of decanting authority in Ohio, the effect of ascertainable standards, and the effect of the absence of ascertainable standards

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on decanting authority. The estate's brief emphasized (1) the language in the original QTIP trusts (including the broad distribution standard that included "comfort" and "general welfare," the ability to make transfers that serve estate or tax planning purposes or for the beneficiary's best interests, and the authority to make distributions in trust) and (2) the decanting authority under the Ohio decanting statute.

c. **IRS Position.** The IRS responded primarily that it needed more factual information to determine if material fact issues existed. The IRS did not respond in detail to the estate's legal arguments regarding the validity of the decanting other than to argue that the original trust had an ascertainable standard on distributions so the broadened power of appointment under the decanted trust was invalid. (The IRS made that argument despite the authority to make distributions for the beneficiary's comfort, general welfare, and best interests. The estate responded that the IRS's definition of an ascertainable standard ironically would mean that many very broad distribution standards in other trust instruments would not result in a beneficiary-trustee having a general power of appointment.)

d. **Observations.**

(1) **IRS's and Court's Reactions to Decanting.** The IRS was reluctant to allow an estate tax charitable deduction for charitable contributions that were made under the broadened power of appointment as a result of a decanting transaction. (It is rather surprising that the IRS chose to raise its objections to allowing an estate tax charitable deduction under a decanting transaction in a case in which about \$20 million actually passed to charities.) The judge expressed no hostility to the decanting transaction or to recognizing it for tax purposes. The IRS eventually conceded (and the taxpayer had good facts in the case to support the decanting authority).

Planners may experience similar IRS hostility in the future to broadened distribution authority granted in decanting transactions (for example, assets in a non-exempt trust might be decanted to a new trust giving someone a power of appointment to appoint assets to a non-skip person, who could engage in further estate planning transfers to minimize tax costs of passing assets to younger generations). Distributions pursuant to a broad authority to make distributions or a broad power of appointment rather than having to use a decanting transaction may be safer.

(2) **Significant Expense.** The dispute about the availability of an estate tax deduction for about \$20 million that actually passed to charities took 8 years after the decedent's death and about 3½ years after the filing of a Tax Court petition to resolve. The litigation involved discovery disputes over "several thousand documents." The estate incurred significant litigation costs.

(3) **Recognition of Prior Transfers That Have Been Uncontested.** A paragraph in the Order questioned whether the IRS could contest the availability of a charitable deduction in a situation in which no one had complained about the decanting, the statute of limitations had passed on the ability to contest the transaction, and money had actually passed to charities. That paragraph of the Order is as follows (footnote omitted):

As far as our record shows, there was no contest asserted as to the 2013 decanting (accomplished almost 10 years ago) or the 2015 contributions (accomplished almost 8 years ago). Presumably, a disappointed beneficiary whose interest might have been affected by either or both of these acts could have challenged them in the appropriate Ohio court, but as far as we know, none did. We know of no authority for the proposition that, in support of disallowing an estate tax deduction for a charitable contribution, the Commissioner may advance a collateral attack (not made by anyone with standing) against the propriety of the contribution. Another sort of deduction by an estate—say, for administration expenses—might be disallowed for tax purposes, even if the expense was demonstrably incurred and paid, if the expense was not "allowable by the laws of the jurisdiction". § 2053. But we know of no such grounds for disallowance of a deduction for a charitable contribution deduction, and we would benefit from further discussion of this issue. The contribution at issue here appears to be plainly described in Section 2055(a)(2). Section 2055(e) does provide for "Disallowance of Deductions in Certain Cases", but we do not see in that subsection the circumstances of this case.)

This argument is reminiscent of Revenue Ruling 73-142, 1973-1 C.B. 405, which addressed the tax effects of transfers pursuant to court construction actions that had become final and binding before a taxable event, even if the construction was improper. In Rev. Rul. 73-142, a settlor reserved the power to remove and replace the trustee with no express limitation on appointing

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himself, and the trustee held tax sensitive powers that would cause estate inclusion under §2036 or 2038 if held by the grantor *at his death*. The settlor obtained a local court construction that the settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the settlor removed the trustee and appointed another, so the settlor no longer had the removal power.

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

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

- (4) **Contrast with Trust Charitable Income Tax Deduction.** A trust is entitled to a charitable income tax deduction for amounts of gross income passing to charity "pursuant to the terms of the governing instrument." §642(c)(1). However, no governing instrument requirement applies for the estate tax charitable deduction. That difference is another reason that the IRS's reluctance to allow an estate tax charitable deduction for assets passing pursuant to provisions in a decanted trust is so puzzling.

A 2016 Chief Counsel Advice refused to give effect to a court modification for purposes of whether or not charitable distributions were made "pursuant to the terms of the governing instrument" to allow a charitable income tax deduction for the trust. CCA 201651013. The trust was modified to give the beneficiary a limited power of appointment in favor of charity. The IRS concluded that if the beneficiary exercised a power of appointment to make distributions to charity, a charitable deduction would not be available under §642(c) because the distribution would not be made pursuant to the terms of the governing instrument. A subsequent Chief Counsel Advice involving the same case similarly concluded that assets appointed to charities under a power of appointment granted in a court modification would not satisfy the "pursuant to the terms of the governing instrument" requirement. CCA 201747005 (includes extended discussion of *Bosch* and Rev. Rul. 73-142).

This conclusion seems incorrect; if the governing instrument is effectively modified under state law before the transfer to charity, subsequent transfers would seem to be made pursuant to the terms of the governing instrument in the absence of guidance under §642(c) that it looks only to the governing instrument as originally executed, without valid modifications. The case involved with that CCA was subsequently settled.

## **26. Successor Trustee of Revocable Trust and Trust Beneficiaries, Who Were Appointed and Received Distributions After Decedent's Death, Were Personally Liable for Unpaid Estate Taxes, *U.S. v. Paulson*, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023), petition for cert. filed (U.S. Oct. 23, 2023) (No. 23-436)**

- a. **Synopsis.** The decedent died in 2000 with most of his assets in a revocable living trust. The executors filed the estate tax return; they paid some estate tax and deferred the rest under §6166. The IRS and the estate in 2005 agreed to a much higher estate tax, which was deferred under §6166. Most of the estate tax was never paid. Distributions were made to various trust beneficiaries between 2003 and 2006. Various family members were appointed as successor trustees in 2009 and 2011.

In 2015, the IRS filed an action against the estate and living trust for the balance of the estate tax liability (then over \$10 million). The IRS also sought judgment under §6324(a)(2) against various family members in their capacities as successor trustees and as beneficiaries.

The district court made various determinations, including that certain individuals were not liable as transferees or trustees because they were not in possession of estate property at the time of Allen's death.

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The Ninth Circuit Court of Appeals reversed that decision. This is the **first case** holding that personal liability under §6324(a)(2) is extended to successor trustees and trust beneficiaries who are appointed or receive property *after* the decedent's death (in this case, years later). (Over the last 70 years, prior cases held that §6324(a)(2) and its predecessors applied only to specified classes of individuals who have or receive property in the gross estate at the time of the decedent's death.) In addition, the court holds that "beneficiaries" who are personally liable under 6324(a)(2) include trust beneficiaries, not just life insurance or annuity beneficiaries.

A dissenting opinion viewed the majority's analysis as a "hypertechnical reading" of statutory language (applying the "rule of the last antecedent" because of the lack of a comma after a particular word) that results in an interpretation with illogical results. The illogical result is that individuals may become successor trustees or receive distributions at a time after values have declined so much that their personal liability for estate tax exceeds the value of the property when received. The IRS made "avowals" in briefs and oral argument that it would not pursue that "excess" liability, but those "avowals" are not binding in future cases.

The conclusion of the majority opinion is that successor trustees who are appointed after and trust beneficiaries who receive trust distributions after the decedent's death are personally liable for estate taxes, but the personal liability of successor trustees is capped at "the value of the property at the time that they received or had it as trustees," and the personal liability of trust beneficiaries "cannot exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it."

*U.S. v. Paulson*, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023), *petition for cert. filed* (U.S. Oct. 23, 2023) (No. 23-436).

- b. **Facts.** Allen Paulson ("Allen"), who was an executive of Gulfstream Aerospace Corp., died July 19, 2000. Nearly all his assets were held in a revocable living trust. When Allen died, his son John Michael Paulson became co-trustee and was appointed co-executor.

In October 2001, he became sole executor and co-trustee with a different co-trustee. That month, he filed an estate tax return reporting a total gross estate of \$187.7 million, a net taxable estate of \$9.2 million, and an estate tax liability of \$4.5 million. The estate paid about \$700,000 and deferred the balance under §6166.

The IRS audited the estate tax return. Eventually the Tax Court (in December 2005) entered a stipulated decision determining that the estate owed an additional \$6.7 million of estate tax which the estate elected to defer under §6166. The executor made one estate tax and interest payment in 2007 and made some other interest payments. No one paid any subsequent installment payments.

The executor made distributions to Allen's widow in 2003 (worth between \$19 million and \$42 million) and to other beneficiaries (including Allen's granddaughter, Crystal Christensen) of at least \$7.3 million between 2003 and 2006.

Various disputes arose among the beneficiaries. In 2009 the probate court removed John Michael Paulson as co-trustee of the living trust for misconduct and appointed Vikki Paulson (the widow of Allen's son who died after Allen's death) and James Paulson (one of Allen's sons) as successor co-trustees. The IRS asserted that the living trust contained assets at that time worth more than \$13.7 million (which exceeded the estate tax liability). Vikki and Crystal claimed the trust was insolvent at that time but agreed that the trust assets exceeded the tax liability. In 2011, the probate court appointed Crystal Christensen as co-trustee with Vikki Paulson. The IRS asserted that the living trust assets were worth at least \$8.8 million at that time. In January 2013, the family members resolved disputes among themselves and entered into a settlement agreement, pursuant to which John Michael Paulson received various assets in exchange for resigning as executor. Vikki and Crystal asserted that the living trust by that time was "completely depleted."

In 2015, the IRS filed an action against the estate and living trust for the balance of the estate tax liability (then over \$10 million). The IRS also sought judgment under §6324(a)(2) against all the individuals named above in their individual and representative capacities.

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The district court entered various findings, including that Vikki Paulson and Crystal Christensen were not liable as transferees or trustees because they were not in possession of estate property at the time of Allen’s death. *U.S. v. Paulson*, 204 F. Supp. 3d 1102, 118 AFTR 2d 2016-5665 (S.D. Calif. 2016). The district court’s determination was appealed to the Ninth Circuit Court of Appeals.

c. **Holding.** Ninth Circuit Court of Appeals reversed that determination and remanded to the district court to determine the amount of each defendant’s liability for unpaid taxes.

(1) **Substantive Ruling.** Section 6324(a)(2) imposes personal liability for unpaid estate taxes on categories of persons listed in the statute (including a surviving joint tenant, transferee, trustee, or beneficiary) who (1) *receive* estate property *on or after* the date of the decedent’s death, or (2) have estate property on the date of the decedent’s death.

(2) **Application of Substantive Ruling to Facts.** James Paulson and Vikki Paulson (who became successor co-trustees nine years after Allen’s death) and Crystal Christensen who became successor co-trustee eleven years after Allen’s death are liable, **as trustees**, for unpaid estate taxes on property from the gross estate held in the living trust, capped at the value of estate property in the living trust at the time of Allen’s death, but each defendant’s “liability cannot exceed the value of the property at the time that they received or had it as trustees.”

In addition, Crystal Christensen and Madeline Pickens are liable as **trust beneficiaries** under §6324(a)(2) for unpaid estate taxes, but their liability “cannot exceed the value of the estate property at the time of [Allen’s] death or the value of that property at the time they received it.” (Crystal received some property as a trust beneficiary between 2003 and 2006, years before she became successor co-trustee, and her liability as to that property, capped at the value of such property on the date of her receipt, would be different than her liability as trustee capped at the value of the living trust assets when she became successor co-trustee some years later.)

*U.S. v. Paulson*, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023), *petition for cert. filed* (U.S. Oct. 23, 2023) (No. 23-436).

d. **Majority Opinion Analysis.**

(1) **Overview.** The court’s analysis focused on two issues regarding the personal liability of certain individuals (who were either successor co-trustees or beneficiaries, or both).

First, does §6324(a)(2) apply to specified persons who receive property after the date of the decedent’s death in addition to persons who have property at the time of the decedent’s death? The 2-judge majority concludes that it does, contrary to the prior accepted interpretation of the statutory language. A dissent by the remaining judge argues strongly that it does not, which would have meant the individuals were not personally liable for the unpaid estate tax.

Second, does the reference to “beneficiaries” in §6324(a)(2) include trust beneficiaries? (The court concludes that it does, contrary to prior cases that would limit the term to beneficiaries of life insurance or annuities.)

(2) **Section 6324(a)(2).** The IRS asserted personal liability of successor trustees and trust beneficiaries under §6324(a)(2). (As discussed below, another possible statutory remedy for personal liability is “transferee liability” under §6901, but the IRS did not assert personal liability under §6901.)

Section 6324(a)(2) provides as follows:

If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee [with one exception not relevant], surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent’s death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent’s death, of such property, shall be personally liable for such tax. ...

The relevant parts of §6324(a)(2) (split apart into the relevant clauses that are numbered for convenience in referring to the clauses) for the *Paulson* facts are:

[1] “If the estate tax ... is not paid, then

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[2] the ... trustee, ... or beneficiary,

[3] who receives, or has *on the date of the decedent's death*, property included in the gross estate under sections 2034 to 2042, inclusive,

[4] to the extent of the value, at the time of the decedent's death, of such property,

[5] shall be personally liable for such tax..."

- (3) **"On the Date of the Decedent's Death" Issue.** The court applies a detailed statutory construction analysis to determine whether the phrase "*on the date of the decedent's death*" refers to both "receives" and "has" or refers only to "has." The government argues that it refers only to "has" so the statute imposes personal liability on the specified persons who "(1) receive estate property at any time on or after the date of the decedent's death, or (2) have estate property on the date of the decedent's death." Therefore, the statute imposes personal liability on "successor trustees or beneficiaries of the living trust, including those who have or received estate property after the date of" Allen's death.

In its detailed construction analysis, the court refers to four construction principles: (1) "rule of the last antecedent," which the majority concludes is the "appropriate tool to interpret the statute," (2) "series-qualifier canon," which the taxpayers argued to apply the modifier at the end of a list to the entire series, (3) "canon against absurdity" (discussed below), and (4) "taxpayer rule of lenity," resolving ambiguities in a statute in favor of the taxpayer.

The rule of the last antecedent provides that "a limiting clause or phrase ... should ordinarily be read as modifying only the noun or phrase that it immediately follows" (quoting *Barnhart v. Thomas*, 540 U.S. 20 (2003)).

The majority shot down the application of the "series-qualifier canon" with this very technical construction and grammatical analysis based on the placement of commas in reference to "immediate and remote antecedents" in the phrase:

Here, however, the limiting phrase in § 6324(a)(2), "on the date of the decedent's death," is *not* separated from both antecedents by a comma, and it does not follow an integrated clause that contains both antecedents. Instead, the limiting phrase is set off by commas *with* the immediate antecedent, "has," from the rest of the sentence ("who receives, or has on the date of the decedent's death, property included in the gross estate").

(Emphasis in original).

The majority reasoned that the construction using the "rule of the last antecedent" is also supported by the "statutory text and context," pointing to the statute's reference to §2039, §2041, and §2042, which could apply for persons receiving assets after the date of the decedent's death.

**Observation:** The court got bogged down with its detailed technical rules-of-construction analysis. A common sense interpretation of the statute, with its "or has on the date of the decedent's death" clause set off by commas, suggests that it begins with the notion of a person "who receives property included in the gross estate under section 2034 to 2042 inclusive." But it is possible that a person would not have to "receive" the property because the person might already "have" it – especially for property described in §2034 to §2042, which focus on transfers made before death that "ripen" into possession or at least some type of vested interest at death. To close that gap, the statute adds "or has on the date of the decedent's death," appropriately set off by commas at both the beginning and the end.

The problem with that common sense interpretation of the statute, as pointed out by the taxpayers (discussed immediately below), is that the personal liability could exceed the value "received" at the time of receipt. As discussed below, the majority "fixes" that problem by limiting the personal liability to the value at the time of the receipt, even though the statute does not say that.

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The taxpayers argued that interpreting the statute to refer to any persons who receive gross estate property at anytime after the decedent's death leads to absurd results because that (1) could make purchasers of property liable for unpaid estate tax and (2) could result in personal liability for estate tax that exceeds the value of property when it is later received.

As to the first example, the majority responded that §6324(a)(2) by its terms does not apply to purchasers (they are not one of the six categories of listed persons, and the last sentence of §6324(a) specifically addresses the effect of a transfer to a purchaser).

The court's discussion of the second example results in a very important caveat in the court's final description of its interpretation of the statute. This example relates to clause [4] of §6324(a)(2) as described above, limiting liability to "the value, at the time of the decedent's death, of such property." The court discusses a number of events that would have to occur before a person who later receives gross estate property would have liability that exceeds the value the property at the time it is first received by the person. The most important of the contingencies that would have to occur is that the IRS "would seek to impose tax liability on a transferee, beneficiary, or other recipient of estate property in an amount that exceeds the value of the property they received." The court relied on the "government's avowals in its briefing and at oral argument that estate tax liability cannot exceed the value of the property received" and that "a person's liability is capped at the value of the property had or received." The majority believed that the government would be judicially estopped from asserting such excess liability on any of the parties in this case and that no cases have been identified in which the government attempted to impose personal liability for estate taxes that exceeded the value of the property received.

The court acknowledged that two prior cases rejected the government's interpretation of the statute. *Englert v. Commissioner*, 32 T.C. 1008 (1959) (interpreting a predecessor statute to §6324(a)(2)); *United States v. Johnson*, No. CV 11-00087, 2013 U.S. Dist. LEXIS 106671, 2013 WL 3924087 (D. Utah 2013). The court rejected the reasoning of both cases as superficial. No prior case has accepted the government's position, so this is the first and only case to adopt the court's interpretation of §6324(a)(2).

- (4) **Interpretation of "Beneficiary" to Include Trust Beneficiaries.** The taxpayers argued that the reference to "beneficiaries" in §6324(a)(2) does not include trust beneficiaries but the term as used in §6324(a)(2) refers to life insurance beneficiaries. (Presumably they would also acknowledge that it includes beneficiaries of annuities included in a decedent's gross estate under §2039.)

