Estate Planning Current Developments and Hot Topics

September 2016

Steve R. Akers

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

BESSEMER TRUST

Bessemer Trust Overview

At a Glance

- Multifamily office founded in 1907
- Industry-leading 3-to-1 client-to-employee ratio
- 19 offices globally, serving 2,400 clients
- More than $100 billion in assets under supervision
- 10-year client asset retention rate of 98%
- Financially stable with a strong balance sheet

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 100 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

Consistently recognized as a leading multifamily office, we provide highly personalized advice and service our clients know they can depend on. We take the time to understand each of our clients' objectives in order to deliver long-term, fully integrated solutions that help them:

- Protect their lifestyles through economic cycles
- Increase their wealth beyond taxes, inflation, and fees
- Manage their day-to-day financial complexities
- Transfer their wealth across generations and fulfill their philanthropic goals

Dedicated Advisor Teams Delivering Fully Integrated Capabilities

Our advisor teams work closely with clients to provide customized, integrated solutions that reflect each client's unique circumstances and aspirations. On average, our Senior Client Advisors have over two decades of industry experience and more than a decade with the firm. Clients place their trust in Bessemer knowing they will have ongoing dialogue with a proactive, experienced, and loyal team.

A commitment to excellence in investment management, wealth planning, and client service has been our focus for more than 100 years and reflects our overarching mission: to provide peace of mind for generations.

The Bessemer Difference

Private ownership and independence
Results in continuity of purpose, stability, and objectivity

Singular focus on private wealth management
Allows us to deliver deep expertise

Alignment of interests among clients, owners, and employees
Encourages long-term success as we invest side-by-side

Culture of service, not sales
Strengthens our ability to provide appropriate and unbiased advice

Multidisciplinary Teams Providing Expert Advice

We deliver best-in-class expertise across investment management, wealth planning, and family office services. A thoughtful approach to planning enables us to integrate and align our broad capabilities with each client's objectives.

Investment Management

We customize our clients' asset allocations to reflect their specific goals. Our investment approach is flexible and highly disciplined, taking advantage of our research insights as we seek attractive long-term returns for clients. Using a mix of internal and external managers, we build multi-asset class, diversified portfolios designed to participate in strong markets, while offering protection in down markets.

Wealth Planning

Wealth impacts all aspects of life – and we find that our clients' needs evolve over time. We stand ready to assist with trust administration and estate planning, to develop strategies aimed at minimizing taxes and managing risks, to help communicate wealth plans to the next generation, and to give guidance on a strategic approach to philanthropy. Our wealth planning teams have one focus: providing advice to help clients preserve and transfer wealth.

Family Office Services

We have helped clients manage the operational and administrative complexities of wealth since 1907 when our owners, the Phipps family, founded the firm. This long history gives us unparalleled experience providing clients with a broad range of family office services, including custody and consolidated reporting, private banking, bill payment and payroll.

For more than 100 years, individuals and families of substantial wealth have depended on Bessemer Trust for sophisticated advice on their complex financial needs. For more information on the breadth of our capabilities, please contact your advisor. Minimum relationship size of $10 million.

ATLANTA • BOSTON • CHICAGO • DALLAS • DENVER • GRAND CAYMAN • GREENWICH • HOUSTON • LONDON • LOS ANGELES • MIAMI • NAPLES • NEW YORK
PALM BEACH • SAN FRANCISCO • SEATTLE • WASHINGTON, D.C. • WILMINGTON • WOODBRIDGE

Visit us at bessemer.com

Selected Biographies

Steve R. Akers, Managing Director and Senior Fiduciary Counsel

Mr. Akers is a Managing Director and Senior Fiduciary Counsel at Bessemer Trust. Mr. Akers serves as Chair of the Estate Planning Committee for Bessemer Trust. He works closely with clients in the Southwest Region regarding their estate and trust planning issues. He also speaks frequently with advisors who work with Bessemer Trust throughout the country.

Mr. Akers is a member of the Advisory Committee to the University of Miami Philip E. Heckerling Institute on Estate Planning and is a frequent speaker at the Institute and at other estate planning seminars across the country. He currently serves as Secretary of The American College of Trust and Estate Counsel (ACTEC), where he is also a Fellow and formerly served as a member of the Executive Committee, Regent, Chair of the Business Planning Committee, and editor of the ACTEC Law Journal. He is also a past Chair of the American Bar Association's Section of Real Property, Trust & Estate Law; the State Bar of Texas Real Estate, Probate and Trust Law Section; and the Dallas Bar Probate, Trusts and Estates Section. In addition, he is a co-author of *A Planning Guide to Buy-Sell Agreements* and *Estate Planning After the Tax Relief and Job Creation Action Act of 2010*.

He earned a J.D. from the University of Texas School of Law and a B.S. in chemical engineering from Oklahoma State University.

Bessemer Trust Advisor Website

Website for Attorneys

Bessemer maintains a website — www.bessemer.com/advisor — specifically for Trust & Estate attorneys. The site features Steve Akers' latest case summaries, estate planning updates, musings, and webcasts going back to 2008. Bessemer's best thinking on the current investing and tax planning environment are also available.

- ☐ Visit www.bessemer.com/advisor
- ☐ Access Steve Akers' latest pieces

Table of Contents

August 15, 2016

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

Introduction

This summary of current developments includes observations from the 50th Annual Philip E. Heckerling Institute on Estate Planning in 2016 as well as other observations from various current developments and interesting estate planning issues.

1. Summary of Top Developments in 2015

2015 was a busy year in the estate planning world. Economic conditions led to some of the activity, including (1) low interest rates (which are very helpful for various transfer planning strategies), and (2) volatility in the financial markets. Clients are interested in preserving assets and exploiting (or capitalizing on) anticipated upswings in the market.

A growing emphasis on income tax planning continues in light of the small difference in the income and transfer tax rates. For the bulk of the U.S. population, the $5 million indexed estate, gift, and GST exemptions have made the transfer tax largely irrelevant.

Ron Aucutt (Washington D.C.), provides the following as his "top ten" list of the major developments in the estate planning world in 2015:

(1) IRS attacks on sales to grantor trusts (including the *Davidson* and *Woelbing* cases), the Administration's budget proposals, new IRS priority guidance plan proposals (that have the effect of attacking various aspects of sale to grantor trust transactions), and the anticipated issuance of new regulations under §2704 (admittedly, that is several top items all thrown into the "number one" category);

(2) Political climate in Washington (new leadership in the House of Representatives appears to have allowed some element of compromise, including the passage of various permanent "tax extenders");

(3) Consistency of basis legislation;

(4) Same-sex marriage recognized as a constitutionally protected right in *Obergefell*;

(5) Final portability regulations;

(6) New Uniform Acts, including acts on trust decanting and access to digital assets;

(7) More flexibility in the support and administration of charities, including various favorable charitable contribution rules included in the tax extenders legislation and *Green v. United States* (a case of first impression allowing a trust income tax charitable deduction for the full value of appreciated property distributed to charity pursuant to the trust agreement, see Item 19 below);

(8) Continued erosion of the power of states to tax trust income (*Kaestner* and *Kassner* cases in North Carolina and New Jersey);

(9) Crummey powers (*Mikel* case and Administration's budget proposal); and

(10) *Redstone* cases, regarding transfers in family discord situations.

Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2015*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2371 (January 4, 2016).

2. Legislative Developments

a. **Transfer Tax Legislation Unlikely in 2016**. The various transfer tax proposals in the Administration's Fiscal Year 2016 Revenue Proposals (released by the Treasury on February 2, 2015) will likely proceed only as part of a general tax reform package, and not as a package of separate transfer tax legislation. Some indications, however, are that transfer taxes will not being considered in the reform measures. With Republicans controlling both the House and Senate, legislation to enhance transfer tax measures seems highly unlikely. It is not out of the question, however, that specific measures that produce some revenue might get enacted; the basis consistency provision passed very quickly (and quite unexpectedly) last year as part of the highway trust fund legislation.

b. **Fundamental Tax Reform Unlikely**. The approaches for fundamental tax reform by the Congress and President have substantial differences. The prospect of fundamental tax reform is unlikely without Congress's ability to override a Presidential veto.

c. **Transfer Tax Repeal Possibilities**. Representative Kevin Brady (R-Texas) has become the Chair of the House Ways and Means Committee, following Paul Ryan's elevation to House Speaker. Rep. Brady has been an outspoken critic of the estate tax, having introduced the Death Tax Repeal Act of 2015 (passed by the House on April 16, 2015)) to repeal the estate and GST tax, retain the gift tax at a 35% rate with a $5 million indexed exemption, and retain stepped-up basis at death.

   One noted commentator observes that Rep. Brady's becoming chair of the Ways and Means Committee may "somewhat" increase the chances of estate tax repeal, but "it would be wrong to jump to conclusions about that. Estate tax repeal remains a politically complex issue, and it is not at all clear that the present or future House leadership would be willing to spend its political capital on this objective rather than others, whether in packaging a repeal to avoid a presidential veto or in positioning it to get 60 votes for a Senate cloture motion." Ronald Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2015,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2371 (Jan. 4, 2016).

d. **President's 2017 and 2016 Fiscal Year Budget Proposals: Increasing Taxes on Wealth**. The Treasury on February 2, 2015 released the General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (often referred to as the "Greenbook") to provide the details of the administration's budget proposals. The 2017 Fiscal Year Greenbook was released on February 9, 2016 and is very similar to the 2016 Fiscal Year plan with respect to the issues discussed below (other than the change to the basis consistency proposal, as described below).

   Some of the items included in the 2017 and 2016 Fiscal Year Greenbooks (released in 2016 and 2015, respectively) are listed below. (The revenue estimates listed are based on estimates in the 2017 Fiscal Year Plan.)

   Expansion of Basis Consistency; Change in in 2017 Fiscal Year Plan. The basis consistency provision in the 2016 Fiscal Year Plan was enacted, in part, in 2015 (as discussed in detail in Item 3 below). The 2015 legislation did not enact the provision in the prior budget proposals to apply the basis consistency rules to gifts. In addition, the 2015 legislation does not apply the basis consistency requirement to estates paying no estate tax because of the marital deduction. The 2017 Fiscal Year Plan proposes expanding the basis consistency rules to include both of those situations. (Estimated 10-year revenue: $1.693 billion, compared to $3.237 billion in the 2015 Fiscal Year Plan, which generally required basis consistency for all estate or gift transfers.)

Treating Gifts and Bequests as Realization Events. A major new proposal in the Fiscal Year 2016 Plan (and repeated in the 2017 Fiscal Year Plan) would raise substantial income taxes by closing the "trust loophole," to cause an immediate realization of gain upon making gifts or at death (with an elimination of the basis step-up at death under §1014). The description released in connection with the 2015 State of the Union Address refers to the basis step-up under §1014 as "perhaps the largest single loophole in the entire individual income tax code." For a description of the details of this proposal, see Item 1.d of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

Increased Capital Gains Rates. The proposal would increase the top rate on capital gains and qualified dividends to 28% for couples with income over about $500,000 (the 2017 and 2016 Fiscal Year Budget proposals make clear that the 28% rate includes the 3.8% tax on net investment income). (Estimated 10-year revenue: $235.208 billion for the combined realization on gift or death proposal and the proposal to increase the capital gains rate.)

Other Individual Income Tax Proposals. The 2017 and 2016 Fiscal Year Plans also continue the items in the 2015 Fiscal Year Budget Proposal to (1) limit the benefit of most individual deductions to a maximum of 28% with similar limitations of the tax benefits of tax-exempt bonds and retirement plan contributions), and (2) enact a "Buffet Rule" requiring that the income tax be at least 30% of an individual's income for wealthy individuals (phased in starting at $1,000,000 of income for married joint filers).

Business Tax Reform. The Fiscal Year 2017 and 2016 Budget proposals include various business tax reforms including lower the corporate tax rate to 28% with a 25% effective rate for domestic manufacturing, various small business relief provisions, and a revised international tax system.

Restore 2009 Estate, Gift and GST Tax Parameters, Beginning in 2017. The 2014 and 2015 Fiscal Year Plans proposed restoring the 45% rate/$3.5 million estate and GST exemption/$1 million gift exemption effective beginning in 2018. The 2016 Fiscal Year Plan moved up the effective date to 2016 (while President Obama is still in office). The 2017 Fiscal Year Plan moves the effective date to 2017. (Estimated 10-year revenue: $201,754 billion, up from $189.311 billion in the 20176 Fiscal Year Plan, up from $118.282 billion in the 2015 Fiscal Year Plan.)

New GRAT Requirements Prior to 2016 Fiscal Year Plan. Requirements proposed in years before 2015 for GRATs included (i) a 10-year minimum term, (ii) a maximum term of life expectancy plus 10 years, (iii) a remainder value greater than zero, and (iv) no decrease in the annuity amount in any year. The 2016 Fiscal Year plan added a proposed requirement that the remainder interest in the GRAT at the time the interest is created has a minimum value equal to the *greater* of 25% of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed). (**Observation: This would kill GRATs as a practical matter**.) In addition, GRATs would be prohibited "from engaging in a tax-free exchange of any asset held in the trust." (Estimated ten-year revenue: The 2015 Fiscal Year Plan broke out the estimated revenue impact of the GRAT provision and grantor trust provision separately, but in the 2017 and 2016 Plans they are combined. The 10-year revenue impact of the GRAT and grantor trust proposal is $19.149 billion, up from $18.354 billion in the 2016 Fiscal Year Plan. In the 2015 Fiscal Year Plan, the revenue impact of the GRAT proposal was $5.711 billion and $1.644 billion for the grantor trust proposal, totaling $7.355 billion. This is a substantial increase in the 2017 and 2016 Fiscal Year Plans compared to the 2015 Fiscal Year Plan.)

Limit Duration of GST Tax Exemption to 90 years. This proposal has not generated a groundswell of criticism. The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date (subject to rules substantially similar to the grandfather rules). (Estimated ten-year revenue impact: Negligible.)

Sales to Grantor Trusts. The 2014 Fiscal Year Plan substantially narrowed this proposal from the 2013 Fiscal Year Plan (which would have included all grantor trusts in the settlor's gross estate). The 2014 Fiscal Year Plan provided generally that if sales to grantor trusts are made, the portion in the trust attributable to the sale (net of the amount of consideration received by the grantor in the transaction) would be in the grantor's gross estate (or would be a gift from the grantor if grantor trust status of the trust terminated during his lifetime). The 2015-2017 Fiscal Year Plans retain that proposal. (Estimated ten-year revenue: $1.644 billion in the 2015 Fiscal Year Plan. See above regarding the GRAT proposal for the revenue estimate in the 2017 and 2016 Fiscal Year Plans.)

Section 6166 Estate Tax Lien. The special estate tax lien under §6324(a)(1) would last for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after the date of death. (Estimated ten-year revenue: $260 million, up from $248 million in the 2016 Fiscal Year Plan.) This almost certainly will be included in any transfer tax legislation that passes.

Health and Education Exclusion Trusts. "HEET" trusts are a seldom-used strategy to create a long term trust out of which tuition and medical payments could be made for future generations without any GST tax. Unfortunately, the proposal is Draconian in approach. It would eliminate the current exclusion under §2503(e) for payments from a trust for the health or tuition payments for second generation (and more remote) beneficiaries. Furthermore, the proposal has a seldom used very harsh effective date provision—applying to trusts created after and transfers after the date of the introduction of this bill. (Estimated ten-year revenue: *Negative* $247 million, compared to negative $231 million in the 2016 Fiscal Year Plan)

Simplify Gift Tax Annual Exclusion. Referencing the complexity of administering *Crummey* trusts and the potential abuses, the 2015 Fiscal Year Plan first proposed deleting the present interest requirement for annual exclusion gifts, allowing the $14,000 per donee exclusion for most outright transfers, and adding a new category of gifts to which a $50,000 *per donor* annual limit would apply. The proposal applies to gifts made after the year of enactment. For a description of the details of this rather confusing proposal, see Item 1.c of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

The 2017 and 2016 Fiscal Year Plans clarify this proposal to indicate that "[t]his new $50,000 per-donor limit would not provide an exclusion in addition to the annual per-donee exclusion; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion." (Estimated ten-year revenue: $3.680 billion, up from $3.446 billion in the 2016 Fiscal Year Plan. Observe, this is large enough to gather possible interest as a revenue raiser for some unrelated legislation needing a revenue offset)

Payment to Non-Spouse Beneficiaries of Inherited IRAs and Retirement Plans Over Five Years. The 2014 Fiscal Year Plan added a new proposal requiring that non-spouse beneficiaries of inherited retirement plans and IRAs generally must take distributions over no more than five years. Exceptions are provided for disabled beneficiaries, chronically ill beneficiaries, individuals not more than 10 years younger than the participant, and minor beneficiaries. The 2014 Fiscal Year plan did *not* specifically make this requirement applicable to Roth IRAs. But the 2015 Fiscal Year plan provided that all of the same minimum distribution rules would apply to Roth IRAs as other IRAs (applicable for taxpayers reaching age 70 ½ after 2014). (This is repeated in the 2016 and 2017 Fiscal Year Plans.) Therefore, Roth IRAs would be subject to the 5-year distribution requirement. Under the 2017 Fiscal Year Plan, the proposal would be effective for plan participants or IRA owners dying after 2016, and the proposal appears to apply to Roth IRAs only if the owner reached age 70 ½ after 2016 and to owners who die after 2016. The general five-year proposal, while a dramatic change, has significant acceptance on a policy basis of requiring that retirement plans be used for retirement. However, extending this rule to existing Roth IRAs seems very unfair. (Estimated 10-year revenue of the general 5-year proposal: $6.264 billion, up from $5.479 billion in the 2016 Fiscal Year Plan)

Charitable Deduction Limitations. The percentage contribution limitations on charitable deductions would be simplified by applying the 50% limit for contributions of cash to public charities but applying a 30% of contribution base limitation to all other contributions (except for qualified conservation contributions which have their own contribution and carryforward limitations). The 30% limitation would no longer depend on the type of property contributed, the type of charitable organization, or whether the contribution was to or for the use of the organization. The carryforward period for excess contributions would be extended from 5 to 15 years.

Miscellaneous Other Proposals. Various other proposals include (1) expanding the applicability of the definition of executor, (2) reporting requirements for the sale of life insurance policies and changing certain transfer-for-value restrictions, (3) limiting the total accrual of retirement benefits, (4) eliminating the MRD requirements for qualified plans and IRAs under an $100,000 (indexed) aggregate amount, (5) allowing non-spouse beneficiaries to rollover IRAs to another IRA, and (6) enhancing the administrability of the appraiser penalty. The 2016 and 2017 Fiscal Year Plans also omitted the proposal to amend §2704 (which had been in the prior Obama administration budget proposals). For a description of the details of these miscellaneous proposals, see Item 1.d of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

e. **Tax Extenders and PATH Act of 2015**.

(1) ***2014 Extenders.*** H.R. 5771 was passed by the House on December 3, 2014, by the Senate on December 16, 2014, and signed by the President on December 19, 2014. Division A of H.R. 5771 is the "Tax Increase Prevention Act of 2014." It extended various items through December 31, 2014, retroactive to January 1, 2014. Negotiations to pass a two-year extender package (through December 31, 2015) occurred, but the President indicated that he would likely veto the two-year extension package (on the basis that it provided more benefits to businesses than individuals), so the two-year extender package was not adopted. Accordingly, the extended provisions were extended just through December 31 (or 13 days from the day they were enacted).

(2) ***2015 Extenders.*** On December 18, 2015, Congress passed and the President signed into law the Protecting Americans from Tax Hikes (PATH) Act of 2015. The PATH Act retroactively reinstated for 2015 the tax extenders that were renewed for and then expired at the end of 2014. Unlike extenders legislation over the last several years, a number of the provisions were renewed *permanently*. The Provisions extended permanently include:

- Qualified charitable distribution (QCD) rules (sometimes referred to as the IRA charitable rollover—see subparagraph (3) below).
- State and local sales tax deduction;
- Enhanced American Opportunity Tax Credit ($2,500/year credit for up to four years of post-secondary education);
- Enhanced Child Tax Credit;
- Basis of an S corporation shareholder's stock is not reduced by the unrealized appreciation in property contributed to charity by the S corporation, §1367(a)(2);
- Reduction from ten to five years of the period in which a newly converted S corporation's built-in gains are subject to a corporate-level tax, §1374(d)(7);
- School teacher expense deduction;
- Section 179 expensing, generally up to $500,000 for an asset, with a maximum of $2 million for a year (including special rules for computer software and certain qualified real property);
- Section 1202 small business stock capital gains exclusion (100%) for qualifying small business tock acquired and held more than 5 years, and elimination of such gain as an AMT item (to qualify the stock must be in a domestic C corporation that did not have more than $50 million of assets when the stock was issued, the stock must be acquired at its original issue, at least 80% of the corporation's assets must be used in various qualified businesses, and the excludable gain is limited to the greater of $10 million or ten times the investor's basis in the stock) [planners should keep in mind that if originally issued shares that qualify under §1202 are transferred in estate planning transactions, the benefit of the §1202 exclusion is lost]; and
- Qualified conservation contributions.

Some of the extender provisions were extended, but just through 2016 (or longer, as noted below). These include:

- Exclusion of up to $2.0 million of discharged mortgage debt for a principal residence on short sales (and debt discharged in 2017 pursuant to a written agreement entered into in 2016 also qualifies);
- Deductibility of mortgage insurance premiums;
- Above-the-line education deduction of qualified tuition and fees;
- 50% bonus deprecation (extended through 2017, it is reduced to 40% bonus depreciation in 2018 and to 30% bonus depreciation in 2019); and
- Work opportunity tax credit is extended through 2019 for businesses that hire certain targeted groups

Section 529 Plans. The PATH Act also made several revisions to Section 529 Plans.

- Qualified higher education expenses (qualifying for tax-free distributions from the Plan) will now include computer equipment and related expense (including software and internet access); and
- The tax treatment of non-qualifying distributions will be based just on the amount of gain in a particular Section 529 Plan account without a requirement of aggregating all 529 Plan accounts.

ABLE Accounts. A change for ABLE accounts eliminates a residency requirement, and allows individuals to choose any state's 529 ABLE plan.

NIMCRUTS and NICRUTS. The PATH Act also clarified rules regarding early termination of charitable remainder unitrusts with a net income limitation (i.e., a NIMCRUT or NICRUT) on the unitrust amount distributable to non-charitable beneficiaries during the lead term of the trust. The income limitation cannot be considered in valuing the charitable remainder at the creation of the trust. *E.g., Estate of Schaefer v.* Commissioner, 145 T.C. No. 4 (2015). The PATH Act provides that the net income limitation similarly cannot be considered in valuing the charitable interest if the CRUT is terminated early to determine the actuarial value of the non-charitable beneficiaries' interest in the trust. The IRS position had been that the income limitation did have to be considered in valuing the unitrust interest if the trust terminated early, which could dramatically lower the value of the noncharitable "lead" interest in the CRUT that would be paid to the noncharitable beneficiaries. §664(e)(1) as revised by §344 of the PATH Act. [Despite this federal law clarification, state attorneys general may still complain if a charitable interest in a CRUT is terminated early in exchange for less than the actual market value of the charitable interest at that time, taking into account any income limitations on the annuity payments to non-charitable recipients.]

Section 501(c)(4) Organizations. Gifts to §501(c)(4) social welfare organizations that educate the public (including "candidate-related political activities") will not be subject to the gift tax. §408 of PATH Act. Gifts to these organizations clearly do not qualify for an income tax charitable deduction, and uncertainty has prevailed as to whether they qualify for the gift tax charitable deduction. The PATH Act makes clear that they do. The PATH Act also requires that these organizations notify the IRS of their formation within 60 days of their establishment, and they may seek declaratory judgments concerning IRS determinations of tax-exempt status under §7428.

Limit on Shifting of Loss to Related Party Transferee. Under §267, a transferor cannot deduct a loss on a sale between related parties, but the benefit of the loss is generally shifted to the transferee to the extent of post-sale appreciation. This allowed individuals who were not subject to federal income tax to enter into transactions with related parties in a way that shifted the benefit of losses (which are useless to the person who is not paying income tax anyway) to the related parties. The PATH Act prevents shifting a loss to a related transferee to the extent that the loss, had it been allowed as a deduction to the transferor, would not have been taken into account in determining federal income tax. §267(d)(3) (applicable to sales after 2015).

(3) ***IRA Charitable Rollover; Qualified Charitable Distributions (QCDs).*** The PATH Act makes the QCD rules permanent, retroactive to January 1, 2015, allowing certain charitable donations from an IRA without having to treat the distributions as taxable income.

- The maximum QCD permitted annually is $100,000 per individual and is available only for individuals age 70 ½ or older who make distributions directly to charity from an IRA.
- The QCDs satisfy required minimum distribution (RMD) requirements for IRAs.
- The QCD must be made directly to a public charity; donor advised funds and private foundations are ineligible recipients.
- No benefit whatsoever can be received from the charity.
- A QCD can fulfill a previously existing pledge.
- Previously received 2015 RMDs cannot be returned to an IRA, but taxpayers who may have already received their RMD can still take advantage of the QCD opportunity.

f. **ABLE Accounts**. The Achieving a Better Life Experience Act of 2014 (the "ABLE Act") created new Code section 529A. It allows the creation of tax-free savings accounts somewhat like 529 Plans that are used for disabled special needs beneficiaries rather than for college expenses. Among the benefits is that amounts in an ABLE account (up to $100,000) do not count as a resource for SSI qualification purposes.

Under the 2014 legislation, the beneficiary of the 529 ABLE plan would have been required to use the plan in his state of residence. The PATH Act (the 2015 tax extenders legislation) eliminates the residency requirement, and allows individuals to choose any state's 529 ABLE plan, which allows more control over investment options and expenses and the state-based maximum account limits.

The IRS issued proposed regulations describing ABLE accounts in detail and interpreting many of the provisions of §529A. Prop. Reg. §1.529A-0-§1.529A-7, I.R.B. 2015-27, REG-102837-15. The preamble and Notice 2015-18 make clear that until final regulations are issued, taxpayers and qualified ABLE programs may rely on the proposed regulations. States have been waiting until getting IRS guidance to establish ABLE account programs.

For a brief description of ABLE Accounts, see Item 1.f of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

g. **Basis Consistency Provisions in Legislation Extending Highway Trust Fund**. Basis consistency and reporting provisions were included in the "Surface Transportation Act" legislation that temporarily extended the "highway trust fund" for three months (but the tax provisions are permanent). The provision will impose significant reporting responsibilities on executors that are required to file estate tax returns. See Item 3 below for a discussion of these provisions.

h. **Other Changes in Surface Transportation Act.** Various return due dates are revised. Some of the changes are that partnership returns are due March 15 rather than April 15, and C corporation returns are due April 15 rather than March 15. Trust and estate returns are due April 15, as before, but extensions now run to September 30 rather than September 15. In addition, the Act overrules *Home Concrete & Supply, LLC*, 109 AFTR 2d 2012-1692, which had held that an overstatement of basis does not give rise to a substantial omission of income for purposes of applying the 6-yer statute of limitations on assessments. §6501(e)(1)(B)(ii). In addition, the adequate disclosure exception does not apply to basis overstatements, so even if a taxpayer discloses a basis overstatement, any resulting underreporting of income is considered in determining if there is a substantial omission of income. §6501(e)(1)(B)(III).

i. **Social Security Claiming Options**. The Bipartisan Budget Act of 2015, signed into law on November 2, 2015, removed several important alternatives for claiming Social Security benefits that were previously available to married couples. These important changes were made without any public discussion of the changes; they surprisingly appeared in the 2015 Budget Act without warning. A married person may elect retirement benefits based on his or her earnings record, based on the spouse's earnings record (spousal benefits are generally 50% of the other spouse's benefit), or possibly may switch between the two options. Spousal benefits (based on the other spouse's earnings record) cannot be elected until after the other spouse has filed to receive benefits.

(1) ***File and Suspend Strategy.*** Beginning in 2000, Social Security has allowed a participant upon reaching his or her "full retirement age" (currently age 66, increasing to age 67 for individuals born after 1960) to file and claim benefits based on that person's earnings record, which allows his or her spouse to begin collecting spousal benefits. The participant could then suspend his or her own benefit until reaching age 70 (but the spouse would continue to receive the spousal benefits). This is important because the amount of monthly Social Security benefits grows by as much as 8% per year (to a maximum increase of 32% at age 70) if the participant delays receiving benefits. Benefits can be claimed as early as age 62, but the monthly benefit will be as much as 75% more if benefits are delayed from age 62 to age 70. This strategy is still available for persons who elect to suspend benefits (after reaching full retirement age) on or before April 29, 2016. After that time, when a person suspends his or her

own benefits, all benefits payable on his or her own earnings record to other individuals (such as spousal benefits) will also be suspended.