As another "first," the court for the first time reaches the conclusion that trust beneficiaries who receive property after a decedent's death have personal liability under §6324(a)(2). The court refers to two construction principles in the discussion of the meaning of "beneficiary": (1) "the word's ordinary meaning;" and (2) "presumption of consistent usage."

The taxpayers pointed to two cases interpreting predecessor versions of the statute that interpreted "beneficiaries" to include just life insurance beneficiaries, and two more recent cases (1994 and 2013) applying the reasoning of those cases to interpret §6324(a)(2). The majority opinion distinguished the cases interpreting predecessor statutes based on differences in the predecessor statutes. The court rejected the conclusion of the 1994 case, *Garrett v. Commissioner*, T.C. Memo. 1994-70, because of its superficial acceptance of the reasoning of the prior cases despite the differences in the predecessor statutes. The court did not address the analysis of this issue in the more recent district court case that reached a contrary result, *United States v. Johnson*, 2013 U.S. Dist. LEXIS 106671, 2013 WL 3924087 (D. Utah 2013).

- (5) **Conclusion of Interpretation of §6324(a)(2) and Finding that Successor Co-Trustees and Trust Beneficiaries Who Became Co-Trustees and Received Assets After the Date of Death Are Personally Liable, But with a Cap on the Personal Liability.** The court concluded that the successor co-trustee had personal liability for the unpaid estate taxes and two of the trust

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beneficiaries who received trust assets years after the decedent's death also had personal liability for the unpaid estate tax, but with a cap on the degree of their personal liability.

We conclude that the ordinary meaning of beneficiary, which includes trust beneficiaries, applies to § 6324(a)(2), and we are not persuaded that the structure or context of the statute, or policy considerations, require a narrower interpretation as the defendants argue. Moreover, applying the presumption of consistent usage further supports our conclusion that the term beneficiary in the tax code includes trust beneficiaries. Therefore, we conclude that Crystal Christensen and Madeleine Pickens are liable for the unpaid estate taxes under § 6324(a)(2) as beneficiaries. However, the liability of each of these defendants cannot exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it.

The cap on each person's personal liability is not to "exceed the value of the estate property at the time of decedent's death, or the value of that property at the time they received it." That description does not explicitly address whether the cap is the lesser of those two amounts, but the literal language is that the liability cannot exceed either of those amounts (meaning that the lesser amount would be the limiting amount). In addition, the court's discussion in response to the "absurdity of the government's interpretation" argument that a person's personal liability would not exceed "the value of the property received" suggests that the court intends the lesser of those two limits to apply. More important, the court's conclusion about personal liability of successor co-trustees explicitly capped their personal liability at "the value of the property at the time that they received or had it as trustees."

The Ninth Circuit remands the case to the district court for further proceedings "necessary to determine the amount of each defendant's liability of the unpaid taxes."

- e. **Dissent Analysis.** The dissent by Judge Ikuta provides a persuasive rebuttal to the majority opinion. Extensive quotations from the dissent are included because the dissent is persuasive and is consistent with the 70-year interpretation that has been applied to the statute and its predecessors.

The dissent begins with the importance of determining the Congressional intent of §6324(a)(2), and if a statute is ambiguous, the court must consider "the most logical meaning" of the statute (quoting a prior Ninth Circuit case).

The dissent's primary argument is that interpreting the statute to impose personal liability for estate taxes on persons receiving estate property after the decedent's death results in an illogical taxing system because the value of the property received years later may be less than the estate tax imposed based on the date of death value of that property.

The dissent criticizes the majority's adoption of a "hypertechnical reading" of statutory language that results in an interpretation with illogical results.

Rather than adopt a reasonable interpretation of the statute that is more likely to reflect congressional intent, the majority adopts a "hypertechnical reading" of statutory language that loses sight of the "fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme." *Davis v. Mich. Dep't of Treasury*, 489 U.S. 803 ... (1989) (citation omitted). In order to justify this approach, the majority and the government proffer a number of unpersuasive rationales. First, the government provides a non-responsive description of its litigating position: it states it "has consistently argued" that it would not impose liability greater than the value of the property received. The majority, in turn, suggests that the result of its interpretation is not likely to occur. But neither the government's nor the majority's assurances about the future (that individuals are unlikely to be held personally liable for estate taxes that potentially exceed the current value of the property received from a decedent's estate) impacts the interpretation of the statute.

Because the taxpayers's [sic] reading is more plausible and avoids the majority's illogical result, it is a better indication of Congress's intent. The inquiry should end there.

- (1) **Prior Case Law.** Prior cases interpreting §6324(a)(2) and its predecessors have concluded that the statute applies only to persons who have or receive property *on the date of the decedent's death* that is included in the gross estate (citing *Englert v. Commissioner* (1959), *Garrett v. Commissioner* (1994), and *United States v. Johnson* (D. Utah 2013)). Section 6324(a)(2) was amended in 1966 (after *Englert* and *Garrett* were decided), and the failure to change the syntax of the relevant clause "indicates that Congress intended to keep the then-current judicial

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interpretation” (citing *Lorillard v. Pons*, 434 U.S. 575, 580 (1978) (“Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change”).

The dissent emphasizes that the interpretation adopted by the majority is the “**first time**” a court has reached that result.

(2) **Criticism of Majority’s Reliance on Technical Grammatical Rules to Reach Illogical Result.**

The dissent decries the majority’s interpretation that reaches an illogical result based on “the lack of a comma” and an interpretive presumption based on the grammatical rule against misplaced modifiers.

To compensate for its failures to use the available statutory options to collect estate taxes, the government here adopted a novel reading of § 6324(a)(2). Although the accepted reading of this language (as noted in *Garrett*, ...) is that it imposes personal liability for estate taxes on any person who receives (or has) property on the decedent’s date of death, the government for the first time reads this language as imposing liability on a person “who receives” property of the estate at any time, even years after the decedent’s death. Under this interpretation, the government calculates the estate tax based on the value of property on the date of decedent’s death, and then imposes personal liability for this tax on a person who receives the property years later. This means that the individual’s tax liability may be completely disproportionate to the value of the property when the individual eventually receives it.

The majority justifies its adoption of the government’s novel reading based on the lack of a comma after the word “has.” The majority views the absence of a comma as triggering the doctrine of the last antecedent, a rule of statutory construction which states that “a limiting clause or phrase . . . should ordinarily be read as modifying only the noun or phrase that it immediately follows.” *Lockhart v. United States*, 577 U.S. 347, 351 ... (2016) (citation omitted). But while “[p]unctuation is a permissible indicator of meaning,” *Navajo Nation v. United States DOI*, 819 F.3d 1084, 1093 (9th Cir. 2016) (citing Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 161-65 (2012)), it “can assuredly be overcome by other indicia of meaning,” *Barnhart v. Thomas*, 540 U.S. 20, 26 ... (2003) (citation omitted). The “last antecedent principle is merely an interpretive presumption based on the grammatical rule against misplaced modifiers.” *Payless Shoesource, Inc. v. Travelers Cos., Inc.*, 585 F.3d 1366, 1371-72 (10th Cir. 2009). “At the same time, though, we know that grammatical rules are bent and broken all the time,” and we should not rely solely on grammar in interpreting a text “when evident sense and meaning require a different construction.” *Id.* (citation and internal quotation marks omitted).

The dissent points to a prior Ninth Circuit case, *United States v. One Sentinel Arms Striker-12 Shotgun Serial No. 001725*, 416 F.3d 977 (9th Cir. 2005) (*One Sentinel*), that interpreted a statute defining a “destructive device” as certain weapons “except a shotgun or shotgun shell which the Secretary finds is generally recognized as particularly suitable for sporting purposes.” The Ninth Circuit in that case refused to follow the last antecedent doctrine, which “would have created the illogical result that no shotgun could be a ‘destructive device.’” The court interpreted that statute “as if an omitted comma after ‘shell’ were included.”

The same principle applies here. The government and majority implicitly concede that the government’s reading of the statute potentially results in allowing the government to impose personal liability for unpaid estate taxes on trust asset recipients in excess of the value of the assets received. This could occur under the government’s interpretation, for instance, if property of the estate had a high value at the time of the decedent’s death but decreased precipitously by the time it was received by a beneficiary. In such a case, the beneficiary would nevertheless be personally liable for the unpaid estate taxes based on the value of the property on the date of death, even if the property were worth mere cents on the dollar when received by the beneficiary. Congress could not have intended to make a person who receives property many years after a settlor’s death personally liable for estate taxes that exceed the value of the property received.

... The taxpayers do not ask the court to disregard the text of § 6324(a)(2). Rather, the taxpayers offer an interpretation of its text that is superior to the government’s, in that it avoids an illogical reading based solely on the lack of a comma after the word “has.”

(3) **Criticism of Majority’s Response to “Illogical Results” Argument Because They Are Unlikely to Occur.**

The majority responds to the “illogical results” argument by saying they are unlikely to occur for various reasons. One reason is that the beneficiary could disclaim and therefore avoid having a personal liability that exceeds the value of property when it is received from the estate. But the dissent points out that disclaimers generally must occur within nine months of the decedent’s death, and at that point a beneficiary would have no way to know that

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the property would decline in value so precipitously before distribution that the beneficiary's personal liability for estate taxes would exceed the value received.

The dissent is particularly bothered with the majority's reliance on the government's "avowals" that it would not assert personal liability against a beneficiary for more than the value received by the beneficiary at the time of distribution. First, it noted the government's "avowals in its briefing and at oral argument ... is merely a description of how the government has argued this case. It does not represent the government's interpretation of § 6324(a)(2) or] any promise regarding its future actions." Judicial estoppel is not applicable for various reasons. Furthermore, even if the government had purported to apply an interpretation that liability could not exceed the amount received, "such interpretation would still not be binding in future cases," and the government could change its position. Even if the government has not historically imposed personal liability that exceeded the value of property received, that "indicates only that the government has managed up until now to use special liens or surety bonds to secure its interest, but does not establish that the government's interpretation of § 6324(a)(2) is reasonable."

(4) **Dissent's Conclusion.**

The majority has overemphasized a single canon of statutory construction—the rule of the last antecedent—to ignore that "fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme." *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 ... (2000) (citing *Davis*, 489 U.S. at 809). Although the punctuation chosen by Congress is important, we must also give due regard to sense and meaning. As our sister circuit has explained, "while the rules of English grammar often afford a valuable starting point to understanding a speaker's meaning, they are violated so often by so many of us that they can hardly be safely relied upon as the end point of any analysis of the parties' plain meaning." *Payless Shoesource, Inc.*, [585 F.3d, at 1372]. Our binding precedent requires this approach; we may not read a statute as defining a "destructive device" to include shotgun shells but not shotguns merely because of a misplaced comma. *One Sentinel*, 416 F.3d at 979. And the Tenth Circuit offers an example that speaks volumes: "Groucho Marx could joke in *Animal Crackers*, 'One morning I shot an elephant in my pajamas. How he got into my pajamas I'll never know,' leaving his audience at once amused by the image of a pachyderm stealing into his night clothes and yet certain that Marx meant something very different." *Payless Shoesource, Inc.*, 585 F.3d at 1372. Because I would interpret the statute according to the most likely intent of Congress, rather than adopt the majority's mechanical adherence to the rule of the last antecedent, I respectfully dissent.

- f. **Request for Rehearing Denied.** Taxpayers filed petitions for a rehearing en banc by the entire Ninth Circuit panel of judges, but that petition was denied July 25, 2023.
- g. **Petition for Certiorari.** A petition for certiorari was filed with the U.S. Supreme Court on October 23, 2023. A response is due by November 27, 2023. (U.S. Oct. 23, 2023) (No. 23-436). Arguments in the petition include the following.
  - (1) **Intolerable Conflict With Prior Cases.** The opinion creates an intolerable conflict regarding the scope of personal liability under §6324(a)(2) with the Tax Court and every federal court that has considered the issue.
  - (2) **Misapplies Rules of Construction.** The opinion misapplies the last antecedent rule of statutory construction and the rule of taxpayer lenity.
  - (3) **Conflicts With Sound Public Policy.**
    - (a) **Attempts to Amend §6324(a)(2) by Judicial Fiat.** The opinion attempts to resolve the practical problem of the possible overly broad potential personal liability resulting from its interpretation of the persons to whom the statute applies by limiting personal liability to the value of property after the date of death at the time of becoming a trustee or receiving property as a beneficiary, contrary to the explicit terms of the statute.

Recognizing that its novel interpretation of the scope of § 6324(a)(2) could impose substantial and unanticipated personal liability on recipients of estate property, the Ninth Circuit sought to limit those consequences by announcing that personal liability will be "capped at the value of estate property in the living trust at the time of Allen Paulson's death, and each defendants' liability cannot exceed the value of the property at the time that they received or had it as trustees." Pet. App. 49a. The Ninth Circuit decision created this new cap on personal liability for estate taxes out of whole cloth. It cites no

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authority—no statutory language, no tax regulation, no case law, no treatise—to support this extraordinary exercise in judicial law-making. This overreaching is contrary to this Court’s precedent. *See, e.g., Griffin v. Oceanic Contractors*, 458 U.S. 564, 576 (1982); *Crooks v. Harrelson*, 282 U.S. 55, 60 (1930). If Congress believed that the Tax Court and other federal courts’ interpretation of § 6324(a)(2) is incorrect or produces unacceptable results, it could amend the statute at any time, as it has on several occasions in the past.

- (b) **Conflicts With Application of Judicial Estoppel.** The opinion conflicts with binding precedent as to the application of the doctrine of judicial estoppel against the government.

The premise for the Ninth Circuit’s creation of a new cap on personal liability for estate taxes under § 6324(a) (2) is its belief that the Government allegedly promised in its briefing and at oral argument that “estate tax liability cannot exceed the value of property received,” and that it will not pursue recipients in this case for “more than the value of the property that the taxpayer received.” Pet. App. 38a. According to the Ninth Circuit, application of the “doctrine of judicial estoppel” will safeguard against any unfair application while imposing personal liability. *Id.* at 38a-42a. It will also bind the Government to that limitation on recovery of unpaid estate taxes in future cases.

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Nevertheless, the Ninth Circuit’s decision stands as support for the erroneous proposition that the United States Government can be bound to its purported concession in its brief in future actions. This proposition raises serious constitutional concerns based on separation of powers. ...

Moreover, if the Ninth Circuit decision stands, the Government would be invited to engage in creative brief writing and attempt to use this new “doctrine strategically to achieve results Congress intended to prevent, thus delivering lawmaking power to the executive.” *Marine Shale Processors*, 81 F.3d at 1348. These conflicts with sound public policy need to be resolved to ensure uniform national enforcement of the tax laws.

h. **Observations.**

- (1) **FIRST CASE to Apply Personal Liability to Trustees or Trust Beneficiaries Who Are Appointed or Receive Distributions Only After Decedent’s Death.** This case is notable because it is the first case (and at the federal court of appeals level, no less) to hold that §6324(a)(2) imposes personal liability on persons who are appointed co-trustees after the date of death or on trust beneficiaries who receive property after the decedent’s death.

Prior cases (going back over 70 years) applied personal liability for estate taxes under §6324(a)(2) or its predecessors only to persons who were or became trustee at the date of the decedent’s death or beneficiaries who have or receive property at the date of death. The first such case was *Englert v. Commissioner*, 37 T.C. 1008 (1959) (construing predecessor of §6324(a)(2)). The most recent case reaching that same position is the unpublished district court opinion, *United States v. Johnson*, 2013 WL 3924087 (D. Utah July 29, 2013):

Because section 6324(a)(2) may be interpreted in multiple ways, it is ambiguous and must be interpreted in favor of the Heirs. The court concludes that in order for a person to be a transferee under section 6324(a)(2), the person must have or receive property from the gross estate immediately upon the date of decedent’s death rather than at some point thereafter.

- (2) **Successor Trustees Should be Wary Before Accepting Office If Estate Tax Remains Unpaid.** Successor trustees of a decedent’s revocable trust (or other trust that is included in the decedent’s gross estate), who may be appointed years after the decedent’s death, must be wary about whether the value of assets remaining in the trust when the trustee accepts appointment is less than the unpaid estate tax liability of the estate. By accepting appointment, the successor trustee may become personally liable for those estate taxes (in the Ninth Circuit or in other states that may adopt the position announced in *Paulson*).

The majority opinion in *Paulson* responded to this potential concern of successor trustees by observing that “trustees serve only if they are ‘willing.’” *Paulson*, n. 38.

- (3) **Trust Distributions May Impact Beneficiaries’ Status with Creditors.** If trust distributions from revocable trusts are made before all estate taxes have been paid, Steve Gorin (St. Louis) points out that the beneficiaries have a contingent liability that perhaps should be reflected on

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balance sheets and to creditors. That contingent liability exists until estate taxes are paid or until the statute of limitations on collections under §6502 have run. Beneficiaries may wish to avoid that complexity with creditors and banks by requesting that trust distributions be delayed until all estate taxes are paid.

- (4) **Time Period of Potential Personal Liability.** Persons who have personal liability for estate taxes under §6324(a)(2) may have that liability hanging for a long period of time. Section 6324(a)(2) has no time limits specified, so the general collection provisions of §6501 and §6502 control. Section 6502 requires that an action to collect tax must be commenced within 10 years after the assessment of the tax, which must occur within three years after the estate tax return is filed, §6501(a), or within six years if items are omitted from the gross estate exceeding 25% of the gross estate stated on the return, §6501(e)(2). However, the 10-year period after assessment can be suspended (for example, during a court proceeding, §6503(a)(1)), or extended (for example, during the period of an extension of payment under §6161 or during a deferral period under §6166, §6503(d)). (Similarly, the 3-year period for assessment of estate tax is suspended during any Tax Court proceeding or any extension period for the payment of tax under §6161(a)(2), §6161(b)(2), §6163, or §6166. §6503(a)(1); §6503(d).) Accordingly, the collection action could be brought about thirteen years after the decedent's death in a normal case and within about 25 years after the decedent's death if estate taxes are extended under §6166.
- (5) **Potential Personal Liability Exceeding the Value of Property Received.** The dissent was quite concerned with interpreting the statute in a way that leads to the illogical result of a trustee or trust beneficiary who may have personal liability for estate taxes that exceeds the value of property when received by the trustee or beneficiary because the trustee or beneficiary is personally liable for estate tax up to the value on the date of death (or alternate valuation date) of property received by the trustee or beneficiary. The court recognized that there is no statute (under its interpretation of §6324(a)(2)) or cases that would prevent that possible result. The government made "avowals" in its brief and oral argument that personal liability is limited to the value received, but as the dissent points out, the government did not make promises that it would never take that position in future cases.