(2) ***Restricted Spousal Benefits (File and Switch Strategy).*** After an individual reaches the full retirement age (currently age 66), the individual could file a restricted application to receive just spousal benefits based on his or her spouse's earning record, but allow the individual's own retirement benefit to continue to grow (up to age 70, after which time no further increase in the retirement benefits arises). Persons age 62 or older by the end of 2015 may continue to use this strategy; otherwise, persons will no longer be able to restrict an application to spousal benefits only, but will have to claim all benefits when electing to receive benefits. Accordingly, the restricted spousal benefits election can still be a viable strategy if BOTH spouses have a Social Security earnings record entitling them to retirement benefits and their spouses to receive spousal benefits and if at least one of the spouses has reached age 62 in 2015. Otherwise, this strategy is no longer available.

3. Basis Consistency and Reporting Requirements

a. **Background**.

(1) ***Prior Law (and Continuing Law For Many Estates) Allowing Inconsistent Valuation Positions Under §1014(a).*** For purposes of determining the basis of assets received from a decedent, the value of the property as determined for federal estate tax purposes generally is deemed to be its fair market value. Treas. Reg. §1.1014-3(a). The estate tax value is not conclusive, however, but is merely a presumptive value that may be rebutted by clear and convincing evidence except where the taxpayer is estopped by the taxpayer's previous actions or statements (such as by filing estate tax returns as the fiduciary for the estate). Rev. Rul. 54-97, 1954-1 C.B. 113; *see Augustus v. Commissioner*, 40 B.T.A. 1201 (1939). In Technical Advice Memorandum 199933001, the IRS ruled that an individual beneficiary who was not the executor of the estate and took no other inconsistent actions or statements was not estopped from trying to establish that the date of death value (and the basis) was higher than the value reported on the estate tax return. Duty of consistency and estoppel principles have resulted in the estate tax value applying for basis valuation purposes in several cases. *Janis v. Commissioner*, 461 F.3d 1080 (9th Cir. 2006), *aff'g* T.C. Memo 2004-117; *Van Alen v. Commissioner*, T.C. Memo 2013-235.

(2) ***Legislative Proposals.*** The President's Budget proposal for fiscal year 2010, published on May 11, 2009 proposed various "loophole closers" to help fund a reserve for health care reform, including a consistency of basis provision. It proposed that gift transferees would be required to use the donor's basis (except that the basis in the hands of the recipient could be no greater than the value of the property for gift tax purposes). The basis of property received by death of an individual would be the value for estate tax purposes. Regulations would address implementation details, such as rules for situations in which no estate or gift tax return is required, when recipients may have better information than the executor, and when adjustments are made to the reported value after the filing of an estate or gift tax return.

The "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal" issued by the Staff of the Joint Committee on Taxation on September 8, 2009 provided further insight. As to the estoppel issue, the report stated that a beneficiary "should not be estopped from claiming a basis different from the value determined by an executor for estate tax purposes where the taxpayer did not participate in the executor's determination." In addition, the report took the position that the basis would be the value "r*eported* for transfer tax purposes" (i.e., the value placed on the gift or estate tax return) and not the value ultimately determined in an estate or gift tax audit. The report says that would have "the salutary effect of encouraging a more realistic value determination in the first instance." The report adds that the salutary effect would be lost if a relief mechanism existed in case the basis used by transferees differed from the fair market value "ultimately determined for transfer tax purposes." In contrast, the Greenbook says that the basis would be "the value of that property for estate tax purposes" and that regulations would address "the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return." Finally, the report clarified that under the proposal, the basis of the recipient can be no *greater than* the value determined for estate and gift tax purposes, but the recipient could claim a lower value to avoid accuracy-related penalties under §6662 if the transferor overstated the value for transfer tax purposes.

This proposal was repeated in the Administration's Revenue Proposals for Fiscal Years 2011-2016 but the Proposals made clear that the value as finally determined for estate tax purposes would apply, not just the reported value. A legislative proposal of that approach was contained in section 6 of the Responsible Estate Tax Act in 2010 (S. 3533 and H.R. 5764), in the December 2010 "Baucus Bill," and in section 5 of "The Sensible Estate Tax Act of 2011" legislative proposal (H.R. 3467).

b. **Legislative Provision in Surface Transportation and Veterans Health Care Choice Improvement Act**. The basis consistency provisions for property received from a decedent (but not the consistency proposals for gifts) were enacted as Section 2004 of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, which extends funding of the "Highway Trust Fund" through October 29, 2015 (but this revenue provision is permanent), and which was signed into law July 31, 2015 (the "Act").

c. **New Section 1014(f)**.

Value Limit. Section 2004 of the Act adds new §1014(f), which provides that the basis of property to which §1014(a) applies (i.e., property acquired from a decedent) shall not exceed the final value determined for estate tax purposes (and detailed provisions govern when the tax is finally determined), or if the final value has not been determined, the value provided in a statement to the decedent's recipients. Observe that the "shall not exceed" wording leaves open the possibility that the IRS could take the position that the date of death value for purposes of §1041(a) is lower than the finally determined estate tax value or that legatees could claim a lower value than the estate tax value to avoid penalties if the executor overstated the value of property on the Form 706. (For example, James I. Dougherty [Greenwich, Connecticut] observes that the IRS might conceivably attempt to take the position that restrictions on discounts under §§2703-2704 apply only for estate and gift tax purposes, but that all relevant restrictions would be considered for basis purposes. *Cf. Delone v. Commissioner*, 6 T.C. 1188 (1946) (basis of stock subject to binding enforceable option at $100 per share was $100 even though the estate tax value was $125 per share.))

Exception If Property Does Not Increase Estate Taxes. This provision applies only to property "whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11… on such estate." Observe that if no estate tax is imposed because of the marital or charitable deduction and therefore inclusion of the asset in the estate does not increase the liability for the estate tax imposed on such estate—because the estate tax liability "on such estate" remains at zero—the basis consistency provision of §1014(f) does not apply. Instructions to Form 8971 make clear that this exception applies to estates that have no estate tax by reason of the marital or charitable deductions in addition to estates that are below the exemption amount. Unfortunately, however, no similar exception is included in the information reporting requirements in new §6035, discussed below; all estates required to file estate tax returns will have to provide reporting information to beneficiaries even if the estate is paying no estate tax. The exception would apply to the penalty under new §6662(k), because it references §1014(f), but no similar exception arises to the penalties under §§6721 and 6722. (See Item 3.e below for a discussion of the penalties.) The 2017 Fiscal Year President's Budget Plan proposes expanding the basis consistency requirement to include estates that pay no estate tax because of the marital deduction. See Item 3.j below.

d. **New §6035; Information Reporting Requirements**.

What Estates Must Report? If the estate is required to file an estate tax return under §6018(a), the executor is required to report valuation information reports to the persons described below. The Instructions to Form 8971 state that estates that file returns "for the sole purpose of making an allocation or election respecting the generation-skipping transfer tax" are not subject to reporting requirements. The proposed regulations, (but not the Instructions) clarify that estates that are under the exemption amount but merely file estate tax returns to make the portability election are not subject to the basis consistency or reporting rules. (Treas. Reg. §20.2010-2(a)(1) had created some uncertainty as to this issue because it provides that an estate that elects portability will be "considered" to be required to file a return under §6018(a) in addressing the timely filing requirement to elect portability.)

Who Receives Reports? Estates that are required to file estate tax returns must give reports to both the recipients (i.e., "each person acquiring any interest in property included in the decedent's gross estate") and the IRS. §6035(a)(1). For amounts passing to trusts, must the report be given to each potential trust beneficiary or just to the trustee of the trust? The Instructions to Form 8971 and proposed regulations indicate that the report would be given just to the trustee. Prop. Reg. §1.6035-1(c)(2).

One possible purpose of providing a statement to the IRS would be to give the IRS information about assets passing to particular beneficiaries in case the IRS will track the basis information that may be reported by those beneficiaries on their future income tax returns. Giving the information to the IRS would permit the IRS to use matching programs, much like with Form 1099s, to match the basis reporting when beneficiaries report sales of assets received from estates. Perhaps the IRS is not doing that, however. For example, the proposed regulations provide that a report must be delivered to the IRS of all assets that could be used to fund a bequest that has not be funded by the due date of the report, but there is no requirement to send a supplemental report when the distribution is actually made.

When Are Reports Due? Under the statute, such statements must be furnished at the time prescribed in regulations, but no later than 30 days after the return's due date, including extensions (or 30 days after the return is filed, if earlier). §6035(a)(3)(A). The Form 8971 Instructions relax this to say that if the Form 706 is filed after the "due date," the Form 8971 and Schedule(s) A to beneficiaries are due 30 days after the "filing date" (apparently referring to the actual date the Form 706 is filed late). If valuation or other adjustments are made after the statements are furnished, supplemental statements must be furnished within 30 days of the date of the adjustment. §6035(a)(3)(B). ACTEC Comments to the IRS dated May 27, 2016 regarding proposed regulations to §6035 request that the final regulations "confirm the Instructions by providing that if the first estate tax return is not timely filed, Form 8971 and Schedule(s) A are due 30 days after the first estate tax return is filed."

Extensions of Due Date for Information Reports. Temporary regulations provide that persons required to file an information statement under §6035(a)(1) or (a)(2) before March 31, 2016 "need not do so" until March 31, 2016. Temp. Reg. §1.6035-2T(a). Notice 2015-57 extended the due date to February 29, 2016, and Notice 2016-19 provided that persons require to give reports "need not do so" until March 31, 2016. Notice 2016-27 (issued March 23—a mere 8 days before the March 31 due date) further extends the "needs not do so" date to June 30, 2016.

Section 6081 authorizes the IRS to grant a reasonable extension for filing any "return, declaration, statement, or other document" required under the Internal Revenue Code for up to 6 months. There appears to be no statutory authority for granting a further due date extension. The Notices do not extend the formal time for filing, but merely say that persons required to file basis consistency returns and statements "need not do so" until the specified extended dates.

Regulatory Authority. Regulatory authority is granted to provide implementation details, including rules for situations in which no estate tax returns are required, or if the surviving joint tenant or other recipient has better information than the executor.

e. **Penalties**.

(1) ***Penalties for Inconsistent Reporting.*** Section 2004(c) of the Act amends §6662 to provide that the accuracy-related penalties on underpayments under §6662 apply if a taxpayer reports a higher basis than the estate tax value basis that applies under new §1014(f).

(2) ***Penalties for Failure to Provide Information Returns and Statements.*** Penalties for the failure to file correct "information returns" or "payee statements" are provided in §§6721 and 6722, respectively. The penalty is generally $250, with a maximum penalty for all failures during a calendar year of $3 million (the maximum penalty is lower for taxpayers with average annual receipts of $5 million or less). The penalty is lowered to $50 per failure, with a maximum penalty of $500,000 per year if the information return is filed within 30 days of the due date. (These amounts are inflation adjusted.) These penalty

provisions are recited in the Instructions to Form 8971 (and the Instructions provide indexed numbers for 2016); separate penalties apply to the Form 8971 to be filed with the IRS and to each Schedule A that is required to be filed with beneficiaries. The Instructions make clear that only one penalty applies for all failures relating to a single filing of a Form 8971 (even if multiple problems with the Form exist) and one penalty applies for all failures related to each Schedule A. If the failure to furnish the required information return or statement is "due to intentional disregard" of the requirement to furnish the return or statement, the statute provides for a penalty of $500 (inflation adjusted) or if greater, "10 percent of the aggregate amount of the items required to be reported correctly." §§6721(e) and 6722(e). ***Thus, the penalty under the statute could be quite large for intentionally disregarding the requirement to file the information returns or statements.*** Interestingly, the Instructions to Form 8971 do not refer to a possible penalty of 10% of the estate, but merely state that if the failure to file Form 8971 or a Schedule A is due to intentional disregard, "the penalty is at least $530 per Form 8971 and the Schedule(s) A required to be filed along with it, with no maximum penalty."

Section 6724(a) provides a waiver of the penalties imposed by §§6721-6723 if the "failure is due to reasonable cause and not … willful neglect." The Instructions to Form 8971 provide that an inconsequential error or omission is not considered a failure to provide correct information, but errors "related to a TIN, a beneficiary's surname, and the value of the asset the beneficiary is receiving from the estate" are never considered inconsequential.

The §§6721 and 6722 penalties are extended to information returns and statements to estate recipients required under new §6035. §2004(b)(2) of the Act.

f. **Effective Date**. The amendments to §§1014(f), 6035 and 6724(d) described above "shall apply to property with respect to which an estate tax return is ***filed after*** the date of the enactment of this Act." §2004(d) of the Act. This applies not only to returns required after but also to any returns actually filed after the date of enactment (July 31, 2015). For example, the executor may have delayed filing the estate tax return for an estate in which sufficient assets pass to the surviving spouse or charity or to a QTIP trust (the QTIP election can be made on the first return that is filed, even if it is filed late, Treas. Reg. §20.2056(b)-7(b)(4)) so that no estate tax is due for the decedent's estate. See Item 3.i.(1) for a discussion about supplemental estate tax returns filed after the effective date.

g. **Form 8971**. Form 8971 and its Instructions were released on January 29, 2016.

- Part I of Form 8971 lists general information about the decedent and executor.
- Part II lists information about beneficiaries (including TIN, address, and the date that Schedules A are "provided" to each beneficiary).
- A Schedule A is attached to provide information to each estate beneficiary. The Schedule A includes the Form 706 Item number and description of property that the beneficiary has acquired from the decedent. For each asset listed, the executor indicates whether the asset increases estate tax liability and provides the valuation date and value. Schedule A contains a "Notice to Beneficiaries" directing the beneficiary to retain the schedule for tax reporting purposes and

informing the beneficiary that if the property increased the estate tax liability, the Code requires consistent reporting of basis. [Observe: ACTEC Comments to the IRS regarding Form 8971 filed on January 19, 2016 pointed out that notice could be confusing and even extremely misleading to some beneficiaries. The executor may want to send the Schedule A with a letter providing more information to the beneficiary about the importance of the information reported on the Schedule A. ACTEC Comments dated May 27, 2016 regarding the proposed regulations request that the Notice to Beneficiaries be revised to delete its reference to "property you received" if the final regulations continue the approach of requiring that beneficiaries whose bequests have not been funded with the reports are due must receive a Schedule A listing all property could be used to satisfy the bequest.]

- Some planners have questioned whether the executor could give a beneficiary whose bequest has not been funded at the time the Form 8971 is filed with all of the Schedules attached to the estate tax return rather than having to transfer all of that detailed information onto a Schedule A (combined with a general statement describing the valuation date and stating that the assets increased the estate tax liability. In that manner, all of the information required by Schedule A would be supplied to the beneficiary without having to draft voluminous descriptions on the Schedule A. (Individual government staff persons have disagreed as to whether that is permissible.)
- If the executor is also a beneficiary, the executor will have to send a Schedule A to himself or herself. (The Instructions say that if the executor is also a beneficiary, "the executor is a beneficiary for purposes of the Form 8971 and Schedule A.")
- The executor is directed to "[s]ubmit Form 8971 with a copy of each completed Schedule A to the IRS." The Instructions direct the executor to file the Form 8971 with all Schedules A to the IRS within 30 days after the due date (but if the return is filed late, within 30 days of the filing date) of the estate tax return. The Form 8971 and attached Schedules A are not to be filed with the Form 706, but must be filed separately. If values are adjusted, a Supplemental Form 8971 and Schedules A must be filed with the IRS within 30 days after the adjustment.
- Beneficiaries only receive Schedules A and not the Form 8971 itself. The Schedules A must be "provided" (in person or by email, U.S. mail or private delivery service) within 30 days of the due date of the estate tax return (or within 30 days of the filing date if the return is filed late). If adjustments are made to assets listed on the estate tax return (such as values or the inclusion of additional assets), an updated Supplemental Schedule A must be given to each affected beneficiary within 30 days of the adjustment.
- If a beneficiary's distributions has not been funded when the Form 8971 is filed, the Instructions instruct:

> the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A should be filed once the distribution to each such beneficiary has been made.

(This issue is also addressed in the proposed regulations, discussed below–which interestingly do *not* require that a supplemental Form 8971 and Schedule(s) A be filed after the distribution is made.)

h. **Temporary and Proposed Regulations–Synopsis**.

- Temporary and proposed regulations, released March 2, 2016 (and published in the Federal Register on March 4, 2016), provide additional guidance regarding the basis consistency and information reporting requirements of new §§1014(f) and 6035. Some of the highlights and surprises include the following:
- The final value for estate tax purposes sets the *initial* basis; normal post-death basis adjustments are still applicable;
- For property subject to non-recourse debt, the basis is the gross value of the property, not just the net value reported on the estate return;
- The reporting requirement does not apply to estates that are not required to file estate tax returns but do so merely to make the portability election;
- Property that qualifies for the marital or charitable deduction is not subject to the basis consistency requirement, but is subject to the reporting requirements;
- Tangible personal property that does not have a marked artistic or intrinsic value over $3,000 is not subject to the basis consistency or reporting requirements;
- After-discovered or omitted property gets a basis of zero if the property is not reported on an estate tax return before the period of limitations on assessments has expired;
- The Form 8971 and Schedules A to beneficiaries can omit cash, IRD, tangible personal property (as described above), and property sold before the information reports are due;
- For bequests to a trust, estate or entity the Schedules A are given to the trustee, executor or entity (not the trust beneficiaries);
- For life estates, Schedules A must be sent to the life tenant and presumptive remainderman (and if the initial remainderman dies before the life tenant, the executor apparently must send supplemental reports to the IRS and to the new remainderman);
- If the executor has not determined what property will be distributed to a beneficiary when the information report is due, all property that could be used to satisfy the bequest must be included on the Schedule A to that beneficiary (and the executor does not have to send supplemental reports to the IRS and to that beneficiary after the bequest is funded);
- The executor must file a supplemental Form 8971 with the IRS and send supplemental Schedules A to beneficiaries if any previously reported information is incorrect or incomplete (such as if the final estate tax value is changed), but a supplement is not needed for inconsequential errors or omissions;
- If a recipient of an asset in the gross estate makes a subsequent gift or distribution to a "related transferee" (which, for some strange reason, includes a grantor trust but not a non-grantor trust for a related party) the recipient must file

a Schedule A with the IRS and transferee reporting the change in ownership and final estate tax value of the property; and

- The Form 8971 and Schedules A to each beneficiary are due 30 days after the earlier of the due date or the date the estate tax return is actually filed (as required by the statute); the proposed regulations do not adopt the relaxation of the due date in the Instructions to Form 8971 saying that if the estate tax return is filed late, the information reports are not due until 30 days after the date the return is actually filed.

i. **Temporary and Proposed Regulations Highlights**.

(1) ***Transitional Relief Regarding Initial Time for Filing; Effective Date***.

Extended Due Date and Transitional Relief. Temporary regulations provide that persons required to file an information statement under §6035(a)(1) or (a)(2) before March 31, 2016 "need not do so" until March 31, 2016. Temp. Reg. §1.6035-2T(a). Notice 2015-57 extended the due date to February 29, 2016, and Notice 2016-19 provided that persons require to give reports "need not do so" until March 31, 2016. Notice 2016-27 (issued March 23—a mere 8 days before the March 31 due date) further extends the "needs not do so" date to June 30, 2016.

Section 6081 authorizes the IRS to grant a reasonable extension for filing any "return, declaration, statement, or other document" required under the Internal Revenue Code for up to 6 months. There appears to be no statutory authority for granting a further due date extension. The Notices do not extend the formal time for filing, but merely say that persons required to file basis consistency returns and statements "need not do so" until the specified extended dates.

Effective Date of Regulations. The regulations will be effective when finalized, but persons may rely on the proposed regulations before the publication of final regulations. Prop. Reg. §§1.1014-10(f) & 1.6035-1(i). This is particular important for these regulations because they are sometimes at variance with the Instructions to the Form 8971, so planner may rely on following the requirements in the proposed regulations.

Effective Date of Statute. The basis consistency rules and reporting rules under §§1014(f) and 6035 apply to "property with respect to which an estate tax return is filed after the date of enactment" [i.e., July 31, 2015]. What if the estate filed an initial estate tax return before July 31, 2015, but files a supplemental return after July 31 to report an after-discovered asset or to report a different value? Is property passing from that decedent subject to the basis consistency and reporting rules? The answer is not clear. The Code nowhere recognizes the concept of an "amended estate tax return." Is a supplemental estate tax return really a "return"? What if the supplemental return is not a complete Form 706 but merely additional information provided to supplement information on an existing schedule (or perhaps a supplemental schedule) together with revised first two pages of Form 706 reflecting the revised estate tax calculation? That limited supplemental information clearly would not constitute a complete "return" for purposes for commencing the period of assessment if a complete return had not previously been filed. ACTEC Comments to the IRS dated May 27, 2016 regarding the proposed regulations take the position that based on Treas. Reg. §20.6081-1(d),

> the proposed regulations do not require the executor to file a Form 8971 in this situation. However, if a Form 8971 is required, ACTEC believes guidance is needed regarding (i) the assets that must be reported on the Form 8971, and (ii) the beneficiaries to whom the executor is required to furnish a Schedule A [*i.e.*, just the additional items reported on the supplemental return and the beneficiaries receiving those assets?] (parenthetical added).

(2) ***Post Death Adjustments***. Section 1014(f) states that the basis of property acquired from a decedent "shall not exceed" the finally determined estate tax value of the property. Post-death adjustments to a property's basis under other Code provisions are still made—the estate tax value of property merely becomes the upper limit on the *initial* basis of the property after the decedent's death. Prop. Reg. §1.1014-10(a)(2).

Property Encumbered by Debt. Post-death payments on debt secured by property in the gross estate do not result in an adjustment to the property's basis because "[t]he existence of recourse or non-recourse debt secured by property at the time of the decedent's death does not affect the property's basis, whether the gross value of the property and the outstanding debt are reported separately on the estate tax return or the net value of the property is reported." Prop. Reg. §§1.1014-10(a)(2), 1.1014-10(e) Ex. 4.

Treas. Reg. §20.2053-7 provides that if the decedent's estate is not liable for the debt (i.e., if it is non-recourse debt), "only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate." In light of that regulation, planners have been uncertain as to whether basis would be allowed for the full gross value of estate property that is subject to non-recourse indebtedness. The proposed regulation clarifies this issue, but the ACTEC Comments regarding the proposed regulations request further clarification, with a specific example indicating that where the net value of property subject to non-recourse indebtedness is listed on the estate tax return, the Schedule A would list the full fair market value of the property rather than the net value.

Schedule A will be confusing for assets subject to non-recourse debt if the net value is reported on the estate tax return. Column E on Schedule A entitled "Estate Tax Value" might suggest that the net value reported on the estate tax return should be listed (the Form 8971 Instructions say to "list the value reported on the Form 706" in this column), but the proposed regulations indicate that the beneficiary's basis will be the gross value of the asset not reduced by the non-recourse debt.

(3) ***Property Subject to Consistency Requirement***. The basis consistency requirement applies to property includable in a decedent's gross estate under §§2031 and 2106 that generates federal estate tax in excess of allowable credits (other than a credit for a prepayment of the tax). Prop. Reg. §1.1014-10(b)(1). (The reference to §2031 is unusual because it is a valuation provision rather than a gross estate inclusion section (the gross estate inclusion sections are §§2033-2044).

Marital or Charitable Deduction Property. Section 1014(f)(2) states that the basis consistency rule only applies to property whose inclusion in the gross estate increased the liability for estate tax (reduced by allowable credits other than the credit for any prepayment of tax). (This exception for property that does not increase the estate tax liability only applies for the basis consistency rule; this exception does not extend to the information reporting requirements.) Proposed regulations clarify that property that qualifies for an estate tax charitable or marital deduction under §§2055, 2056, or 2056A "does not generate a tax liability under chapter 11 and therefore is excluded from the property subject to the consistency requirement." Therefore, even if the estate pays estate tax, any property passing to a surviving spouse or charity that qualifies for a marital or charitable deduction is excluded from the basis consistency requirement. Prop. Reg. §1.1014-10(b)(2).

Certain Tangible Personal Property. The proposed regulations add an exclusion (not included in the statute) for tangible personal property for which an appraisal is not required under Regulation §20.2031-6(b), which requires an appraisal for "household and personal effects articles having marked artistic or intrinsic value of a total value in excess of $3,000 (e.g., jewelry, furs, silverware, paintings, etchings, engravings, antiques, books, statuary vases, oriental rugs, coin or stamp collections)" Prop. Reg. §1.1014-10(b)(2).

By way of background, §20.2031-6(a) indicates that a room by room itemization of household and personal effects is desirable; all articles should be named and valued specifically except that items in the same room may be grouped as long as none of them exceed $100. Alternatively, in lieu of an itemized list, an aggregate value appraised by a competent appraiser (or dealer in the class of items involved) may be used. Reg. §20.2031-6(b) has a special rule that applies, notwithstanding paragraph (a), that applies for articles with marked artistic or intrinsic value of $3,000 or more. Interestingly, the $3,000 amount has not been adjusted since this regulation was adopted in 1958.

An example in the proposed regulations of an analogous exception under the information reporting rules hints that this exception applies for any *individual* asset that is under $3,000. Prop. Reg. §1.6035-1(b)(2)Ex.1. However, Reg. §20.2031-6(b) applies if the *"total value"* of articles "having marked artistic or intrinsic value" exceeds $3,000. The Instructions to Form 706 relax this appraisal requirement somewhat, though, by requiring an appraisal for "works of art or items with collectible value (for example, jewelry, furs, silverware, books, statuary, vases, oriental rugs, coin or stamp collections) … [i]f any item or collection of *similar items* is valued at more than $3,000." (emphasis added). This suggests, for example, that jewelry and furs would not be aggregated for purposes of the $3,000 test amount.

All Property Other Than Exceptions. If the estate must pay any estate tax, all property in the gross estate, other than marital or charitable deduction property or tangible personal property for which an appraisal is not required, is subject to the basis consistency requirement. (Observe that while the proposed regulations list other property that is not subject to the reporting requirements [i.e., cash, IRD and assets sold], only marital or charitable deduction property or the specified tangible personal property is excepted by the basis consistency requirement of §1014(f).) If the estate pays no federal estate tax, none of the estate property is subject to basis consistency. Prop. Reg. §1.1014-10(b)(3).

(4) ***Final Value***. The proposed regulations address how the "final" estate tax value is determined. Prop. Reg. §1.1014-10(c)(1). The "final value" is the value reported on the estate tax return once the period of limitations on assessment has expired, or the amount determined by the IRS once it can no longer be contested, or the amount determined in an agreement binding on all parties, or the value determined by a court once the court's determination is final. The ACTEC Comments regarding the proposed regulations request additional guidance regarding precisely when a "final"

value is determined in various circumstances. Until the final value of property is determined, the recipient of the property may not claim a basis for that property in excess of the value reported on the information statement (i.e., the Schedule A) given to the recipient. If the final value, once it is determined, is less than the reported value, the recipient may not rely on the value listed in the initial statement and may have a deficiency and underpayment attributable to the difference. Prop. Reg. §1.1014-10(c)(2).

(5) ***After-Discovered or Omitted Property***. If property is discovered after the estate tax return has been filed or is otherwise omitted from that return, special rules apply. If the property is later reported on a supplemental estate tax return before the period of limitation on assessment of tax expires, the normal "final value" rules apply. Prop. Reg. §1.1014-10(c)(3)(i)(A). In an extension of the basis consistency statute, however, if the after-discovered or omitted property is not reported on a supplemental estate tax return before the limitation period expires (generally three years from the filing date, §6501(a)), the basis of such property is *zero*. Prop. Reg. §1.1014-10(c)(3)(i)(B).

Many planners generally believe that no duty exists to report after-discovered property if the estate tax return was filed in good faith. *See Badaracco v. Commissioner*, 464 U.S. 386 (1984) (amended estate tax return is "a creature of administrative origin and grace" and is not required by statute); David Pratt & George Karibjanian, *Filing a Supplemental Estate Tax Return After Probate Litigation*, 36 EST. PL. 17 (Sept. 2009). If a supplemental estate tax return is not filed reporting the additional asset, however, the recipient may not take the position that the basis is the fair market value at the date of death even though the property was acquired from a decedent (despite the language of §1014(a) which says that property "acquired from a decedent" has a basis equal to the fair market value of the property at the date of death). Accordingly, if a preparer determines that no obligation to amend a return exists to report omitted property, the failure to report the property may result in a 40% estate tax savings, but that savings may be offset by a 23.8% federal capital gains tax (plus any state capital gains tax) or an even higher income tax attributable to the inability to depreciate the property or situations that may generate ordinary income. If the recipient of the after-discovered asset is not the party responsible for paying estate tax with respect to that asset, the executor may be put in an inherent conflict situation; the party who bears estate taxes will not want the property reported but the party who receives the asset will want it reported to have a basis equal to the date of death value of the asset.