Despite the lack of authority for that limitation on personal liability, the Ninth Circuit's conclusion imposes a cap on each person's personal liability of "the value of the estate property at the time of decedent's death, or the value of that property at the time they received it."

The majority opinion reasoned that its construction of §6324(a)(2) to apply to persons who are appointed as trustees or receive trust property after the decedent's death is not illogical despite the possibility that the estate tax could exceed the value of property when received in part because the IRS "avowed" it would not take that position. However, the IRS has taken positions contrary to even published (and not withdrawn) Revenue Rulings in later cases. *See e.g., Estate of Hoensheid v. Commissioner*, T.C. Memo. 2023-34 (despite the court's attempt to distinguish Rev. Rul. 78-197 and *Rauenhorst v. Commissioner*, 119 T.C. 157 (1993)). The IRS in this same case (*i.e., Paulson*) took a position seemingly contrary to Rev. Rul. 75-553 and the district court accepted the IRS's position. Similarly, the IRS took a position contrary to Rev. Rul. 75-553 in *United States v. Johnson*, 224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781 (D. Utah 2016), as well as in this case. See Item 26.h(7)(c) below.

Even if the personal liability exists only up to the value received by the beneficiary, the beneficiary must be careful to realize that she has potential personal liability for unpaid estate taxes up to that amount even if the value of the property received later declines in value.

- (6) **IRS May Proceed Against Any Beneficiary or Trustee.** Within the limits applicable to any particular trustee or beneficiary, the IRS may proceed against any one or more of them to collect unpaid estate taxes. The person or persons tagged with having to pay the estate taxes could try to proceed against other estate beneficiaries in accordance with applicable apportionment provisions in the governing instruments or under state law.

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- (7) **Coordination With Other Personal Liability Statutory Provisions; Non-Probate Property Limitation in §6324(a)(2).** The IRS has a special estate tax lien for 10 years on estate property for the payment of estate taxes, §6324(a)(1). (The dissent discusses in its Section I.A the automatic estate tax lien and ways the government can protect itself during a §6166 deferral period that could last longer than the 10 years of the estate tax lien.)

If the government does not avail itself of those lien remedies, it can impose personal liability on certain persons. The government can impose personal liability on executors who make distributions during or causing insolvency. 31 U.S.C. §3713. It can also impose personal liability on “transferees” under §6901 and on six categories of persons identified in §6324(a)(2) regarding non-probate property. Certain limitations apply to personal liability under §6901, and the government can choose to assert personal liability under §6324(a)(2), for example if some of the limitations under §6901 would prevent the government from collecting tax under that section. For an excellent discussion of transferee liability under §6324(a)(2) as well as under §6901, see St. Amand, *The Intersection of Estate Tax Deferral, Liens, and Transferee Liability, Part II: The Complex Consequences of Deferral of Estate Tax Under §6166*, 48 TAX MGMT. EST., GIFTS & TRSTS. J. No. 3 (May 11, 2023).

- (a) **Section 6901 Limitations.** There are significant limitations on personal liability of transferees under §6901 that do not apply to §6324(a)(2).

**Time Limitation on Assessment.** Section 6901(c) provides that the period of limitations for assessment of transferee liability against an initial transferee is one year after the expiration of the period of limitation for assessment against the transferor. The IRS generally must assess tax against the estate within three years of filing the estate tax return (§6501(a)), so §6901(c) generally requires assessment against the transferee within four years after the return was filed. However, the 3-year period for assessment of estate tax is suspended during any Tax Court proceeding or any extension period for the payment of tax under §6161(a)(2), §6161(b)(2), §6163, or §6166. §6503(a)(1); §6503(d).

**Limit on Amount of Liability.** For transferee liability under §6901, federal courts have generally held that the transferee's liability is limited to the value of the transferred assets on the date of transfer. *E.g., Commissioner v. Henderson's Estate*, 147 F.2d 619 (5th Cir. 1945). As discussed in *Paulson*, the personal liability under §6324(a)(2) is not clearly limited to the value received at the time of distribution. It is clear that interest on unpaid estate tax is subject to the transferee liability rules. However, the cases have not been consistent with respect to whether the limit on liability to the value of property at the time of the decedent's death applies to interest as well as the unpaid principal of the tax itself.

**State Law Insolvency Analysis (But Not Required for Estate and Gift Tax Liability Under §6324(a)(2)).** Section 6901 does not impose personal liability on a transferee. Generally, the IRS must establish a transferee's liability under state law (typically under “fraudulent transfer” principles if the transferor was insolvent at the time of the transfer or was rendered insolvent by the transfer); §6901 provides a remedy or procedure to be used by the IRS as a means of enforcing the liability. However, that is not the case for estate and gift tax if personal liability can be established under §6324(a)(2) (estate tax) or §6324(b) (gift tax). *See Poinier v. Commissioner*, 858 F.2d 917 (3d Cir. 1988), *cert denied*, 490 U.S. 1019 (1989) (insolvency of transferor was not a prerequisite for establishing transferee liability for unpaid gift tax). Personal liability under those statutes may be enforced against a transferee through §6901.

- (b) **Section 6324(a)(2) Personal Liability is Not Subject to Strict Four-Year Limitations Period.** Even if the IRS fails to assess a tax deficiency against beneficiaries within the general four-year period that would be allowed under §6901(c)(1) (keeping in mind that the assessment period is suspended during a Tax Court proceeding or when the tax is deferred under §§6161, §6163, or §6166), a transferee may nevertheless be liable for transfer taxes in some situations in which §6324(a)(2) applies. Various cases have reasoned that §6901(c) and §6324(a)(2) are “cumulative and alternative — not exclusive or mandatory.” *E.g., U.S. v.*

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*Kulhanek*, 106 AFTR 2d 2010-7263 (W.D. Pa. 2010) (collection action against transferees 17 years after date of death); *Estate of Mangiardi v. Commissioner*, T.C. Memo. 2011-24, *aff'd in unpublished opinion*, 108 AFTR 2d 2011-6776 (11th Cir. 2011) (collection against IRA beneficiary commenced eight years after IRA owner's death with no prior assessment against the beneficiary). Therefore, the IRS may proceed against a transferee under §6324(a)(2) even if an assessment is not made against the transferee within four years as generally required under the §6901(c) alternative.

- (c) **Section 6324(a)(2) Applies Only to Recipients of Non-Probate Property; *Paulson, Johnson*.** A significant limitation of personal liability under §6324(a)(2) is that it applies only to recipients of assets included in the decedent's gross estate under §§2034-2042. Are the assets in a funded revocable trust includable in the gross estate under §2036 or §2038 or merely under §2033? If the trust assets are included only under §2033, then §6324(a)(2) would not apply.
- i. ***Paulson*.** The *Paulson* Ninth Circuit opinion does not address that issue, but the district court determined that the revocable trust assets were includable under §2038 and not §2033, so the trustee was therefore subject to personal liability for the estate tax §6324(a)(2) (despite a published Revenue Ruling to the contrary which the court did not discuss or even cite). 331 F. Supp. 3d 1066, 122 AFTR 2d 2018-5808 (S.D. Calif. 2018). The district court's only analysis of §2033 vs. §2038 quotes from statements in *Estate of Tully v. United States*, 528 F.2d 1041 (Ct. Cl. 1976), that §2038 "taxes property which an individual has given away while retaining enough 'strings' to change or revoke the gift," while §2033 "is more general in its approach, and taxes property which has never really been given away at all." The district concluded that the decedent's "ability to amend, revoke, or terminate the Living Trust triggers § 2038." Although the district court cited the 2018 district court case of *U.S. v. Johnson* (discussed below regarding another issue), it does not even mention that *U.S. v. Johnson* had a detailed analysis of the §2033 vs. §2038 issue for purposes of §6324(a)(2) and concluded that the revocable trust in that case was includable under §2033, so that §6324(a)(2) did not apply to the trustee of the trust. (The *Paulson* district court noted as to the other issue that *Johnson* was on appeal "and thus its conclusions are unpersuasive," but the appeal did not address the §2033 vs. §2038 issue for purposes of §6324(a)(2).) The *Paulson* district court case did not cite, let alone discuss, Rev. Rul. 75-553 that seemingly reached a contrary result (but addressed a revocable trust that passed to the decedent's estate at death rather than passing for the benefit of third parties).
  - ii. **Other Cases Applying §6324(a)(2) to Revocable Trusts.** Other cases have similarly stated that §6324(a)(2) applies to assets in revocable trusts without express analysis of the §2036-§2038 vs. §2033 issue. *E.g.*, *U.S. v. Allison, et al*, 587 F. Supp. 3d 1015, 129 AFTR 2d 2022-830 (E.D. Calif. 2022), *order adopting parties' stipulation for entry of judgment*, 131 AFTR 2d 2023-327 (E.D. Calif. 2023); *Garrett v. Commissioner*, T.C. Memo. 1994-70 (beneficiary did not have discharge of indebtedness income from trustee's payment of estate taxes because the trustee, not the beneficiary, was personally liable for estate tax under §6324(a)(2)).
  - iii. ***U.S. v. Johnson*.** A prior district court case had held to the contrary, that the revocable trust assets were includable solely under §2033. *United States v. Johnson*, 224 F. Supp. 3d 1220, 118 AFTR 2d 2016-6781 (D. Utah 2016). *See* Rev. Rul. 75-553, 1975-2 C.B. 477 (trustee of revocable trust does not have personal liability for estate tax under §6324(a)(2) because revocable trust assets are includable only under §2033 and not §2036 or §2038 for a trust in which the decedent had retained all beneficial interests). *Johnson* referred to Technical Advice Memorandum 8940003, which addressed a transfer by "A" to a third party as trustee of a trust to be distributed as directed by A. The trust assets "were held solely for the benefit of A during A's lifetime and were payable to A's estate at A's death." The TAM concluded that the assets were includable in A's gross estate under §2033, not §2038.

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*Johnson* also relied on Rev. Rul. 75-553, 1975-2 C.B. 477, to support the conclusion that §2033 applied, not §2038, for purposes of §6324(a)(2). In Rev. Rul. 75-553 the decedent transferred assets to a third party as trustee of a revocable trust that would be paid to the decedent's estate upon her death. Rev. Rul. 75-553 reasoned that §2036 - §2038

do not become operative unless someone other than the decedent receives a beneficial interest in the transferred property. The transfer of property to a trustee acting as agent for the transferor, without a third party receiving any interest in the property, would not fall within the scope of section 2036, 2037, and 2038. In the instant case the trust corpus is payable to the decedent's estate and is property of the decedent within the meaning of section 2033 and is includible in the gross estate only under that section.

*Johnson* acknowledged that the trust in Rev. Rul. 75-553 passed to the decedent's estate whereas the revocable trust in *Johnson* remained in trust for other beneficiaries. *Johnson* did not find that difference to be critical or even relevant.

Additionally, the IRS was not focused on the fact that upon the Revenue Ruling decedent's death, trust assets were distributed to his estate, as opposed to a beneficiary or to a testamentary trust. It is true that here, Decedent's Trust arrangement meant that Trust assets avoided probate and allowed retention of control over a closely held business after Decedent's death. But Trust asset passage through probate—or any other after-death process or event—is not relevant to what beneficial ownership of the property the Decedent held during her lifetime.

The *Johnson* court had originally found that §2036 and §2038 applied, so the trustees could be personally liable for estate tax under §6324(a)(2), concluding that §2036 and §2038 "are 'transfer provisions' intended to capture 'all incomplete transfers, which includes transfers taking effect at death via revocable trusts.'" Upon reconsideration the court vacated that determination, reasoning that "Trust assets were never 'given away' such that Decedent lost the beneficial ownership of them during her lifetime, and thus that there was no transfer—incomplete or not—for purposes of sections 2036 and 2038 prior to Decedent's death." Therefore, *Johnson* concluded that the revocable trust assets were includable in the gross estate under §2033, which precluded the trustees from having personal liability for estate taxes under §6324(a)(2). This finding was strongly criticized by Professor Jeff Pennell. Pennell, *U.S. v. Johnson*, LEIMBERG EST. PL. NEWSLETTER #2497 (Jan. 10, 2017); see also Chuck Rubin, *U.S. v. Johnson: 3 Strikes Against the IRS in Attempting to Impose Fiduciary and Beneficiary Liability for Estate Taxes*, LEIMBERG EST. PL. NEWSLETTER #2496 (Jan. 10, 2017).

The district court subsequently awarded attorneys' fees and expert witness costs to the defendants. 121 AFTR 2d 2018-341 (D. Utah 2018). The court found that the government's position (regarding the §2033 vs. §2038 issue) was not substantially justified, **in part because of the failure to follow its own published guidance** in Rev. Rul. 75-553.

While the defendants acknowledge that "the question of the proper code section of inclusion was a novel issue," ..., the government's defense of this position merely restates their litigation position, without demonstrating why their position was reasonable.

In particular, the government continues to assert that its "transfer" arguments were reasonable without addressing the court's conclusion that this position was inconsistent with the IRS statutory scheme and contradicted both IRS Technical Advice Memorandum 89-40-003 and IRS Revenue Ruling 75-553. *Johnson*, 224 F. Supp. 3d at 1232-34. 26 U.S.C. § 7430(c)(4)(B)(ii) provides that "the position of the United States shall be presumed not to be substantially justified if the Internal Revenue Service did not follow its applicable published guidance." Although the statute allows this presumption to be rebutted, the court concludes that the government's arguments fail to do so. Under the IRS statutory scheme, the only potentially applicable transfer sections (§§ 2036 and 2038) require beneficial ownership to have been given away while at the same time retaining some of the value of what has been given away. The government has not presented any factual or legal arguments that reasonably support a conclusion that Anna S. Smith divested herself of the beneficial ownership of her trust assets during her lifetime. Instead, its arguments directed the court's attention away from this critical fact. Because the government has not demonstrated that its

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position on trustee liability pursuant to 26 U.S.C. § 6324(a)(2) had a reasonable basis in fact or law, the defendants should be awarded attorney's fees for all aspects of their defense to these claims.

The Tenth Circuit heard an appeal, but only as to other issues. 920 F.3d 639, 123 AFTR 2d 2019-1272 (10th Cir. 2019). The government did not appeal as to whether §6324(a)(2) applied to funded revocable trusts.

- iv. **Inconsistency With Rev. Rul. 75-553.** The IRS's published ruling position (Rev. Rul. 75-553) is that a revocable trust in which the decedent retained all beneficial interests is included in the estate under §2033, not §2036 or §2038, so §6324(a)(2) cannot apply. The IRS has claimed personal liability of trustees of funded revocable trusts under §6324(a)(2) seemingly in direct contravention of the holding of Rev. Rul. 75-553. What is the point of the IRS publishing its official position on issues in Revenue Rulings if taxpayers cannot rely on them? The Tax Court in *Rauenhorst v. Commissioner*, 119 T.C. 157 (1993), discussed in Item 27.b(8)(c) below, strongly criticized the IRS for taking positions contrary to published rulings.

Respondent's counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law.

Arguably, however, the IRS is not taking inconsistent positions as to revocable trusts that are not paid to the decedent's estate following the decedent's death. The *Johnson* district court expressly rejected that distinction (and awarded litigation costs against the government in part because of the IRS's failure to follow Rev. Rul. 75-553), but the IRS could legitimately take the position that such a distinction is appropriate. Professor Pennell believes that the distinction is very important. Pennell, *U.S. v. Johnson*, LEIMBERG EST. PL. NEWSLETTER #2497 (Jan. 10, 2017).

- v. **Conclusion.** If future courts side with *Johnson* (which is consistent with Rev. Rul. 75-553), many of the concerns raised by *Paulson* would disappear (keeping in mind that §6324(a)(2) personal liability does not apply to probate property or property includable in the estate only under §2033). However, the concerns presumably would still be applicable to beneficiaries of IRAs or life insurance, trusts that are includable in the gross estate under §2035, or assets of limited partnerships or LLCs that are includable in the gross estate under §2036 or §2038.

## **27. Application of Anticipatory Assignment of Income Doctrine and Availability of Charitable Deduction; Recent Cases Involving Gift to Charity Followed Quickly by Sale, *Hoensheid v. Commissioner*, T.C. Memo. 2023-34, *Keefer v. U.S.*, *Dickinson v. Commissioner*, 130 AFTR 2d 2022-5002 (July 6, 2022) 130 AFTR 2d 2022-5405 (N.D. Tex. August 10, 2022) (denying motion for reconsideration)**

- a. **Overview.** Three cases in the last several years have provided insight to when the anticipatory assignment of income doctrine will apply when a gift of shares is made to charity that are sold by the charity soon after the contribution. One case allowed the donor to avoid recognition of gain (*Dickinson*) but the other two, *Keefer* and *Hoensheid*, held that the anticipatory assignment of income doctrine applied to cause the donor to recognize the gain on the sale of shares. The latter two cases also denied an income tax charitable deduction (because of the charity's failure to provide an appropriate contemporaneous written acknowledgement or the donor's failure to attach a qualified appraisal to the income tax return claiming the deduction). These cases will be addressed in reverse chronological order.
- b. **Assignment of Income Applied and Charitable Deduction Denied, *Estate of Hoensheid v. Commissioner*, T.C. Memo. 2023-34.**
- (1) **Synopsis.** Donor and his two brothers each owned one-third of the shares of a Company, and they all decided to sell their shares when one brother wanted to retire. Donor expressed a desire to contribute some of his shares to a Fidelity donor advised fund (the DAF) "to avoid some capital

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gains," but wanted to "wait as long as possible to pull the trigger" because he did not want to own fewer shares than his brothers if the sale did not go through. His attorney warned about waiting too late to make the charitable gift, advising that "the transfer would have to take place before there is a definitive agreement in place." Donor later told his attorney "I do not want to transfer the stock until we are 99% sure we are closing." On June 11, 2015, the shareholders unanimously approved the sale of all of the shares to Purchaser and consented to Donor's donation of part of his shares to the DAF (but the number of shares to pass to the DAF was left blank). Various subsequent communications and documents from Donor continued not to specify the number of shares that would be donated to the DAF until a PDF stock certificate was emailed to the DAF on July 13, 2015. The final stock purchase agreement was signed by all the parties and the sale was closed two days later on July 15, 2015 in a "simultaneous close" transaction.

- (a) **Date of Charitable Gift.** The court determined that the delivery of the gift to the DAF did not occur until July 13, 2015 when the PDF stock certificate was sent to the DAF. Fidelity sent a "corrected confirmation letter" and year end account statement stating that the shares were transferred (and presumably accepted) on June 11, 2015, but the court did not view that as credible and found that acceptance of the shares did not occur until July 13.
- (b) **Anticipatory Assignment of Income Applied.** The court made clear that the test for whether the donor was treated as having sold the assets and as having recognized the gain before the charitable gift occurred is not whether the transfer occurred before the definitive purchase agreement was signed. Instead, the test is whether the transfer was made before Donors had an "already fixed or vested right to the unpaid income" looking to the realities and substance of the underlying transaction rather than to formalities or hypothetical possibilities.

The court looked to several specific factors in determining whether the sale of shares was "virtually certain to occur" at the time of the charitable gift: (1) any legal obligation to sell by the charitable donee; (2) actions already taken by the parties to effect the transaction; (3) any remaining unresolved transactional contingencies; and (4) the status of corporate formalities required to finalize the transaction.

After examining those factors, the court concluded that "a donor must bear at least some risk at the time of contribution that the sale will not close." The court echoed prior decisions in not specifying a "bright line," test, but reasoned that the analysis of the four factors indicated that the delayed contribution in this case "eliminated any such risk and made the sale a virtual certainty." The anticipatory assignment of income doctrine applied to cause Donors to be taxed on the gain attributable to the eventual sale of the donated shares.

- (c) **Charitable Deduction Denied.** A charitable deduction for the gift of shares to the DAF was not allowed because the qualified appraisal requirement was not satisfied. The IRS listed a number of defects in the appraisal, and the court determined that neither the doctrine of substantial compliance nor the statutory reasonable cause defense were sufficient under the facts of the case to excuse the defects. A primary factor was the failure to use a qualified appraiser and the treatment of June 11, 2015 as the transfer date. The appraisal was prepared for no additional charge by a representative of the investment banking firm used to structure the sale transfer. That representative did not hold himself out as an appraiser, had no certifications from a professional appraisal organization, and testified that he conducted valuations "briefly" and "on a limited basis."
- (d) **Understatement Penalty.** The §6662(a) 20 percent understatement penalty for negligence or substantial understatement of income did not apply because Donor's attorney was a competent professional with sufficient expertise to justify reliance, and Donors adhered to her advice that "execution of the definitive purchase agreement" was the firm deadline for avoiding capital gains. While the attorney's substantive tax advice was incorrect, it was reasonable for Donors to rely on it.

*Estate of Hoensheid v. Commissioner*, T.C. Memo. 2023-34 (March 15, 2023, Judge Nega).

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(2) **Basic Facts.** Mr. Hoensheid (Donor) and his two brothers each owned one-third of CSTC (Company) that manufactured heat-treating metal fasteners for use in autos and other commercial vehicles. After one brother announced his intention to retire, the three brothers in the fall of 2014 decided to explore selling the Company. They concluded with their investment banking firm (Firm) that \$80 million was a fair target price. In early 2015 the Firm began soliciting bids, and the ultimate purchaser (Purchaser) submitted a bid for \$92 million on April 2, 2015.

Mr. Hoensheid and his wife (collectively referred to as Donors) wanted to give some of his stock to a Fidelity donor advised fund (DAF) and began discussing the donation with Fidelity in mid-April 2015. A longtime tax and estate planning attorney at Donor's law firm advised him that to avoid recognizing capital gains on the donated shares "the transfer would have to take place before there is a definitive agreement in place." [Observation: The court ultimately determined that is not the correct test.]

Donor emailed his attorney that he and his wife wanted

to put 3.5MM in the fund, but I would rather wait as long as possible to pull the trigger. If we do it and the sale does not go through, I guess my brothers could own more stock than I and I am not sure if it can be reversed. I have not definitively given [his wealth advisor] a number. Please know this and help us plan accordingly.

The following is a brief summary of a timeline of activities leading up to the donation and sale.

- April 23, 2015 – Nonbinding letter of intent signed to sell the Company for \$107 million.
- May 21, 2015 – Donor's attorney emailed him that a draft purchase and sale agreement had been drafted.
- May 22, 2015 – Donor signed an affidavit representing that the buyer had a "good faith intention of completing the transaction."
- June 1, 2015 – Donor signed a Letter of Understanding with the DAF describing the planned donation but not specifying the number of shares that would be donated.
- June 1, 2015 – Donor asked his attorney to prepare a shareholder consent agreement allowing him to give shares to the DAF but stated "I do not want to transfer the stock until we are 99% sure we are closing."
- June 11, 2015 – The shareholders unanimously approved the sale of all of their shares to Purchaser and consented to Donor's donation of part of his shares to the DAF (but the number of shares to pass to the DAF was left blank). Immediately after the shareholder meeting, the board of directors approved the transfer of some of Donor's shares to the DAF and agreed to distribute all balances in an Incentive Compensation plan prior to a recapitalization of the Company (which would occur as part of the sale process).
- June 12, 2015 – Sometime after the 6-11-15 board meeting, a stock certificate was prepared to transfer shares to the DAF, but Donor kept it on his desk until July 9 or 10 when he delivered it to his attorney.
- June 12, 2015 – Purchaser's investment committee and managing partners unanimously approved the acquisition subject to completion of their financial and business due diligence.
- June 15, 2015 – Donor emailed the signed shareholder agreement to his attorney and the number of shares to pass to the DAF was still left blank.
- July 1, 2015 – Purchaser's counsel prepared a revised draft of the stock purchase agreement that still left blank the number of shares being transferred to the DAF and prepared a minority stock purchase agreement with the DAF to purchase all of the shares transferred to the DAF.
- July 6, 2015 – Purchaser organized a new corporation to purchase the shares.

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- July 6, 2015 – Donor emailed the attorney, stating “We are not totally sure of the shares being transferred to the charitable fund yet” but they would know more on Wednesday or Thursday of that week.
  - July 7, 2015 – Donor emailed his wealth advisor that the Company would sweep the cash from the Company prior to closing and distribute it to the brothers and Donor executed a document specifying that the impending sale would trigger bonus payments to key employees.
  - July 9, 2015 – The Company prepared a revised draft of the purchase agreement with a recital that “On July ..., 2015 [petitioner] transferred 1,380 shares of Common Stock to” the DAF. (The ellipsis and bracketed insert are in the court’s opinion.)
  - July 10, 2015 – Purchaser prepared a revised draft of the stock purchase agreement that still left blank the date of transfer of shares to the DAF and proposed resolving an outstanding negotiating issue about an environment liability.
  - July 10, 2015 – Three significant actions occurred. (1) About \$6.1 million of employee bonuses were paid. (2) The Company’s Article of Incorporation were amended as requested by Purchaser. (3) The attorney forwarded an updated draft of the minority stock purchase agreement to be signed by Fidelity for the DAF.
  - July 13, 2015 – A revised stock purchase agreement was prepared that still left blank the date of the transfer of shares to the DAF. Later that morning, an advisor requested Fidelity to sign the minority stock purchase agreement, but Fidelity responded that it must receive the stock certificate before it could sign that agreement. About 30 minutes later a PDF stock certificate was emailed to Fidelity. It was undated but stated that 1,380.40 shares were owned by the DAF. Later that day, the Company confirmed that 1,380 shares had been transferred to the DAF and Fidelity signed the minority stock purchase agreement agreeing to sell those shares to Purchaser.
  - July 14, 2015 – Attorneys for the Company forwarded a revised draft of the stock purchase agreement stating that the contribution to the DAF was made on July 10, 2015. The Company made a dividend distribution of the remaining cash in the Company, about \$4.8 million, to the brothers (none to the DAF).
  - July 15, 2015 – The Purchaser, Company, and the three brothers signed the final stock purchase agreement (with the provision stating that 1,380 shares had been transferred to the DAF on July 10, 2015), and a representative of Fidelity signed a document assigning 1,380 shares to Purchaser in return for about \$2.94 million.
  - November 18, 2015 – Fidelity sent Donor and his wife an amended contribution confirmation letter acknowledging a contribution of 1,380.400 shares on June 11, 2015, stating that Fidelity had exclusive control over the shares and that it provided no goods or services in exchange for the contribution.

Donors received a quote from a national accounting firm to appraise the donated shares but decided to use an appraisal that would be prepared for no additional charge by a representative of the Firm. The representative, who had performed limited valuations but no prior appraisals substantiating a charitable contribution of shares of a closely held corporation, prepared an appraisal of the donated shares as of June 11, 2015, providing three different values, one of which was the actual amount received by Fidelity (about \$2.94 million) and two others taking into consideration additional payments made to the brothers (but not the DAF). The highest value (about \$3.28 million) was reported as the value on Donors’ income tax return to support the charitable deduction.

A notice of deficiency disallowed the claimed charitable deduction and applied a penalty under §6662(a). Donor filed a petition with the Tax Court contesting the disallowance of the charitable deduction and penalty. The IRS’s amended answer in the Tax Court proceeding for the first time asserted that Donor made an anticipatory assignment of income and should have reported the

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income with respect to the sale of the 1,380 shares that had been transferred to the DAF and applied the §6662(a) penalty attributable to the anticipatory assignment of income rather than the disallowed charitable deduction.

(3) **Issues.**

- (1) Whether and when Donors made a contribution of shares to the DAF.
- (2) Whether Donors had unreported capital gain income “due to their right to proceeds from the sale of those shares becoming fixed before the gift.”
- (3) Whether Donors are entitled to a charitable contribution deduction.
- (4) Whether Donors are liable for an accuracy-related penalty under §6662(a).

(4) **Whether and When Donor Made a Contribution to DAF.**

- (a) **Intent.** A valid gift under Michigan law requires (1) donor intent to make a gift, (2) actual or constructive delivery, and (3) donee acceptance.

Various communications and documents beginning mid-April, 2015 evidenced an intent by Donor to make a gift of shares to the DAF, including a unanimous shareholder approval on June 11 to sell all of the Company shares and consenting to a charitable contribution of some unspecified number of shares to the DAF. However, a present intent to make a gift did not occur until July 9, 2015 when Donor settled on a number of 1,380 shares.

- (b) **Delivery.** No specific action occurred on June 11 placing shares within the DAF’s dominion and control. Indeed, Donor kept the stock certificate for transferring shares to the DAF in his office until July 9 or 10, at which point he delivered it to his attorney. An email of a PDF stock certificate to Fidelity on July 13 provided “the strongest documentary evidence of the shares’ leaving [Donor’s] dominion and control,” evidencing “an open and visible change of possession.”
- (c) **Acceptance.** Fidelity sent an amended contribution confirmation letter acknowledging a contribution of 1,380.400 shares and a year-end account statement stating that the shares were transferred (and presumptively accepted) on June 11. However, Donor did not produce the original contribution confirmation letter dated July 15 that could have confirmed whether Fidelity consistently understood the date of the contribution to be June 11 and what errors were present in the original letter. An email from Fidelity on July 13 stating it would have to receive the stock certificate before it could take action to sell the shares to Purchaser was the more convincing evidence. **Acceptance occurred on July 13, 2015.**

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

The determination that the charitable gift was made on July 13, 2015, satisfied the first prong, leaving the issue of whether the gift occurred early enough to satisfy the second prong.

The test applied by the court for that “early enough” issue is whether the “donor [had] an already fixed or vested right to the unpaid income.” The court looked at several factors in determining whether the “fixed or vested” right to income had occurred before the charitable gift.

- (1) The DAF did not have a legal obligation to sell the shares. (While Rev. Rul. 78-197 viewed the donee’s obligation to sell the donated assets as supporting an anticipatory assignment of income finding, the court did not view that as the only factor to be considered.)
- (2) Numerous actions already taken by the parties suggest the sale was a virtual certainty. These include the creation of a new holding company by Purchaser to purchase the shares, amendment

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of the Company's Articles of Incorporation as requested by Purchaser, and various "cash sweeping" transactions that emptied the Company of its working capital (the court viewed the cash sweeping transactions as "strongly" suggesting the sale to Purchaser was a "virtual certainty" before the charitable gift on July 13).

(3) Any unresolved sale contingencies that still existed on July 13 were not "substantial enough to have posed even a small risk of the overall transaction's failing to close."

(4) Corporate formalities required to finalize the transaction were sufficiently completed for this to be a neutral factor. While the Company and shareholders did not sign the final purchase agreement until two days after the charitable gift, "final written consent was a foregone conclusion." The selling shareholders were receiving a substantial premium over their initial target price. All three brothers, and especially Donor, were involved in negotiating the transaction, making their approval "all but assured" as of July 13. The court found that "formal shareholder approval was purely ministerial, as any decision by the brothers not to approve the sale, was as of July 13, 'remote and hypothetical.'"

The court also observed that the reasoning in *Dickinson v. Commissioner*, T.C. Memo. 2020-128 did not require a different result. That court summarized that the assignment of income doctrine applies only if (1) the redemption was practically certain to occur at the time of the gift, and (2) would have occurred whether the shareholder made the gift or not. In *Dickinson*, the redemption occurred only because the charitable gift was made (because of Fidelity's established practice of immediately selling closely-held shares after receiving them) and the shares would not have been redeemed otherwise. In *Hoensheid*, on the other hand, the shares would have been sold to Purchaser even if the shares had not been given to the DAF before the sale closing.

The court's conclusion is an excellent summary of the anticipatory assignment of income analysis regarding charitable gifts.

To avoid an anticipatory assignment of income on the contribution of appreciated shares of stock followed by a sale by the donee, a donor **must bear at least some risk at the time of contribution that the sale will not close**. On the record before us, viewed in the light of the realities and substance of the transaction, we are convinced that petitioners' delay in transferring the CSTC shares until two days before closing **eliminated any such risk and made the sale a virtual certainty**. Petitioners' right to income from the sale of CSTC shares was thus fixed as of the gift on July 13, 2015. We hold that petitioners recognized gain on the sale of the 1,380 appreciated shares of CSTC stock.

We echo prior decisions in recognizing that our holding **does not specify a bright line** for donors to stop short of in structuring charitable contributions of appreciated stock before a sale. See *Allen*, 66 T.C. at 346 (rejecting proposed bright-line rule approach and noting that "drawing lines is part of the daily grist of judicial life"); see also *Harrison v. Schaffner*, 312 U.S. 579, 583-84 (1941). However, as petitioners' tax counsel seems to have recognized in her advice to petitioner, "any tax lawyer worth [her] fees would not have recommended that a donor make a gift of appreciated stock" so close to the closing of a sale. *Ferguson v. Commissioner*, 174 F.3d at 1006; see *Allen*, 66 T.C. at 346 (recognizing that realities and substance approach puts "a premium on consulting one's lawyer early enough in the game"). By July 13, 2015, the transaction with HCl **had simply "proceeded too far down the road to enable petitioners to escape taxation on the gain attributable to the donated shares."** *Allen*, 66 T.C. at 348.

T.C. Memo. 2023-34 (emphasis added).

## (6) Charitable Deduction Contribution.

Section 170(f)(8)(A) and (11)(D) set forth two requirements for receiving a charitable deduction in this situation: (1) a contemporaneous written acknowledgement of the donation by the charitable organization; and (2) a qualified appraisal.

The contemporaneous written acknowledgement requirement was satisfied. The acknowledgement must be received before the relevant tax return was required or, if earlier, the due date of the return. For a gift to a donor advised fund, the written acknowledgement must state that the donee "has exclusive legal control over the assets contributed." The acknowledgement met the requirements, but the IRS argued that the acknowledgement said the charity received "shares" rather than cash, and for income tax purposes Donors were treated as

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effectively recognizing the income before the transfer. The court disagreed with the IRS's "bootstrap" argument, noting that the acknowledgement correctly identified shares that were actually transferred to the DAF and that the acknowledgement does not have to describe correctly how the interest is classified for federal tax purposes.

The qualified appraisal requirement was not satisfied. The IRS listed a number of deficiencies in the appraisal (illustrating how strictly the IRS applies those requirements).

Respondent contends that petitioners' appraisal is not a qualified appraisal because it (1) did not include the statement that it was prepared for federal income tax purposes; (2) included the incorrect date of June 11 as the date of contribution; (3) included a premature date of appraisal; (4) did not sufficiently describe the method for the valuation; (5) was not signed by Mr. Dragon or anyone from FINNEA; (6) did not include Mr. Dragon's qualifications as an appraiser; (7) did not describe the property in sufficient detail; and (8) did not include an explanation of the specific basis for the valuation. Aside from petitioners' already rejected claim that the June 11 date of contribution was correct, petitioners do not meaningfully dispute that their appraisal had at least some defects.

Donors argued that "the doctrine of substantial compliance and the statutory reasonable cause defense" excused any defects.

As to substantial compliance, the court found especially important that the appraiser was not a qualified appraiser. The appraisal did not state the appraiser's qualifications, he did not hold himself out as an appraiser, he had no certifications from a professional appraisal organization, and he testified that he conducted valuations "briefly" and only "on a limited basis" (once or twice a year to solicit business for prospective clients). The discrepancy in the stated date of contribution (June 11 vs. July 13) was also significant because of various substantial distributions from the Company occurring between those dates.

The court also found that the reasonable cause exception did not apply because Donors could not show reliance on the appraisal in good faith. Donors decided to rely on a free appraisal prepared by a representative of the Firm who had limited experience rather than engage a national accounting firm on a paid basis. Also, Donor's statements in various emails and retention of the undated physical stock certificate strongly suggest Donor knew or should have known that the shares were not contributed on June 11.

Accordingly, the charitable deduction was disallowed.

#### (7) **Section 6662(a) Penalty.**

Section 6662(a) imposes a 20% penalty for any underpayment attributable to negligence or a substantial underpayment of income tax (meaning the greater of 10% of the tax required to be reported or \$5,000). The notice of deficiency assessed the penalty because of the disallowed charitable deduction, but in an amended answer, the IRS conceded that the penalty related to the charitable deduction would not apply but asserted a new §6662(a) penalty related to the anticipatory assignment of income. Because that assessment came after the notice of deficiency, the IRS bore the burden of proof that no defenses to the penalty applied.

The relevant issue was different than the reason for the finding that no reasonable cause existed for the failure to comply with the qualified appraisal requirement.

Accordingly, respondent must show that (1) [Donor's attorney] was not a competent professional with sufficient expertise to justify reliance; (2) petitioners failed to provide her with necessary and accurate information; or (3) petitioners did not actually rely in good faith on her judgment.

The court reasoned that while Donors failed to follow their attorney's cautionary note about timing, "they did adhere to the literal thrust of her advice: that 'execution of the definitive purchase agreement' was the firm deadline to contribute the shares and avoid capital gains." While the attorney's advice about the substantive tax law was incorrect, Donors could reasonably rely on it (citing *United States v. Boyle*, 469 U.S. 241 (1985)).