If the after-discovered or omitted property passes to the surviving spouse, the zero basis rule would not apply—because assets passing in a manner that qualifies for the marital deduction is not subject to §1014(f).

The effect of this "zero basis rule" is that if the estate has filed an estate tax return and the assessment period has run, there is no way to avoid the deemed basis of zero. Apparently, this would be the case even for after-discovered or omitted cash, as discussed below.

On the other hand, if a return had never been filed, the executor could file a late return and secure a fair market value basis for the assets. Filing a supplemental estate tax return may not even result in any additional estate tax (if debt or administrative expense deductions can reduce the taxable estate below the exemption amount). In this respect, an estate that is close to the filing limit but arguably below the limit may be better off by not filing an estate tax return by the initial due date. This rule may also impact how aggressive a return preparer may be in omitting assets that are arguably in the gross estate (such as under a §2036 "implied agreement" of retained enjoyment argument)–if the questionable assets are not listed but the IRS later (perhaps many years later) determines that they should have been included in the gross estate, the articles may have a zero basis.

ACTEC Comments to the IRS dated May 27, 2016 regarding the proposed regulations take the position that the zero basis rule is "unjustifiably harsh," that a statutory basis for imposing the zero basis rule does not exist, and that "Treasury and the IRS by these provisions are proposing to legislate new law."

> ACTEC believes that Treasury and the IRS lack authority to impose this Zero Basis Rule. Treasury and the IRS are, in essence, declaring that, because the executor did not file an estate tax return or unintentionally omitted certain assets from the return, the estate's beneficiary receives neither the decedent's adjusted basis in the property nor the basis as provided under section 1014(a). Rather, the proposed regulations appear to be an attempt, when estate tax can no longer be assessed because of the running of the assessment period, to replace the potentially lost revenue by increasing the income tax on the beneficiary when the asset is sold or exchanged, by denying the beneficiary the basis in such asset to which the beneficiary is otherwise entitled. If this is desired, ACTEC believes it is up to Congress and not Treasury and the IRS to impose such laws. This is particularly troubling when a decedent's Will apportions estate tax in a manner whereby the particular beneficiary would receive the assets and other beneficiaries would bear the burden of the estate tax (*e.g.*, the asset in question is specifically bequeathed or passes by joint tenancy with right of survivorship to the beneficiary and the decedent provided that any estate tax be paid by the residuary …estate).

The ACTEC Comments reason that the zero value approach "ignores the well-settled law that a beneficiary is estopped from adopting a value different from that used by the executor only if the beneficiary and the executor are the same person or are persons in privity, usually due to a close family relationship" (citing a wide variety of cases). While §1014(f)(4) authorizes regulations to "provide exceptions to the application of this subsection, the Comments view the zero basis rule not as an exception to §1014(f), "but rather a substantial extension of that section." Furthermore, the ACTEC analysis notes that "[t]here is no explicit requirement in the Code, the regulations, court decisions, or precedential IRS rulings that a supplemental estate tax return must be filed where the value of an estate changes or unintentionally omitted assets are thereafter discovered." Therefore, it concludes that "Treasury and the IRS arguably are proposing to penalize executors for not filing a return that they are not otherwise required to file."

Applying the zero basis rule to after-discovered ***cash*** (including life insurance proceeds, a bank account, or a P.O.D. cash account)–seems especially harsh. Treating cash as having a zero basis which raises interesting issues. Is the use of the cash to buy something treated as a "sale or exchange" of the cash, thus generating capital gain? Would the contribution of such cash to a corporation or partnership result in the contributor having a zero basis in the corporate or partnership interest that was received in return for that contribution? Obvious tracing problems will exist in determining what cash is the cash that has a zero basis. Would the tax benefit rule apply to treat the discovery of such cash as currently-taxable ordinary income? ACTEC Comments regarding the proposed regulations address the treatment of cash under the zero basis rule:

> Cash cannot have a basis below its face amount, and the final regulations should clarify that the Zero Basis Rule does not apply to cash. If the Zero Basis Rule did apply to cash, the final regulations should state whether the discovery of such cash results in currently-taxable ordinary income under the tax benefit rule.
>
> …
>
> If the final regulations provide that the tax benefit rule applies because cash receives a zero basis, the final regulations should also explain when income would be recognized. Income could arguably be recognized in the year the cash is discovered, or a later year in which the period of limitations on the assessment of an estate tax deficiency expires.

(6) ***Executor***. For purposes of knowing who must file information reports under §6035, the term "executor" is defined broadly to mean the appointed executor, or if none is appointed, any person in possession of property (incorporating §2203), or any other beneficiary required to file a return under §6018(b). Prop. Reg. §§1.1014-10(d), 1.6035-1(g)(1).

(7) ***Requirement to Provide Information Statement***. The "executor" (see immediately above) who is required to file an estate tax return under §6018(a) (i.e., if the size of the gross estate plus adjusted taxable gifts exceeds the basic exclusion amount), must provide information statements to the IRS (on Form 8971) and the recipients of property that was included in the gross estate (with several exceptions described below in sub-paragraph (8)). Prop. Reg. §1.6035-1(g)(2)-(3). The preamble says this means that Form 8971 and all Schedules A must be provided to the IRS and Schedules A must be provided to recipients.

Portability Returns and Other Returns Filed But Not Required. The reporting requirement does not apply if the executor is not required to file an estate tax return but does so anyway (such as to make a GST exemption allocation or portability election, or to file a protective return in case an asset value is later determined to cause a return to be required). Prop. Reg. §1.6035-1(a)(2).

Uncooperative Beneficiaries. The executor is required to submit Form 8971 and Schedules A for the beneficiaries, and the instructions require that certain information be included that the executor may be unable to determine from uncooperative beneficiaries. For example, the form must include the tax identification number (TIN) and address of beneficiaries. If a beneficiary is unwilling to give that information to to the executor, how can the executor complete the required forms? If the forms cannot be completed the executor is subject to penalties unless reasonable cause exists but the instructions to Form 8971 provide that errors "related to a TIN, a beneficiary's surname, and the value of the asset the beneficiary is receiving from the estate" are never considered inconsequential." Furthermore, "a significant item in a beneficiary's address" is not an inconsequential omission in a report to justify not filing a supplemental report when the correct information is determined. ACTEC Comments regarding the proposed regulations address the impossible situation this may impose on the executor:

> The Instructions state that a form with an answer of "unknown" or similar language will not be a complete return. In the case of a TIN, the Instructions provide that errors or omissions related to a TIN are never inconsequential.
>
> ACTEC believes that the Instructions impose an impossible and unreasonable burden, which the regulations should relieve. ACTEC believes that if an executor, after reasonable due diligence, cannot obtain the address or TIN for a beneficiary the executor should be allowed to answer "unknown," similar to how the estate tax return instructions for Part 4, Line 5 allow the executor

to '[e]nter the SSN of each individual beneficiary listed. If the number is unknown, or the individual has no number, please indicate 'unknown' or none.'"

(8) ***What Property Must be Reported***? The reporting requirement generally applies to all property on the estate tax return (or property with basis determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property). For a non-resident alien, this includes only property subject to the U.S. estate tax. Only the decedent's one-half of community property is subject to the reporting requirement (even though both community halves get a basis adjustment under §1014(b)(6)).

The proposed regulations provide four exceptions: (i) cash other than coins or paper bills with a numismatic value; (ii) income in respect of a decedent assets; (iii) tangible personal property for which an appraisal is not required under Reg. §20.2031-6(b); and (iv) property in the gross estate that has been sold, exchanged or otherwise disposed of by the estate (and therefore not distributed to the beneficiary) in a transaction in which capital gain or loss is recognized. Prop. Reg. §1.6035-1(b)(1). These exceptions are very important. The executor does not have to give reports to the IRS or recipients about any of those four types of assets that are distributed to estate recipients.

Cash. Does "cash" include amounts in checking accounts, bank accounts, money market funds, certificates of deposit, or life insurance proceeds? Does cash included accounts denominated in a foreign currency (those accounts could result in currency gains or losses)? ACTEC Comments to the IRS filed on May 27, 2016 regarding the proposed regulations recommend that the regulations be clarified to include the following in the cash exception: bank accounts, money market accounts, cash in brokerage accounts, certificates of deposit, similar accounts, foreign currency, life insurance proceeds (whether payable in a lump sum or annuitized), promissory notes and accounts receivable that are reported on the estate tax return with a value equal to the unpaid balance, and bonds or other financial instruments that mature and are redeemed prior to being distributed to a beneficiary.

IRD. The executor should not assume that any amounts in IRAs or retirement plans are not reportable. Non-deductible contributions may have been made to the IRA or plan, and a portion of the IRA or plan may not be income in respect of a decedent. That portion of the IRA or retirement plan would be reportable. ACTEC comments regarding the proposed regulations request guidance as to whether the entire asset should be reported or only the portion of the asset for which there is a basis component.

Tangible Personal Property. The tangible personal property exception references Treas. Reg. §20.2031-6(b) (as discussed in Item 3.i.(3) above. ACTEC Comments regarding the proposed regulations observes that the $3,000 limit in that estate tax reporting regulation has been in place for more than 50 years, and that prudence suggests an increase to this amount to $50,000m as a reasonable de minimis rule.

> Because §20.20311-6(b) provides such a low threshold for the Tangible Personal Property Expectation, to further ease the burden on fiduciaries with regard to reporting this type of property, ACTEC respectfully requests that Treasury and the IRS consider a de minimis rule to exempt from the reporting requirement items of tangible personal property (excluding property individually listed on the estate tax return) that are report on the estate tax return with a value in the aggregate of $50,000 or less (which represents less than 1% of the basic exclusion amount).

Sold Assets. Commentators have questioned why the exception applies only if "capital" gain or loss is recognized. What if property is disposed in a transaction in which ordinary income is recognized (such as the sale or trade of business assets)? What if property is sold in a transaction for an amount exactly equal to the basis so that neither gain nor loss is recognized? Because of this exception, some planners have suggested liquidating (and diversifying) the estate assets soon after date of death, so that no reporting would be required under §6035. (However, if the executor repurchases the same assets within 30 days, the wash sales rules would apply, and the assets may no longer be excepted from the reporting requirement.)

ACTEC Comments regarding the proposed regulations recommends that the regulations be clarified to apply the "sale exception" to

> any property that is sold, exchanged, or otherwise disposed of (and not distributed by an executor, administrator or trustee to an heir, legatee, devisee or beneficiary in a manner that does not cause gain recognition) in a transaction that constitutes a sale or exchange that is reportable for income tax purposes (or that would be reportable if the gain or loss were not zero).

Assets may be actively traded in a brokerage account. If so, the executor will need to decide what cut-off date to use in deciding what assets to list that have not been sold by that date for listing on Schedule(s) A passing to beneficiaries of undistributed assets.

The "sold assets" exception raises the issue of whether assets used to fund a pecuniary bequest will ever be reportable? Satisfaction of the pecuniary assets with assets in-kind will necessarily result in a gain or loss (e.g., *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940)). Perhaps nothing needs to be reported to the pecuniary legatee, even if the bequest has not been funded by the time the Form 8971 is filed (because gain or loss will be recognized when it is funded). Query whether the IRS might still want some reporting? A preparer's mantra will likely be: When in doubt, report:

> Thus, it could be argued that an executor who is certain that a pecuniary legacy will be satisfied either in cash or in property on which a gain or loss is recognized, might not be required to report this gift on a Form 8971 and Schedule A. It would, however, be prudent to report such gifts until the IRS clarifies its position on this issue. After all, there are penalties for failing to report to someone to whom the law requires reporting, but there are no penalties for having reported to someone to whom the law does not require reporting. Howard Zaritsky, *The Treasury's Proposed Regulations Implementing Consistent Basis Rules*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2403 (March 29, 2016).

The ACTEC Comments to the proposed regulations regarding the proposed regulations address some of these unusual situations as well in requesting clarification

> that the Sale Exception applies to all disposition in which gain or loss would be recognized, including distributions in kind to beneficiaries that are recognition dispositions because they satisfy a right to a pecuniary amount, to a specific bequest, or to income, or because the executor or trustee elects to recognize gain or loss pursuant to section 643(e)(3).

Non-Probate Assets. No exception exists for property includable in the gross estate under the "string" statutes of §§ 2035-2042 (including assets in a funded revocable trust). The executor is required to provide information to the IRS and recipients of assets included in the gross estate under those sections even though the executor may not have any control over those assets. (If a trust holds those assets, the information would be given to the trustee or the beneficiaries as discussed in sub-paragraph (9) below.) However, adjustments to the gross estate under §2035(b) for gift tax on gifts made within three years of the date of death do not reflect assets passing to a beneficiary and therefore would not seem to be reportable to the IRS or any beneficiary.

(9) ***Who Are "Beneficiaries" Who Must Receive Reports With Respect to Reportable Property***? Beneficiaries generally include any person receiving reportable property, including the executor who is also a beneficiary. Prop. Reg. §1.6035-1(c)(1). (No exception applies for beneficiaries who are surviving spouses or charities to whom bequests qualify for the marital or charitable deduction. Even though they are not subject to the basis consistency limitation, as discussed above in sub-paragraph (3), they must still receive the required information under the reporting requirements.)

A beneficiary who receives only property within one of the exceptions listed in Item 3.i.8 above would not receive any Schedule A. ACTEC Comments regarding the proposed regulations request clarification regarding the answer to the number of beneficiaries receiving property from the estates requested in Part II of Form 8971 in case some beneficiaries do not receive a Schedule A, and whether a Form 8971 must be filed if no beneficiaries receive a Schedule A.

Life Estates. A special complicating rule applies for life estates. Beneficiaries who receive reports include the life tenant and the remainderman(men) who would receive property if the life tenant were to die immediately after the decedent. If a "contingent beneficiary" changes (presumably because a presumptive remainderman dies before the life tenant), the executor must do a supplemental reporting to the IRS and new remainderman. Prop. Reg. §1.6035-1(c)(1). This could create a continuing duty of the executor to give reports years in the future. What if the estate has been closed and the executor is discharged—does the life tenant become the "executor" for reporting purposes? How will the executor know years later that a presumptive remainderman has predeceased the life tenant? The regulation does not make clear which remaindermen would receive the notice—only the new presumptive remainderman or all possible future remaindermen? (The word "not" appears to have been inadvertently omitted from the proposed regulation; the regulation apparently should say the beneficiary of a contingent interest is "not" a beneficiary unless the contingency occurs before the Form 8971 is filed.) ACTEC Comments to the IRS regarding the proposed regulation recommends that "Schedule A should need to be provided only to the life tenant and the presumptive remainder beneficiaries as of the due date of the filing of the Form 8971."

Trusts or Estates. If the beneficiary is a trust or another estate, the executor gives the information to the trustee or executor—not to the beneficiaries of that trust or estate. Prop. Reg. §1.6035-1(c)(2). (See sub-paragraph (12) below as to whether additional reporting requirements may apply when that trust or estate distributes the property.)

Funded Revocable Trusts; Other Trusts Includable in Gross Estate. For a funded revocable trust or other trust whose assets are included in the gross estate, does the executor give the Schedule A reports to the trustee of the trust or to the recipients of the trust? What about a pour over to an unfunded revocable trust? The answer is not clear, but many planners think that the executor would report assets to be distributed to an unfunded revocable trust to the trustee, but would report assets in a funded trust includible in the gross estate to the recipients of the trust (and for a revocable trust, that might be the trustee of a credit shelter trust or marital trust or other trust created under the revocable trust at the decedent's death). If there is no executor appointed because all of the estate assets are in a funded revocable trust, the trustee would file the Form 8971 with the IRS and Schedule(s) A with the revocable trust beneficiaries. Howard Zaritsky summarizes this approach as follows:

> If a decedent has a fully funded revocable trust, no executor would be appointed by a court and the trustee would be the "executor" for this purpose. The trustee would then file the Form 8971 and Schedule A with respect to all distributions from the trust to its beneficiaries.
>
> If the revocable trust holds some, but not all, of the decedent's assets and an executor is appointed, the executor must file Form 8971 and Schedule A with respect to distributions from the trust of those assets already held by the trust on the date of death.
>
> The executor should, however, report assets poured-over to the trustee as a distribution to the trustee, without regard to the ultimate distributees of the trust. Neither the executor nor the trustee appears to have an obligation to file another Form 8971 or Schedule A with respect to re-distribution of the assets received by the trust from the estate. Howard Zaritsky, *The Treasury's Proposed Regulations Implementing Consistent Basis Rules*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2403 (March 29, 2016).

ACTEC Comments to the IRS regarding the proposed regulations recommend that the executor be allowed to give the information statement either to the trustee or to the beneficiaries, whichever is more efficient, for assets in revocable trusts or other trust assets includible in a decedent's gross estate (e.g., under §§2036, 2037,2038, 2041, or 2044).

Undistributed Property (Undetermined Beneficiary). If the executor has not decided what property will be distributed to each beneficiary by the due date of the information statement (30 days after the estate tax return due date, as discussed below), "the executor must report on the Statement for each such beneficiary all of the property that the executor could use to satisfy that beneficiary's interest." Prop. Reg. §1.6035-1(c)(3). In effect, "mini-706s" will have to be given to each such beneficiary listing all remaining property in the gross estate, other than cash, IRD, or certain tangible personal property. The preamble acknowledges that this will result in duplicate reporting of assets on multiple Schedules A. If the executor has "determined" what property will be distributed to a beneficiary but has simply not made the distribution when the information statement is due, this special provision would not literally apply, and presumably the executor would list the property that the executor has determined will be used to satisfy that beneficiary. *See* Prop. Reg. §1.6035-1(e)(3)(ii)Ex.1. After the executor later determines what property will be used to satisfy a particular beneficiary's interest, "the executor may, but is not required" to file a supplemental return with the IRS and a supplemental statement with the beneficiary. [Presumably the beneficiary would not need a supplemental statement because the beneficiary would know what property was actually received and can find the property listed on the initial statement.]

The Instructions to the Form 8971 provide that

> the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A. (This means that the same property

> may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A should be filed once the distribution to each such beneficiary has been made.

The last sentence quoted above from the Instructions has been revised by the proposed regulations; supplemental reporting is allowed but is not required.

When the Form 8971 is filed 30 days after the Form 706 has been filed (and before most of the assets have been distributed), each beneficiary will receive a Schedule A reporting all items in the gross estate that "could be used" to fund the bequest to that beneficiary, "in whole or in part" (which presumably would be pretty well all of the assets in the gross estate that have not previously been distributed or sold).

The proposed regulations state that "all of the property that the executor could use to satisfy that beneficiary's interest" must be listed. It does not refer merely to remaining "reportable" property in the estate, but an example suggests that only reportable property must be listed. Prop. Reg. §1.6035-1(e)(3)(ii)Ex. 2 (the initial Schedule A for an unfunded bequest did not list tangible personal property for which no appraisal was required in the list of property that could be used to satisfy the bequest). Accordingly cash, IRD, tangible personal property for which an appraisal is not required, or the proceeds of liquidated assets would not have to be included in this list because those assets are not property "for which reporting is required" under Prop. Reg. §1.6035-1(b). [One way to avoid advising beneficiaries whose bequests cannot be funded prior to the reporting date about most of the assets in the gross estate would be to liquidate the estate soon after the date of death (unless the same assets are re-purchased within 30 days, triggering the wash sales rules).]

This reporting requirement for undistributed property may cause real heartburn for some estates. Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only entitled to receive a general bequest that may represent a fairly small portion of the estate. Furthermore, it will be burdensome. In effect, *each* beneficiary who has not already been funded by the 30 day due date will receive a report that may be about as long as the Form 706 without attachments– including a list of all assets listed on the return that have not yet been sold or distributed and that could be distributed to the beneficiary.

The ACTEC Comments regarding Form 8971and the ACTEC Comments regarding the proposed regulations both take the position that a beneficiary who has not received his or her distribution when the Form 8971 is filed should receive a Schedule A that merely lists the value of the bequest, and that when the bequest is subsequently funded, the executor should file a supplemental Form 8971 and Schedule A listing the assets actually distributed to the beneficiary. The Comments point that listing all assets that could be used to fund the bequest can be very misleading:

> Furnishing Schedule A to a beneficiary listing all items of property that could be used to fund the beneficiary's distribution, when the beneficiary will not, in fact, receive all of such assets (even when the listing states that the beneficiary's distribution will be funded in whole or in part with the listed assets), can result in a beneficiary believing he or she will be entitled to all of such assets. In fact, in an extended administration, many of the assets of an estate may be sold, so that the beneficiary will not receive any of the assets reported on the estate tax return. Schedule A does not provide a place for the executor to notify such a beneficiary that the assets reported on the Schedule as property in which the beneficiary has acquired an interest includes assets (and

potentially a significant number of assets) that the beneficiary will not receive. Moreover, it is likely that the confusion will be increased by the portion of Schedule A titled "Notice to Beneficiaries" that states "[y]ou have received this schedule to inform you of the value of property *you received* from the estate of the decedent named above" (emphasis added).

The ACTEC Comments to the proposed regulations reason that §6035 requires the executor to furnish "to each person *acquiring* any interest in property included the decedent's gross estate … a statement identifying the value of each interest in such property." Before assets have been distributed, all that a beneficiary has "acquired" is "a general claim equal to the value of the assets allocable to the beneficiary." The ACTEC Comments propose the following:

> Accordingly, ACTEC believes that the mandatory 30-day statutory timeframe should be limited to assets that are distributed before the filing date (or due date for filing) of the estate tax return, including assets that pass by reason of the decedent's death without action by the executor. In addition, ACTEC believes that with respect to assets that have not yet been distributed to a beneficiary the executor should have the choice of either (1) furnishing a Schedule A with an initial valuation of the beneficiary's interest in the estate, with the requirement in that case that a supplemental Schedule A be furnished once assets of the estate that were initially included on the estate tax return are actually distributed to the beneficiary. In a challenging state that cries out for interpretation, this approach would give the word "acquiring" as used in section 6035(a)(1) its customary meaning and would preserve the mandatory 30-day rule of section 6035(a)(3)(A)(i) and (ii) for such property and interests in property so acquired before the estate tax return is due or filed, thus "carry[ing] out" section 6035 within the meaning of section 6035(b).

From a policy standpoint, the ACTEC Comments state that

> In many situations allowing executors to delay reporting until actual distribution will reduce the administrative burden and conserve resources of both the estate and the IRS. However, in some instances, it may be more efficient for the executor to report the assets that are intended to be distributed to a beneficiary within the initial 30-day filing deadline and before the distribution is actually made.

Various commenters at the IRS hearing regarding the proposed regulations emphasized the impracticality of the position of the proposed regulations regarding distributions that have not been funded at the time of the Form 8971 due date. Ron Aucutt, one of the speakers on behalf of the ACTEC, referred to "the wasteful reporting of the estate value of assets long before those assets are in the hands of the beneficiaries who have any need or reason to care about basis" as the "biggest element of the proposed regulations" needing revision. He emphasized the statute's requirement of furnishing information to the IRS "and each person ***acquiring*** any interest in property, §6035(a)(1), and that official summaries of similar predecessor legislative proposals made reference to reporting information to the IRS and to ***recipients*** of property. Lora Davis (Dallas, Texas) speaking on behalf of the State Bar of Texas Tax Section, referenced the requirement of reporting any assets that could be distributed to a beneficiary even if this results in duplicative reporting. "In Texas we might call that *fishing with dynamite*, but I'm going to refer to that as the kitchen sink approach."

Beneficiary Cannot Be Located. If a beneficiary cannot be located by the time the report is due, the executor must still file the information report, explaining the efforts to locate the beneficiary, and a supplemental report must be filed within 30 days of later locating the beneficiary. Prop. Reg. §1.6035-1(c)(4).

(10) ***Due Dates of Reports***. The information reports to the IRS and recipients of reportable property (as described above) are due the earlier of 30 days after the due date of the estate tax return or the date it is actually filed. Prop. Reg. §1.6035-1(d).

This reiterates the due date as provided in §6035(a)(3)(A). The Instructions to Form 8971 revise this due date—stating the reports are due within 30 days of the *filing* date if the estate tax return is not filed until after the due date. [This makes sense because the information on the Schedules A is based on information in the estate tax return and the Schedules A could not be completed if the estate tax return has not been filed. The statute is flawed and the Instructions adopt the only reasonable approach—even though that results in an extension of the statutory due date.]

(11) ***Supplemental Information***. Supplemental information returns (Form 8971) and statements (Schedules A) generally must be provided if any change occurs that causes the reported information to be incorrect. Examples include the discovery of additional property, a change in value of property pursuant to an examination of litigation, or the executor's disposition of property in a transaction in which basis is determined in whole or in part with reference to property in the gross estate, such as a like-kind exchange. Prop. Reg. §1.6035-1(e)(1)-(2). Two exceptions apply, in which event supplemental reports are not required: (1) inconsequential errors or omissions; and (2) the actual distribution of property previously reported as being available to satisfy unfunded bequests described in sub-paragraph (9) above. Prop. Reg. §1.6035-1(e)(3).

***Inconsequential Error or Omission*.** No further guidance is in the proposed regulations as to what constitutes an "inconsequently error or omission, but the Instructions to Form 8971 give further guidance as to inconsequential errors or omissions that would qualify for the reasonable cause exception from penalties. Errors on Form 8971 "that are **never** inconsequential are those related to a TIN, a beneficiary's surname, and the value of the asset the beneficiary is receiving from the estate." (emphasis included in original). Errors on a Schedule A "that are **never** inconsequential are those related to (a) the value of the asset the beneficiary is receiving from the estate, and (b) a significant item in a beneficiary's address." (emphasis in original).

Due Date. The due date of supplemental returns and statements is 30 days after (1) the final value is determined, (2) incorrect or incomplete information is discovered by the executor, or (3) a supplemental estate tax return is filed reporting additional assets. Prop. Reg. §1.6035-1(a)(4)(i). An exception to the due date applies for undistributed property from a probate estate or revocable trust—if one of the three events listed in the preceding sentence occurs before the property is distributed to a beneficiary from the probate estate or revocable trust, the due date of the information return and statement is 30 days after the property is distributed to the beneficiary. Prop. Reg. §1.6035-1(a)(4)(ii).

(12) ***Subsequent Transfers***. A surprise in the proposed regulations is the requirement for recipients of a decedent's property to provide a "supplemental Statement" with the IRS and a transferee upon making subsequent distributions or transfers to a "related transferee" in which the basis is determined, in whole or in part, by reference to the recipient/transferor's basis (for example, a gift or contribution to a partnership). Prop. Reg. §1.6035-1(f). If the subsequent transfer occurs before the final value is determined, the recipient/transferor must also give the executor a copy of the information Statement that is provided to the IRS and transferee, so that if the executor subsequently provides any information Statements, they can be given to the new transferee.

These requirements regarding subsequent transfers can impose a significant reporting burden on estate recipients for possibly many years in the future (and penalties can apply if the reports are not given). Some planners have even suggested that executors might consider liquidating many of the estate assets so that estate beneficiaries would not receive assets that were in the gross estate; the assets would not have to be reported to the initial recipient on a Schedule A, and the initial recipient would not be burdened with having to provide reports on making any future gifts of those assets to related parties.

Purpose. The preamble to the proposed regulations gives the following reason for imposing this requirement: "The Treasury Department and the IRS are concerned, however, that opportunities may exist in some circumstances for the recipient of such reporting to circumvent the purposes of the statute (for example, by making a gift of the property to a complex trust for the benefit of the transferor's family)." Some planners have questioned why this reporting is needed in light of the fact that the basis of gifted assets must be listed on the gift tax return. However, a gift tax return may not be filed (for example, if all gifts are covered by the annual exclusion) and the beneficiary typically does not receive a copy of the gift tax return. One planner suggests that if a subsequent gift will be reported on a gift tax return, the regulations should be modified to provide that Schedule A reporting the value of the asset in the decedent's gross estate would not have to be given to the donee and IRS until 30 days after the gift tax return is filed. In any event, the Schedule A to the donee may be misleading because the basis of the asset at that time may be far different than the estate tax value in the decedent's gross estate (perhaps many years earlier).

Related Transferee. The proposed regulation has an objective definition of who constitutes a "related transferee" of a subsequent transfer that will require supplemental Statements.

> For purposes of this provision, a related transferee means any member of the transferor's family as defined in section 2704(c)(2), any controlled entity (a corporation or any other entity in which the transferor and members of the transferor's family (as defined in section 2704(c)(2)), whether directly or indirectly, have control within the meaning of section 2701(b)(2)(A) or (B)), and any trust of which the transferor is a deemed owner for income tax purposes. Prop. Reg. §1.6035-1(f).

Section 2704(c)(2) defines a "member of the family" with respect to any individual as meaning (1) the individual's spouse, (2) any ancestor or descendant of such individual or such individual's spouse, (3) any sibling of the individual, and (4) any spouse of an individual described in items (2) or (3). For example, if the estate distributes an asset to the decedent's surviving wife, who later gives the asset to a daughter, the subsequent transfer would require the surviving wife to give an information Statement to the IRS and her daughter (even if that subsequent gift occurs many years later).