The court concluded that the IRS failed to establish that Donors did not have reasonable cause for the understatement of income and refused to apply the §6662(a) 20% penalty.

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(8) **Observations.**

- (a) **Expanded Anticipatory Assignment of Income Analysis.** The court provides a very detailed expansive analysis of the anticipatory assignment of income issue, focusing on whether the charitable transfer was made early enough before the right to income arose (the second prong of the *Humacid* test). The court made clear that the test is not whether the transfer occurred before the definitive purchase agreement was signed. Instead, the test is whether the transfer was made before Donors had an “already fixed or vested right to the unpaid income” looking to the realities and substance of the underlying transaction rather than to formalities or hypothetical possibilities.

The court looked to several specific factors in determining whether the sale of shares was “virtually certain to occur” at the time of the charitable gift: (1) any legal obligation to sell by the charitable donee; (2) actions already taken by the parties to effect the transaction; (3) any remaining unresolved transactional contingencies; and (4) the status of corporate formalities required to finalize the transaction.

After examining those factors, the court concluded that “a donor must bear at least some risk at the time of contribution that the sale will not close.” The court echoed prior decisions in not specifying a “bright line,” test, but reasoned that the analysis of the four factors indicated that the delayed contribution in this case “eliminated any such risk and made the sale a virtual certainty.”

- (b) **First Prong of *Humacid* Test Might Also Have Been a Basis for the Anticipatory Assignment of Income Result.** Interestingly, the court did not have any extended detailed analysis of the first prong of the *Humacid* test, but the “partial interest” analysis of that first prong in *Keefer v. Commissioner* might also have been applicable. The *Keefer* court concluded that the first prong was not satisfied because Donor retained some disproportionate right to partnership assets and did not transfer all rights under a 4% limited partnership interest that was assigned to charity. Similarly, in *Hoensheid*, Donors transferred 1,380 shares to the DAF, but they apparently retained various rights to dividend payments that generally would have been attributable to those shares. The Company made various distributions characterized as dividends after the transfer of shares to the DAF, and those dividend distributions were made just to the three brother-shareholders and not to the DAF.

- (c) **Inconsistent With Result of Rev. Rul. 78-197 and *Rauenhorst v. Commissioner*.** *Hoensheid* (and *Dickinson v. Commissioner* discussed in Item 27.d below) reasoned there is no “bright line” test to determine when the assignment of income doctrine applies. *Hoensheid* briefly addressed the court’s prior discussion of Rev. Rul. 78-197, 1978-1 C.B. 83 (which has been viewed by the Tax Court as a “bright line” test) and *Rauenhorst v. Commissioner*, 119 T.C. 157 (1993). Despite the court’s attempt to distinguish *Rauenhorst* and Rev. Rul. 78-197, the court’s approach in *Hoensheid* seems very inconsistent with the result in *Rauenhorst*. First some background.

In *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff’d on another issue*, 523 F.2d 1308 (8th Cir. 1975), the taxpayer had voting control of a corporation and foundation. The taxpayer donated shares of stock to the foundation and the following day caused the corporation to redeem the foundation’s shares. When the foundation received the stock, no vote for the redemption had been taken, and the foundation had the voting power to prevent the redemption. The Tax Court refused to apply the assignment of income doctrine (to treat the donor as having sold the stock and contributed the sale proceeds to the foundation) because the foundation was not a sham or the alter ego of the taxpayer, the transfer to the foundation was a valid gift, and the foundation was not “powerless to reverse the plans of the petitioner.”

The IRS acquiesced in *Palmer* in Rev. Rul. 78-197. The ruling discussed a charitable contribution followed by a prearranged redemption. The ruling briefly summarized *Palmer* and concluded the Tax Court recognized the transfer of stock (rather than sale proceeds) to the

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foundation in *Palmer* because the foundation was not a sham, the transfer of stock was a valid gift, “and the foundation was not bound to go through with the redemption at the time it received title to the shares.” The ruling concluded: “The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if one is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.”

*Rauenhorst* involved a contribution of stock warrants to charities which seven days later agreed to sell them to a purchaser who was going to purchase all the stock of the corporation. The IRS argued that the donor’s right to receive the sale proceeds from the stock sale “ripened to a practical certainty” at the time of the assignments, and the assignment of income doctrine should apply. The court summarized Rev. Rul. 78-197 as establishing a “bright-line” test:

The Internal Revenue Service (IRS), in Rev. Rul. 78-197, 1978-1 C.B. 83, acquiesced to our decision in *Palmer v. Commissioner, supra*, and in doing so devised a “bright-line” test which focuses on the donee’s control over the disposition of the appreciated property. ...

119 T.C. at 165.

The court then stated that it had not adopted the bright-line test of Rev. Rul. 78-197.

[W]e have indicated our reluctance to elevate the question of donee control to a talisman for resolving anticipatory assignment of income issues. For example, in *Allen v. Commissioner*, 66 T.C. 340, 347-348 (1976), we stated that the donee’s power to reverse the donor’s anticipated course of disposition “is only one factor to be considered in ascertaining the realities and substance of the transaction.” Cf. *Jones v. United States*, 531 F.2d 1343, 1346 (6th Cir. 1976). In a more recent opinion, we further extrapolated our position as follows:

In determining the reality and substance of a transfer, the ability, or the lack thereof, of the transferee to alter a prearranged course of disposition with respect to the transferred property provides cogent evidence of whether there existed a fixed right to income at the time of transfer. Although control over the disposition of the transferred property is significant to the assignment of income analysis, the ultimate question is whether the transferor, considering the reality and substance of all the circumstances, had a fixed right to income in the property at the time of transfer. [*Ferguson v. Commissioner*, 108 T.C. at 259; citations omitted.]

This Court has not adopted the “bright-line” test stated in Rev. Rul. 78-197, *supra*, as the test for resolving anticipatory assignment of income issues, and instead we have considered the donee’s control to be merely a factor, albeit an important factor.

119 T.C. at 166.

The IRS argued that the appropriate test was whether the sale was a “practical certainty” before the contribution, which the court viewed as an abandonment by the IRS of its “legally obligated” test from Rev. Rul. 73-197: “When respondent’s arguments are boiled down to their essential elements, he argues against the validity of the bright-line test of Rev. Rul. 78-197 ....”

The court stated, in very forceful terms, though, that the IRS was bound to follow its own revenue rulings.

Respondent’s counsel may not choose to litigate against the officially published rulings of the Commissioner without first withdrawing or modifying those rulings. The result of contrary action is capricious application of the law. [Quoting *Phillips v. Commissioner*, 88 T.C. at 529, 534 (1987).]

119 T.C. at 172.

Thus, although the *Rauenhorst* court stated that it did not adopt the bright-line test in Rev. Rul. 78-197, because it viewed the IRS’s position as contrary to its own revenue ruling, the court proceeded to decide the case based on “whether the charitable donees were legally obligated or could be compelled to sell the stock warrants at the time of the assignments.” The Tax Court reasoned that Rev. Rul. 78-197 had been in existence nearly 25 years without being revoked or modified and the taxpayers relied on that ruling in planning their charitable

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contributions. The IRS pointed to various facts suggesting that the right to the sale proceeds had “ripened to a practical certainty” before the transfer to the charity, but the court viewed that as unimportant:

Those items might be particularly relevant for determining whether the stock warrant purchase ripened to a practical certainty; however, none of those items alone, or in combination, show that the donees were legally bound, or could be compelled, to sell their stock warrants.

That reasoning would suggest that in Tax Court litigation the court should apply the legally obligated “bright-line” test in any case in which the IRS argues that a “practical certainty” test or any test other than the legally obligated test should govern to determine whether there is an assignment of income if assets contributed to charity are sold soon after by the charity.

Although the “virtually certain to occur” approach in *Hoensheid* is consistent with the Court’s *statement* in *Rauenhorst* that it does not adopt the legally obligated test as the proper approach, the approach in *Hoensheid* seems hard to reconcile with the analytical approach in and result of *Rauenhorst* (again, a full Tax Court opinion).

- (d) **A Tax Court Case Basing a Holding on the Burden of Proof.** Tax Court cases very frequently mention which party has the burden of proof as to particular issues, but go on to say that it does not matter in the particular case because the court is making its decision based on a preponderance of the evidence. *Hoensheid* is an example of a case in which one of the holdings (the penalty issue) apparently was based on the IRS not meeting its burden of proof (i.e., “respondent has failed to establish”).

c. **Assignment of Income Applied and Charitable Deduction Denied, *Keefe v. U.S.***

- (1) **Brief Facts.** Donor owned an interest in a partnership that was attempting to sell a hotel owned by the partnership.

- On April 23, 2015, the eventual purchaser sent a nonbinding letter of intent for the purchase of the hotel. The partnership did not sign the letter of intent but continued to negotiate with other potential buyers.
- On June 5, 2015, 13 days before the assignment was made to Charity, Charity sent a 12-page packet to Donor relating to the establishment of a donor advised fund (DAF). It discussed ownership, grantmaking, and management details, including that the Distribution Committee had “ultimate authority and control of all assets in the DAF” and that “[d]onor advised funds will be the exclusive property of The Pi Fund.”
- Donor signed the packet on June 8, 2015, (the “June 8 Packet”).
- On June 18, 2015, a buyer tentatively agreed with the partnership to purchase the hotel for \$54 million, Donor assigned a 4% limited partnership interest to Charity (which had the intriguing name “Pi Foundation”), with an oral side agreement that Charity would share in the proceeds of only the hotel sale but not other partnership assets.
- On July 2, 2015, the parties signed a contract for the partnership to sell the hotel, under which the buyer had a 30-day review period.
- The hotel sale closing occurred on August 11, 2015.
- On September 9, 2015, almost three months after the donation, Charity sent a letter to Donor acknowledging the donation and stating that no goods or services were provided in exchange for the donation, but it did not state that Charity had exclusive legal control over the assets contributed.

*Keefe v. U.S.*, 130 AFTR 2d 2022-5405 (N.D. Tex. August 10, 2022) (denying motion for reconsideration of Order denying charitable deduction for failure to meet contemporaneous written acknowledgement requirement), 130 AFTR 2d 2022-5002 (July 6, 2022).

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(2) **Assignment of Income.** The IRS asserted that the assignment of income doctrine applied, and Donor had to recognize gain on its portion of the sale proceeds. The court applied the two-part test described in *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964): (1) the donor gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale.

(a) **Second Prong Satisfied.** The court held that Donor satisfied the second prong of the test. Many of these cases involve the redemption of donated stock, and the second prong generally focuses on whether the right to the income from the redemption of appreciated stock vested before the donation. Some cases have extended the doctrine to situations in which a redemption was so imminent that the right to income “had already crystallized at the time of the gift.” The Ninth Circuit in *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999) applied the doctrine to a situation in which a redemption is “practically certain to proceed” without a binding obligation. Even that “practically certain to occur” *Ferguson* test is not satisfied by the facts in *Keefe*.

The letter of intent sent from the eventual buyer on April 23, 2015, was nonbinding and was never signed by the partnership. No contract of sale had been signed when the assignment was made. Even after the contract had been signed at the time of the donation, the buyer had a 30-day review period, and until that review period closed, there was “no binding obligation to close and the deal was not ‘practically certain’ to go through.”

(b) **First Prong Not Satisfied.** The first prong of the *Humacid* test, however, was not satisfied. The court described the assignment of income doctrine, quoting from *Caruth Corp., v. United States*, 865 F.2d 644, 64<sup>8</sup> (5th Cir. 1989). “[T]he crucial question is “whether the asset itself, or merely the income from it, has been transferred.” “If the taxpayer gives away the entire asset, with accrued earnings, the assignment of income doctrine does not apply.” But it does apply “[i]f the taxpayer carves income or a partial interest out of the [granted] asset, and retains something for himself.” See also *Salty Brine I, Ltd. v. United States*, 761 F.3d 484, 49<sup>1</sup> (5th Cir. 2014).

The court concluded that the first prong was not satisfied because Donor assigned only the right to his portion of the Hotel sale proceeds and not all rights under its 4% limited partnership interest. Prior to the assignment to Charity, the partnership had accrued money that was owed to pre-existing partners for pre-donation earnings that the partnership could not distribute because it was required to maintain a certain amount of cash reserves to comply with loan and franchise obligations for the hotel (to be able to make renovations required under the franchise agreement if the sale did not go through). Donor argued that the “payment of pre-existing liability to its pre-existing partners is not a ‘carving out’ from the 4% partnership interest” but is merely like the partnership paying a pre-existing light bill. The court disagreed, reasoning that the reserves were not to pay liabilities like a pre-existing light bill but were reserves of cash held back to address future potential liabilities. The cash reserves fall within the partnership’s definition of “Available Cash Flow” for distributions, and by withholding those reserves from the donated 4% limited partnership interest, Charity and Donor agreed that Charity “would only share in the proceeds from Seller’s Closing Statement; [Charity] would not receive its pro rata share in other net assets of the Partnership.” (Emphasis in original). Therefore, donor had to recognize income attributable to his portion of the hotel sale proceeds.

(3) **Charitable Deduction Denied; No Acknowledgement of Donation.** To receive an income tax charitable deduction for a contribution Section 170(f)(8) requires a contemporaneous written acknowledgment (CWA) containing certain items, and §170(f)(18) requires that for contributions to a donor advised fund the acknowledgment must state that the DAF has exclusive legal control over the assets contributed. The June 8 Packet (signed ten days before the assignment to Charity) did not qualify because a pre-donation document cannot serve as a CWA. An “acknowledgement” “memorializes a gift that has been completed or is legally obligated to occur, not one that is merely contemplated or uncertain to occur.” Also, it did not supplement

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the written acknowledgement that was subsequently sent almost three months later for various reasons, including that neither document references the other and the CWA requirement requires strict (not merely substantial) compliance.

Critically, each of the cases cited above gives the Court *permission* to construe multiple documents together, where appropriate under all the circumstances and to give effect to the intent of the parties. None of these cases *requires* the Court to do so. And here, considering the ten-day gap between the June 8, 2015 DAF Packet's signing and the June 18, 2015 Assignment of Interest's execution; that only one (Kevin) out of three signatories to the June 18, 2015 Assignment of Interest signed the June 8, 2015 DAF Packet; that neither document references the other; and that the CWA requirement requires strict (not substantial) compliance, the Court finds that the realities of the situation do not permit the documents to be read together. See Doc. 66, DAF Packet, 38; Doc. 69-5, Assignment Int., 443-44; see also *Keefer*, 2022 WL 2473369 at \*16-17 (discussing cases permitting a court to consider multiple documents as forming a CWA and the strict compliance requirement). 130 AFTR 2d 2022-5406 at 2022-5408.

- (4) **Harsh Result.** Donor had to recognize income on the sale of the hotel attributable to the donated interest (4% of a \$54 million sale – which could be a sizeable amount of income, depending on the partnership's basis in the hotel) AND failed to receive an income tax charitable deduction for his very substantial donation because of failure to follow a formality requirement. (Presumably, Charity will change its acceptance procedures and acknowledgement letter after seeing the horrendous results of this case.) For a discussion of *Keefer*, see Richard Fox & Jonathan Blattmachr, *Keefer v. US Provides Harsh Reminder to Donors of Potential Application of Assignment of Income Doctrine and Requirement to Obtain Proper Contemporaneous Written Acknowledgement*, LEIMBERG CHARITABLE PLANNING NEWSLETTER #319 (September 20, 2022).

d. **No Assignment of Income, *Dickinson v. Commissioner*.**

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

- (2) ***Humacid v Commissioner* Analysis.** The two-pronged test of *Humacid Co. v. Commissioner* avoids an assignment of income if “the donor (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale.”

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

The second prong, that the donation was made before the “property gives rise to income,” “ensures that if stock is about to be acquired by the issuing corporation via redemption, the shareholder cannot avoid tax on the transaction by donating the stock before he receives the proceeds.”

- (3) ***Dickinson* Test.** The court summarized its test in this type of situation as follows: The assignment of income doctrine applies “only if”
- (1) “the redemption was practically certain to occur at the time of the gift, and”

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

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

- (4) **Refusal to Apply “Legally Bound” Test of Rev. Rul. 78-197.** The IRS announced in Rev. Rul. 78-197, 1978-1 C.B. 83, that it refuses to treat a redemption in this type of situation as an anticipatory assignment of income as long as the charity is not legally bound to sell the donated shares and cannot be compelled to surrender the shares for redemption. The IRS argued in *Dickinson* that taxpayer’s and corporation’s reliance on the Fidelity policy of immediately offering donated shares for redemption, “may suggest the donor had a fixed right to redemption income at the time of the donation.” The court disagreed, reasoning that it refused to adopt Rev. Rul. 78-197 as the test for resolving anticipatory assignment of income claims in *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002), and does not do so in this case either.
- (5) **Further Discussion.** For a more detailed summary of *Dickinson v. Commissioner* and its analysis of the assignment of income doctrine, see Item 30 of Estate Planning Current Developments (December 2021) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

## **28. Tax Affecting for Valuing an S Corporation Recognized When Used by All Experts in the Case But Is Not Always (or Even Usually) Proper, Marketability Discounts for Different Block Sizes of Stock, Zero Weight Given to Asset Value in Valuing Ongoing Business, *Estate of Cecil v. Commissioner*, T.C. Memo. 2023-24**

- a. **Synopsis.** In 2010, William Cecil, Sr. (grandson of George W. Vanderbilt who built the famed Vanderbilt Biltmore House in Asheville, North Carolina between 1889 and 1895) and his wife gave stock (and made the split gift election) in an S corporation that owned the Biltmore House and some of the surrounding land, an Inn, and other tourist facilities. (The Biltmore House remains the largest privately owned house in the United States.)

The Cecil family has been through three gift tax audits: (1) 1999; (2) 2005-2006; and (3) 2010 (the gift tax audit resulting in this case). In 1999, the donors and IRS agreed on an earnings/asset hybrid valuation formula. In the 2005-2006 audit, the IRS initially rejected that approach but ultimately agreed to use the same approach.