Statutory Authority? The ACTEC Comments regarding the proposed regulations state that there is no statutory authority for the Subsequent Transfers rule; §6035(a)(1) requires that the *executor* furnish information to the IRS and persons acquiring property included in the decedent's gross estate. The ACTEC Comments reason:

> Whether or not the creation of a perpetual chair of title to aid the IRS in enforcement of section 1014(f) may be desirable as a matter of policy, it is not the policy Congress reflected in section

6035 when it limited the reporting requirement to an "executor," and, indeed explicitly eliminated from the Administration's legislative proposal the statutory imposition of a similar reporting requirement on donors of gifts.

Subsequent Distribution From Trust Recipient. What about a transfer from a decedent's estate to a trust and later distribution from the trust to a beneficiary? The trust clearly is a recipient and is making a subsequent transfer in which the basis is determined, at least in part, by the trust's basis (assuming the distribution is not made in satisfaction of a pecuniary distribution (which is a gain recognition event) and assuming the trustee does not make the election to recognize gain under §643(e)(3)). However, it is not clear that the beneficiary who receives the distribution from the trust is a "related transferee" of the trust (which is the "recipient/transferor"). Section 2704(c)(2) describes who is a member of the family "with respect to any *individual*," and the trust is not an individual. However, if the attribution rule of §2704(c)(3) were to be applied to determine the interests held by any individual, the individuals who are beneficiaries of the trust would likely be treated as indirectly owning the trust assets, and a distribution to another beneficiary may be treated as a transfer to a "related transferee." The definition of related transferee in the proposed regulation, makes reference to §2704(c)(2), and does not specifically make reference to §2704(c)(3) (but is §2704(c)(3) necessarily applicable in applying §2704(c)(2)?).

Thus, if a trust that receives estate property (and receives a Schedule A from the executor) makes a later distribution to a beneficiary, the distribution would not appear to require the trustee (or other trust beneficiaries who might be deemed transferors under §2704(c)(3) if it applied) to file an Information Statement with the IRS and trust beneficiary about the finally determined estate tax value of the property. Howard Zaritsky's agrees, in this summary of whether a distribution from an unfunded revocable trust to trust beneficiaries must be reported (after the initial transfer has been reported to the trustee of the revocable trust):

> If the rev trust was entirely unfunded on the date of death, however, then the only Schedule A is filed by the executor to the trustee of the rev trust. The redistribution from the rev trust to the marital trust of assets that were in the probate estate on the date of death should not require a supplemental Schedule A, because the marital trust is not a related party to the rev trust. The regs do not address it directly, but I feel strongly that the trustee of the rev trust is viewed only in his/her/its fiduciary capacity, and not as an individual. The mere fact that he or she may be related to the trust beneficiaries (or those of the marital trust) should be immaterial. Obviously, the IRS may disagree and the final regs may take a different position, but I feel quite strongly that this is the right view. [Quoted with Howard's permission]

Another uncertainty is a "retransfer" from a trust by the exercise of a power of appointment.

> The proposed regulations do not, however, explain how the retransfer rule might apply when a decedent transfers property to a trust in which someone is given a limited power of appointment. The exercise of that limited power of appointment in favor of a related transferee appears to be a retransfer under these rules, but it is unclear whether the new Schedule A must be filed by the trustee of the holder of the power of appointment. Howard Zaritsky, *The Treasury's Proposed Regulations Implementing Consistent Basis Rules*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2403 (March 29, 2016).

The ACTEC Comments ask the IRS to clarify the proposed regulations as to a variety of situations involving trusts and subsequent transfers, including the exercise of substitution powers, powers of appointment, and decanting powers.

Subsequent Distribution From Individual Recipient to a Grantor Trust. If the recipient/transferor who is an individual who makes a transfer to a grantor trust, the individual would have to provide information Statements to the IRS and the trustee of the grantor trust. This applies even to a transfer to a revocable trust (which would be a grantor trust). On the other hand, if the individual gives the property received from an estate to a non-grantor trust, apparently, no such information Statements are required. This makes no sense, and seems inconsistent the a statement in the preamble to the proposed regulation that this subsequent transfer rule is an attempt to address possible circumventing of the purpose of the statute "(for example, by making a gift of the property to a complex trust for the benefit of the transferor's family.)" Indeed, giving information Statements for gifts to a non-grantor trust would make more sense because the distribution from an individual to a grantor trust is generally treated as a non-event for income tax purposes and the person would in effect be giving notice to herself. For example, if a surviving wife who receives assets from her husband's estate makes a subsequent gift of such an asset outright to her daughter or to a GRAT that is a grantor trust or to another type of grantor trust for her daughter, the gift would be reportable; if the gift is made to a non-grantor trust for her daughter, the gift would not be reportable. The ACTEC Comments take the position that the subsequent transfers reporting rule should not apply to grantor trusts, suggesting that the proposed regulations "inadvertently omitted the word 'not.' The rule should logically apply to 'any trust if which the transferor is *not* a deemed owner for income tax purposes.' (emphasis added)."

Subsequent Retransfer. If a transfer is made and reported, must a subsequent retransfer by the first transferee also be reported?

> It is unclear, furthermore, whether a subsequent retransfer by the first re-transferee requires yet another Schedule A. Unless the final regulations clarify this point, practitioners should assume and advise that all carryover basis retransfers to related parties, no matter how long after the original distribution from the decedent's estate or trust, must be reported on a new Schedule A filed with the transferee and the IRS. Howard Zaritsky, *The Treasury's Proposed Regulations Implementing Consistent Basis Rules*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2403 (March 29, 2016).

The proposed regulation is ambiguous, and the ACTEC Comments take the position that having the subsequent transfers reporting rule extend into perpetuity is unnecessary.

Due Date. The supplemental Statement must be given to the IRS and the transferee within 30 days of the date of the distribution or other transfer.

Information Statement. The term "Statement" is defined to be Schedule A of the Form 8971 (or any successor schedule issued by the IRS). Prop. Reg. §1.6035-1(g)(3). Therefore, information regarding subsequent transfers will be described on a Schedule A (both to the transferee and the IRS). This is different from the way that basis consistency information is given to the IRS in all other circumstances; in other situations the IRS is advised with an "information return" (which is Form 8971), but in this situation both the IRS and recipient are advised using a Schedule A.

***How Will Recipient Know About Requirement To Report Subsequent Transfers*?** Perhaps the Notice on Schedule A should be revised by the IRS, or perhaps the transmittal letter sending a Schedule A to a beneficiary should notify the beneficiary that reporting requirements may exist with respect to certain subsequent transfers of property reported on the Schedule A.

(13) ***"Information Return" and "Statement"***. The proposed regulations use the terms "Information Return" and "Statement" throughout the regulations. "Information Return" is defined as Form 8971 and "Statement" is defined as Schedule A (or any successor form issued by the IRS). Prop. Reg. §1.6035-1(g))(2)-(3).

(14) ***No New Process for Beneficiaries to Contest Estate Tax Values***. This basis consistency limitation can lead to unfair results because the beneficiary may have had no input in the values reported on an estate tax return or in audit negotiations. In an audit, the executor may have "traded off" on the valuation of various assets. With this provision, the executor will have to consider the effect of audit negotiations on the basis of assets received by the various individual beneficiaries. Furthermore, the executor will have to consider the values that are reported on the Form 706 with respect to the impact upon beneficiaries for basis purposes. Some planners have questioned whether Wills should be revised to more protection to the executor with respect to the valuation of assets on the Form 706 and the negotiation of values in the estate tax audit.

The preamble to the proposed regulations says that one commenter asked the IRS to provide a process by which a beneficiary could challenge a value reported by the executor on an estate tax return. The IRS responded that "[t]he beneficiary's rights with regard to the estate tax valuation of property are governed by applicable state law"—meaning that the beneficiary can pursue state law remedies with the executor.

(15) ***Effect of Section 1014(e)***. If appreciated property is given to a decedent within one year of the decedent's death and that property passes from the decedent back to the donor (or to the spouse of a donor), §1014(e) provides that no basis adjustment occurs under §1014(a). ACTEC Comments regarding the proposed regulations observes that the "executor may not know whether a decedent acquired an asset from a beneficiary within one year of death, but the beneficiary who transferred the asset to the decedent would know." Therefore the Comments request "that the final regulations provide that the application of section 1014(e) does no change the executor's reporting requirements," and that Schedule A would report the value of property as reported on the estate tax return, without regard to the possible application of §1014(e).

i. **Proposal in 2017 Fiscal Year President's Budget Plan**. The 2017 Fiscal Year Budget Plan proposes that the basis consistently requirement be expanded to apply to "(1) property qualifying for the estate tax marital deduction, provided a return is required to be filed under section 6018, even though that property does not increase the estate's federal estate tax liability, and (2) property transferred by gift, provided that the gift is required to be reported on a federal gift tax return." The proposal would be effective "for transfers after the year of enactment." The estimated 10-year revenue impact of this expansion of the basis consistency requirement is $1.693 billion.

j. **Revenue Impact; "Cracking Nuts With a Sledgehammer."** Most planners are unaware of any situations in which beneficiaries have taken the position that the basis adjustment under §1014 is different than the value listed on the estate tax return. Many wonder if the revenue estimates (the Joint Committee on Taxation estimated a ten-year revenue impact of $1.542 billion, and the 2016 Fiscal Year Plan estimated a $3.237 billion revenue impact between 2016-2025) are realistic. (Perhaps the estimates assume there is substantial intentional cheating and that having basis numbers reported to the IRS will discourage cheaters.) Furthermore, will the additional actual revenue be less than the additional expense that will be incurred by estates in complying with the information reporting measures within 30 days after estate tax returns are filed?. For large estates having various beneficiaries who cannot be funded by the due date of the reports, imagine the volume of reports that will be required when issuing "mini-Form 706's" to each beneficiary. One wonders if the government's revenue estimate takes into consideration that the additional expenses incurred by estates in complying with the reporting requirements will be deductible for estate tax purposes, resulting in an immediate estate tax savings. Most planners believe the revenue estimate is wildly overblown; one planner has referred to this basis consistency and reporting concept as "cracking nuts with a sledgehammer."

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

a. **Overview.** The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015 was released on July 31, 2015; it is available at **http://www.irs.gov/pub/irs-utl/2015-2016_pgp_initial.pdf**. Two items from last year's list for Gifts, Estates and Trusts have been eliminated because of the issuance of final regulations: final regulations under §67 and the final portability regulations.

The 2015-2016 Plan includes the new item in last year's Priority Guidance Plan: "Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability." This will likely make clear that QTIP trusts can be used in connection with portability planning even if the QTIP election is not needed to reduce the estate tax in the first decedent's estate, despite the provisions of Revenue Procedure 2001-38. For a more detailed discussion of this issue, see Paragraph b(3) of this Item 4, below.

Four new items are included in the 2015-2016 Plan:

> "1. Guidance on qualified contingencies of charitable remainder annuity trusts under §664.
> …
> 3. Guidance on basis of grantor trust assets at death under §1014.
> …
> 5. Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872.
> …
> 8. Guidance on the gift tax effect of defined value formula clauses under §2512 and 2511."

Items 3, 5, and 8 all relate to sales to grantor trusts, suggesting that issues related to sales to grantor trusts are major "radar screen" issues for the IRS. These issues are discussed further in Items 4.b, 4.c, and 4.d of this Summary below.

Other items in the Priority Guidance Plan carried over from prior years include:

- Final regulations under §2032A regarding imposition of restrictions on estate assets during the six month alternate valuation period (this project first appeared in the 2007-2008 plan and proposed regulations were published in November 2011);
- Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against an estate (this project first appeared in the 2008-2009 plan);
- Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP (for example, the allocation of GST exemption to trusts created under a GRAT at the end of the initial GRAT term) (this project first appeared on the 2012-2013 plan);
- Final regulations under §2642(g) regarding extensions of time to make allocations of the GST exemption (this project first appeared in the 2007-2008 plan and proposed regulations were published in April, 2008);
- Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships (this item first appeared in the 2003-2004 plan) (proposed regulations were released August 2, 2016, discussed in Item 5 below); and
- Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates (this item first appeared in the 2009-2010 plan to implement the provisions of the "HEART Act" of 2008, and proposed regulations were issued on September 10, 2015).

b. **Projects That May Be Issued By This Summer**.

At the ABA Tax Section Meeting on May 6, 2016 Cathy Hughes with the Treasury Department Office of Tax Policy) and Melissa Liquerman (Branch 4 chief, IRS Office of Associate Chief Counsel [Passthroughs and Special Industries]) spoke about upcoming IRS guidance. In addition Ms. Liquerman spoke at the ABA Real Property, Trust & Estate Law Section meeting on May 12, 2016. They addressed various projects on which guidance would likely be issued in the near future. Ms. Liquerman said that "we hope in the next couple months to issue five or six projects." *Several Gift, Estate, and Trust Projects Expected Before July,* TAX NOTES TODAY, 2016 TNT 90-11 (May 10, 2016) (hereinafter "*Projects Expected,* TAX NOTES TODAY").

Cathy Hughes also referenced other projects that are longer term projects and that will not be issued anytime in the near future. These include the project under §469 regarding material participation by trusts. "We have taken an approach to this project by deciding we weren't going to be bound by any other approach in the code that exists to the question of material participation; we're starting from scratch and evaluating from the ground up… This is a heavy lift; it will not be out soon." *Projects Expected,* Tax Notes Today.

In addition, Melissa Liquerman indicated that the new "trust and estate" projects in the 2015-2016 Priority Guidance Plan (other than qualified contingencies for CRTs) are not as far along in development and will not be issued anytime soon. These include guidance on the basis of assets in a grantor trust after the grantor's death, the valuation of promissory notes, and the gift tax effect of defined value clauses. In addition, two generation-skipping transfer tax projects addressing allocation issued under §2642 are also longer term projects.

The projects on which guidance will likely come this spring or summer include the following.

1) ***§2704 Proposed Regulations.*** At various times the following terms were used by Treasury Officials to describe the timing of when these will be issued: "very, very shortly," "this spring, before summer," "some could come as soon as the next two weeks," "the next four to eight weeks". They spoke of these as proposed regulations as compared to other possible types of guidance. Melissa Liquerman indicated that the first of the estate and gift projects that would be issued by the IRS in the near future would be the §2704 proposed regulations.

The proposed regulations may place further restrictions on being able to apply valuation discounts in valuing transfers of interests in entities (such as limited partnerships and LLCs). The approach and scope of the proposed regulations are highly uncertain at this point, but the regulations could have a very important impact on valuing transfers of interests in entities.

Neither of the speakers gave any hint as to whether the proposed regulations would take the rare approach of providing that the regulations, once finalized, would be applied retroactively to the date of the proposed regulations.

2) ***§1022 Final Regulations.*** The regulations provide guidance to recipients of property acquired from decedents who died in 2010; there will likely be few changes from the proposed regulations that were issued in May 2015).

3) ***Revenue Procedure 2001-38.*** The IRS will clarify whether portability can be used in connection with QTIP trusts (in light of Revenue Procedure 2001-38). The 2014-2016 IRS Priority Guidance Plans include the following item: "Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability." This will likely make clear that QTIP trusts can be used in connection with portability planning even if the QTIP election is not needed to reduce the estate tax in the first decedent's estate, despite the provisions of Revenue Procedure 2001-38. (Rev. Proc. 2001-38 appears to give estates the option of electing to treat the unneeded QTIP election as null and void; a revenue procedure announcing the Service's administrative forbearance cannot negate an election clearly authorized by statute.) The preamble to the portability final regulations (T.D. 9725) addresses the effect of the portability election on the application of Rev. Proc. 2001-38 in a cursory fashion: "The Treasury Department and the IRS intend to provide guidance, by publication in the Internal Revenue Bulletin, to clarify whether a QTIP election made under section 2056(b)(7) may be disregarded and treated as null and void when an executor has elected portability of the DSUE amount under section 2010(c)(5)(A)." (The preamble does not mention that an example in the temporary regulation regarding the application of the exception from having to report values for certain property applies in a situation involving a trust for which a QTIP election was made, Reg. §20.2010-2T(a)(7)(C) Ex.2, was revised to omit the reference to a QTIP election.). Planners had been hopeful that this issue would be clarified in connection

with the finalizing of the portability regulations by June 15, 2015 (which was the only new item on last year's list of projects in the Gifts and Estates and Trusts section of the Priority Guidance Plan). One wonders why this guidance regarding Rev. Proc. 2001-38 is taking so long. Perhaps the IRS wants to craft a solution dealing with situations in which the portability election is made and QTIP assets decline in value by the time of the surviving spouse's death to keep the executor from being able to invoking Rev. Proc. 2001-38 to keep the assets from being included in the surviving spouse's gross estate in order to avoid a step-DOWN in basis under §1014.

This issue is important for portability planning. Being able to use QTIP trust planning creates flexibility by being able to decide after the first spouse dies whether to make a full QTIP election (and rely on portability to save estate taxes at the second spouse's death) or whether to have the assets in the QTIP trust pass into a credit shelter trust. One of the advantages of making the QTIP election, even though the estate is not large to result in estate taxes in any event at the first spouse's death, is that the assets would receive a basis adjustment at the second spouse's death. If Rev. Proc. 2001-38 would preclude inclusion of the assets in the gross estate at the second spouse's death, planners often would not be willing to use QTIP planning in a scenario in which neither spouse owns assets in excess of the estate tax exemption amount. Some planners are concerned about how to plan for clients in that situation until the IRS provides further favorable guidance about Rev. Proc. 2001-38 and portability. *See e.g.*, Rodney L Goodwin, *IRS Rules No Date-of-Death Basis on Death of Surviving Spouse–PLR Finds QTIP Election Null and Void* , Trusts & Estates (June 20, 2016 (discussing PLRs 201615004 & 201603004).

Observe that another government official has predicted that the charitable remainder annuity trust guidance project will be issued before the Rev. Proc. 2001-38 project, they agree that both projects should be published by Fall 2016.

4) ***Qualified Contingencies in Charitable Remainder Trusts.*** The "exhaustion test" requires that there be no more than a 5% probability that the charity will receive nothing at the termination of the CRT, assuming that any life annuitant will live to age 110, *see* Treas. Reg. §25.7520-3(b)(2); Rev. Rul. 77-374, 1977-2 C.B. 199. Meeting the exhaustion test is significantly more difficult for CRTs with life annuities than meeting the requirement that the remainder has a present value of at least 10% of the initial CRT value. For example, with a 2% §7520 rate, a life annuitant must be at least 72 years old for a CRAT to meet the exhaustion test. The California bar suggested including as a qualified contingency (*see* §664(f)) in a charitable remainder annuity trust that the trust will terminate immediately before the payment of an annuity that would cause the CRT to fall below 5% of the initial value of the CRT. *See* Parks, Finestone, & Laehy, *Charitable Remainder Trusts and The Probability of Exhaustion Test,* Tax Notes, at 1411 (September 7, 2015).) The IRS has issued Revenue Procedure 2016-42 approving this approach, effective for trust created on or after August 8, 2016. The Revenue Procedure includes a sample provision that would be applicable for an inter vivos CRAT for one measuring life. For an excellent general discussion of Rev. Proc. 2016-42, see Larry Katzenstein, *Revenue Procedure 2016-42: IRS Issues Helpful Revenue Procedure on Charitable Remainder Annuity Trust Exhaustion Test*, Leimberg Charitable Planning Newsletter (Aug. 11, 2016).

Planners using this approach to be able to use CRATs with young individuals than previously possible will have to recognize that a risk exists that the clause could terminate the trust before the life annuitant's death, eliminating cash flow that the annuitant may have been relying on during retirement years. For many individuals, CLUTs are more attractive than CRATs (and the exhaustion test is not applicable for CLUTs).

5) ***§2053 Proposed Regulations.*** This project will address issues left unresolved in the regulations that were issued in 2009 regarding the valuation of disputed claims against an estate. The preamble to those regulations includes the following statement: "The Treasury Department and the IRS believe that the issue of the appropriate use of present value in determining the amount of the deduction allowable under section 2053 merits further consideration. The final regulations reserve §20.2053-1(d)(6) to provide future guidance on this issue." T.D. 9468, §13, I.R.B. 2009-44. The Treasury Priority Guidance Plans for 2009-2016 include a project to address when present value concepts should be applied in determining the deductible amount of claims against an estate and administration expenses (including, for example, attorneys' fees, Tax Court litigation expenses, etc.) as well as the treatment of personal guarantees. (Officials have previously indicated informally that *Graegin* loans–on which interest that will be payable for the full term of the loan is deduced from the outset as an administration expense–are within the scope of this project).

6) ***§2032(a) Final Regulations.*** These regulations will address whether certain transactions will be treated as distributions or dispositions during the six-month alternate valuation period. As a general rule, a sale or distribution of an asset within the six-month alternate valuation period fixes the alternate valuation of that particular asset as of the date of the sale or distribution. Proposed regulations were issued in 2008 in response to *Estate of Kohler v. Commissioner*, T.C. Memo. 2006-152, *nonacq*. AOD 2008-001 (tax-free reorganization is not a disposition that accelerates alternate valuation date). Those proposed regulations were controversial in various respects, and the proposed regulations were revised and re-issued on November 18, 2011. For example, the proposed regulations, among other things, provide that making multiple distributions of minority interests within the first six months cannot convert a majority interest into a series of minority interests for valuation purposes and that contributing assets to a limited partnership in the first six months cannot result in discounting the assets under the alternate valuation rules. *See* Prop. Reg. § 20.2032-1(c)(1).

c. **Basis of Grantor Trust Assets Following Grantor's Death**. One of the new items on the Business Plan is the basis of grantor trust assets following the grantor's death under §1014. Some commentators take the position that the deemed change of ownership for income tax purposes at the grantor's death (from the grantor to the trust) constitutes the receipt of property from a decedent for purposes of §1014, and that a basis step up should be available even though the assets are not included in the gross estate. *See* Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. TAX'N 149 (Sept. 2002). The article observes that the basis step-up under §1014 is not limited to assets included in a decedent's gross estate for estate tax purposes. While §1014 provides for a basis adjustment to the date of death value for property included in a decedent's gross estate, various other situations arise in which property that is "acquired from a decedent" will receive a basis adjustment, detailed in nine paragraphs of §1014(b). Section 1014(b)(9) is the "included in the decedent's gross estate" section, but other subsections are far more general, including subsection (b)(1) which simply refers to "property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." (An example of an asset not in a decedent's gross estate for estate tax purposes that receives a basis adjustment is foreign property left from a foreign person to a U.S. person; or property in the hands of the U.S. person has a basis equal to the date of death value even though it was not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.) The Blattmachr, Gans & Jacobson article reasons "a good argument can be made that assets held in such a trust should be viewed as passing as a bequest or devise when the trust ceases to be a grantor trust at the moment of death." Up until the grantor's death, the assets have been treated as being owned by the grantor for income tax purposes.

CCA 200923024 draws a distinction between the effects of a grantor trust status terminating during the grantor's lifetime and of a lapse of grantor trust status "caused by the death of the owner which is generally not treated as an income tax event." *But see* CCA 200937028 (questioning whether basis adjustment is allowed under §1014 for assets transferred to grantor trust if assets are not in decedent's gross estate). A response to that CCA is that foreign property left from a foreign person to a U.S. person receives a basis step-up even though the assets are not in the decedent's gross estate for U.S. estate tax purposes. Rev. Rul. 84-139; PLR 201245006.

The IRS added to its "no-ruling" list earlier in the year that it will not issue rulings as to "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code." Rev. Proc. 2015-37; *see* Diane Freda, *IRS No-Rule on Basis in Grantor Trust Sales Reflects Clash of Opinions*, BNA Daily Tax Report (June 19, 2015) (noting that tax attorney Alan Lederman observes that private rulings are conflicting; PLR 201245006 concludes that a basis step-up would be available for the grantor trust assets at the grantor's death but CCA 200937028 reasons that "since the decedent transferred the property into the trust," no basis step-up arises under §1014).

Ron Aucutt provides insight regarding these rulings:

> The holdings in Letter Ruling 201245006 and CCA 200937028 would be entirely reconcilable under the standards of section 1014(b) if the trusts involved were both U.S. trusts and the grantors were U.S. persons. In Letter Ruling 201245006 the grantor retained the right to income for life, which of course would be a retained section 2036 interest (although that doesn't explain the ruling's invocation of section 1014(b)(1)). In CCA 200937028 the reservation was only of a power to substitute assets, which under Rev. Rul. 2008-22, 2008-1 C.B. 796, the IRS does not regard as a section 2036 power. In that light, the opposite results in those two rulings may have limited significance in the context of U.S. grantor trusts that buy assets from U.S. grantors.

> For other possible clues about the origin and purpose of the guidance project, or at least the Service's no-rule position, see Letter Ruling 201544002…. In that ruling the IRS ruled that the assets in a revocable trust created by foreign grantors for their U.S. citizen children would receive a basis equal to date-of-death value under section 1014(b)(2) at the grantors' deaths. The ruling acknowledged the no-rule policy of Rev. Proc. 2015-37 (which had been published in the Internal Revenue Bulletin the day before the ruling was issued), but avoided it on the ground that the ruling request had been submitted before the no-rule policy was announced. (And for a particularly ambitious, but unsuccessful, attempt to obtain a stepped-up basis in a cross-border context, see *Hughes v. Commissioner*, T.C. Memo 2015-89.)

Aucutt, ed., *Recent Developments 2015*, 50TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2016).

d. **Valuation of Promissory Notes**. The Business Plan refers to the valuation of promissory notes under §§2031, 2033, 2512, and 7872. Some examining agents have taken the position in gift tax audits that promissory notes bearing interest at the AFR should not be treated as being worth the face amount of the note, but have been reluctant to allow discounts in valuing such notes for estate tax purposes.

(1) *Gift Tax Value of Notes in Sale Transactions*.

For gift tax purposes, the IRS sometimes challenges the value of promissory notes, either arguing that the AFR is not a sufficient interest rate, or that the collateral is not sufficient such that collectability problems exist. While §7872 clearly applies in valuing a cash loan for gift tax purposes, its concepts do not clearly apply for sale transactions. The taxpayer response is that §7872, *Frazee v. Commissioner*, 98 T.C. 554, 588 (1992), and *True v. Commissioner*, T.C. Memo. 2001-167, *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004) support using the AFR with notes given in sales transactions. Private Letter Rulings 9535026 and 9408018 similarly take the position that §7872 will apply to the gift tax valuation of notes issued in intra-family sales transactions. (Private Letter Ruling 200147028, on the other hand, concluded that a trust would retain its GST exempt status following loans to second generation beneficiaries as long as the loan were adequately secured and were subject to a *market rate of interest*.)

Another argument made in some audits is that the note transaction is not a bona fide loan but is a gift. Cases list a variety of factors that are considered in determining whether debt is legitimate or not (in a variety of different contexts beyond just gift issues), but the fundamental issue is whether a reasonable expectation of repayment exists.

(2) ***Estate Tax Value of Notes.***

While §7872 addresses gift tax issues, and subsequent authority recognizes that notes with interest at the AFR will not be discounted merely for gift tax purposes because of the interest rate, no such similar certainty exists for estate tax purposes. Does that mean that the note can be discounted for estate tax purposes because no regulations are on point for estate tax purposes? Because no coordinating regulation exists some attorneys take the position that general valuation principles should be applicable, and it may be possible to discount the note for estate tax purposes if the note uses the AFR as the interest rate. *Be aware, however*, the IRS estate tax agent may feel that taking a discount for this reason alone is abusive (because the note was not similarly discounted for gift tax valuation purposes at the time of the sale) and may closely scrutinize every aspect of the sale or loan.

Section 7872 specifically authorizes the issuance of regulations addressing the valuation of notes in light of §7872. The IRS indeed has issued a proposed regulation that purports to say that the value of the note could not be discounted for estate tax purposes except to make adjustments where the stated interest rate under the note is lower than the AFR in effect at the date of death or where the facts impacting the collectability of the note have changed "significantly since the time the loan was made." Prop. Reg. § 20.7872-1. This regulation has never been finalized.

For a more detailed discussion of the note valuation issues, see Item 2.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

(3) ***Income Tax Effects of Discounting Notes.***

If a note is discounted for estate tax purposes, but the full amount of the note is later paid, the excess payments over the basis of a note (i.e., the estate tax value) will be ordinary income to the recipient. If an individual inherits a note (other than an installment sale note) that is valued below face, and if the individual receives payments on the note exceeding the discounted value of the note, the excess is treated as ordinary income. For example, §§ 1271-1275 deal with OID by requiring the debt holder to take any discount into income as ordinary income, not as capital gain. *E.g.,* Treas. Reg. §1.1275-1(b)(3) (treatment of market discount for calculating OID accruals).