In the 2010 gift transactions, voting stock (one of seven shares of voting stock, representing 14.29% of the voting stock) was given to the donors’ two children (Bill Cecil and Dini Pickering) and nonvoting stock was given to their five grandchildren. Bill Cecil’s three children each received 15.57% of the nonvoting stock and Dini Pickering’s two children each received 23.36% of the nonvoting stock. (The donors’ two children are both very active in the company; Bill Cecil is the president and CEO and Dini Pickering is vice chairman of the board of directors and has worked for the company for over 30 years.) The corporate assets were used to generate earnings, producing about \$70 million of revenue in 2010 (\$38.4 million of that coming from admission tickets). The company reported assets and liabilities of about \$53.6 million and \$33.3 million, respectively, or a net of \$20.2 million. The company operated at least 17 lines of business and employed 1,304 employees (“over 1,800 combined full-time and part-time employees including associated businesses”).

The donors attached an appraisal to the gift tax return (using a weighted average of value under an asset approach and an income approach) reporting a value of \$3,308 per share of voting stock and \$2,236 per share of nonvoting stock, for gifts by each donor of about \$10.44 million. The donors used the same settlement formula that was agreed to by the IRS in the 1999 and 2005-2006 gift tax audits. The IRS rejected that approach and valued the stock solely using an asset approach and claiming that the ongoing business operation had no economic substance. The IRS came up with a **much** larger value of the gifts, asserting a gift tax deficiency of about \$13.1 million by each donor, or

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over \$26 million. Both donors later died and were substituted in the gift tax case by their coexecutor Bill Cecil.

At trial, donors presented two experts (neither of which prepared the appraisal attached to the gift tax return). Both used the income and market methods of valuation (not the asset method), and both used tax affecting to adjust for the fact that their analyses used capitalization and discount rates based on data for C corporations (presumably publicly traded companies), whereas the S corporation's income was before-tax cashflow. Both of the donors' experts said the values under the 1999 and 2005-2006 settlement formulas were too high, and the donors claimed they were entitled to a substantial refund of gift tax paid.

Shortly before trial (on the 30-days-before-trial deadline for offering valuation opinions) the IRS backed off substantially by offering their expert's appraisal that gave only a 10% (down from 100%) weighting to the asset value approach, reducing the alleged deficiency to \$3 million (down from \$26 million!). The IRS used one appraiser to appraise artwork (at \$13,250,000) and another to value the donated shares using an asset-based method (but weighting it at only 10%) and an income method (and also using tax affecting under the income approach analysis).

The taxpayer's opening brief commented on the extreme "stubborn" position that had been taken by the IRS throughout the audit:

With interest through the trial date, the total demand exceeded \$30 million. Respondent left this 84 and 87 year-old couple living with that Sword of Damocles swinging over their heads for nearly two years.

Despite knowing his Notice lacked any rational basis, Respondent stubbornly refused to concede "economic substance" in his Answer, his informal responses, his formal discovery responses, and various motions. For the first time 30 days prior to trial, he tendered an appraisal proving his Notices overstated the tax by at least \$22,989,798. Even though he adopted that valuation in his trial memorandum, he never amended his pleadings or admitted he overstated his claims by 90 percent. To this day, he will not concede the words "economic substance" in writing.

The gifts were made in November 2010, the Tax Court trial was held February 25-26, 2016 (**seven years ago!**), and the briefing was completed in July 2016. Based on the long delay, many planners (and probably the attorneys representing the taxpayers) assumed this case might result in an opinion reviewed by the full Tax Court with a detailed analysis of the court's approach to tax affecting. Not so. The opinion devoted only about two pages to its tax affecting analysis.

The court noted that beginning with the *Gross v. Commissioner* Tax Court case in 1999, the court has generally held that tax affecting is not appropriate for valuing S corporations, citing various subsequent cases that have rejected using tax affecting (*Estate of Gallagher, Dallas, Wall, and Estate of Giustina*) The court discussed two more recent cases, one of which (*Estate of Jones*) allowed tax affecting in part because the IRS's expert was largely silent about tax affecting other than to disagree with the way taxpayer's expert had applied it, and the other (*Estate of Jackson*) rejected a tax affecting analysis based on an assumption that buyers would be C corporations but the court was not persuaded of that. Because all the experts in the *Cecil* case (other than the art expert), including the IRS's expert, agreed that tax affecting was appropriate and one of the taxpayers' experts and the IRS expert agreed on the appropriate tax affecting analysis, the court concluded the circumstances "require our application of tax affecting." The court made very clear, however, that it was sanctioning the use of tax affecting generally with this important caveat: "We emphasize, however, that while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation."

The court analyzed the reports from the various experts. The court assigned "zero weight" to the IRS expert because it used an asset-based approach even though liquidation was "most unlikely" (without commenting on the fact the appraiser assigned merely a 10% weight to its asset-based approach and without noting that it actually *did* apply parts of that expert's analysis). Assigning a **zero weight to the asset-based approach** was very significant because of the dramatic difference between the ongoing concern value and the asset value of the business—reportedly **roughly \$15 million vs. \$147 million** (the total asset value as determined by the IRS's valuation expert). The

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court adopted the IRS's expert's 17.6% rate for applying the tax affecting analysis. The court found flaws in both of the taxpayers' experts reports as well, but used one of the reports as "the truest value of the subject stock's prediscount fair market value" (but applying a different rate for the tax affecting analysis). The court adjusted the lack of control and marketability discounts, applying a 20% lack of control discount (used by one of the taxpayer's experts) and applying lack of marketability discounts of 19%, 22% and 27%, respectively, for the voting stock, the 15.57% blocks of nonvoting stock and the 23.36% blocks of nonvoting stock (marketability discounts used by the IRS's expert).

The court did not arrive at a final value for the gifted shares. However, the expert's report that the court accepted as the "truest value of the ... prediscount fair market value" concluded that the gifted shares were worth \$1,131 per share for voting stock and \$1,108 for nonvoting stock. It used a **20% lack of control discount** (which was accepted by the court) and a 30% lack of marketability discount (vs. the **19%, 22% and 27% lack of marketability discounts** the court decided were proper). Even after adjustments are made for the differences in the lack of marketability discount and the adjustment to the rate used in the tax affecting analysis, the approximately \$1,100 per share value in the report is much lower than the roughly \$3,300 per share value used on the gift tax return, All of that suggests the taxpayers may be entitled to a substantial gift tax refund. *Estate of Cecil v. Commissioner*, T.C. Memo. 2023-24 (February 28, 2023, Judge Ashford).

- b. **Overview of Valuation Approaches.** The opinion provides a helpful overview of three general approaches used for valuing assets.
- (1) **Market Approach.** The market approach values property by considering the sale prices of substantially similar comparable properties and making adjustments to account for differences between the subject property and the comparable properties.
  - (2) **Income Approach.** The income approach computes the present value of the estimated future cashflow, using an appropriate discount rate for that type of property and adds that to the present value of the residual value of the property.
  - (3) **Asset-Based Approach.** This approach is generally the fair market value of the net assets (assets less liabilities). (This approach is often not appropriate for ongoing businesses that will not be liquidated in the foreseeable future.)
- c. **Brief Summary of Experts' Reports.**
- (1) **Taxpayers' Experts.** At trial, donors presented two experts (neither of which prepared the appraisal attached to the gift tax return).  
  
Donors' first expert, David Adams, chose a combination of the income and market methods (using two approaches under his market method). He rejected the asset-based approach because the number of donated shares was too small to force a liquidation. He took into account tax affecting and a shareholder agreement, and applied a 50% weighting to each method. After including a 30% discount for lack of marketability and a 20% discount for lack of control, he valued the voting and nonvoting shares at \$1,019 per share with tax affecting and the shareholder agreement in effect.  
  
Donors' second expert, George Hawkins, also used the income and market method, rejecting the asset-based method because the donated shares could not force a liquidation. His income approach applied a capitalization rate presumably based on data from publicly traded companies because he first valued it as if the company was a C corporation and then tax affected that preliminary value to value the S corporation's share as if the S corporation paid the same level of taxes as a C corporation. (Mr. Hawkins, as well as the IRS's expert, both used the "S Corporation Economic Adjustment Model (SEAM)" method for their tax affecting analysis.) His income method produced a value per share of \$1,353.83 and his market method resulted in a value of \$1,131 per share for voting stock and \$1,108 per share for non-voting stock (after applying a 25% discount for lack of marketability and a 2% discount for lack of voting rights).
  - (2) **IRS's Experts.** The IRS used one expert to appraise art owned by the company (appraising the artwork at \$13,250,000). Its other expert, Robert Morrison, valued the company using the asset-

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based approach and income method. For his asset-based method analysis, he adjusted the \$20.2 million) net asset value reported by the company in various ways, resulting in a much larger net asset value of \$146.6 million. However, he applied only a 10% weighting to the asset-based method because the company “did not seek to maximize its assets.” His income method analysis used capitalization rates and discount rates based on after-tax cashflows, so he tax affected the results using the SEAM method. After weighting the two methods, he applied lack of marketability discounts of 19% for the voting stock and 22% and 27% for the smaller and larger blocks of gifted nonvoting shares, respectively, resulting in values of \$4,000 per share for the voting stock and \$3,066 per share for the 23.36% block and \$3,276 per share for the 15.57% block of nonvoting shares.

d. **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. The rationale for tax affecting was described very simply in *Cecil*: “Where, as here, the data used to value an S corporation are largely based on the data from C corporations, proponents of tax affecting believe that the mismatch from pretax cashflows and after-tax discount rates must be adjusted through tax affecting to ascertain the fair market value of the S corporation.” Typically, tax affecting is discussed in the context of S corporation valuations, but tax affecting can be applied in valuing other passthrough entities, i.e., partnerships. (*Estate of Jones* applied a tax affecting analysis in determining the valuation of an S corporation and a limited partnership.)

(1) **Analysis in Cecil.** Although the IRS’s internal valuation guide had for years in discussing S corporation valuations referred to the need to adjust the net income for income taxes using corporate tax rates when using industry price to earnings ratios, the *Gross v. Commissioner* Tax Court case in 1999 concluded that tax affecting is not appropriate in that case; in fact, Judge Halpern pointed out that owners expect to save money by using S corporations and that savings should not be ignored. T.C. Memo. 1999-254, aff’d, 272 F.3d 333 (6th 2001). The *Cecil* court observed that the Tax Court has continued to reject tax affecting in valuing S corporations, citing various subsequent cases (*Estate of Gallagher*, *Dallas*, *Wall*, and *Estate of Giustina*)

The court discussed two more recent cases. *Estate of Jones* allowed tax affecting in part because the IRS’s expert was largely silent about tax affecting other than to disagree with the way taxpayer’s expert had applied it. However, *Estate of Jackson* rejected a tax affecting analysis based on an assumption that buyers would be C corporations. In *Jackson* the court was not persuaded that the buyers would necessarily be C corporations.

In light of that history, Judge Ashford seemed reluctant to adopt a tax affecting analysis. But the court concluded, based on the facts of that case (and that even the IRS’s expert agreed that tax affecting should be applied) the circumstances of the case “require our application of tax affecting.”

Here, experts on both sides agree that tax affecting is necessary to value the subject stock. Messrs. Morrison [the IRS’s expert] and Hawkins [one of the taxpayers’ experts] also agree that the SEAM method is the appropriate method to employ in the setting at hand to account for tax affecting and that a factor of at least 17.6% applies here for that purpose. As we observed in *Estate of Jackson*, there is not a total bar against the use of tax affecting when the circumstances call for it. Now given that each side’s experts (with the exception of Ms. Wolf [the IRS’s art appraiser] who did not opine on this point) totally agree that tax affecting should be taken into account to value the subject stock, and experts on both sides agree on the specific method that we should employ to take that principle into account, we conclude that **the circumstances of these cases require our application of tax affecting.** While Messrs. Morrison and Hawkins do not agree on the specific rate that applies here to implement tax affecting (Mr. Hawkins determined the rate to be 24.6% while Mr. Morrison determined the rate to be 17.6%), we consider it appropriate on the basis of the record (and relying on Mr. Morrison’s opinion in this regard) to set that rate at 17.6%. **We emphasize, however, that while we are applying tax affecting here, given the unique setting at hand, we are not necessarily holding that tax affecting is always, or even more often than not, a proper consideration for valuing an S corporation.** (emphasis added)

(2) **Core Justifications of Tax Affecting.** 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

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investment and necessarily will enjoy and therefore evaluate that return only on an *after-tax* basis and (2) that comparable data to use in the valuation process typically comes from public sources and therefore largely comes from C corporations, for which earnings are, again, necessarily determined on an *after-tax* basis. Corollaries to those justifications are that passthrough status (3) confers a benefit of a single level of tax compared to a C corporation, but also (4) limits the universe of potential buyers and investors, who might not be able to buy or invest without forfeiting or jeopardizing (or at least complicating) the S corporation status or other passthrough status. Thus, tax affecting sometimes includes adjustments to accommodate those corollaries, or sometimes is followed by the application of, for example, an "S corporation premium" as the next step following the tax affecting. That approach is incorporated in a well-known model used by many appraisers in valuing S corporation stock, referred to sometimes as the S Corporation Economic Adjustment Model and sometimes as the S Corporation Equity Adjustment Model, or, in either case, "SEAM." (This is the tax affecting approach that was used by two of the experts (including the IRS expert) in *Cecil*.) This approach was developed by Daniel R. Van Vleet (and is sometimes referred to as the Van Vleet model), and it is an approach for valuing passthrough entities when C corporation data is used to estimate the value. It adjusts for differences in entity-level and shareholder-level taxation between C corporations, S corporations, and their shareholders. See Daniel Van Vleet, *A New Way to Value S Corporation Securities*, TRUSTS & ESTATES (March 2003). For a more in-depth discussion of the Van Vleet Model see William Frazier, *In Defense of Tax Affecting*, <http://www.srr.com/article/defense-tax-affecting>.

- (3) **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.

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

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

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

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

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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.

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

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

- (7) **Until *Kress v. United States*.** 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.

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- (8) **Another Case Allowing Tax Affecting by Looking to Experts, *Jones*.** In *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101, the taxpayers' expert, Robert Reilly, tax affected the earnings of an S corporation and a limited partnership 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 the companies would lose their passthrough status and insisting that the Tax Court had rejected tax affecting in cases such as *Gross v. Commissioner*, *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, and *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141.

In *Jones*, the court explained that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax affecting the earnings of a flowthrough entity per se. The court viewed those cases as concluding that (1) assuming a zero income tax rate on the earnings properly reflected the overall tax savings of operating as an S corporation (*Gross v. Commissioner*), (2) the taxpayer's expert did not justify tax affecting the earnings in balancing the burden of the individual level tax with the benefit of the reduced total tax burden (*Estate of Gallagher v. Commissioner*), and (3) tax affecting the earnings resulted in a post-tax cash flow but the expert applied a pre-tax discount rate (*Estate of Giustina v. Commissioner*). To the contrary, Judge Pugh concluded in *Jones* that the taxpayer's appraiser considered both the advantages as well as the disadvantages of operating as an S corporation and that the taxpayer's expert's "tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate." Judge Pugh viewed the issue as fact-based, and noted that the court in the prior cases had simply concluded that tax affecting was not appropriate for various reasons on the facts of those cases. 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 (emphasis added):

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.**

To the contrary, based on the evidence in *Jones* 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 [the limited partnership'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.

Some planners thought that the *Estate of Jones* case might represent a "crack in the 20-year old dam" of the Tax Court's reluctance to recognize tax affecting. Subsequent cases (*Jackson* and *Cecil*) suggest the court is not ready to accept tax affecting as a normal aspect of valuing S corporations.

- (9) **A Subsequent Refusal to Tax Affect Based on an Assumption That a C Corporation Was the Most Likely Hypothetical Purchaser, *Estate of Michael L. Jackson*.** One of the issues involved in valuing interests in bankruptcy trusts (NOT a passthrough entity) was whether to "tax affect" the income on an assumption that a C corporation would be the most likely hypothetical buyer and would have to pay a corporate level income tax on the income. The court refused to extend the analysis of *Estate of Jones* and refused to tax affect the income. *Estate of Michael L. Jackson v. Commissioner*, T.C. Memo. 2021-48.

This tax affecting analysis in *Jackson*, though, is quite different from the tax affecting rationale in valuing interests in S corporations under an income method based on a need to adjust the pretax

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income where capitalization and discount rates are determined from data involving after-tax income of publicly traded corporations (C corporations). In the *Estate of Jackson* case, the rationale of the estate's experts was based on an assumption that "the appropriate hypothetical buyer of each asset would be a C corporation, and therefore, each of them reduced cashflows by the income-tax liability that would be paid by a hypothetical C corporation buyer." However, Judge Holmes concluded that "the Estate has failed to persuade us that a C corporation would be the hypothetical buyer of any of the three contested assets."

Rather than basing a refusal to allow tax affecting merely for that reason, the court distinguished *Jones* (which had allowed tax affecting), viewing it primarily as a case in which the IRS's expert did not contest tax affecting:

We distinguish Estate of Jones as an instance where the experts agreed to take into account the form of the business entity and agreed on the entity type. The Commissioner argued there, as he does here, that we shouldn't tax affect, but his own experts didn't seem to be on board. As we observed, "[t]hey do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers." Estate of Jones, at \*39.

We do not hold that tax affecting is never called for. But our cases show how difficult a factual issue it is to demonstrate even a reasonable approximation of what that effect would be. In Estate of Jones, there was expert evidence on only one side of the question, and that made a difference.

That was not the case here.

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

The estate's appraisal in *Jones* provides an excellent example of such a detailed approach that considered both the burden on net cashflow by the anticipated individual income taxes on the business income as well as the benefits of passthrough treatment. Mr. Reilly tax affected the earnings of the partnership to reflect a 38 percent combined federal and state income tax 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 [the limited partnership'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 appraiser used the same tax affecting methodology in valuing an S corporation except that "he used a different rate for the dividend tax avoided because his analysis of the implied benefit for [the corporation's] shareholders in prior years yielded a different rate."

- e. **Asset Value vs. Ongoing Concern Value; Planning Considerations.** There was a dramatic difference between the ongoing concern value and the asset value of the business—reportedly **roughly \$15 million vs. \$147 million** (the total asset value as determined by the IRS's valuation expert). The donors initially reported gift values on their gift tax returns giving some weight to the asset values. The IRS reportedly kept increasing the weighting that should be applied to the asset value approach in negotiations, and eventually assessed a \$13 million gift tax deficiency by each of the donor-spouses. The donors filed a petition with the Tax Court taking the position that zero weight should be given to the asset value and that they should be entitled to a refund. This is a classic case where the net asset value of an entity is far far greater than its value as an ongoing business.

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The IRS's appraiser determined that the total net asset value of the entity was \$146,587,000, comprised of the following general assets:

Real estate	\$95,922,000
Art, antiques, collectibles	41,421,000
Note receivable	2,700,000
Trademarks and trade name	9,514,000
Workforce-in-place	<u>1,624,000</u>
Total	\$146,587,000

The IRS's appraiser reduced that net asset value to \$92 million on a "noncontrolling but marketable and liquid basis," and gave only a 10% weighting to the net asset value in his valuation of the company because the company "does not seek to maximize its assets."

The donors' two experts gave the company's asset value a zero weighting, instead using the market and income approaches. Observe the dramatic valuation difference based on valuing the company merely on its value as an ongoing operating company vs. its liquidation value.

The court agreed that the asset value should be given a ZERO weighting in valuing the company. The court pointed to various reasons.

- Cases, citing *Estate of Ford v. Commissioner*, T.C. Memo. 1993-580, aff'd, 53 F.3d 924 (8th Cir. 1995) ("[P]rimary consideration is generally given to earnings in valuing the stock of an operating company, while asset values are generally accorded the greatest weight in valuing the stock of a holding company."). Other cases (not cited for this issue in *Cecil*) have valued operating companies based entirely on the income method. *E.g.*, *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101 (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); *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.
- Uniform Standards of Professional Appraisal Practice (USPAP) Standards Rule 9-3, which states:

In developing an appraisal of an equity interest in a business enterprise with the ability to cause liquidation, an appraiser must investigate the possibility that the business enterprise may have a higher value by liquidation of all or a part of the enterprise. . . . However, this typically applies only when the business equity being appraised is in a position to cause liquidation.

The court observed, "That is not the setting here."

- Liquidation is most unlikely.
  - A hypothetical buyer would be unlikely to acquire enough shares to force liquidation, convince other shareholders to vote for liquidation, or wait until shareholders decide to liquidate.
  - The family members who own the company's shares all testify they have no intention of selling their stock or liquidating the company.
  - The court refused the IRS's request to disregard that testimony as self-serving, because the court found their testimony credible and because documentary and other evidence supports that testimony.
- Documentary and other evidence supporting the unlikelihood of a liquidation was summarized by the court:

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The 2009 Shareholders' Agreement and the 1999 Voting Trust sufficiently established that petitioners, their children, and their grandchildren aspired to keep TBC in their family by restricting the transfer of stock outside of the family. We also understand the family's holding of the annual meetings to serve strategically to minimize and control business disputes that could occur within the family, to obviate any TBC shareholder's rogue attempt to sell his or her TBC shares to an outsider, and to make most unlikely any breakup of TBC similar to the breakup effected by Mr. Cecil and his brother in 1979. These meetings also serve to groom TBC's shareholders to manage TBC as a family asset. The fact that TBC has been in the family since its incorporation in 1932 also speaks loudly to the fact that the Cecil and the Pickering families are committed to maintaining TBC as a family business.

- Having a formal succession plan and a plan for continuing the ongoing operation of the company, with consistent repeated documentary evidence of that plan, can be very important to convincing a court that little (or no) weight should be given to the liquidation value of the company assets. Tax litigators point out that the Tax Court places an obsessive emphasis on documentation. Some say "undocumented testimony is almost worthless. Whatever the issue is, get it formalized in documents."

f. **Extended Case Arising From IRS's Extreme Valuation Position.** The extended gift tax audit arose from the IRS's insistence on valuing the business solely based on the value of its assets despite the fact it was a large ongoing business operation. The IRS backed off that position substantially a mere 30 days before trial. A commentator has roundly criticized the unfairness of this situation, noting perceived failures by the IRS, IRS Appeals, and the Tax Court.

I'm **gobsmacked-appalled-outraged** about this case.

...

In short, ladies and gentlemen, we have a tax system that, at least at present, only effectively exists due to **voluntary compliance** by the overwhelming majority of taxpayers. But the system, including the IRS and the Tax Court, **must work fairly and efficiently in order to give taxpayers confidence to voluntarily comply.**

Make no mistake: **our tax system failed the Cecils.**

...

But in the 2010 gift tax audit, **despite no changes in the Company's business operations or the family's clear desire to continue the Company's business (with mountainous supporting evidence-how many companies have you heard of with 300 YEAR plans?) since the 2005-2006 gift tax audits**, the IRS gift tax auditor didn't feel bound by the settlement valuation formula to which the IRS had agreed in three prior gift tax audits of gifts in four separate taxable years, in favor of **completely disregarding the Company's existence altogether as "lacking economic substance,"** and the IRS valued the shares of Company stock using an *asset liquidation* approach. The result? A deficiency notice valuation resulting in a number **four to five times the per share values of the 2010 gifts**, which had been valued based on the previously agreed-to IRS settlement valuation formula.

...

... The undeniable effect of allowing the IRS to take such an outrageous, flimsy case to trial essentially is the **flipside of the allegations from the IRS that taxpayers are playing the "audit lottery" and as equally reprehensible.**

Three audits (gift tax returns for four different calendar years involved) in less than 12 years? I don't think that the word **"shakedown"** is an unfair word to say. [The writer described an overly aggressive agent in another situation], but IRS Appeals curbed his excessive exuberance, which, frankly, is what should've happened here. **In my opinion, this case should've never left IRS Appeals.**

...

... Make no mistake: if the IRS is allowed to take cases that aren't supported by admissible expert witness evidence to trial, **the unmistakable effect is the IRS flipside of taxpayers playing the "audit lottery," forcing taxpayers to either litigate or settle based on sheer size of the deficiency, which erodes taxpayer confidence in our predominantly voluntary tax system, and, as such, equally reprehensible as the audit lottery.**

Why did it take 2,558 days (more than **seven years** between trial and rendered decision/decision) to decide this case? That's a fair question, especially given that the case docket report reveals nothing apparent going on in the interim, especially given the slam-dunk taxpayer victory this case was?

...

## Conclusion

Houston, we have a problem. Steps must be taken to ensure that this never happens again.

Paul Hood, *Estate of Cecil v. Commissioner: Appalling IRS Valuation Shakedown Effort Averted in the Tax Court, Finally!*, LEIMBERG ESTATE PLANNING NEWSLETTER #3063 (September 7, 2023) (emphasis in original).

## 29. Estate Tax Value of Shares Included Proceeds of Corporate-Owned Life Insurance to Fund Buy-Sell Agreement; Buy-Sell Agreement Did Not Meet §2703(b) Safe Harbor or Other Requirements to Fix Estate Tax Value, *Connelly v. U.S.*, 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023), *aff'g* 128 AFTR 2d 2021-5955 (E.D. Mo. Sept. 2, 2021), *petition for cert. filed* (U.S. Aug. 16, 2023) (No. 23-146)

- a. **Synopsis.** A buy-sell agreement required that a company purchase a decedent's shares of a corporation owned by two brothers. The pricing provision called for the parties to agree annually on the company value, and if an annual value had not been agreed on, the price would be determined by securing two or more appraisals (which would not consider control premiums or minority discounts). The company funded the agreement with life insurance policies on the two brothers' lives. The brothers never entered into any agreement about the company value, and on the death of the brother owning about 77% of the company, the estate and the company did not comply with the appraisal requirement in the agreement, but agreed to pay the estate \$3 million (using part of the \$3.5 million of life insurance proceeds paid to the company) (as well as providing other benefits for the deceased brother's son).

The estate reported the shares at about \$3 million, but the IRS assessed an additional \$1 million of estate tax, maintaining the \$3.5 million of life insurance proceeds should have been taken into consideration in setting the value. The estate paid the additional estate tax and sued for a refund. The parties stipulated that the value of the decedent's shares was \$3.1 million if the life insurance proceeds were not considered, and the only issue was whether the life insurance proceeds should be considered in determining the value of the shares for estate tax purposes.

The district court determined that the buy-sell agreement did not fix the value of the shares. First, it did not satisfy the §2703(b) safe harbor; although the agreement met the bona fide business purpose test it failed to meet the device test (because the purchase price did not include the life insurance proceeds in determining the company's value, the *process* of selecting the redemption price indicates the agreement was a testamentary device, and the agreement prohibited considering control premiums or minority discounts) and the comparability test (the estate "failed to provide any evidence of similar arrangements negotiated at arms' length"). Second, the agreement did not satisfy requirements recognized by various courts for buy-sell agreements to fix estate tax values: the agreement did not provide a fixed and determinable price; it was not binding at death (evidenced by the fact that its procedures were not followed); and it was a substitute for a testamentary disposition for less than full consideration. The Eighth Circuit agreed, reasoning more succinctly that the agreement did not set the estate tax value of the decedent's stock because the agreement did not establish a "fixed and determinable price." (Even if the pricing mechanism in the agreement had been followed, the court expressed reservations about whether those pricing mechanism would have been sufficient to establish a fixed and determinable price.)

Having determined that the agreement did not fix the estate tax value of the decedent's shares, the district court determined the value of the stock without regard to the agreement. The court concluded that the life insurance proceeds should be considered, disagreeing with the Eleventh Circuit's rationale in *Estate of Blount v. Commissioner* that the contractual obligation of a company to purchase a decedent's shares offset the life insurance proceeds on the decedent's life paid to the company. A hypothetical willing buyer of a company would not factor the company redemption obligation into the value of the company because the buyer would merely be obligated to redeem the shares the buyer then held, and "the buyer would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The taxpayer's request for a refund was denied. The Eighth Circuit affirmed, expanding on the district court's rejection of the rationale of *Estate of Blount*.

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The U.S. Supreme Court granted the taxpayer's petition for certiorari on December 13, 2023. *Connelly v. United States*, 70 F.4th 412, 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023), *aff'g* 128 AFTR 2d 2021-5955 (E.D. Mo. September 2, 2021), *petition for cert. filed* (U.S. Aug. 16, 2023), writ granted (U.S. December 13, 2023) (No. 23-146).

- b. **Basic Facts.** Two brothers owned an operating business (Michael owned about 77% and Thomas owned about 23%). As is typical for family businesses, they entered into a buy-sell agreement regarding the purchase of shares at the death of a brother. The surviving brother had an option to purchase the shares, but if he chose not to do so, the company would be required to purchase the shares. The company purchased life insurance on each of the brothers' lives (including a \$3.5 million policy on Michael's life) to fund the purchase agreement.

The purchase price would be determined under a two-step process. First, the brothers "shall, by mutual agreement, determine the agreed value per share by executing a new Certificate of Agreed Value" at the end of every year. Second, if they failed to do so, the "Appraised Value Per Share" would be determined by securing two or more appraisals.

The brothers never signed a single Certificate of Agreed Value. One brother died, Michael, who owned about 77% of the shares. The other brother, Thomas, chose not to purchase the shares, so the company purchased the shares, using \$3 million of life insurance proceeds on Michael's life to fund the purchase price. The parties did not obtain appraisals, as required by the agreement, but Thomas and Michael's estate agreed (1) the estate would receive \$3 million cash (from the life insurance proceeds), (2) Michael's son had a three-year option to purchase the company for \$4,166,666, and (3) if Thomas sold the company within 10 years, Thomas and Michael's son would split evenly any gains from the sale.

The estate reported the value of Michael's shares at \$3 million, but the IRS asserted that the value should also include the value of the \$3.5 million of life insurance proceeds as a corporate asset and assessed over \$1 million in additional taxes.

During the audit, the estate obtained an appraisal of the decedent's shares from an accounting firm. The appraisal reasoned that the buy-sell agreement created "an enforceable obligation to use the life insurance proceeds to purchase" the decedent's stock and that, pursuant to the holding in *Estate of Blount v. Commissioner* (428 F.3d 1338 (11th Cir. 2005)), the life insurance proceeds should be excluded in determining the value of the company.

The estate paid the tax and sued for a refund of over \$1 million. The estate and the IRS stipulated that if the life insurance proceeds should not be considered in determining the value of the shares, the value of the decedent's shares was \$3.1 million. The only remaining issue was whether the life insurance proceeds received by the corporation as a result of the decedent's death should be considered in determining the value of the estate's shares.

- c. **District Court Analysis Summary.** For a more detailed discussion of the district court analysis, see Item 39.c of Estate Planning Current Developments (December 2021) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

(1) **Estate Tax Value of the Shares Is Not Fixed Pursuant to the Buy-Sell Agreement.**

- (a) **Section 2703(b) Safe Harbor Does Not Apply.** The buy-sell agreement did not satisfy the §2703(b) safe harbor. The agreement met the bona fide business purpose test, but it failed to meet the other two §2703(b) tests:
- It failed to meet the device test because the purchase price did not include the life insurance proceeds in determining the company's value, the *process* of selecting the redemption price indicates the agreement was a testamentary device, and the agreement prohibited considering control premiums or minority discounts; and
  - It failed the comparability test (the estate "failed to provide any evidence of similar arrangements negotiated at arms' length").

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(b) **Additional Requirements Under Regulations and Case Law Not Satisfied.** Various cases have recognized several requirements for a buy-sell agreement to determine the price that will be recognized for estate tax purposes. These requirements are also embodied in Reg. §20.2031-2(h). The court summarized these requirements as follows:

(1) the offering price must be fixed and determinable under the agreement; (2) the agreement must be legally binding on the parties both during life and after death; and (3) the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition for less than full-and-adequate consideration.

The agreement did not satisfy these requirements. The agreement did not provide a fixed and determinable price; it was not binding at death (evidenced by the fact that its procedures were not followed); and it was a substitute for a testamentary disposition for less than full consideration.

(2) **Determination of Fair Market Value.** Because the buy-sell agreement did not control the value of the decedent's shares, the court determined the fair market value of the shares. Under the stipulation of the IRS and the estate, the only issue was whether the life insurance proceeds paid to the company at the decedent's death should be considered in valuing the decedent's shares.

The estate's primary argument was based on the Eleventh Circuit's opinion in *Estate of Blount*. The court in that case held that the fair market value of a closely-held corporation did not include life insurance proceeds used to redeem the shares of a deceased shareholder under a stock purchase agreement. The district court summarized the *Blount* holding and rationale:

The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life insurance proceeds. [Citation omitted] The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate."

The district court in *Connelly* disagreed with the Eleventh Circuit's analysis, preferring the reasoning of the Tax Court in *Estate of Blount*: a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued."

The district court pointed out that a hypothetical willing buyer purchasing a company subject to a redemption obligation would not reduce the value of the company by the redemption obligation "because with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation." The buyer would merely be obligated to redeem the shares the buyer then held, and "the buyer would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The district court observed that "construing a redemption obligation as a corporate liability only values [the company] post redemption (i.e., excluding Michael's shares), not the value of [the company] on the date of death (i.e. including Michael's shares)."

The district court concluded that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." The \$3 million in life insurance proceeds used to redeem Michael's shares must be taken into consideration in determining the fair value of the company and of the decedent's shares.

*See also Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999) (life insurance proceeds paid to deceased shareholder's estate was partly taxable income for uncompensated work in progress, not just for purchasing stock; life insurance proceeds were not "an asset of the firm for stock valuation purposes" because proceeds were "offset dollar-for-dollar" by the company's obligation to "pay out the entirety of the policy benefits" to the decedent's estate).

d. **Eighth Circuit Analysis.** The Eighth Circuit Court of Appeals decision addressed both (1) whether the estate tax value was established by the stock purchase agreement, and, if not, (2) whether the \$3.0 million of life insurance proceeds used to redeem the estate's stock should be included in determining the value of the decedent's stock.

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- (1) **Value Not Established by Agreement.** The Eighth Circuit applied a much simpler analysis than the district court, determining that the §2703(b) exception was inapplicable because the agreement did not establish a “fixed and determinable price” given that the parties “ignored the agreement’s pricing mechanisms.” (Indeed, the determinable price must be binding during life as well as at death.)

The court also expressed reservations about what types of mechanisms for determining the purchase price would be sufficient. Even if the parties had followed the procedures in the agreement to determine the purchase price, the court stated (presumably in dictum) that the two pricing mechanisms in the stock purchase agreement would not have satisfied the “fixed and determinable price under the agreement” requirement. Those pricing alternatives were (1) the price per share set by “mutual agreement” in agreements executed annually by the shareholders, and if that was not done, (2) by appraisals of the fair market value. (Both are pricing mechanisms often found in buy-sell agreements.) The first alternative is “nothing more than price by ‘mutual agreement’—essentially, an agreement to agree,” and while the second alternative “seems to carry more objectivity, there is nothing in the stock-purchase agreement, aside from minor limitations on valuation factors, that fixes or prescribes a formula or measure for determining the price that the appraisers will reach.” The court viewed a “determinable price” as one “arrived at” by “formula,” “a fair, objective measure,” or “calculation.” Neither of the pricing mechanisms in the agreement were used (there were no annual agreements of value and no appraisals were obtained); the parties simply agreed on a purchase price after the decedent’s death.

The court concluded that “neither price mechanism constituted a fixed or determinable price for valuation purposes. [Regulation citation omitted.] If anything, the appraisal mechanism calls for a rather ordinary fair-market-value analysis, which § 2031 and § 2703(a) essentially require anyway. Nothing therefore can be gleaned from the stock-purchase agreement.”

- (2) **Determination of Value Without Regard to Buy-Sell Agreement.** The parties stipulated the estate tax value of the stock, depending on whether the \$3.0 million of life insurance proceeds that were used to redeem the decedent’s stock is included as a corporate asset in valuing the decedent’s stock. The parties had stipulated that the operational value of the company, exclusive of the life insurance proceeds, was \$3.86 million and that the estate’s 77.18% interest of the operational value was \$2.982 million.

The Eighth Circuit observed that

in valuing a closely held corporation, “consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.” 26 C.F.R. § 20.2031-2(f)(2). This need to “take[] into account” life insurance proceeds appears again in a nearby regulation. 26 C.F.R. § 20.2042-1(c)(6).

The court stated that the decedent held no “incidents of ownership” in the policy, so the death proceeds were not includible directly in the gross estate under §2042, but they could be included indirectly in considering how the insurance proceeds impact the valuation of the decedent’s stock. “Indeed, the \$500,000 of proceeds *not* used to redeem shares and which simply went into [the company]’s coffers undisputedly increased [the company]’s value according to the principles in § 2031 and 26 C.F.R. § 20.2031-2(f)(2).”

As to the \$3.0 million of insurance proceeds used to redeem the decedent’s stock, the Eighth Circuit agreed with and expanded upon the district court’s rejection of the rationale of *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005) that the insurance proceeds were offset by the company’s obligation to use the proceeds to redeem the shares.