The income tax effect should be different if an individual receives the note by gift. Under the dual basis rules of § 1015, the donee's basis in the note would be the donor's basis for purposes of determining the amount of any gain. Therefore, the reduction in value of the note up to the time of the gift would not result in a decreased basis for purposes of determining later gain on the note.

If the note is an installment sales note, special rules apply if the note is satisfied at less than face value, if a disposition or cancellation of the note occurs, or if related parties dispose of property purchased with the installment note within two years of the sale. I.R.C. §§ 453B(a), 453(e)(1).

In summary, discounting a note may provide immediate estate tax benefits, but it may come at a cost for income tax purposes. (The income tax cost may be greater than the estate tax savings; the federal top rate is 39.6% +3.8% net investment income tax, or 43.4%. In addition, some states have income tax rates of up to 10%.)

e. **Defined Value Clauses.** The new item regarding *defined value formula clauses* suggests that the IRS will eventually issue regulations regarding the effect of defined value formula clauses, despite its losses in the *McCord, Christianson, Petter, Hendrix* and *Wandry* cases. Sales to grantor trust transactions may use a *Wandry* clause, providing for a sale of that number of shares equal to a given value. (That was the approach taken in the *Woelbing* sale transaction, which was settled with the IRS apparently respecting the *Wandry* provision. *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner,* Docket No. 30260-13.) The *Woelbing* cases are discussed in Item 11.b below. Alternatively, a sale transaction may use a price adjustment clause. Either of these may be within the scope of the regulation project.

For further discussion of defined value clauses, see Item 9 below.

f. **ABLE Act and §6166 Guidance**. Other projects receiving attention from the National Office include the ABLE Act and §6166. At the September 2015 meeting of the ABA Tax Section, Cathy Hughes (with the Treasury Department, Office of Tax Policy) reported that the government is continuing work on implementation of the "ABLE Act" following the issuance of proposed regulations earlier this year, and IRS further guidance is expected in early 2016. An additional project receiving attention is a guidance project regarding section 6166; the government expects to issue comprehensive proposed regulations, and this project may come out "sooner rather than later." *See* Alison Bennett, *Guidance on Valuation Discounts "Getting Closer,"* BNA DAILY TAX REPORT (September 21, 2015).

g. **Section 2704 Project**. The IRS issued proposed regulations on August 2, 2016. They are discussed in detail in Item 5.

h. **Closing Letters.** In a June 16, 2015 update to the "Frequently Asked Questions on Estate Taxes" on the IRS website, the IRS indicated that for all estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. Taxpayers are asked to wait at least four months after filing the estate tax return to make the closing letter request "to allow time for processing." Apparently, this change in procedure is made in light of cuts to the IRS budget and in light the fact that a closing letter does little good for returns filed solely to elect portability (because the statute of limitations on that return for determining the DSUE amount does not lapse until the statute of limitations lapses on the surviving spouse's return). Estates that owe estate taxes will almost routinely want to request the closing letter before making estate distributions.

   This notice on the IRS website says that for returns filed before June 1, 2015, estates can expect to receive a closing letter about 4 to 6 months after the return is filed unless the return is selected for examination or reviewed for statistical purposes.

   The closing letter issue was addressed at the American Institute of CPAs Fall Tax Division Meeting on November 4, 2015 in discussions with the Trust, Estate and Gift Tax Technical Resource Panel. In response to an IRS suggestion that practitioners could request a transcript that would indicate the status of the return, practitioners expressed concern that a code on the estate tax return transcript will not carry the same weight as a closing letter, and that locating a code on the transcript is too complex for the executors of small estates. Practitioners said a more convenient approach would be to include a box on Form 706 that the executor could check off requesting a closing letter. The "Frequently Asked Questions on Estate Taxes" webpage on the IRS website was revised on November 2, 2015 to add a telephone number for requesting closing letters: (866) 699-4083 (which is also listed in the 2015 Form 706 Instructions). *See* Freda, *IRS: Forget 2013 Treasury Proposal on Valuation Discounts*, BNA DAILY TAX REPORT 214 DTR G-6 (November 5, 2015).

   In early December 2015, the IRS added a webpage entitled "Transcripts in Lieu of Estate Tax Closing Letters." It describes using accounts transcripts as an alternative to closing letters.

> Account transcripts, which reflect transactions including the acceptance of Form 706 and the completion of an examination, may be an acceptable substitute for the estate tax closing letter.

Account transcripts are available online to registered tax professionals using the Transcript Delivery System (TDS) or to authorized representatives making requests using Form 4506-T.

Transcript Delivery System (TDS)

For all estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. In lieu of an estate tax closing letter, account transcripts are available online to tax professionals. An account transcript from the Transcript Delivery System (TDS) reflects transactions including the acceptance of Form 706 and/or completion of an examination.

Tax professionals can register on IRS.gov to secure estate tax transcripts…. Requests for these products will be fulfilled only when a properly executed Form 2848, Power of Attorney or Form 8821, Tax Information Authorization, is already on file….

NOTE: The decision to audit a Form 706 is typically made four to six months after the filing date. Please wait four to six months after filing Form 706 before submitting a request for an account transcript.

[Details governing the mechanics of making requests under the TDS system are explained.]

Following a successful request, an **Account Transcript** will display on the screen.

- The **Transactions** section of the transcript contains details of the entire account…
- **Transaction Code 421 indicates an Estate Tax Return (Form 706) has been accepted as filed or that the examination is complete**. Please note that the Transaction Code 421 explanation will display "**Closed examination of tax return**" in all instances. If Transaction Code 421 is not present, the tax return remains under review. Allow additional time before checking again.

[In addition, details about requesting an account transcript for estate tax returns by mailing or faxing Form 4506-T, Request for Transcript of Tax Return are explained.]

i. **Inflation Adjustments for 2016.** Revenue Procedure 2015-53 describes inflation adjustments for 2016. Some of the adjusted figures include the following:

- Individual income tax brackets: The top bracket for married individuals begins at $466,950 of taxable income; the top bracket for single individuals begins at $415,050 of taxable income;
- Estate and trust income tax brackets: The top bracket begins at $12,400 of taxable income;
- Transfer tax exemption amount: The basic exclusion amount (i.e., the estate, gift, and GST "exemption" amount) is $5,450,000;
- Annual exclusion: The gift tax annual exclusion remains at $14,000; and
- Gifts to non-citizen spouse: The first $148,000 of present interest gifts to a non-citizen spouse are excluded from taxable gifts.

5. Section 2704 Proposed Regulations

a. **Brief Background and Synopsis of Proposed Regulations**. Section 2704 was enacted in 1990 as a part of Chapter 14. The goal in particular was to limit discounts for certain family partnership or LLC interests that are transferred to family members.

Section 2704(a), titled "Treatment of Lapsed Voting or Liquidation Rights," treats certain lapses of voting or liquidation rights as deemed transfers if the family controls the entity both before and after the lapse.

Section 2704(b), titled "Certain Restrictions on Liquidation Disregarded," provides that any "applicable restriction" is disregarded in valuing an interest in a corporation or partnership that is transferred to a family member if the transferor and family members control the entity. An "applicable restriction" is any restriction that (i) effectively limits the ability of the corporation or partnership to liquidate, and (ii) the restriction lapses (entirely or partially) after the transfer OR the transferor or family members can remove the restriction (entirely or partially), but an "applicable restriction" does not include "any restriction imposed, or required to be imposed, by any Federal or State law" (or commercially reasonable restrictions imposed by unrelated persons in a financing transaction). Regulations interpreted the "imposed, or required to be imposed, by Federal or State law" exception to mean that default restrictions on the ability of an owner to withdraw from an entity could be considered, even though the family could have overridden those restrictions in the governing documents. Many states have a default rule limiting the ability of a limited partner or member of an LLC to withdraw, and the IRS has stated that the default rule in the regulations has made §2704(b) rather toothless.

Section 2704(b)(4) gives the IRS the authority to provide in regulations that other restrictions may similarly be disregarded in valuing transfers of interests in the entity if the restriction merely reduces the value for transfer tax purposes but does not ultimately reduce the value of the interest for the transferee.

These proposed regulations implement the provisions of a proposal (included in the Administration's budget proposals submitted in 2009-2012) to amend §2704 legislatively. (the administration removed the proposal in the Fiscal Year 2014 budget proposal after no bills were ever introduced to enact the proposal).

The IRS on August 2, 2016 released long-awaited proposed regulations under §2704 that will dramatically reduce the ability to apply valuation discounts to intra-family transfers of interest in entities (such as corporations, partnerships, or LLCs). **In large part, these regulations will significantly restrict (or eliminate) lack of control discounts in valuing interests in entities and may impact marketability discounts as well.** These proposed regulations implement the provisions of a proposal (included in the Administration's budget proposals submitted in 2009-2012) to amend §2704 legislatively. The administration removed the proposal in the Fiscal Year 2014 budget proposal.

Very importantly, the proposed regulations are not effective until they are finalized (or for some provisions, until 30 days after they are finalized. A new "three-year rule" might apply, however, to transfers made before the effective date if the transferor dies after the effective date but within three years of making the initial transfer.

Major provisions of the proposed regulations include:

- *Covered Entities*. Covered entities are defined broadly (for example, including LLCs regardless of whether they are disregarded as separate entities for federal tax purposes), to include LLCs, and control rules are described for various types of entities.
- *Assignees*. Transfers to assignees may result in lapsed liquidation or voting rights under §2704(a) and will be subject to the "disregarded resections" rules.
- *Deaths Within Three Years*. Transfers that result in the transferor losing a liquidation right may be subject to a three year rule, requiring inclusion of the liquidation value in the transferor's gross estate at death if the transferor dies within three years of the transfer. The phantom value included in the gross estate (generally speaking, the value attributable being a minority interest or being less than the percentage ownership required to force the liquidation of the entity) would not qualify for the marital or charitable deduction.
- *State Law Default Restrictions Not Considered*. Default restrictions under state law (such as withdrawal restrictions that can be overridden by the family) can no longer be considered in valuing transferred interests.
- *Disregarded Restrictions.* The most far-reaching aspect of the proposed regulations is the creation of a new category of "disregarded restrictions," which effectively values transfers of interests in family-controlled entities as if the holder of the interest has a put right to sell the interest to the entity within six months for a value at least equal to a pro rata part of the net value of the entity in return for cash or property (but not notes except in certain situations).
- *Unrelated Parties Generally Not Recognized for Removal of Disregarded Restrictions By Family Test.* In determining whether the family can remove "disregarded restrictions," the interests of unrelated parties are not considered unless unusually stringent conditions are satisfied (which usually will not be the case).
- *Commercially Reasonably Restrictions for Active Business Entities*. In light of the very broad scope of the application of the new provisions, a "commercially reasonable restriction" exception for entities with trade or business operations may become important.
- *Valuation Uncertainties*. Numerous uncertainties exist regarding the manner of determining the values of transferred interests that are subject to the new rules, but lack of control discounts will be significantly reduced or eliminated.
- *Marital and Charitable Deduction*. Values will generally be applied consistently for both estate inclusion and for deduction purposes (for the marital deduction and charitable deduction).

b. **Effective Date**. The proposed regulations are NOT effective immediately. They apply only to transfers made after final regulations are promulgated, and the most pervasive provisions of the proposed regulations (regarding the new category of "disregarded restrictions") only apply to transfers made at least 30 days after the regulations become final. Prop. Reg. §§25.2701-8, 25.2704-4(b)(1)-(2).

The new rules might also apply to transfers made before that date if the transferor dies after the effective date but within three years of the date of the transfer. The new three-year rule, discussed below, provides that a lapse of a liquidation right under §2704(a) is treated as a lapse "*occurring*" on the date of the transferor's death in certain situations if the transferor dies within three years of making the transfer. The new regulations "apply to transfers of property subject to restrictions created after October 8, 1990, *occurring* on or after the date these regulations are published as final regulations in the Federal Register" (emphasis added). Does this effective date language apply to (i) the actual lapse that occurs at the time of the gift or (ii) the deemed lapse "occurring" at death? If the former, gifts made before the regulations become final would not be subject to the new three-year rule. If the latter, gift made before the regulations are finalized (and possibly even before the proposed regulations were issued) may result in significant amounts being included the gross estate of the transferor if the transferor dies after the regulations are finalized and within three years of the gift. Interestingly, the same word "occurring" is used both in the three-rule and in the effective date provision.

A hearing about the proposed regulations is scheduled for December 1, 2016. Most proposed regulations (even non-controversial ones) are not finalized for two years or more. These proposed regulations will be quite controversial, and the IRS will, no doubt, receive many comments for consideration, which presumably will mean that the final regulations will not be issued any time soon after the December 1 hearing. If the IRS makes this a high priority project, the regulations conceivably could be finalized sometime by mid-2017. In any event, planners will have an additional 30 days after the regulations are finalized before the far-reaching disregarded restrictions provisions become effective.

c. **Entities Subject to §2704**. The types of entities subject to §2704 are described very broadly to include any "entity or arrangement that is a business entity within the meaning of §301.7701-2(a)" that is controlled by the family, and a definition of control is provided. In particular, LLCs are included (regardless of whether they are disregarded for federal tax purposes), as well as corporations and partnerships. Prop. Reg. §§25.2701-2(b)(5)(i), (iv); 25.2704-2(a), (c)-(d); 25.2704-3(a). The definition of "control," as cross referenced in §2701 is clarified regarding LLCs or other entities other than corporations, partnerships, or limited partnerships to mean 50% of either capital or profits interests or the ability to cause the liquidation of the entity. (Existing regulations provide that for corporations, control means at least 50% (by vote or value) of the stock, and for partnerships, control means at least 50% of the capital or profits interests or the holding of any interest as a general partner in a limited partnership. Reg. §25.2701-2(b)(5).)

Section 2704 (and the regulations thereunder, including the proposed regulations) apply only to transfers of interests in *entities* and not assets outside of entities (including undivided interests in real estate or art). However, if the undivided interests held by various owners are deemed to be a "business entity," the new rules could apply to transfers of those undivided interests. See Item 5.I.(3) below.

d. **Section 2704(a) Lapses (Assignee and Three-Year Rules)**. The rules regarding lapses under §2704(a) (which treats lapses of voting or liquidation rights as deemed transfers) are revised in three ways. First, the types of entities subject to §2704(a) (including the family's ability to liquidate an interest and the manner in which liquidation may be achieved) are described broadly. Prop. Reg. §25.2704-1(a)(1), (a)(2)(i), (a)(2)(ii), (a)(4).

Second, a transfer to an "assignee" is subject to §2704(a) (even if the transferor can continue to exercise the voting or management rights associated with the interest transferred to the assignee). Prop. Reg. §25.2704-1(a)(5). Assignees would also be subject to the new "disregarded restrictions" rules of §2704(b) (because they do not have "put" rights), but the new "disregarded restrictions" regulations do not specifically refer to assignees.

Third, and most important, a new three-year rule will apply to certain transfers made within three years of death. Prop. Reg. §25.2704-1(c)(1), (c)(2)(i)(B), (f)Exs. 4 & 7. The existing regulations include an important exception, providing that a transfer that results in a loss of a voting right or liquidation right for the transferor will not constitute a lapsed right subject to §2704(a) if the "rights with respect to the transferred interest are not restricted or eliminated." Reg. §25.2704-1(c)(1). For example, if an individual owns 84% of the stock of a family controlled company that requires 70% vote to liquidate, and if the individual gives 14% to each of three children (leaving the individual with 42%), §2704(a) will not apply, even though the individual has lost the right to force the liquidation of the company, because the voting rights with respect to the corporation are not restricted or eliminated. Reg. §25.2704-1(f)Ex. 4. This allows the very common practice of donors giving or selling minority interests leaving the transferor with a minority interest, in effect converting a controlling interest into various minority interests for transfer tax purposes (as recognized in Rev. Rul. 93-12). The IRS views that as an abusive transaction when done on an individual's deathbed (citing *Estate of Murphy v. Commissioner*, T.C. Memo. 1990-472). Under the proposed regulation, a three-year rule applies to treat any transfer within three years of death, which transfer results in the transferor losing a liquidation or voting right, as a deemed transfer of the lapsed voting or liquidation power even though rights associated with the ownership of the transferred interest are not restricted (for example, children who receive gifts of stock continue to have the right to vote the stock). Accordingly, any transfers of interests in family-controlled entities made within three years of death that result in a loss of the ability to force the liquidation of the entity [such as a transfer of a minority interest that leaves the transferor with an interest below the level required to be able to force liquidation of the entity] will result in a deemed transfer of the value of the lapsed voting or liquidation right at the transferor's death. (This "phantom asset" value would be included in the transferor's gross estate and would not qualify for a marital or charitable deduction.)

How this three-year rule works mechanically under the regulations is unclear. Presumably, the intent is to include the lapsed liquidation value with respect to the transferor's remaining assets and the transferred assets in the gross estate. Howard Zaritsky (Rapidan, Virginia) offers this example as a logical interpretation of the three-year rule (although he adds "what the IRS will ultimately say is anyone's guess"):

> If I own 100% of the stock of ACME and give my three hypothetical children 20% blocks each, Section 2704(a) does not currently apply, because the right to liquidate has not lapsed; it has just been divided among the four shareholders. Under the proposed regs, however, if I die within three years, the right to liquidate is now deemed to have lapsed at my death, and my gross estate should include the difference between 100% of the stock (no discount) and 40% of the stock (discounted). In effect, the estate tax base eliminates the discount on the 40% I retained, and recaptures the discounts on the 60% I transferred.

A calculation uncertainty exist as well in determining the amount of the deemed transfer. Even though a deemed lapse of a liquidation right may occur at the transferor's death if the transferor dies within three years, the *amount* of the deemed transfer is calculated (under existing regulations) by comparing the value of all interests in the entity owned by the holder before the lapse (as if the lapsed right were nonlapsing) with the value of those interests immediately after the lapse "(determined as if all such interests were held by one individual)." Treas. Reg. §25.2704-1(d).

In determining the amount of the value of the deemed lapsed liquidation value, are values on the date of the gift or on the date of death used? The proposed regulation is unclear.

Such transfers will often also be subject to §2704(b) under the new "disregarded restrictions" provisions of the proposed regulations; how these two sections will apply in coordination with each other to avoid taxing the same "liquidation value" multiple times is not addressed in the proposed regulations. Howard Zaritsky offers a logical explanation of how the interaction should work, based on the example quoted above:

> If, however, Section 2704(b) denied me the discounts on the interests I gave my children, because of the deemed right to liquidate the entity or the interests, then there should be no additional amount included in my gross estate under Section 2704(a), because there would be no difference between the value of the 60% and the 40% interests (with their put rights), and the value of the 100% I had before the transfer.

No provisions in the proposed regulations, however, state that the deemed lapse under §2704(a) if the transferor dies within three years would not apply if the liquidation value was effectively already taxed because of the new "disregarded restrictions" rules. Assuming the regulations are clarified to avoid taxing the same liquidation value at the time of the transfer and at the time of death, the three-year rule may become relatively unimportant in light of the wide application of the new disregarded restrictions rules.

e. **Restrictions "Imposed or Required to Be Imposed" - Change From Default to Mandatory Rule**. Restrictions (including both "applicable restrictions" on the ability to force liquidation of the entity (in whole or in part) and "disregarded restrictions" on the ability to force the liquidation of the transferor's interest in the entity [described below]) that are disregarded under §2704(b) in valuing an interest in an entity include restrictions imposed under the governing documents *and* default restrictions imposed under local law that can be superseded by the governing documents (i.e., any default state law restrictions that are not mandatory). Even mandatory restrictions are disregarded if they apply only to family-controlled entities or if state law provides an optional or alternative statute for the creation of "that same type of entity" that do not include the mandated restriction. Prop. Reg. §§25.2704-2(b)(2), (b)(4)(ii), (e) (regarding applicable restrictions); 25-2704-3(b)(2), (b)(5)(iii) (regarding disregarded restrictions). The proposed regulations clarify that the "Federal or State law" referenced to in the exception does not include the laws of foreign jurisdictions. Prop. Reg. §§25.2704-2(b)(4)(ii) & 25.2704-3(b)(5)(iii).

These provisions are important because state laws generally provide that limited partners in a partnership that last for a fixed term have no right to withdraw before the end of that fixed term. Many states have revised their statutes to allow the liquidation of the entity only on the unanimous vote of all owners (unless the governing documents provide otherwise) and to restrict partners from withdrawing from the entity unless the partnership agreement provides otherwise. The typical default rule in LLC statutes similarly is that members do not have the right to withdraw unless allowed in the operating agreement. Limited partnerships and LLCs are often structured in accordance with these state law default rules, so the ownership interests are valued taking into account that the limited partner or member has no withdrawal rights, which typically leads to discounts. The typical default rule in LLC statutes similarly is that members do not have the right to withdraw unless allowed in the operating agreement. Under the proposed regulations, because the state law restriction on withdrawal is not a mandatory requirement, it will be ignored under §2704(b).

f. **Disregarded Restrictions—General Description**. Section 2704(b) refers to "applicable restrictions," which term has been construed to refer to a limitation on the ability to force the liquidation *of the entity*, in whole or in part. (*Kerr v. Commissioner*, 113 T.C. 449. 473 (1999), *aff'd on other grounds*, 292 F.3d 490 (5th Cir. 2002)). A new category of "disregarded restrictions" applies to restrictions on the ability to force the liquidation or redemption of an *interest in the entity*. The "disregarded restrictions" rules effectively provide that entity transfers will be valued as if the transferred interest had a deemed put right to sell the interest to the entity at any time on six months' notice if the family (determined under detailed rules summarized in Item 5.g below) had the ability to cause a put right to exist. These provisions will significantly reduce (or eliminate) lack of control discounts for transfers of interests in family-controlled entities.

The legislative proposal to amend §2704 referred to "limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations." Based on that proposal, many had expected a list of the *kinds* of restrictions that would not be given effect in valuing entity transfers (for example, the imposition in governing documents of a 70% vote to liquidate the entity). Instead, the regulation describes "disregarded restrictions" by reference to their *effect* (i.e., anything that has the effect of limiting the holder's ability to liquidate the interest at a described value, at a described time, and for a described type of consideration). *See* McGuireWoods, *Proposed Section 2704 Regulations Would Impose Major Restrictions on Valuation Discount Planning* (August 5, 2016).

A disregarded restriction is one that does one or more of the following things:

(a) limits the ability of the holder of the interest to liquidate the interest [observe that this is VERY broad, including any transfers without a put right if the family could have forced inclusion of a put right unless state law *mandates* that the holder could not possibly have the ability liquidate his or her interest];

(b) limits liquidation proceeds to less than a "minimum value" (defined as a pro rata share of the "net value of the entity" – defined as the net value of property held by the entity less outstanding obligations of the entity that were incurred for consideration in money or money's worth (referencing §2053);

(c) defers payment of the liquidation proceeds for more than six months; **OR**

(d) permits payment of the liquidation proceeds other than in cash or other property (in particular, for a note from the entity or family members unless the note is (i) consideration for payment with respect to an entity that is in an active trade or business, (ii) attributable to active trade or business assets, (iii) that is adequately secured, (iv) with periodic payments, (v) at "market interest rates," (which presumably would not be the AFR), and (vi) that has a fair market value (when discounted to present value) equal to the liquidation proceeds). Prop. Reg. §25.2704-3(b)(1).

The regulations do not include specific examples of corporations or limited partnerships or LLCs that are merely ***silent*** on the ability of a shareholder, limited partner, or member to withdraw and have the interest redeemed by the entity. Presumably, interests in such entities will be treated the same as entities with explicitly stated limitations on the ability of the holder to liquidate the interest. (For example, what is the difference between a corporation that explicitly states in governing documents that shareholders have no right to be paid for their stock on six months' notice and corporations without such explicit restrictions but that have no requirement under state corporate law principles to redeem shareholders' stock on six months' notice?) The regulations provide that the source of limitations on the ability to liquidate an interest can include restrictions in governing documents "and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise." Prop. Reg. §25.2704-3(b)(2); *see also* Prop. Reg. §25.2704-2(b)(2) (identical provision with respect to applicable restrictions). Similarly, the regulations address the statutory exception for restrictions "imposed, or required to be imposed by Federal or State law":

> A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. Prop. Reg. §25.2704-3(b)(5)(iii).

If local law does not give the owner a right to be redeemed, that would presumably be a "limitation on the ability of the holder of the interest to compel liquidation or redemption of the interest" even though the governing documents could grant such a right. *See* Mitchell Gans & Jonathan Blattmachr, *Recently Proposed Section 2704 Regulations*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2441 (August 5, 2016) ("What would be the outcome in Example 1 if the partnership agreement had been silent on the put-right issue? Assuming no mandatory provision in state or federal law precluding the partnership from granting a put right, and it is difficult to imagine such a provision under state or federal law, the failure to include a put right would presumably be disregarded.")

Provisions in the preamble and the proposed regulations suggest that the "minimum value" rules do not restrict the "net value of the entity" to the mere liquidation value of the entity's assets. The minimum value rule cross-references other regulations to make clear that the net value of the entity for operating businesses is not limited to the liquidation value of the hard assets of the entity, but also considers the entity's earning capacity. (See Item 5.i below.) Presumably, the net value of the entity's assets would take into consideration appropriate undivided interest discounts of any undivided interests held by the entity and perhaps lack of marketability adjustments (although marketability discounts are traditionally considered at the level of determining the value of an owner's interest in the entity because that is the only asset typically being valued). Considering the company's earning capacity rather than its asset value will not always lead to a higher "minimum value. The net value of the business may be less than the liquidation value of its assets for ongoing businesses that have no intention of liquidating. *See Giustina v. Commissioner*, T.C. Memo. 2016-114 (basing value on ongoing entity value of forestry operation under cash flow method even though the timber asset value of the entity was much larger).

The definition of "minimum worth" states that "the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations instead were claims against an estate." The reference to §2053 creates uncertainty. Limitations apply on the deductibility under §2053 for contingent or uncertain obligations or guarantees. Does the proposed regulation's reference to "(if paid)" mean that the value of such contingent obligations can be considered despite the limitations under §2053 for deducting such claims until actually paid?

One appraiser (Curtis R. Kimball, national director for wealth management valuations at Willamette Management Associates) points out (his personal opinion) how important this §2053 issue will be in valuations:

> Only certain obligations allowable under §2053 are counted. In valuing a business that sells goods and services, business analysts routinely incorporate estimates of the impact of risks and other unbooked obligations and exposures. Are these to be ignored? For C corps, are built-in gains to be ignored?

If the family has sufficient control of an entity that it could force the inclusion of a put right (and that will be the case for most entities because unrelated parties will generally be ignored, as discussed in Item 5.g immediately below), almost any transfer of an interest in an entity will be valued as if there were a deemed put right unless the transfer meets a safe harbor exception (described in Item 5.h below), which is a put right held by each holder of the entity (even unrelated parties) that avoids the four possible categories of disregarded restrictions.

g. **Disregarded Restrictions—Ability of Family to Remove Restriction**. One of the requirements for treating a liquidation restriction as an applicable restriction (that is disregarded in valuing the interest) is that the restriction later lapses or the family can remove the restriction. The Fifth Circuit in the *Kerr* case reasoned that §2704 did not apply to the partnership in that case because charities had small limited partnership interests, and all partners had to consent to removing restrictions; thus, the family acting alone could not remove the restrictions. *Kerr v. Commissioner*, 292 F.3d 490, 494 (5th Cir. 2002). The preamble cites *Kerr* in reasoning that taxpayers have avoided §2704(b) by transferring a nominal partnership interest to a nonfamily member, such as a charity or employee, "to ensure that the family alone does not have the power to remove a restriction." The preamble says that non-family members will be recognized only if "the interest is an economically substantial and longstanding one that is likely to have more substantive effect."

In determining if the transferor's family can remove a disregarded restriction (or stated otherwise, has the ability to impose a right to sell the interest to the entity), any interest held by a non-family member will disregarded if *any* of the following situations exist:

(a) the interest has been held for less than three years;

(b) the interest is less than 10% of the value of all equity interests (or capital and profits interests in an entity other than a corporation);

(c) all non-family members hold less than 20% of all equity interests (or capital and profits interests in an entity other than a corporation); OR

(d) the non-family member does not have a put right to receive the "minimum value" on no more than six months' notice. Prop. Reg. §25.2704-3(b)(3)-(4).