The IRS has the better argument. *Blount*’s flaw lies in its premise. An obligation to redeem shares is not a liability in the ordinary business sense. See 6A Fletcher Cyclopedic of the Law of Corporations § 2859 (Sept. 2022 update) (“The redemption of stock is a reduction of surplus, not the satisfaction of a liability.”). Treating it so “distorts the nature of the ownership interest represented by those shares.” See *Est. of Blount v. Comm’r*, T.C. Memo 2004-116, 87 T.C.M. (CCH) 1303, 1319 (2004), *aff’d in part and rev’d in part*, 428 F.3d at

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1338. Consider the willing buyer at the time of [the decedent]’s death. **To own [the company] outright, the buyer must obtain all its shares. At that point, he could then extinguish the stock-purchase agreement or redeem the shares from himself. This is just like moving money from one pocket to another. There is no liability to be considered—the buyer controls the life insurance proceeds.** A buyer of [the company] could therefore pay up to \$6.86 million, having “taken into account” the life insurance proceeds, and extinguish or redeem as desired. See C.F.R. § 20.2031-2(f)(2). On the flip side, a hypothetical willing seller of [the company] holding all 500 shares would not accept only \$3.86 million knowing that the company was about to receive \$3 million in life insurance proceeds, even if those proceeds were intended to redeem a portion of the seller’s own shares. To accept \$3.86 million would be to ignore, instead of “take[ ] into account,” the anticipated life insurance proceeds. See id.

(Emphasis added).

The court added a simple example and concluded: “In sum, the brothers’ arrangement had nothing to do with corporate liabilities. The proceeds were simply an asset that increased the shareholders’ equity. A fair market value of Michael’s shares must account for that reality.”

e. **Supreme Court Will Review.** The U.S. Supreme Court granted the estate’s writ for certiorari on December 13, 2023 (over the opposition of the Solicitor General). The Supreme Court takes a very small percentage of cases and rarely hears cases regarding estate tax matters. The Court’s acceptance of *Connelly* is surprising. See Hood & Morrow, *Supreme Court Grants Writ of Certiorari in Connelly v. Internal Revenue Service*, LEIMBERG BUSINESS ENTITIES NEWSLETTER No. 286 (Dec. 18, 2023).

f. **Observations.**

(1) **Result Not Unexpected.** Given the many lapses in the implementation of the redemption transaction, the taxpayer’s loss is not unexpected. Including the life insurance proceeds received by a company at the decedent’s death in valuing the decedent’s interest in the corporation for estate tax purposes is not surprising, but the Eighth Circuit Court of Appeals’ opinion is very significant as a repudiation of the contrary holding by the Eleventh Circuit Court of Appeals in *Blount*.

(2) **Buy-Sell Agreement With Life Insurance Funding.** One of the factors in determining whether to use a corporate purchase or a cross-purchase arrangement in structuring a buy-sell agreement that will be funded with life insurance is that life insurance proceeds received by the company may be included in the estate tax value of the decedents’ shares, resulting in escalating values of the shareholders’ interests in the company. (If the purchase price is fully funded with life insurance, as each owner’s interest is purchased at death using the life insurance proceeds the company value remains constant but the remaining owners have increasing percentage interests in the entity as each owner dies, which increases the value of their interests and requires more life insurance funding.) A pricing formula that does not include the full amount of insurance proceeds payable to the company is very suspect as failing to satisfy the §2703(b) safe harbor (as evidenced by the *Connelly* opinion).

The economic impact of not including insurance proceeds in valuing a decedent’s shares is to produce a huge windfall to the surviving shareholders. They end up owning the company free of the decedent’s shares without having to pay anything following the decedent’s death.

The windfall to the surviving shareholders may be greatly reduced by including the amount of the insurance proceeds on the decedent stockholder’s life in the value of the corporation. However, this approach will be circular and thus greatly increase the amount of insurance coverage needed in order to fund fully the buy-sell agreement. But including life insurance proceeds in determining the value of the company following a shareholder’s death reflects the economic reality of the value of the company at that time. That the IRS maintains that the estate tax value of the decedent’s shares following an insured shareholder’s death should reflect that economic reality is not surprising.

(3) **Buy-Sell Agreement Structuring.** A very important issue in structuring a buy-sell agreement is whether an entity purchase or cross purchase arrangement will be used. For example, the *Connelly* agreement gave the surviving shareholders the first option to purchase a decedent’s

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shares, but if that option was not exercised, the agreement required the corporation to buy the shares.

- Entity Purchase – the parties may feel more comfortable with the entity taking steps to fund the purchase agreement rather than relying on other owners to accumulate funds (or purchase life insurance) to fund a purchase obligation, but the funding in the entity (such as life insurance) may increase the value of the entity (as in *Connelly*); for a corporation, tax considerations include whether the redemption of stock by the corporation will be given sale or exchange vs. dividend treatment.
- Cross purchase – the parties must rely on the remaining owners to purchase their interests at death, funding will be outside the entity, not increasing the entity's value at the death of an owner, and a basis step up for the units purchased will be permitted; these advantages are quite significant; if an entity has multiple owners, one approach is to have the owners form a separate partnership to own a life insurance policy on each owner's life rather than having each owner purchase a life insurance policy on each other owner's life. See Private Letter Ruling 200747002 (LLC owned life insurance for funding of cross-purchase buy-sell agreement of S corporation, with all shareholders of the S corporation as members of the LLC).

- (4) **District Court's Section 2703(b)(3) Comparability Analysis Is Consistent With Various Other Cases.** The *Connelly* district court opinion observed that the estate "failed to prove any evidence of similar arrangements negotiated at arms' length" [about determining the purchase price without including life insurance proceeds received by the company at the decedent's death]. Various other cases regarding §2703 have similarly been pretty strict in requiring examples or evidence of actual comparable arrangements negotiated at arms' length. *E.g., Kress v. U.S.*, 123 AFTR 2d 2019-1224 (E.D. Wi. 2019) ("Though Plaintiffs contend *restrictions* like the Kress Family Restriction are common in the commercial world, they have not produced any evidence that unrelated parties at arms' length would agree to such an arrangement."); *Estate of Blount v. Commissioner*, T.C. Memo. 20014-116, *aff'd in part, rev'd in part*, 428 F.3d 1338 (11th Cir. 2005) ("He did not present evidence of other buy-sell agreements or similar arrangements, where a partner or shareholder is bought out by his coventurers, *actually entered into* by persons at arm's length... Because Mr. Grizzle has failed to provide any evidence of *similar arrangements actually entered into* by parties at arm's length, as required by section 2703(b)(3), and his opinion is based solely on his belief that the purchase price for decedent's BBC shares was set at fair market value, Mr. Grizzle's conclusion that the terms of the Modified 1981 Agreement are comparable to similar agreements entered into by parties at arm's length is unsupported."); *Smith v. Commissioner*, 94 AFTR 2d 2004-5283 (W.D. Pa. 2004) ("In this case, both parties concede that it would be inherently difficult to find an agreement between unrelated parties dealing at arms' length that would be comparable to a family limited partnership, which, by its terms, is restricted to related parties.... Nevertheless, Plaintiffs have submitted the affidavits of two attorneys... who essentially state that restrictive provisions requiring installment payments and charging interest at the applicable federal rate are common in both family limited partnerships and transactions involving unrelated parties.... Upon review, these affidavits merely state opinions that are conclusory in nature and do not constitute evidence sufficient to dispel any genuine issue of material fact as to whether of [*sic*] the restrictive provision in the Smith FLP agreement meet the test set forth in Section 2703(b)(3).")

The comparability test was satisfied in *Amlie v. Commissioner*, T.C. Memo. 2006-7, involving a rather complicated fact pattern. The court concluded that an agreement met the comparability test because it was based on price terms in an earlier agreement, which was based on a survey of comparables.

- (5) **"Fixed and Determinable Price in the Agreement" Dictum by Eighth Circuit Suggests That Many Buy-Sell Agreements Would Not Set the Estate Tax Value.** The Eighth Circuit held that a "fixed and determinable price" was not established under the stock purchase agreement, partly because the parties did not follow the pricing mechanisms set out in the agreement. Even

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if those procedures had been followed, however, the Eighth Circuit suggested (presumably in dictum) that would not have been sufficient to determine the estate tax value of the stock. That observation by the court is quite significant because the pricing procedures in the buy-sell agreement in *Connelly* ((1) annual valuation agreements and (2) appraisal procedures) are often found in buy-sell agreements. A purchase under a binding agreement pursuant to those procedures might not be recognized as the value for estate tax purposes of the purchased interest under the reasoning of this dictum in *Connelly*.

- (6) **Effect of Considering Life Insurance Proceeds in Determining Value.** If a buy-sell agreement does not effectively fix the estate tax value of the stock, the corporate insurance proceeds should be considered as a factor in determining the corporation's value, and the proceeds should not merely be added to the value of the corporation determined without regard to the proceeds. See *Estate of Huntsman*, 66 T.C. 861, 872-76 (1976), *acq.* 77-1 C.B. 1 ("determine fair market value ... by giving 'consideration' to the insurance proceeds"); *Newell v. Commissioner*, 66 F.2d 102, 103-04 (7th Cir. 1933) (key shareholder's estate established that stock increase was offset by decrease in corporation's value caused by the loss of a key shareholder).

### 30. Transfer Planning With QTIP Trusts, *McDougall v. Commissioner*, CCA 202118008

- a. ***McDougall v. Commissioner*, CCA 202118008.** Chief Counsel Advice 202118008 is an excellent illustration of the difficulty and complexity of planning with QTIP interests. The spouse-beneficiary ("Spouse") held a testamentary limited power of appointment. The Spouse, his two children ("Children") as remainder beneficiaries, and virtual representatives of the contingent remainder beneficiaries, entered into an agreement to have all the trust property (valued at \$118 million) distributed to the Spouse. On the same day, the Spouse transferred the trust assets to trusts for the Children and their descendants, partly as a gift and partly as a sale in return for secured promissory notes. The CCA addressed various issues.

The IRS ruled that this transaction had significant adverse tax consequences: (1) the Children were treated as making gifts to the Spouse of their remainder interest; (2) the Spouse was treated as making a deemed disposition under §2519 of the full value of the remainder interest; and (3) the gift/sale by the Spouse of the trust assets utilized his gift exclusion amount and the Spouse would have the value of notes included in his estate for estate tax purposes. For a detailed discussion of CCA 202118008, see Item 8.h of Estate Planning Current Developments (March 16, 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).

The three gift tax cases involving the Spouse and each of the two Children were consolidated for trial. *McDougall v. Commissioner*, Docket Nos. 2458-22, 2459-22, and 2460-22 (Petitions filed February 18, 2022, Judge Halpern). (The taxpayers are represented by John Porter, Keri Brown, and Tyler Murray.) The court is now considering motions for summary judgment filed by the various parties. See Erin McManus, *QTIP Trust Beneficiaries Say IRS is Triple-Dipping*, TAX NOTES (May 19, 2023).

Motions filed in the case reflect the values involved in the transactions. The value of the QTIP trust at the time of the commutation was about \$117.6 million. The Notices of Deficiencies asserted that the surviving husband made a gift of the remainder interest under §2519 equal to about \$106.8 million and the remaindermen made gifts in an equal amount back to the surviving husband. The surviving husband's gift tax deficiency was about \$47.7 million and the remaindermen's gift tax deficiency was about \$43.4 million, resulting in total gift tax deficiencies of over \$80 million. And the husband was left owning promissory notes equal to the value of the QTIP assets that would be subject to transfer tax in the future.

The IRS made the arguments described above in CCA 202128008 and also argued, in the alternative, that the surviving husband's sale of substantially all of the QTIP assets that he received as a result of the nonjudicial agreement (NJA) in exchange for promissory notes resulted in a disposition of his qualifying income interest in the trust, thus triggering §2519.

The surviving husband's motion for summary judgment summarized the IRS's position as follows:

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Despite the fact that Bruce's [Bruce was the surviving husband] gross estate remained unchanged, Respondent issued notices of deficiency asserting that the termination of the Residuary Trust and the distribution of its assets to Bruce resulted in two simultaneous taxable gifts of the same assets. First, in his notice of deficiency to Bruce, Respondent asserts that there was a "deemed" gift by Bruce to Linda and Peter [the children of Bruce and his deceased wife who are the contingent remainder beneficiaries] equal to the value of the remainder interest in the Residuary Trust for which gift tax is due. Second, in nearly identical notices of deficiency issued to Linda and Peter, Respondent asserts that there were simultaneous gifts by Linda and Peter, collectively, back to Bruce, consisting of the same assets and in the same amount as Bruce's gift to them, for which Respondent claims gift tax from each of Linda and Peter is due. Finally, under Respondent's theory, there will be a third tax on the value of those assets when Bruce subsequently transfers the assets by gift or upon his death.

The surviving husband's responses in his motion for summary judgment to the IRS's arguments are summarized.

(1) The NJA, which resulted in the termination of the QTIP trust and distribution of its assets to the surviving husband, expressly invoked and followed the IRS's guidance for reciprocal gifts in Rev. Rul. 69-505, created offsetting reciprocal transfers of equal value, resulting in the surviving husband receiving the assets. The NJA expressly states that it (1) "results in a deemed gift, for federal gift tax purposes, of the remainder interest in the Trust assets from Bruce [the surviving husband] to Linda and Peter under Section 2519 of the Code," and (2) also results in a gift of the remainder interest in the trust from the remaindermen to the surviving husband. Those two gifts result "in a reciprocal gift transfer." "The simultaneous transfer of interests was part of an integrated transaction."

(2) Rev. Rul. 69-505 involved transfers by joint tenants to a trust. The ruling concluded that "[t]he transfers between the joint tenants are treated as a reciprocal exchange for consideration in money or money's worth.... Thus, neither is considered to have made a gift to the other to the extent that the transfers are of equal value."

(3) The concept of the QTIP rules is to create a tax fiction in effect treating "the second spouse as owning the subject property outright, rather than owning merely a life or other terminable interest." *Estate of Sommers v. Commissioner*, 149 T.C. 209, 223-24 (2017). The NJA produced the same result as if the assts had been left outright to the husband rather than in the QTIP trust "and thus should have the same transfer tax consequences because the value of the assets included in [the surviving husband's] gross estate remained unchanged by the execution of the NJA," and the husband's sale of the assets in exchange for promissory notes left the value in his gross estate unchanged. In effect, the husband's acquisition of all the assets of the terminated QTIP trust as a result of the NJA left "the surviving spouse's real world **unchanged** from the 'tax fictional' world that evaporated when the QTIP terminated." (Emphasis in original)

(4) The taxpayer distinguished *Kite* because it would have resulted in a transfer without gift or estate tax because of the deferred private annuity coupled with a premature death if gifts had not occurred under §2519, but in *McDougall* there was no transaction wherein the children received assets of the trust in a manner that would result in no gift or estate tax upon the husband's transfer of the assets because the promissory notes are subject to transfer tax.

(5) The rationale of Rev. Rul. 98-8, 1998-7 I.R.B. 24, is consistent with the taxpayer's position. In Rev. Rul. 98-8, the surviving spouse's purchase of the remainder interest in the QTIP trust was treated as a gift to the remainder beneficiaries equal to the purchase price paid because the assets comprising the remainder interest were already included in the surviving spouse's gross estate. Under the QTIP regime, the remainder was already owned by the spouse (*i.e.*, it was in the spouse's gross estate), so "nothing was acquired by the surviving spouse for the consideration paid and the surviving spouse's gross estate was diminished." That is not the result in the *McDougall* facts; the surviving husband's gross estate was not diminished.

(6) The position of the IRS results in triple taxation that is inconsistent with the structure and purposes of the QTIP rules.

**In light of this, Respondent's position that would tax the same asset twice in the same day in a back-and-forth transfer and, for a third time, when the patriarch passes away (which could theoretically cause the triple transfer taxation of the property on the same day) is preposterous.** Bruce will be subject to estate tax on the value of the Residuary Trust received upon its termination, unless those assets are consumed or the

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object of a subsequent *inter vivos* taxable gift, which is the same circumstance that would have resulted had the Residuary Trust been left undisturbed. Perhaps the better analogy is that this is the same outcome that would have arisen had the surviving spouse been given the assets outright; or, in a more flexible variation of the standard QTIP marital trust, where a fiduciary is given the power to terminate the trust in favor of the surviving spouse at its discretion. Why should the termination of the QTIP trust through the NJA give rise to more than a single incident of taxation? The answer is that it should not. Taxpayer consistency does not support such an outcome, and Respondent's **attempt to achieve triple taxation** is contrary to the IRS's own published guidance applicable to these situations, further undermining confidence in the tax system. Similarly, Linda and Peter have not reduced their potential estate tax obligations, as their gross estates would be taxed on the assets of the Residuary Trust only to the extent of gifts or bequests from Bruce. This is the same circumstance that would have existed had the Residuary Trust been left undisturbed. (Emphasis added)

(7) In response to the IRS alternative argument that the husband's sale of substantially all the QTIP assets in exchange for promissory notes resulted in a disposition of his qualifying income interest in the trust, thus triggering §2519, the taxpayer argues that the husband did not relinquish his income interest. The receipt of the promissory notes was not a disposition of a qualified income interest but was the conversion of QTIP property into other property in which the husband holds an income interest. See Treas. Reg. §§ 25.2519-1(f) ("conversion of qualified terminable interest property into other property in which the donee spouse has a qualifying income interest for life is not, for purposes of this section, treated as a disposition of the qualifying income interest"); 25.2519-1(e) (exercise of a power to appoint QTIP assets from the trust to the surviving spouse is not treated as a disposition under §2519).

An interesting article emphasizes the "tax fiction" created by the QTIP regime that in effect treats the spouse as owning the trust assets for transfer tax purposes, similar to the arguments being made by the taxpayer in *McDougall*. Irwin, *Removing the Scaffolding: The QTIP Provisions and the Ownership Fiction*, 84 Neb. L. Rev. 571 (2005).

- b. **Planning Regarding Spouse's Interest in QTIP Trusts.** Planning for surviving spouses who are beneficiaries of substantial QTIP trusts is complicated but very important because assets remaining in a QTIP Trust at the surviving spouse's death will be included in the spouse's gross estate for estate tax purposes.

For an outstanding detailed discussion of planning alternatives for a surviving spouse who is the beneficiary of a QTIP trust, see Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44<sup>th</sup> U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 1202.3 (2010). For a discussion of other planning alternatives (including planning for distributions to the spouse, and the risks of unauthorized distributions, so the spouse can make estate planning gifts and transfers of those assets), see Item 9.h of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found [here](#) and available at [www.bessemertrust.com/for-professional-partners/advisor-insights](http://www.bessemertrust.com/for-professional-partners/advisor-insights).