In reality, non-family owners would almost never satisfy all of those conditions; almost no business arrangement gives a put right to owners as described in sub-paragraph (d) above. As a practical matter, involving an unrelated third party in the entity merely to avoid the "disregarded restrictions" rule is unworkable. (Interestingly, the same limitation regarding whether unrelated persons are considered in determining whether restrictions can be removed does not apply to "applicable restrictions.")

h. **Exceptions: Safe Harbor Put Right; Commercially Reasonable Restriction**. A liquidation restriction will not be an "applicable restriction" or "disregarded restriction" if the following conditions apply:

(a) *every* owner has an enforceable "put right" to sell the interest to the entity or other owners [presumably, the reference to sales to owners refers to a constructive redemption transaction made directly with the other owners, because "disregarded restrictions" are limitations on the ability to "liquidate or redeem," not restrictions on selling to other owners] for cash and/or other property at least equal to the "minimum value";

(b) the payment must be made within six months of exercise of the put right; AND

(c) payment is not in the form of a note except for certain types of notes as described in Item 5.f.(d) above. Prop. Reg. §25.2704-2(b)(4)(iv) regarding applicable restrictions); §25.2704-3(b)(v), (b)(6) (regarding disregarded restrictions).

A commercially reasonable restriction imposed by unrelated persons (referencing relationships described in §267(b)) providing capital to the entity for its trade or business operations (whether in the form of debt or equity) are not applicable restrictions or disregarded restrictions. Prop. Reg. §§25.2704-2(b)(4)(i) (applicable restrictions); 25.2704-3(b)(5)(ii) (disregarded restrictions). (A similar exception exists for applicable restrictions under the existing regulations. Reg. §25.2704-2(b).) This may be a very important exception for companies with active business activities. Banks often require various covenants including restrictions on redeeming owners' interests as a condition of making loans to businesses. If the exception applies, restrictions under such covenants could be considered in valuing the owners' interests for transfer tax purposes. Otherwise, some unrelated owners may not be able to avoid the disregarded restriction provisions. (For example, in a 50-50 entity, each owner would be deemed to have control [for purposes of being a family-controlled entity and for purposes of satisfying the "ability to remove the restriction" requirement] because regulations use "at least 50%" as the test for control.)

i. **Determining Value If §2704(b) Applies**. If an "applicable restriction" or "disregarded restriction" exists, the fair market value of the transferred interest is determined under "generally applicable valuation principles" as if the restriction does not exist (for example, as if the holder of the interest has a put right to sell the interest to the entity within six months for a value at least equal to a pro rata part of the net value of the entity in return for cash or property (but not notes except in certain situations)). The section of the preamble to the proposed regulations regarding "applicable restrictions" states that the value is determined "as if the governing documents and the local law are silent on the question … and thus, there is deemed to be no such restriction on liquidation of the entity." The section of the preamble to the proposed regulations regarding "disregarded restrictions" states that the value is determined under "generally accepted valuation principles*, including any* *appropriate discounts or premiums*" (emphasis added) as if the restriction does not exist. None of the examples address how discounts or premiums would apply or discuss the valuation of interests in an active trade or business entity vs. an entity that merely holds passive investment assets. The preamble's discussion of the "minimum value" rule states that "if the entity holds an operating business, the rules of §20.2031-2(f)(2) or 20.2031-3 apply in the case of a testamentary transfer and the rules of §25.2512-2(f)(2) or 25.2512-3 apply in the case of an inter vivos transfer. (Those regulations refer to various factors including the earning capacity of the business.)

One appraiser concurs that determining the "minimum value" involves considerations beyond just the liquidation value of the entity's assets:

> Many attorneys will assume that minimum value is just net asset value under a premise of orderly liquidation, but it is not. The fair market value of "property" owned by the company has to be valued. Does this include unidentifiable intangible assets implied by a capitalization of earnings or unallowable personal goodwill or self-created intangibles? … The IRS definitions and standard of minimum value for new §2704 appears to me to bear an uneasy and unclear relationship with the regulations under Regulation §§20.2031-2, 20.2031-3, 25.2512-2 & 25.2512-3 that the IRS refers to. Curtis R. Kimball, Willamette Management Associates (his personal opinion).

Particularly for disregarded restrictions, these provisions create considerable uncertainty as to what assumptions the appraiser would make in valuing the business "under generally accepted valuation principles" as if the holder of the transferred interest has a six-month put right, to be paid in cash or property. Should the appraiser assume that all owners have six-month put rights when valuing the business? Even if the value should be determined assuming that only the transferred interest has a six-month put right for cash or property, would the company have to keep cash and assets on hand to fund the liquidation when requested, thus reducing available capital and increasing borrowing requirements?

One planner frames the issue this way – "What is a company worth in which all of the shareholders can (in theory) take their share at any time? How could there be comparables? No such third party operating businesses exist." Other planners have asked whether a "lack of continuity discount" would be applied.

One expert appraiser has raised various questions about how the value would be determined under "generally accepted valuation principles" in this hypothetical situation, and the impracticality of valuing the company under these assumptions:

> Let us assume a significant minority of the company shareholders prefers cash while the majority is content to hold shares. If suddenly one-third of the family wants to be cashed out what will happen? Most companies, will have not have enough spare cash to honor but a small fraction of this demand. Accordingly, they would have to borrow either from a bank or provide the sellers with a note at a market interest rate.
>
> …
>
> Meanwhile, the company's existing bank lender will be none too happy about the redemptions and increased subordinated debt. In fact, such redemptions may well be prohibited by the company's existing loan agreements. If such is the case, is this an acceptable restriction under the Proposed Regs?
>
> Assuming they can borrow for this purpose at all, it would push the company into a higher risk category since these borrowings will diminish the company's ability to borrow for working capital or capital expenditure needs. The greater risk means the company's cost of equity must also rise. These two negative developments will drive up the company's cost of capital and drive down its value.

> …
>
> Of course, this is a fictional scenario since no operating company, family-owned or otherwise, has ever enacted such a nonsensical policy. So, in reality, if the Proposed Regs are finalized as produced, valuation for tax purposes will have no connection to the reality of values in the marketplace. Taxpayers will be taxed on a theoretical value that is impossible even in the theoretical world.
>
> …
>
> A company which gave its employees a put right as the regs suggest would probably have to book this contingent liability similar to an unfunded pension liability. It would devastate the company's balance sheet.
>
> William H. Frazier (Stout Risius Ross, Inc.), *Musings on the Theoretical Redemption Rights in Proposed Regulation 163113-02* (Aug. 8, 2016).

Two Step Process. Valuation issues are involved in two separate steps for disregarded restrictions: (i) in valuing the "minimum value" (which is a pro rata portion of the net value of the entity) price for the assumed six-month put option, Prop. Reg. §25.2704-3(b)(1)(ii), and (ii) in valuing the holder's interest in the entity under generally accepted valuation principles (even with the assumed six-month put option at minimum value), Prop. Reg. §25.2704-3(f).

Lack of Control Discounts. The major impact will be to restrict (or perhaps eliminate in some cases) a lack of control adjustment if the owner is deemed to have a six-month put right at the "minimum value." Even with that limitation, some appraisers have suggested that a lack of control discount would still be available for lack of control over day-to-day operations (about 10%) and for the six months delay in receiving the liquidation payout (about 5%).

Lack of Marketability Discounts and Other Discounts. Even though the holder is deemed to have the ability to liquidate its interest, lack of marketability discounts would still seem appropriate, in both of the two steps, to the extent that marketability delays would exist in selling the entity's assets (Step 1-minimum value determination) or in selling the transferor's interest in the entity (Step 2). *See, e.g., Estate of Jameson v. Commissione*r, T.C. Memo. 1999-43 (marketability discount allowed for valuing 98% interest in corporation, despite the fact that holder could liquidate the entity, based on the nature and marketability of the corporation's assets; low marketability discount allowed because the major assets [timberland] "would sell within a few weeks after being placed on the market"), *rev'd on other grounds*, 267 F.3d 366 (5th Cir. 2001). In determining the value of the transferred interest in the second step, the marketability discount may be lower (based on the assumption that the transferor has a six month put right at the minimum value—thus having a deemed built-in purchaser). The size of the marketability discount in the Step 2 process may depend on the size of the interest being valued (for example, a 100% block may be entitled to a 10% lack of marketability discount, but a 10% block may be entitled to a 30% lack of marketability discount). Marketability concerns may impact the appropriate capitulation factor used in an EBITDA approach of determining the net value of the entity.

Another potential discount is a "lack of continuity" discount that would apply if the company is actually re-structured to comply with the safe harbor rule, which would give all owners a six month put right. Even if all owners do not have put rights, the valuation of the net value of the entity would seemingly take into consideration the amount of capital that would have to be set aside to satisfy the transferor's deemed six-month put right.

One appraisal firm takes the position that discounts adjustments can be appropriate even for 100% controlling interests:

> In appraising the control value of the company, will the IRS oppose the use of discount adjustments (often relatively minor) for lack of (100%) control and lack of marketability for the entire entity? Our firm believes that market evidence indicates that arm's length buyers and sellers take these risks into account in negotiating a price for the business interests, and therefore should be considered, even if the interest is a 100% controlling interest. Not every appraisal firm does. Curtis R. Kimball (Willamette Management Associates).

j. **Buy Sell Agreements**. Buy sell agreements that impose restrictions on transfers of interests in the entity that comply with the safe harbor rules under §2703 apparently are still be respected (even if those transfer restrictions are "applicable restrictions" or "disregarded restrictions"). Prop. Reg. §§25.2704-2(b)(4)(iii); 25.2704-3(b)(5)(4). The preamble to the proposed regulations gives this explanation: "Note that, although it may appear that sections 2703 and 2704(b) overlap, they do not. While section 2703 and the corresponding regulations currently address restrictions on the sale or use of individual interests in family-controlled entities, the proposed regulations would address restrictions on the liquidation or redemption of such interests."

In fact, significant overlap between §§2703 and 2704 seems to exist, but the issue has arisen infrequently despite a provision in the existing regulations that an "agreement that is subject to section 2703 is not an applicable restriction." Reg. §25.2704-2(b) (last sentence). The disregarded restrictions will be much more pervasive than applicable restrictions are under the existing regulations, so the §2703-2704 interaction will arise more frequently. For example, what if an agreement specifically provides that an owner will have no right to withdraw from the entity at the owner's election, and the agreement meets the safe harbor test of §2703(b) (after all, most commercial entities do not give put rights to owners to withdraw at any time – the point of making contributions to the investment or operating entity is to make long-term commitments for long-term growth opportunities)? Will that restriction avoid treatment as an applicable restriction or disregarded restriction? (To meet the §2703(b) safe harbor test, the taxpayer will have to demonstrate not only that the restriction was comparable to similar arrangements entered into by persons in an arms' length transaction, but also that the restriction is a bona fide business arrangement and is not a device to transfer property to members of the family for less than full consideration.)

k. **Marital and Charitable Deductions.** The preamble explains that if property must be valued taking into account the special valuation assumptions of §2704(b), "that same value generally will apply in computing the marital deduction attributable to that interest. The value of the estate tax marital deduction may be further affected, however, by other factors justifying a different value, such as the application of a control premium. See, e.g., Estate of Chenowith v. Commissioner, 88 T.C. 1577 (1987)." What does the reference to *Chenowith* mean? If the decedent's interest is divided between the surviving spouse and a credit shelter, and if the interest left to the spouse is a minority interest, does the reference to *Chenowith* mean that the minority interest passing to the spouse will be valued as a minority interest? If so, if the decedent's interest in the entity passes to multiple beneficiaries, including the spouse, the marital deduction amount may not equal the inclusion value.

The substantive proposed regulations are rather vague in reaching this result (provisions address transfers passing to multiple persons). Prop. Reg. §§25.2704-2(f), 25.2704-3(e). An example in the disregarded restrictions proposed regulations, in which a decedent leaves a 53 limited partners interest to the surviving spouse, states that "[t]he fair market value of the 53 percent interest is determined for both inclusion and deduction purposes … assuming that the disregarded restriction does not exist …." Prop. Reg. §2502704-3(g) Ex. 4(ii). *See also* Prop. Reg. §§25.2704-2(f), 25.2704-3(e).

Interests passing to charity will not be subject to §2704 because it only applies to transfers to family members. The same value generally will apply for inclusion and deduction purposes, although the deduction value may differ if interests pass to multiple nonfamily members. The preamble explains:

> Thus, if the sole nonfamily member receiving an interest is a charity, the interest generally will have the same value for both estate tax inclusion and deduction purposes. If the interest passing to nonfamily members, however, is divided between charities and other nonfamily members, additional considerations (not prescribed by section 2704) may apply, resulting in a different value for charitable deduction purposes. See, e.g., Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981).

l. **Planning Implications**.

(1) ***Planning Prior to Effective Date.*** Perhaps the most important aspect of the proposed regulations from a planning perspective is that they are not currently effective, but generally only apply after the regulations are finalized. The process of finalizing regulations (even of non-controversial regulations) typically is a multi-year process, but if the IRS treats this project as a high priority, the regulations could conceivably be finalized by the second quarter of 2017. (The original Chapter 14 regulations were finalized within 15 months of the date of enactment of the statute!). Planners have no certainty about how long the process will take (a hearing on the regulations is scheduled for December 1, 2016), but planners have time to address how the new rules will apply to prior transactions and implement new transactions before the new rules become effective. Even after the regulation is finalized, the important disregarded restrictions rules will not be effective for another thirty days (but the IRS's new position ignoring the default restrictions under state law would be applicable with respect to the applicable restriction provisions).

The exception to the effective date good news is that transfers before the effective date (even before the proposed regulations were issued) *may* be subject to the three-year rule (requiring lost liquidation value to be added back into the transferor's gross estate if the transferor dies after the regulations are finalized and within three years of the transfer. Transactions completed prior to when the regulations are finalized are inherently subject to the possible application three-year rule, and clients should understand the possibility of additional value being included in the gross estate that would not qualify for a marital or charitable deduction if the client were to die within three years of making the transfer. Planners should consider whether tax apportionment clauses should be adjusted to reflect that risk.

(2) ***Valuation Impact.*** As discussed in Item 5.i above, major uncertainties exist as to the approach that will be used in valuing interests in entities that are transferred that are subject to the new rules. Most obviously, lack of control discounts will be impacted significantly, because the transferor will be deemed to hold a six-month put right to receive a pro rata share of the "net value of the entity." Even so, reduced lack of control discounts may be appropriate for the lack of control over day-to-day operations and for the six-month delay in receiving the liquidation value.

Valuation issues are involved in two separate steps for disregarded restrictions: (i) in determining the "minimum value" exercise price of the deemed put right, and (ii) in valuing the holder's interest in the entity under generally accepted valuation principles (even with the assumed six-month put option at minimum value), Prop. Reg. §25.2704-3(f).

The new regulation may significantly impact lack of control discounts, but marketability discounts should still be appropriate for consideration at each of the two valuation steps (although the marketability discount may be less in valuing the interest under the second step in light of the fact the holder will have an assured market for the interest if the entity has sufficient cash or other property to fund the redemption)**.**

Completing transfers before the regulation is finalized may allow being able to take advantage of discounts that will not be available later. Indeed, the balance of 2016 may be a busy year for planners structuring gifts, sales, and other transfer planning transactions.

Appraisal expenses may be increased in light of the additional valuation steps that are required under the proposed regulations. Furthermore, one appraisal (with the two-step approach) will be needed for family interests, and a separate appraisal may be needed for non-family interests that are not subject to §2704:

> There will be many cases that will now require two valuations: one for intra-family ownership transactions and one for others not covered by new §2704. Heretofore most closely-held entities had a single buy-sell value that would apply to all minority interest parties, regardless of affiliation or attribution. Curtis R. Kimball (Willamette Management Associates) (his personal opinion).

(3) ***Undivided Interests.*** Section 2704 addresses transfers of interests in entities, not assets outside of entities (including undivided interests in real estate or art). However, if the undivided interests held by various owners are deemed to be a "business entity," the new rules could apply to transfers of those undivided interests. Rev. Proc. 2002-22 discusses the types of items that can be in a co-tenancy agreement without creating a partnership. Under Rev. Proc. 2002-22, "mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes." *See also* Reg. § 301.7701-1(a)(2) (describing joint undertakings that are characterized as entities for tax purposes; generally, carrying on a trade, business, financial operations, or other venture and dividing the profits therefrom); UNIF. PARTNERSHIP ACT §202(c). In addition, a restriction on partition will be ignored under Sec. 2703 (see *Elkins v. Commissioner*, 757 F.3d 453 (5th Cir. 2014), *aff'g in part, rev'g in part* 140 T.C. 86 (2013).

(4) ***Corporations***. The rules will apply to interests in corporations, as well as partnerships and LLCs. A transfer of a minority interest in a corporation may be subject to the disregarded restrictions rule, which may disallow much of the lack of control discount that ordinarily would be permitted under the existing regulation.

As discussed in Item 5.g above, most "unrelated" owners will not satisfy the unrelated owner test to determine if the family can remove "disregarded restrictions" (in particular, most owners will not have a six-month put right equal to the owner's pro rata share of the net value of the entity). Giving all owners six-month put rights would dramatically impact the economics of many business arrangements, leaving the business at constant risk of having its capital withdrawn through redemptions.

(5) ***Commercially Reasonable Exception*.** Because of the incredibly broad application of §2704 under the proposed regulations to all family-controlled entities, the commercially reasonable exception for entities with active businesses may become very important. If the business has legitimate needs for bank borrowing, and if the bank legitimately imposes covenants that include restrictions on redemptions of the owners' interests, §2704 may not apply and lack of control discounts may still be available.

(6) ***Arbitraged Transactions*.** Transactions may occur in which the value is not artificially inflated at one step but interests would be artificially inflated in value under §2704 at a later time. For example, existing trusts or entities that have been funded with discounted assets may later sell assets to the donor after the regulations become effective. The values of those assets may be determined under §2704 (at artificially inflated values) in order to avoid deemed indirect gifts by the trust beneficiaries or entity owners. Even assuming the step transaction doctrine does not apply, query whether the IRS may make a "duty of consistency" argument in these types of situations?(The trustee would have no fiduciary concern with being paid a higher amount under these artificial valuation rules than the interest is actually worth.)

Similarly, in kind payments (using the artificially high §2704 values) of annuity amounts after the effective date for GRATs that were funded before the effective date with discounted assets may result in a similar value-shift.

On the other hand, sales of interests in entities to grantor trusts may be more difficult after these regulations become effective. The trustee will have fiduciary concerns with paying a price that is artificially higher than the actual value of the transferred interest. Perhaps trust agreements in the future will authorize trustees to purchase assets from family members based on values as determined for gift tax purposes even if those values exceed the actual market value of the purchased interests. (The amount of the discount is a much smaller factor than the estate freezing and income tax "burn" aspect of sales to grantor trusts in the overall long-term transfer planning result.)

When family members make contributions to existing entities in return for an additional interest in the entity, will the artificially high value of the additional interest in the entity as determined under §2704 be used to determine the amount of the contribution to the entity?

(7) ***Active Trade or Business***. Planners have speculated about whether the new regulations would focus on entities holding passive investment assets rather than active trade or business entities. The regulations apply similarly to both, however. The only concessions for trade or business entities are (i) the ability of the entity or owners to use a note to pay the redemption proceeds on exercise of the six-month put right, and (ii) the availability of the "commercially reasonable restrictions" exception that applies only to trade or business operations. See Items 5.f and 5.h above.

(8) ***Tax Apportionment Clauses***. Tax apportionment clauses should be reviewed for clients owning interests in family-controlled entities. Apportioning estate taxes to the recipients of assets in the gross estate rather than merely apportioning all taxes to the residue will be more important under the new regulations. Interests in entities may be valued at increased (some would say artificially high) values and apportioning all taxes to the residue may carry even more risk of unfairness than in the past.

(9) ***GRATs and Defined Value Transactions***. Using GRATs (with the built-in defined value clause allowed by the GRAT regulations) and using defined value transfers will be even more advantageous in the future in light of the increased inherent valuation risks under the proposed regulations.

(10) ***Validity of Regulations.*** The regulatory authority for additional regulations under §2704 (in §2704(b)(4)) is very broad. Even so, some planners question whether the proposed regulations extend so far beyond the origin, legislative history, and purpose of Chapter 14 as to be an invalid regulation, even under the relaxed standard for testing the validity of regulations under the Supreme Court's announcements in the *Chevron* [467 U.S. 837 (1984)], *Mayo Foundation* [562 U.S. 44 (2011)], and *Home Concrete* [132 S. Ct. 1836 (2012)] cases.

The legislative history of Chapter 14 (the 1990 Conference Report) has rather explicit statements that it was not intended to "affect minority discounts or other discounts available under [former] law."

> The value of property transferred by gift or includable in the decedent's gross estate generally is its fair market value at the time of the gift or death. Fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031-1(b)). This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer. Accordingly, courts generally have refused to consider familiar relationships among co-owners in valuing property. For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.
>
> . . . .
>
> *The bill does not affect minority discounts or other discounts available under present law.*
>
> . . . .
>
> *. . . the bill does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally* in all items of income, deduction, loss and gain in the same

> proportion *(i.e.*, straight-up allocations)." (136 Cong. Rec. § 15679, 15681 (October 18, 1990) (emphasis added)).

Perhaps the existence of this legislative history is the reason that the IRS beginning in 2009 sought legislative changes to §2704 before issuing its new proposed regulations.

Richard Dees (Chicago, Illinois) wrote a 29-page letter to the Assistant Secretary of Tax Policy in the Treasury Department and to the Commissioner of the Internal Revenue Service on August 31, 2015, in which he maintains that if the regulation implements the provisions in the statutory proposal, the regulation "would be invalid as contrary to the origin, purpose and scope of the current statute." The letter provides a detailed summary of the statutory provisions in §2704, the legislative history behind §2704, and case law interpreting §2704 to support his position. Some of his reasoning is that the origin and intent of §2704 was "only to disregard liquidation provisions and other provisions of the organizational documents that lowered the value of interests in a family business for transfer tax purposes below what would occur under state law if those provisions were not in the documents." He argues that §2704(b) only empowers the IRS to *disregard* certain restrictions in family entity organizational documents, but not to replace those disregarded provisions with IRS-invented alternatives "that would make the valuation of minority interests in a family business the same as if family attribution applied;" instead the balance of the provisions in the documents that are not disregarded and provisions supplied by the operation of state law would be considered in valuing the transferred interest.

The potential invalidity of the regulations has no practical impact on planning. Many planners believe the validity of the regulations will be upheld. Even those planners who question the validity of the regulations would be unwilling to advise clients to make transfers assuming that the regulations do not apply.

(11) ***Comparison to Legislative Proposal***. The proposed regulations implement all of the legislative proposals included in Greenbooks for the Obama Administration, beginning with the 2010 Fiscal Year ending with the 2013 Fiscal Year Greenbook. The Obama Administration proposal included included five major items, all of which are addressed in the proposed regulations.

(i) *Additional "Disregarded Restrictions*." The IRS would be authorized to provide by regulations an additional category of restrictions ("disregarded restrictions," which are in addition to the liquidation restrictions addressed in §2704) that would be disregarded in determining the value of interests in "family-controlled entities" that are transferred to family members. Transferred interests would be valued by substituting for "disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard to be identified in regulations."

(ii) *Assignee Interests*. Restrictions on a transferee being able to become a full-fledged partner (or member of an LLC) would be a disregarded restriction.

(iii) *Third Party Involvement in Removing Restrictions*. Section 2704(b)(2)(B)(ii) says that one of the general requirements of an "applicable restriction" is that the transferor or family members can remove the restriction. (The Greenbook proposal generally retained this family-removal requirement with respect to "disregarded restrictions.") Under the legislative proposal, in response to the Fifth Circuit's holding in *Kerr,* "certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family."

(iv) *Safe Harbor*. The statute would provide regulation authority that would include "the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met."

(v) *Marital and Charitable Deduction*. The legislation would include provisions dealing with the interaction of the marital and charitable deductions for transfer tax purposes. Therefore, if an interest is valued higher than its actual fair market value for transfer tax purposes, the higher value might also be applied for marital deduction and charitable deduction purposes (a taxpayer-friendly provision).

To view the legislative proposal that was included in the President's budget proposals for fiscal years 2010-2013, click **here**.

(12) ***Implications for Basis Adjustment Purposes Under §1014.*** The timing of the IRS's emphasis regarding §2704 is curious. In an environment in which very few decedents pay transfer taxes, presumably many taxpayers will might benefit from not being required to discount interests in family entities, to permit larger basis adjustments under §1014 following an owner's death.

Some planners have granted put rights to clients who own interests in entities but do not have estate tax concerns in order to minimize discounts for basis adjustment purposes. That approach raises the inherent risk that some family members may actually exercise the put right; under the proposed regulations, discounts may be avoided even without granting actual put rights that can be exercised.

A caveat: Section 2704 applies only "for purposes of this subtitle" [i.e. Subtitle B-Estate and Gift Taxes], and the basis consistency provisions in §1014(f) state that the fair market value (for purposes of the basis adjustment under §1014(a)) "shall not exceed" the finally determined estate tax value. The IRS might argue that the fair market value that applies for basis purposes is not augmented as a result of ignoring certain liquidation restrictions under §2704.

6. Overview of Estate Planning Practice Trends in the Current Environment

a. **Stability of Estate Transfer Tax Laws**. The American Taxpayer Relief Act of 2012 ("ATRA") provides for permanent provisions in the transfer tax area, without any further phase-ins. That stability dnnid not exist from 2001-2012.

b. **Small Percentage of Population Subject to Transfer Taxes**. Estimates are that with a $5 million indexed gift and estate exemption ($5.45 million in 2016) only 0.14% of Americans who die each year will owe any federal estate tax (or about 2 out of every 1,000 people who die). The $5 million indexed gift exemption also means that many individuals have no concern with lifetime gifts ever resulting in the payment of federal gift taxes.

c. **Cannot Ignore GST Tax**. Even low to moderate-wealth individuals cannot ignore the GST tax. Without proper allocation of the GST exemption (also $5 million indexed), trusts created by clients generally will be subject to the GST tax at the death of the beneficiary. (Sometimes that will occur by automatic allocation, but the planner must be sure that proper GST exemption allocation is made to long-term trusts even though the purpose of the trusts is not to save transfer taxes.)

d. **Fear of Estate Tax Uncertainty Is No Longer Driving Clients to Estate Planners**. Prior to 2012, Congressional action (or inaction) was driving clients to estate planning practices to make changes to estate plans. That is no longer happening. Estate planning practitioners will need to be more proactive in communicating with clients the importance of estate planning matters.

e. **Increased Relative Importance of Income Tax Issues**. At a time when the estate and gift tax for many Americans is zero, income tax planning is more significant than transfer tax planning. Even for couples with about $11 million of assets, little or no federal estate taxes may be due at the surviving spouse's death. Achieving basis step-up at each of the spouse's deaths may be very important. The ordinary income tax rate (39.6%) is about the same as the federal estate tax rate (40%). Even the capital gains rate (23.8% including the 3.8% tax on net investment income), when combined with state income taxes, may approach the federal estate tax rate.

f. **Routinely Using Traditional Credit Shelter Trust/Marital Deduction Planning is Out Other Than For Very Wealthy Clients**. The days of automatically using traditional credit shelter trust/marital deduction planning for all clients with assets more than one exemption amount are gone. Some planners believe that planning for the $10 million (now almost $11 million) estate is *more* difficult than planning for the $100 million estate, because of the balancing required between various alternatives, depending on future events, for the $10 million estate. Situations in which credit shelter trust planning is appropriate for the $10 million and under estates arise, but only with careful consideration of a wide variety of factors.

g. **Portability Approach Has Become More Predominant**. Unless strong reasons exist to use credit shelter trusts in $10 million and under estates, an approach of using portability to take advantage of the first spouse's estate exemption will become more predominant. The surviving spouse has both spouses' exemptions to cover estate taxes, but a basis step-up is achieved at both spouses' deaths. Some of the factors for favoring the creation of a credit shelter trust at the first spouse's death include if there is (i) a likelihood or significant possibility of substantial appreciation of estate assets after the first spouse's death, (ii) a state estate tax, (iii) a blended family situation, (iv) a younger client scenario (in which remarriage of the surviving spouse is likely), (v) a situation in which the couple wants to use trusts after the first spouse's death and wants to have both the surviving spouse and descendants as discretionary beneficiaries of the trust.

h. **Planning Is More Difficult for Planners**. Many attorneys report that discussing the portability alternatives with clients and the various factors impacting the decision often takes 20-30 minutes or more, and the planner must document the discussion, including the factors that were considered and the reason that the client made the decision that was made. Twenty years later, facts may occur that mean that an alternative course of action would have been preferable, and the planner needs to be able to document that the client made an informed, reasoned decision.

i. **Transfer Planning Still Important for Wealthy Families.** Transfer planning is still important for clients who will be subject to estate taxes (individuals with assets over about $5.5 million and couples with assets over about $11 million). An initial step is to focus on strategies that use no gift exemption or that leverage the use of gift exemption (therefore, leaving the client with estate exemption so that the client can own low basis assets at death, covered by the exemption, to achieve a basis step-up for those assets). Low-interest loans, GRATs, leveraged GRATs, and sales to grantor trusts are all strategies that may accomplish those goals. (A description of the leveraged GRAT strategy is discussed in Item 11.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.) GST planning is very important; with appropriate planning a large portion of even very large estates can be left in a GST exempt manner. See Item 5.j of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor** for a rather dramatic illustration of the huge GST tax savings that can result from traditional transfer planning strategies.

   Discounts for interests in partnerships and LLCs may at some point be diminished. The rumored §2704 regulations are making their way up the bureaucratic approval process. *Transfer planning with these interests might be accelerated*; the issuance of those proposed regulations may still take years, but it could happen sometime this year.

   SLATs. The favored approach of some attorneys is the "spousal lifetime access trust," or SLAT. Some attorneys are increasingly using "non-reciprocal SLATs," with each spouse creating a trust for the other spouse (at different times, with differing terms, and with differing amounts). Assets are available for the settlor-client's spouse (and possibly even for the settlor-client following the other spouse's death) in a manner that is excluded from the estate for federal and state estate tax purposes. The trust also provides protection against creditors, elder financial abuse, and identity theft. Over time, the trust can accumulate to significant values (because it is a grantor trust, the client will pay income taxes on the trust income out of other assets and can provide a source of funding for retirement years). For a detailed discussion of SLATs and "non-reciprocal" SLATs, see Items 16-17 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor**.

j. **Be Very Careful Before Making Lifetime Gifts of Low Basis Assets**. 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. For example, a gift of a $1 million asset with a zero basis would have to appreciate to approximately $2,470,000 (to a value that is 247% of the current value) in order for the estate tax savings on the future appreciation ($1,469,135 x 40%) to start to offset the loss of basis step-up ($2,469,135 x 23.8% for high bracket taxpayers). The required appreciation will be even more if state income taxes also apply on the capital gains.

k. **Grantor Trust Planning Still Advantageous**. Grantor trust planning continues to be very desirable for clients with large estates who are interested in transfer planning strategies to reduce estate taxes. Even for more modest estates, grantor trusts afford substantial flexibility. Advantages of using grantor trusts include:

(i) the grantor pays the income taxes on the trust income so the trust can grow faster and the tax payments further reduce the grantor's taxable estate (studies have shown that this is the most important factor in the long-term effectiveness of transfer planning strategies—even more important than discount or freeze planning aspects of transfer planning strategies);

(ii) the grantor can sell additional assets to the trust in return for a low-interest note without gain recognition on the sale (and all of the appreciation can be in a GST exempt trust if GST exemption is allocated to the initial gift to the trust); and

(iii) the grantor has the flexibility to purchase back trust assets, in case the grantor prefers having assets that were transferred to the trust or if the grantor wants to reacquire low basis assets so they will receive a basis step-up at the grantor's death (the purchase should be made with cash or high basis assets because the income tax effects of purchasing low basis assets in return for a note are not certain).

Examples of the flexibilities of grantor trusts are that the grantor can keep the ability to end the grantor trust status when desired and distributions can be made to the grantor's spouse to pay the income taxes if desired (assuming the spouse is a discretionary beneficiary).

Analytical studies of the financial impact of various strategies demonstrate that sales to grantor trusts can be incredibly efficient in accomplishing wealth transfer, particularly accomplishing wealth transfer in a way that is largely GST exempt. In several recent cases, the IRS has taken that position that §2036 applies to sales to grantor trust transactions. Planners should take careful steps to create the best defense around a §2036 argument. (See Items 8.f and 11.d below.)

A substitution power under §675(4)(c) is the most popular grantor trust trigger, While substitution powers do not create estate inclusion risks (Rev. Ruls. 2008-22 and 2011-28), consider whether a creditor of a power holder might be able to step into the shoes of the power holder and exercise the substitution power to acquire a favored asset? To minimize that risk for a power holder with potential creditor issues, consider adding a requirement that some non-adverse, non-fiduciary party must consent to the exercise of the substitution power. *See* Edwin Morrow, *Ed Morrow and the Dark Side to Swap Powers in Irrevocable Grantor Trusts*, LEIMBERG ASSET PROTECTION PLANNING EMAIL NEWSLETTER #313 (Feb. 3, 2016).

l. **Undoing Prior Planning Strategies, Rejuvenating or "Fixing" Stale or Broken Trusts**. A number of clients will want to engage in planning to "undo" the effects of prior planning transactions if the client will not face estate taxes with the larger exemptions and does not want to lose the basis step-up at each spouse's death (or at a beneficiary's death). This includes avoiding the funding of bypass trusts under the wills of clients who die without updating their wills, causing previously transferred low-basis assets to be included back in the donor's gross estate, undoing prior discount planning or life insurance trusts that are no longer needed, turning off grantor trust status, and causing inclusion of assets in a beneficiary's (or other third party's) estate.

Irrevocable trusts that were created previously may have become "stale" for various reasons. Various strategies can be used either to "fix" the outdated trust or to dwindle the stale trust and build a new trust over time. See Item 16.

Avoiding Funding Bypass Trust. Countless situations will arise in which a spouse dies with a traditional formula bequest in a will that has not been reviewed in years that creates a bypass trust when the couple has no federal estate tax concerns at the surviving spouse's subsequent death. Creating the bypass trust will create administrative complexity that the surviving spouse wants to avoid and, perhaps more importantly, will eliminate any basis step-up for trust assets at the surviving spouse's death (because he or she would not own the trust assets). Strategies include (i) reading the will closely to see if provisions apply that could justify not funding or immediately terminating the trust (such as a small trust termination provision, etc.), (ii) using a court reformation or modification to authorize not funding the trust, (iii) negotiating a family settlement agreement to avoid funding the trust, or (iv) decanting to a trust with broader provisions that would authorize terminating the trust.

Significant transfer tax issues may arise—the children may be deemed to have made a gift to the surviving spouse if they consent to disbanding the credit shelter trust. That gift may be very difficult to value, especially if the surviving spouse has a lifetime or testamentary limited power of appointment. Furthermore, the assets passing to the spouse at the first spouse's death will not qualify for the marital deduction unless a legitimate dispute exists (because they do not pass from the decedent but rather pass pursuant to the settlement agreement, *see Ahmanson Foundation v. U.S.,* 674 F.2d 761 (9th Cir. 1981)), so the decedent's full exemption will not be available for portability. Also, the first spouse's GST exemption would not be utilized if the assets do not pass to a QTIP trust (for which the "reverse QTIP election" could be made).

If the bypass trust has not been funded, theories may still apply under which the trust would be recognized. *See Estate of Olsen v. Commissioner,* T.C. Memo. 2014-58 (court determined amount that should have been in bypass trust and excluded that amount from surviving spouse's gross estate); *see generally* Mickey Davis, *Funding Unfunded Testamentary Trusts*, 48TH ANNUAL HECKERLING INST. ON EST. PLANNING ch. 8 (2014). See Item 27 of the Heckerling Musings 2014 and Other Current Developments Summary (February 2014) found **here** and available at **www.Bessemer.com/Advisor**.

m. **Basis Adjustment Planning**. Planning to leave open the flexibility to cause trust assets to be included in the gross estate of a settlor or trust beneficiary if the settlor or beneficiary has excess estate exemption, to permit a basis adjustment at the settlor's/beneficiary's death without generating any added estate tax, is increasingly important.

Settlor. A very flexible alternative to cause estate inclusion for the trust settlor would be to give an independent party the authority to grant a power to the settlor that would cause estate inclusion, such as a testamentary limited power of appointment, which would cause estate inclusion under §§2036(a)(2) and 2038 and result in a basis adjustment under §1014(b)(9).

Beneficiary. Possible strategies include planning for the flexibility to make distributions to the beneficiary (either pursuant to a wide discretionary distribution standard or under the exercise of a non-fiduciary limited power of appointment), to have someone grant of general power of appointment to the beneficiary, to use of a formula general power of appointment, or to trigger the Delaware tax trap (by the exercise of a limited power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment).

See Item 14 for a more detailed discussion of these strategies. Perhaps this type of planning is given a boost by the statement in President Obama's 2015 tax proposal that the "trust loophole" under §1014 is "perhaps the largest single loophole in the entire individual income tax code."

n. **Trust Planning**. Planning to use trusts will continue to be important, if for no other reason, for the non-tax advantages of trusts (including planning for long-term management and creditor protection or "divorce" protection for beneficiaries). However, these advantages must be balanced against the greater administrative and income tax costs for trusts. Trust structuring should incorporate planning for flexibility provisions to react to future conditions. See Item 6 below. Powers of appointment are becoming increasingly popular for various reasons in facilitating future flexibility.

o. **Estate and Trust Distribution Planning.** Estates and trust reach the maximum income tax bracket at only $12,400 in 2016; if distributions are made that "carry out" income to the beneficiaries instead, they may be in much lower brackets. This planning is particularly important for capital gains; trusts with income taxable income over $12,400 in 2016 are taxed on capital gains at 23.8% (not counting any state income taxes). Individuals may have a 15% or even lower rate on capital gains. Increasing attention is devoted to causing capital gains to be in distributable net income (DNI) so that distributions can result in capital gains being subject to the15% or even lower rates. See Item 23.b below.

Trusts with business income will focus on whether they can satisfy the material participation requirements so that the resulting non-passive business income is not subject to the 3.8% tax on net investment income. See Item 24 below.

p. **State Estate Taxes**. Clients in states with state estate taxes will continue to need tax planning to minimize state estate taxes, which can be very significant. About one-third of the states and the District of Columbia have state estate taxes. New York's experience may be followed in other states (relaxation of the state exemptions but estate inclusion for gifts within three years of death).

q. **Emerging Trends for Estate Planning Practices**.

- The bulk of the population has no transfer tax concerns (although many "high-end" practices will continue to have clients with significant estate tax concerns). From a tax perspective, income tax issues are becoming relatively more important than in the past.
- Planning for flexibility, in light of the many rapid changes in society, is essential. See Item 6 below.

- Polls of baby boomers reflect the following as their top issues: (1) cash flow to provide support past retirement (which could be 30 years post-retirement); (2) Alzheimer's disease and dementia; (3) minimizing discord among beneficiaries and preventing beneficiaries from mismanaging bequests; and (4) asset protection planning. Observe that tax planning is not in the top four.
- The focus throughout many planners' entire careers has been on transferring wealth. Planners are having to rethink that focus, as a (if not THE) key concern for many clients is preserving sufficient wealth to provide support during retirement years.
- Aging society – practices are increasingly involving what has traditionally been viewed as "elder law" issues. Providing services for an aging client base is an emerging trend.
- Single adult clients. Fifty percent of households are headed by unmarried individuals.
- Administration practice. Many estate planning practices traditionally have not had a great deal of administration work. Even within just the last several years, some attorneys report that they are beginning to see a significant increased amount of administration work from the intergenerational wealth shift that has occurred. This trend will likely continue in light of the estimated $41 trillion of wealth transfer expected by 2050. This includes filing more estate tax returns and more administration work. The shifting balance toward administration work in some practices has been striking.
- Transform to counselors. Estate planners need to evolve into the role of being estate counselors, addressing real needs of clients beyond traditional estate planning documents. As an illustration of that process, planners should be having annual review meetings with clients regarding estate planning issues, family changes, financial planning issues, etc.
- Engagement letters. Marty Shenkman suggests that engagement letters should emphasize the importance of a coordinated complete financial planning team. The estate planning attorney's engagement letter should authorize the attorney to discuss estate planning matters with the CPA, insurance consultant, trust officers, and other team members. He prepares letters to the other team members, to be signed by the client, authorizing them to communicate with the attorney.
- Practice Challenge—Simplicity. Rob Romanoff observes: "I long for the days when we had documents that were simple. The challenge now is in drafting a document that addresses all of the opportunities available to our clients to provide flexibility and doing that in a way that is simple to draft and manageable in terms of cost for our clients. Life gets more complicated with the increasing ways of adding flexibility that we can incorporate into trust documents."

r. **Future Trends for Estate Planning Practices**.

- Avvo has announced it will offer fixed fee legal services throughout the United States from attorneys in the same geographical area as the client.

- Artificial intelligence will have a huge impact in the future. For example, the YouTube clip "How Watson Works" is rather shocking as to how IBM's Watson has similar thought processes as humans. The documentary "Humans Need Not Apply" (also released on YouTube) has been described as "compelling," "terrifying," and "sobering" in describing how many human jobs will disappear over the coming years, because automation will do them "faster, better, and cheaper." Professional estate planning practices are not immune from these developments.
- Efficiency in estate planning practices is becoming more and more important. Delivering documents on time is vital. If a planner is efficient, he or she will have more time to counsel with clients to let them know that the planner cares about them.
- Computers can never replicate personal relationships that advisors develop with clients. Having strong relationships with clients has always been critical, but will be more critical as "better, faster, cheaper" alternatives become available through technology.
- In polls of estate planning attorneys, 43% have indicated that they have not changed any of their offerings following ATRA (with its $5 million indexed exemptions). Changes will become necessary for most practices.

7. Advising Clients in Changing Times; Planning For Flexibility

a. **Developments Resulting in Increased Uncertainty, Turmoil, and Change**. Increasing uncertainty and the need for flexibility in estate planning arises for a wide variety of reasons including: political turmoil, social change (with rapidly changing views on marriage and the family), safety concerns, conflicts of laws rules (particularly in international dealings, conflicts of laws rules are changing), privacy concerns (with the Internet and unstoppable cyber breaches, secrecy is pretty much dead), a worldwide recession in which every asset category is down (that did not happen even in the Great Depression), increasing private client litigation, adult adoption trends, posthumous conception, the burgeoning importance of digital assets to all clients, an increasingly aging population with financial concerns and increasing incidence of dementia or other capacity issues, among many others.

b. **Overview of Approach to Planning in a Time of Turmoil and Change**.

- Plan for change.
- Plan for controversy.
- Use customized solutions and a variety of vehicles/approaches; one size does not fit all. The plan is a process, not a product. This may cost more but in the long run may be cheaper by avoiding controversy.
- When possible, keep it flexible. Formulas may be helpful. Encourage giving someone the ability to make changes as needed.
- When possible, keep it simple. Realize that these two goals may be at odds, incorporating flexibility may involve some complexity, but sophisticated plans can still be designed to be as simple as possible. Dial back; do not put every bell and whistle in every structure.
- Where possible, be transparent – avoid surprise. Most controversies arise from dashed expectations, but most people are afraid to confront difficult family

situations. When the family members finally find out what mom did and believes they were not treated fairly, because mom never said anything they assume that whoever got treated better unfairly influenced mom.

- Stay inside the lines.
- Do not use structures for purposes that were not intended.
- Many options for building flexibility are available, including whether or not the trust is a grantor trust, directed trust, using co-trustees with divided responsibilities, trust protectors, powers of appointment, etc.

c. **Family Changes**. The typical family is no longer the "traditional" family. Forty percent of children in the United States are now born to unmarried parents. That may be somewhat less in the pool of wealthy clients, but planners are seeing many more situations involving unmarried parents of children. Fifty percent of households are headed by an unmarried individual. Although clients are still marrying, they are marrying later and more often. In any given year, 40% of marriages are not first marriages for both individuals in the marriage. All of this means that planning for the single individual is becoming a very important part of estate planning practices.

d. **"Will My Money Run Out?"** Perhaps the biggest pressure facing the bulk of the population is the financial uncertainty of knowing whether the person will have sufficient assets for support during retirement years. Planning for financial security may be the most important aspect of estate plans for many clients.

e. **Trustee Appointments**. Planners often see changes in a family situation appearing first in trustee designation matters (as father becomes disabled, etc.) The provisions for appointment of the initial and successor trustees are the most important provisions in the entire document. See Item 4.l of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor** for highlights from a recent article about this same topic. Charles A. Redd, *The Most Disrespected Decision in Estate Planning,* TRUSTS AND ESTATES 13-14 (July 2014).

Successor Trustees. A fixed list of original and successor trustees does not work well; the settlor invariably will want to change that list at some point in the future. Alternatively, provide a list of persons who can appoint trustees, and perhaps the flexibility to add to that list of appointers. The appointers should also have the authority to specify the conditions and terms for who can be appointed as successor trustee (for example, to specify that spouses of children would not be permissible trustees).

Trustee Removal. The trustee appointers may also be given the authority to remove trustees. If a list of removers is used, it typically includes the grantor, the grantor's spouse, and then descendants if above a certain age. (Under Revenue Ruling 95–58, the grantor can have a trustee removal power as long as the trustee must be replaced by someone who is not related or subordinate to the grantor.)

Beneficiaries as Trustees. A client may want to leave the flexibility for a beneficiary to serve as trustee based on future circumstances. If a beneficiary is a co-trustee, the trust must have an ascertainable standard for distributions in which the beneficiary co-trustee participates. An independent trustee could also have a broader discretionary standard for making distributions to the beneficiary. A beneficiary-trustee who can make distributions to himself only for health, education, support and maintenance could be authorized to add an unrelated co-trustee who would have broad authority to make distributions to the beneficiary.

Adding Co-Trustees. The instrument can provide a procedure for adding co-trustees (by a settlor, beneficiary, trustee, trust protector, or others). The settlor can have the power to add co-trustees as long as the settlor cannot appoint himself or herself. *Durst v. U.S.*, 559 F.2d 910 (3d Cir. 1977) (corporate trustee had a power to control disposition, and grantor reserved right to name an individual trustee as co-trustee; court concluded that grantor could not name himself, no estate inclusion applied).

Administrative Trustees. Being able to add an administrative trustee, if circumstances require, can be helpful. The instrument can authorize the appointment of a co-trustee for certain functions, including as an administrative co-trustee who would have the responsibility of maintaining records of the trust. An administrative trustee in a particular state may be appointed to facilitate obtaining sufficient nexus with a state to apply that state's governing law.

f. **Directed and Divided Trusteeships**. Directed trusteeships are now becoming more commonplace to deal with specialized assets and special circumstances. But keep in mind that they are not a device to provide shelter against misfeasance (the wrongful exercise of lawful authority). The directed trustee is responsible for understanding the scope of the authority of the directing party and to act in compliance with directions given within the scope of that authority.

Developed law exists in Delaware regarding directed trusteeships. State statutes are becoming more complete and thoughtful regarding directed trusteeships, such as in Missouri (see §808 of its Uniform Trust Code) and Alaska, among others. *See* RESTATEMENT (THIRD) OF TRUSTS §75; UNIF. TRUST CODE §808. The Uniform Law Commission has a project to develop a Uniform Divided Trusteeship Act, expected to be completed in the summer of 2017. Be careful with the jurisdiction being selected if a directed trust relationship will exist.

g. **Trust Protectors**. A trust protector may be given the authority to take "settlor-type" actions that the settlor cannot retain directly for tax reasons. For example, a trust protector could have the authority to amend the trust to make administrative changes (which could include such things as providing a broker with specific authorization language to implement a certain transaction, to correct scriveners' errors, to make adjustments for tax law changes, or to change the name of the trust). Be wary of authorizing broader trust amendments, for fear the settlor would constantly want to amend the irrevocable trust every time the settlor amends his or her revocable trust or will.

A problem with appointing a trust protector is deciding who should serve in that role. The trustee is the most "trusted" person from the settlor's point of view. Who can override that? The settlor needs "an even smarter and even more trusted person" to override the trust with the trust protector powers.

For very long term trusts, having a procedure for appointing successor trustee protectors is very important.

h. **Powers of Appointment**. Powers of appointment are one of the most powerful tools for providing flexibility in trusts. The trust might give an individual (usually a family member) a non-fiduciary power of appointment to redirect who will receive assets, to change the division of assets among beneficiaries, to change the trust terms, etc. Many years later the settlor's children may be in a better position than the settlor to decide how the assets should be used for their respective children. "A fool on the spot is worth a genius two generations ago." Also, the power of appointment is a "power of disappointment," giving the power holder a "stick" over other disgruntled beneficiaries.

Powers of appointment are one of the best ways of being able to react to a variety of changes, include changes in tax laws (such as estate, gift and GST tax changes), creditor rights, family changes, etc. If concern is present about the possibility of appointing assets away from favored beneficiaries, circumscribe the class of possible appointees, but do not eliminate the power of appointment totally. It is needed to provide flexibility to adjust to future changes.

The power of appointment should specify the manner in which it may be exercised (for example, in further trust, with the ability to grant further powers of appointment, etc.). It should also specify the mechanics of exercising the power (such as whether the last exercise controls and whether an exercise is revocable until it becomes effective).

i. **Divorce**. The trust may provide that in the event of a divorce from a family member of the settlor, the divorced person and his or family members will be removed as beneficiaries, trustees, and power holders. (This may be important to avoid being stuck with grantor trust status inadvertently. Under §672(e), a grantor is deemed to hold any power or interest held by someone who was a spouse of the grantor at the time the trust was created. It is bad enough that the divorced spouse remains as a trust beneficiary; the grantor may also be struck with paying all income taxes on the trust's income.)

The divorce clause may cover details as to when it applies such as whether it is triggered by being legally separated or upon the filing of a divorce petition.

In structuring distribution standards, fiduciary appointments, and powers of appointment, give consideration to how those provisions might impact whether the trust assets are considered as "marital assets" of a beneficiary in the event of the beneficiary's divorce. The *Pfannenstiehl* divorce litigation in Massachusetts is illustrative of the issues that can arise.

The trial court considered the husband's interest in a discretionary spendthrift trust created by his father in 2004 as a marital asset, and ordered the husband to pay about $1.4 million from the trust to his wife. The trust provided for distributions to husband and the father's other descendants for their "comfortable support, health, maintenance, welfare and education." The husband had received substantial distributions in 2008-2010 prior to the divorce action (distributions continued to his siblings but not to husband during the divorce proceedings). The judge viewed the husband's interest in the trust as a "vested interest" and as marital property in determining equitable distribution in divorce. The trust spendthrift clause did not protect the beneficiary's trust interest in the divorce action; the court concluded that "settled trust law … holds that the mere statement of a spendthrift provision in a trust does not render distributions from a trust, such as this one, immune to inclusion in the marital estate" *Pfannenstiehl v. Pfannenstiehl*, Mass. App. Slip Op. 13-P-906 (August 27, 2015). See Item 26.p below for further discussion of the trial court decision.

When the trustee refused to distribute the $1.4 million amount to the husband and the husband could not and did not pay that amount to the wife, the trial court held the husband in contempt and put him in jail. An appellate court set aside the judgment of contempt, commenting that the husband had "at least ostensibly tried" to obtain funds from the trust and that he had not "willfully and intentionally violated a clear and unequivocal order. 88 Mass. App. Ct. 121, 135 (2015).

The Massachusetts Supreme Judicial Court recently reversed the trial court's prior finding that the trust interest was part of the marital estate. The court reasoned that whether a trust is included in a divisible marital estate depends on whether the interest is a "fixed and enforceable" property right, or "whether the party's interest is too remote or speculative" to be included. That determination turns "on the attributes" of the specific trust at issue and an evaluation of the facts and circumstances of each case. The court concluded that the husband's discretionary trust income and remainder interest was not part of the marital estate, taking into account various facts including: the trustee could distribute assets to the husband and 10 other beneficiaries in the trustees' "sole discretion" as they "may deem advisable from time to time" under an ascertainable standard; the trust had an open class of beneficiaries, unequal distributions could be made among the beneficiaries, trust distributions were not equal from year to year and from beneficiary to beneficiary. The court distinguished another case (*Comins v. Comins,* 33 Mass. A.. Ct. 28 (1992)) in which a spouse was the sole beneficiary of the trust and held a testamentary power of appointment over the trust:

> Unlike the spouse in Comins, however, Curt is one of eleven living beneficiaries among an open class of beneficiaries. The trustees of the 2004 trust are required to take into account the trust's long-term needs and assets, unpredictability in the stocks that funded it (which the judge found at times in the past have provided no income or have incurred a loss), the changing needs of the eleven current beneficiaries, and the possibility of additional beneficiaries. Curt's present right to distributions from the 2004 trust is speculative, because the terms of the trust permit unequal distributions among an open class that already includes numerous beneficiaries, and because his right to receive anything is subject to the condition precedent of the trustee having first exercised his discretion" in determining the needs of an unknown number of beneficiaries [citation omitted].
>
> …
>
> Considering the language of the 2004 trust, and the particular circumstances here, the ascertainable standard does not render Kurt's future acquisition of assets from the trust sufficiently certain that they may be included in the marital estate….

The court did leave several issues open. First, the "trust may be considered an expectancy of the future 'acquisition of capital assets and income' in determining how to divide the assets that are subject to division. Second, the trial court originally did not "use any future stream of [trust] income from distributions in assessing alimony" because the husband's interest in the trust was included in the division of property. Because the court determined that the trust interests "should not have been included in the divisible marital estate, it may be appropriate on remand for the judge and the parties to revisit whether alimony is now appropriate, and, if so, in one amount, on the basis of the factors the judge may deem relevant" pursuant to statutory authority.

For further planning issues about the effect of trust structuring on the protection of a beneficiary's discretionary interest in a trust for divorce purposes, see Item 4.k of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

j. **Defining Spouse.** Trust instruments may make clear who is included as a "spouse" for purposes of the instruments, including same-sex marriages, domestic partnerships, or civil unions.

k. **Defining Children and Descendants**. Specify whether children and descendants include the settlor's children and descendants or only include children and descendants of the settlor *and the settlor's spouse*.

   Instruments should address whether adult adoptions are recognized for purposes of the agreement. Some states are changing their laws as to the effects of adult adoptions. Documents can also address whether descendants by artificial reproduction technology should be included.

l. **Incapacity of Fiduciary.** Specific procedures should be included to determine the incapacity of a fiduciary, short of having to a court declaration of incapacity (which would be very difficult for the family). For example, an incapacitated person might be someone who is a minor or under a legal disability, incarcerated, absent with unknown whereabouts for 90 days, or who does not produce a letter from a physician within 90 days of a request that the person is able to manage business affairs.

m. **Merger or Decanting Authority**. The trust may authorize the trustee to merge the trust assets with a trust for the same beneficiaries having substantially similar terms (not permitting merger with a trust that has a longer applicable perpetuities period). Alternatively the trust may have an even broader provision allowing the trustee to distribute assets, in accordance with the distribution standards, to a trust for a beneficiary (*i.e.*, a decanting provision). Even if the state does not have a decanting statute, the trust can spell out the terms of permitted decanting transactions. Such a provision should incorporate safeguards that are included in some of the state statutes; for example, that the decanting cannot be exercised in a way that would disqualify the trust for the marital or charitable deduction, that a decanting power may not be exercised by a beneficiary in a manner that would cause inclusion of the trust assets in the beneficiary's gross estate, and that a decanting power may not be exercised in a manner that causes the trust not to qualify for a "tax benefit" available to the trust. In addition, do not permit accelerating a remainder interest because that may be deemed to constitute a power to add beneficiaries that would inadvertently cause the trust to be a grantor trust. Mergers are discussed in Item 16.n.2 below. Decanting is discussed further in Items 16.n.3 and 20 below.

n. **Conflicts Waiver**. The trust instrument may specifically authorize a trustee to enter into transactions with itself or an affiliate. For example, it may allow the trustee to invest in its own mutual funds or other proprietary investments that will provide additional investment flexibility for the trust. As another example, this would permit an individual trustee who is with an accounting or investment firm to use the services of those firms. (That is probably why the settlor selected that person as a trustee.)

8. IRS's Radar Screen

John Porter (tax litigator in Houston, Texas) and Marty Basson (previously an IRS estate and gift tax manager) discussed trends of issues that taxpayers are seeing in IRS examinations and in court proceedings.

a. **Summary of Hot Issues on the IRS Radar Screen**. Hot issues on the IRS radar screen include the following: installment sales, §2036, valuation, formula clauses, valuation of promissory notes, GRATs, art valuations, adequate disclosure of older transactions, donee liability, Graegin loans, S corporation valuation (including "tax affecting"), BDITs, and penalties (having qualified appraisals is the best way to avoid penalties over valuation issues). Some of these issues are discussed in more detail below.

b. **Return Selection Process**. All estate and gift tax returns are initially screened and reviewed at the Cincinnati service center. Returns can be sent anywhere in the United States depending on local workloads. A second review is done by the local estate tax manager (but the local manager has less autonomy than in prior years).

   About 200 attorneys are in the IRS estate and gift tax area.

c. **IRS Valuation Engineers**. The IRS has upgraded its Engineering and Valuation Division. The engineers are now all credentialed appraisers. The IRS engineers still have less credibility in the Tax Court than outside appraisers. For large cases, the IRS sometimes refers cases to outside appraisers (assuming it is given a budget to do so). Once a case has been assigned to an outside appraiser, it becomes difficult to settle the case at the audit level, but settlement is still possible at appeals.

   The number one audit issue is the valuation of closely held entities.

d. **Numbers of Returns and Percentage of Returns Audited**. The number of taxable estate tax returns has dropped dramatically from 2001 when 51,736 taxable returns were filed, compared with 5,158 taxable returns filed in 2014. About 20% to 30% of estate tax returns are examined.

   About 220,000 gift tax returns were filed in the years before 2012. The number of gift tax returns filed has been increasing since then (249,000 in 2012, 369,063 in 2013, and 371,747 in 2014). The number of gift tax returns involving over $1 million of gifts jumped dramatically in 2013 (from 31,529 in 2012 to 114,190 in 2013), reflecting the large amount of gifts made in late 2012 in light of the uncertainty of future legislation. Historically, only about 1% of gift tax returns are examined (and some of those are merely "correspondence audits" seeking additional information). The percentage of gift tax returns audited in the last six years are 0.6% in 2009, 0.7% in 2010, 1.2% in 2011, 1.4% in 2012, 1.1% in 2013, and 0.8% in 2014.

e. **Appeals.** The IRS announced in a memo to estate and gift tax employees on September 3, 2014 that at least 270 days must remain on the statute of limitations before Appeals will accept an estate tax case, and 365 days must remain on the statute for a case involving gift or fiduciary income taxes. If Appeals receives the case with less time than that, they will not accept it and a statutory notice will be issued—requiring a Tax Court petition to proceed in contesting the assessment. Many families will be unhappy with that result because they do not want the publicity of a public fight with the IRS. The Tax Court typically allows docketed cases to go back to Appeals, but many taxpayers will be aggravated with the additional time, expense, and publicity.

A substantive change is that Appeals will not be allowed to raise new issues. Appeals does not want to be reviewing documents for the first time—that is the function of examination. In the estate and gift tax context, this means particularly that if the taxpayer is securing a new appraisal, it should be presented at the exam level, not at Appeals.

f. **Installment Sales to Grantor Trusts**. The IRS is closely examining sale to grantor trust transactions, from both a gift and estate tax standpoint.

- ***Gift tax.*** The major gift tax issue is the value of the property that is sold. The IRS may also question the value of the note (see Item 4.d above and Item 8.i below). Alternatively, the IRS may argue that the note is valued at zero for gift tax purposes under §2702 (or perhaps under §2701) or because it is not a bona fide debt transaction.

- ***Valuation–Step transaction.*** A valuation issue that arises is the *Pierre* step-transaction argument. *Pierre v. Commissioner* (T.C. Memo 2010-106) required that interests given and sold on the same day had to be aggregated for valuation purposes (but in that case, aggregating the gifted and sold limited partnership interests only decreased the discount from 38% to 35%) The sale should be made some time after the "seed gift." How long? John suggests 30 days should suffice, but 60 days is better, and the next tax year is better yet.

  Estate tax. The IRS sometimes also makes an estate tax argument—that §2036 applies and the assets that were sold should be brought back into the estate at the date of death value rather than including the remaining value of the note in the estate. Traditionally, the IRS has not argued that §2036 applies to sales to grantor trusts (and many sale transactions have been through audits without the IRS making that argument). However, the IRS made the §2036 argument in the ***Woelbing* case** (see Item 11 below), a case in which concerns about the amount of equity in the trust to support the sale may have existed since several of the decedent's sons gave personal guarantees for 10% of the purchase price. The *Woelbing* case was settled without any additional estate tax for the Donald Woelbing estate–indicating that §2036 was not applied to include the sold shares in Mr. Woelbing's gross estate. John Porter reports that he tried another case in December, 2013 (*Estate of Beyer v. Commissioner*, trial judge is Judge Chiechi) in which the IRS also made the §2036 argument; the IRS argued that all of the assets of a family limited partnership are included in the estate under §2036 and it also argued that partnership interests that were sold to a grantor trust should also be brought back into the estate under §2036.

- ***Step transaction issue regarding §2036.*** The *Pierre* step transaction argument may come into play with the §2036 issue—if the IRS argues that the gift and sale should be treated as a single transaction so that the transfer for full consideration exception of §2036 could not possibly apply (though the IRS does not appear to have made that argument directly in any case.)

- ***Planning regarding §2036.*** To help in defending against a §2036 argument for sales to grantor trusts, John suggests (1) that the partnership distributions should not be made at the same time and in the same amounts as the note payments, and (2) separating the gift and sale so that the taxpayer can argue that the sale transaction is for full and adequate consideration and that the full consideration exception to §2036 applies.
- ***Repay note before death.*** If the note is repaid by the trustee before the seller's death, §2036 should not apply (and indeed §2035 should not apply even if the note is repaid within 3 years of death because the grantor/seller is not affirmatively relinquishing any deemed "retained interest;" it is the trustee that took the action to pay off the note.)
- ***Other structure issues for sales to grantor trusts.*** Carol Harrington and Dennis Belcher summarized their practices as to various structuring issues for sales to grantor trusts.
  - 10% cushion—Uncomfortable using less than 10% cushion; if significant cash flow is present, 10% should be enough; but generally will want 10%-20% cushion. Some planners argue that no cushion is necessary, analogizing to real estate development deals that sometimes have been done with 100% financing. Less than 10% cushion may be appropriate in some cases, but carefully explain risks so "the client's risk does not become your risk."
  - In the *Davidson* malpractice case, one of the allegations is that the transaction was structured with insufficient cushion–suggesting that the IRS made that same claim.
  - Guaranties—less comfortable using guaranties, in part because of the difficulty in valuing them.
  - Timing—the sale should be at least 30 days after the grantor trust is funded.
  - Cash flow—look at the estimated cash flow to see if the transaction can be justified in terms of being able to make interest payments.
  - No cash flow—if the sale involves unimproved real estate with no cash flow, consider funding the trust with some cash to be able to make interest payments for at least some of the years of the note.
  - Balloon—do not use a balloon note for both the principal and interest; banks shoo borrowers away who want a 5-year loan with no payments at all for 5 years.
  - §2702—having a 10% cushion may not help with §2702, but §2702 should not apply to a loan that is bona fide debt; that is not the same as having a retained interest in a trust.
- ***"Reality of the sale" approach rather than 10% test.*** Some commentators suggest that the 10% rule of thumb cushion test is arbitrary, and that a more appropriate analysis is to apply a "Reality of Sale" approach:

> There is a popular myth or "rule of thumb" that the initial funding of an IDGT should be 10% (a ratio of 9:1) in order to give the sale transaction "economic substance…. In other words, subscribers to the 10% test contend that a rational seller in the "real world" would not sell assets to a buyer who does not own the 10% minimal amount to protect against the downside risks of the sale.
>
> But is that arbitrary test correct? Although addressed primarily with respect to sales to grantor trusts for transfer tax purposes, the issue is one of "reality of the sale" for both income and transfer tax. The same issues arise for related party sales in the income tax. That said, nowhere in any published ruling, case or other unofficial pronouncement of the Internal Revenue Service can this theoretical 10% rule of thumb be found. The 10% rule of thumb is based on several analogies and has unfortunately developed a life of its own. In so doing, it has become the ultimate "urban legend" in the estate planning space.
>
> …[I]ncome tax cases dealing with the identical reality-of-sale issue are much more indicative of the proper approach. Indeed, the United States Supreme Court, in several cases analyzing the "reality of the sale" issue, never mentioned this conjectural, assumed test. We feel that the 10% minimum funding myth is inapplicable and not indicative of real world behavioral patterns in engaging in similar transactions.
>
> The Reality of the Sale concept approaches the Economic Substance theory and instead uses a more realistic approach that is consistent with the realities of life. The "key" is that sellers expect to be paid, and that their analysis will be generally be controlled by that factor. Therefore, the better test, and the one consistent with the Supreme Court in analyzing the economic approach of sellers is: "Based on all of the facts, can it be reasonably expected that the purchaser will be able to meet its financial obligations on the promissory note in a timely manner as they come due." In the real world, a savvy seller would not look at an artificial number in determining whether to sell. Rather, the crucial question involves the seller desiring to know if the note will be paid in accordance with its terms. Many factors are taken into account in the decision making process to determine if the transaction makes economic sense. Generally, considerations as to the cash flow from the source of payments are much more impactful than a 10% cushion would be. In addition, tax consequences matter and are generally given higher consideration than the 10% negligible protection.

Jerome Hesch, Richard Oshins, & Jim Magner, *Note Sales, Economic Substance and "The 10% Myth*," LEIMBERG ESTATE PLANNING NEWSLETTER #2412 (May 9, 2016).

- ***Further planning ideas to avoid §2036 argument.*** Avoid the §2036 issue by having the grantor's spouse or another grantor trust loan funds to the trust that will purchase the assets from the grantor for cash, so that note payments will not thereafter be made to the grantor/seller. *See* Jonathan Blattmachr, *Protecting an Estate Tax Plan from Turner, Trombetta, Davidson, Woelbing, Etc.,* ANNUAL NOTRE DAME ESTATE PLANNING INST. (2014).

g. **Family Limited Partnerships and LLCs.** The most litigated issue is whether assets contributed to an FLP/LLC should be included in the estate under §2036 (without a discount regarding restrictions applicable to the limited partnership interest). About 37 reported cases have arisen. The IRS typically argues that assets should be included under §2036(a)(1) as a transfer to the FLP/LLC with an implied agreement of retained enjoyment. In a few cases, it 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 property contributed to the entity. The government wins about 2/3 of those cases. (In some of those cases, the FLP/LLC assets have been included in the estate under §2036 even though the decedent had transferred the partnership interests during life (*Harper, Korby*).)

Bona Fide Sale for Full Consideration Defense. Almost every one of these cases that the taxpayer has won was based on the bona fide sale for full consideration exception to §2036. (The two exceptions are *Kelly* and *Mirowski,* which held that no retained enjoyment under §2036(a)(1) applied as to gifts of limited partnership interests.) The key is whether "legitimate and significant nontax reasons" existed for using the entity. Having tax reasons for creating entities is fine, but the test is whether "A" legitimate and significant nontax reason applied as well. John Porter summarizes factors that have been recognized in particular situations as constituting such a legitimate nontax reason.

- Centralized asset management (*Stone, Kimbell, Mirowski, Black, Purdue* [recent case discussed in Item 10 below])
- Involving the next generation in management (*Stone, Mirowski, Murphy*)
- Protection from creditors/failed marriage (*Kimbell, Black, Murphy, Shurtz*)
- Preservation of investment philosophy (*Schutt, Murphy, Miller*)
- Avoiding fractionalization of assets (*Church, Kimbell, Murphy*)
- Avoiding imprudent expenditures by future generations (*Murphy, Black*)

Section 2036(a)(1) Implied Agreement of Retained Enjoyment. Courts have considered the following factors in determining that an implied agreement of retained enjoyment existed (as summarized by John Porter).

- Non pro-rata distributions (*Harper, Korby, Thompson*)
- Personal expenditure with partnership funds (*Strangi, Hurford, Rector*)
- Personal use assets in partnership (*Strangi*)
- Payment of estate tax and expense when assets were transferred to the FLP/LLC close to death (*Miller, Strangi, Erickson, Jorgenson, Bigelow*)
- Accurate books and records not kept (*Harper*)
- Insufficient assets outside of FLP/LLC for living expenses (*Thompson, Miller, Strangi, Rector*)

Section 2036(a)(2). The §2036(a)(2) issue impacts whether the client can serve as the general partner of an FLP or manager of an LLC. Three cases are relevant, two of which held that §2036(a)(2) applied, but in unique fact situations (*Strangi* [T.C. Memo 2003-145] and *Turner II* [T.C. Memo 2011-209]). The Tax Court in *Cohen* (79 T.C. 1015 (1982)) said that being co-trustee of a Massachusetts business trust does not necessarily require inclusion under §2036(a)(2) if cognizable limits on making distributions apply rather than a situation in which trustees could arbitrarily and capriciously withhold or make distributions. Traditionally, planners have relied on the *Byrum* Supreme Court case for the proposition that investment powers are not subject to §2036(a)(2).

As discussed in *Strangi*, §2036(a)(2) applies even if the decedent is just a co-general partner or manager, but John Porter finds that as a practical matter, the IRS does not views co-manager situations as critically as if the decedent was the sole manager.

Having co-managers also typically helps support the nontax reasons for the partnership or LLC.

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

Chart of FLP/LLC Discounts. John Porter has prepared a helpful chart summarizing the discounts that have been recognized in cases involving FLP or LLC interests. The chart is attached as Appendix A.

h. **Formula Transfers With Defined Value Clauses.** Various cases have recognized differing types of defined value clauses. Four of the cases addressed formulas involving both intra-family and charitable transfers, and those are the types most likely to be allowed by the IRS. The *Wandry* case approved a clause defining the amount transferred based on values as finally determined for federal gift tax purposes (but that is just a Tax Court memorandum case). Planners have had some success settling cases involving *Wandry* transfers, but the IRS is still looking for the right case to challenge the validity of *Wandry* clauses. See Item 9 below for a discussion of defined value clauses.

i. **Challenges of Promissory Notes.** The IRS challenges the value of promissory notes, either arguing that the AFR is not a sufficient interest rate, or that the collateral is not sufficient giving rise to collectability problems. The taxpayer response is that §7872, the *Frazee* case, and the *True* case support using the AFR, and John said the note valuation issue generally falls out at Appeals. (The IRS contested the valuation of a note in a Tax Court case, *Estate of Williams*, but a stipulated decision was entered on March 19, 2015 providing an estate tax deficiency much less than that requested by the IRS.)

Another argument made in some audits is that the note transaction is not a bona fide loan but is a gift. Cases list a variety of factors that are considered in determining whether debt is legitimate or not (in a variety of different contexts beyond just gift issues), but the fundamental issue is whether a reasonable expectation of repayment is present.

Having underlying equity in a trust that gives a note is a factor in determining whether a reasonable expectation of payment exists in order to treat the debt as bona fide debt and to support that note's value. Guarantees could also be used to support the note, assuming the guarantor has the financial ability to "make good" on the guarantee. (Guarantors should be cautious and remember that the guarantor may be on the hook if trust assets decline in value to the point that the trust cannot satisfy the note.)

The IRS sometimes challenges note refinancings (to lower interest rates). John thinks the IRS position that the refinancing results in a gift is weak; notes are often renegotiated in commercial transactions. John has resolved several of these cases. Practical Pointers: Document clearly any refinancing of an existing note to a lower interest rate; recite the prepayment clause, the debtor's willingness to prepay, the lender's willingness to exchange a new note for the prior note, and the revised terms.

The 2015-2016 Priority Guidance Plan (sometimes referred to as the IRS's "Business Plan") adds the following item: "Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872." See Items 4.a. and 4.c above. Apparently, the IRS is adding a regulations project to address promissory note valuation issues. Regulations currently address the valuation of notes (Treas. Reg. §§ 25.2512-4 and 25.2512-4); presumably the focus of the new regulations will be to address the valuation impact of using the AFR as the interest rate.

j. **GRATs.** Significant audit activity of GRATs has occurred, typically to confirm that the terms of the GRAT are being satisfied and that the annuity payments are being made properly and timely. If not, the IRS makes an argument under *Atkinson* that the GRAT should be disqualified ab initio. *Atkinson v. Commissioner,* 115 T.C. 26, *aff'd*, 309 F.3d 1290 (11th Cir. 2002), *cert. denied*, 540 U.S. 946 (2003).

On occasion, the examining agents scour the trust instrument to confirm that all of the requirements of the GRAT regulations are included in the instrument.

If substitution transactions with the GRAT have occurred, the examining agent closely reviews the values of property involved in the exchange. If hard-to-value assets have been used to make annuity payments, the IRS reviews that proper valuations have been used. John suggests using a *Wandry* formula transfer of hard-to-value assets that are used to satisfy annuity payments.

k. **Art Valuations**. The IRS frequently contests art valuations. The IRS refers valuable art to the art panel to determine valuations for transfer tax or charitable deduction purposes. In 2013 the art panel reviewed 291 items with a total value of $444 million. It accepted 44% of the appraisals at the original value. It recommended total net adjustments of $54 million on transfer tax appraisals (a 33% increase, and recommended total net adjustments of $51 million for charitable contribution appraisals (a 32% reduction). As these large adjustments suggest, the IRS is very suspicious of art valuations. Quality appraisals are important in dealing with art transfers.

The *Elkins* case addressed the valuation of fractional interests in art. The Fifth Circuit reversed the Tax Court, which had allowed a discount of only 10%). *Elkins v. Commissioner*, 767 F.3d 443 (5th Cir. 2014). For a detailed discussion of *Elkins*¸ see Item 29 of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**. The IRS is looking for an appropriate case to address fractional interests in art (likely in a case appealable to a different circuit). Interestingly, the IRS is more inclined to allow discounts of interests in partnerships or LLCs that hold art rather than giving direct undivided fractional interests in art.

l. **Gift Tax Statute of Limitations; Adequate Disclosure Rules**. John Porter encourages clients to file gift tax returns to report gift or nongift transactions to start the statute of limitations. Otherwise, the possibility of owing gift tax on an old transaction is always present. (In part, this is because of the very low rate of gift tax returns that have been audited historically. Query whether this will change in light of the dramatic reduction of taxable estates for estate tax purposes? The audit rate was still extremely low for the last year for which we have data—2014. Presumably, a number of gift tax audits will arise this year in light of the large amount of gifting that was done in 2012, and for which gift tax returns were filed by October 15, 2013.)

In order to start the statute of limitations, the return must meet the adequate disclosure requirements of Reg. §301-6501(c). For a detailed discussion of the background and planning issues around the adequate disclosure rules see Item 20 of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

In Field Attorney Advice 20152201F the IRS determined that the adequate disclosure requirements had not been satisfied. The gift tax return included a one-paragraph supplement entitled "Valuation of gifts" describing the valuation of various partnership interests but: (i) partnerships were not identified correctly, (ii) one digit was left off each partnership's taxpayer identification number, (iii) the description said that the land owned by the partnership was appraised by a certified appraiser, but the appraisal was not attached and the appraisal did not value the partnership interests, and (iv) the description summarily stated that "Discounts of __% were taken for minority interests, lack of marketability, etc., to obtain a fair market value of the gift."

An interesting 2015 PLR emphasized that filing the gift tax return can foreclose the IRS from later contesting not only valuation issues but also legal issues—such as whether a split gift election was property made. PLR 201523003.

m. **Graegin Loans**. Unlike interest payable to the IRS on deferred estate tax payments, interest on private loans used to pay estate taxes is not automatically deductible for estate tax purposes as an administrative expense. The IRS recognizes that interest is deductible on amounts borrowed to pay the federal estate tax where the borrowing is necessary in order to avoid a forced sale of assets. Rev. Rul. 84-75, 1984-1 C.B. 193 (interest on private loan obtained to pay federal estate taxes deductible because loan was obtained to avoid a forced sale of assets). In *Estate of Graegin v. Commissioner*, T.C. Memo, 1988-477, the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation. The court reasoned that the amount of the interest was sufficiently ascertainable to be currently deductible because of the fixed term of the note and because of the substantial prepayment penalty provisions in the note. Whether the interest deduction is allowed depends on the facts of the case and whether the expense was "actually and necessarily incurred."

Various cases have allowed the deduction. *Estate of Kahanic v. Commissioner.* T.C. Memo. 2012-81; *Estate of Duncan v. Commissioner*, T.C. Memo. 2011-255; *Beat v. United States*, 107 AFTR 2d 2011-1804 (D. Kan. 2011); *Estate of Murphy v. U.S.*, 104 AFTR 2d 2009-7703 (W.D. Ark. October 2, 2009); *Keller v. U.S.*, 104 AFTR 2d 2009-6015 (S.D. Tex. August 20, 2009)($114 million borrowed after death from FLP on a 9-year note); *Estate of Thompson v. Commissioner*, T.C. Memo 1998-325 (estate borrowed $2 million from irrevocable life insurance trust; court observed that regulations "do not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary"); *McKee v. Commissioner*, T.C. Memo. 1996-362 (court refused to disallow interest deduction even though estate could have qualified for §6166 election to defer payment of estate tax, concluding that it would not "second guess the business judgments of the executors"); *Estate of Graegin*.

Other rulings and cases have not allowed the deduction as a necessarily expense under the facts of the case. TAM 200513028, *Estate of Koons v. Commissioner,* T.C. Memo. 2013-94; *Beat v. United States*, 107 AFTR 2d 2011-1804 (D. Kan. 2011); *Estate of Stick v. Commissioner*, T.C. Memo. 2010-192; *Estate of Black v. Commissioner*, 133 T.C. 340 (2009).

n. **Recent Case Addressing Various "Radar Screen" Issues; *Estate of Purdue v. Commissioner***. This recent Tax Court case addresses three of the issues "on the IRS radar" that frequently arise in estate tax audits. The decedent and her husband transferred marketable securities, an undivided interest in a building, and several other assets to an LLC in 2000. The decedent made annual gifts of LLC interests to a Crummey trust in 2002-2007. Following the decedent's death in 2007, some of the estate beneficiaries made a loan to the estate to pay the estate taxes and the estate deducted the interest payments as an administration expense for estate tax purposes. The court ruled favorably as to the §2036 issue arising from the funding of the LLC, the annual exclusion issue arising from the gifts of LLC interests, and the deductibility of the interest. *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249 (December 28, 2015) (Judge Goeke). This case is discussed in more detail in Item 10 below.

9. Defined Value Clauses and Savings Clauses

John Porter and Marty Basson also addressed defined value clauses.

a. **Types of Defined Value Formula Approaches**. John Porter reports that he has had a lot of success over the last few years in upholding transfers made under defined value formulas. Five basic types of these clauses exist:

(1) Formula allocation clause, allocating portions of a transferred asset between taxable and non-taxable transfers based on the subsequent agreement of the parties (*McCord, Hendrix*)

(2) Formula allocation clause, allocating 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)

(3) Clause defining the amount transferred based on values as finally determined for federal gift tax purposes (*Wandry*)

(4) Price adjustment clause (*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.)

(5) Reversions to donor of excess over a specified value (*Procter*)—this condition subsequent approach 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. 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, GRATs, formula disclaimers, etc.).

General Observations.

- In the charity cases, the charities received 6-figure values; John thinks the charity preferably should have "skin in the game" to review the transaction closely.
- Marty Basson reports that the view of the IRS, even in cases involving charities, is that these are "shams" in the sense that the charity will find no buyers of the closely held interest other than the family.
- The IRS looks at these cases closely, but largely at whether the clause was implemented properly. No pre-arrangements should exist.
- With a *Petter* type of formula (based on values as finally determined for gift tax purposes) it is essential that a gift tax return be filed.

b. **2015-2016 Treasury Priority Guidance Plan Project**. The 2015-2016 Priority Guidance Plan (sometimes referred to as the IRS's "Business Plan") adds the following item: "Guidance on the gift tax effect of defined value formula clauses under §2612 and 2511." See Item 4.a. above. Apparently, the IRS is adding a regulations project to address defined value formula clauses.

c. **Discussion of *Procter* in *Belk***. *Procter* was discussed by the Fourth Circuit (the same circuit that decided *Procter)* in *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. December 16, 2014). *Belk* was not a valuation case but involved a violation of one of the substantive requirements to obtain a conservation easement. The taxpayer argued that a "savings clause" in the contribution agreement prohibiting any agreements that would cause the property to fail to satisfy §170(h) should make the taxpayer eligible for the charitable deduction. The court disagreed:

> Indeed, we note that were we to apply the savings clause as the Belks suggest, we would be providing an opinion sanctioning the very same "trifling with the judicial process" we condemned in *Procter*. 142 F.2d at 827. Moreover, providing such an opinion would dramatically hamper the Commissioner's enforcement power. If every taxpayer could rely on a savings clause to void, after the fact, a disqualifying deduction (or credit), enforcement of the Internal Revenue Code would grind to a halt.

Belk suggests that savings clauses intended to protect against inadvertent or incidental violations will be respected, but not "save" transactions involving violations that go to the core of the transaction.

d. **Structuring Allocation Clauses**. Formula allocation clauses are supported by more judicial authority if the portion passing as a non-taxable transfer passes to charity. John's preferred defined value approach is using a formula allocation approach with the "excess" value passing to a public charity-donor advised fund. The public charity directors have independent fiduciary obligations, and the charity is subject to private inurement and excess benefit rules. (Private foundations create complex self-dealing and excess business holdings issues.) Other possible "pour-over" non-taxable recipients could include QTIP trusts or GRATs. If a public charity is not used, John thinks the IRS argument is weakest if the GRAT is used, because the §2702 regulations support using an approach of defining the annuity amount based on the value contributed. (The IRS may argue, however, that a GRAT results in assets passing back to the donor and invokes *Procter*.) If a QTIP trust or GRAT is used for the non-taxable portion of the transfer, John prefers that different trustees and somewhat different beneficial interests apply compared to the trust that receives the taxable portion of the transfer. See Item 17.e. for a discussion of using an inter vivos QTIP trust as the pour over recipient.

e. **Compliance Best Practices**. The IRS will "nibble around the edges" of these clauses and try to find pitfalls to show that the clauses were not respected. If a clause is used that is based on values as finally determined for federal gift tax purposes, a federal gift tax return must be filed reporting the formula transfer, or else a final determination of the gift tax value will never arise. The transaction should be reported on the gift tax return consistent with the formula transfer, providing that all that was transferred is the amount determined by the formula, but the units are initially allocated based on values as reflected in an attached appraisal.

f. **Wandry Clauses**. John has negotiated several favorable settlements with *Wandry* type clauses. A number of *Wandry* transfers were likely made in late 2012. Gift tax returns for many of them were likely filed in the late summer-early fall of 2013, and gift tax audits should begin to emerge regarding those transfers.

Some commentators suggest that the issue more important than whether the *Wandry* clause is respected to determine the *amount* that is transferred, is whether the gift tax audit/case causes a final determination of the *extent* of property transferred. They suggest a risk persists for years after the gift tax audit, that the IRS might contend that the gift tax audit/case merely determined a gift tax deficiency and does not preclude the IRS from later claiming that the donor/seller continued to be the owner of a larger fraction of the property. *See* Austin Bramwell & Brad Dillon, *Not Another* Wandry *Article: Real Issue With* Wandry *Formulas*, 41 EST. PLANNING (May 2014).

The IRS is waiting for the right case to challenge *Wandry* clauses. Marty Basson suspects the IRS will not make its challenge in a case appealable to the Fifth Circuit (or perhaps the Tenth Circuit because the IRS did not appeal *Wandry* to the Tenth Circuit).

For a detailed discussion of *Wandry* and planning considerations in using defined value clauses, see Item 27 of the Current Developments and Hot Topics Summary (December 2013) found **here** and Item 12 of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

g. **Exercise of Substitution Powers**. Consider using a defined value clause in exercising the substitution power to minimize possible gift issues. Advise the client of the possibility of disclosing this "non-gift" transaction on a gift tax return and making adequate disclosure to start the statute of limitations on gift tax assessments. (Interestingly, the adequate disclosure regulations do not require that an appraisal be attached to a return reporting a "non-gift" transaction.)

h. **Sample Clauses.** For a simple sample price adjustment clause and a sample defined value clause suggested by Ron Aucutt, see Item 13.e.(7)-(8) of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

10. Assets in LLC Not Included in Estate Under §2036; Gifts of LLC Interests Qualify for Annual Exclusion; Interest on Loan from Beneficiaries to Pay Estate Tax is Deductible, *Estate of Purdue v. Commisisoner*; FLP Assets Included Under §2036 in *Estate of Holliday*

a. **Synopsis of *Purdue***. This Tax Court case addresses three of the issues "on the IRS radar" that frequently arise in estate and gift tax audits. (1) The decedent and her husband transferred marketable securities, an undivided interest in a building, and several other assets to an LLC in 2000. (2) The decedent made annual gifts of LLC interests to a Crummey trust in 2002-2007. (3) Following the decedent's death in 2007, the estate beneficiaries made a loan to the estate to pay the estate taxes and the estate deducted the interest payments as an administration expense for estate tax purposes.

Section 2036. The case is an excellent summary of principles announced in prior §2036 FLP/LLC cases. The court held that the assets in the LLC were not included in the decedent's estate under §2036 because the contribution to the LLC satisfied the bona fide sale for full consideration exception to §2036. The court focused on the management of the consolidated family assets as a legitimate and significant nontax reason for the LLC (and also noted that the parents were not financially dependent on distributions from the LLC, no commingling of LLC and personal assets occurred, formalities were respected, and the parents were in good health at the time of the transfers to the LLC).

Annual Exclusion. Gifts of interests in the LLC were present interest gifts that qualified for the annual exclusion because the donees received income from the interests. The court reasoned that (1) the LLC generated income, (2) some of the income flowed steadily to the donees (they received almost $2 million from 2000 through 2008), and (3) the anticipated income could be estimated. (This is similar to the analysis in *Estate of Wimmer v. Commissioner*, T.C. Memo. 2012-157.)

Deductibility of Interest on Loan to Pay Estate Tax. Interest on the loan from some of the estate beneficiaries to the estate to pay estate taxes was deductible as an administration expense for estate tax purposes. The loan was bona fide and it was "necessary" because one of the decedent's daughters (who was a member of the LLC) refused to consent to a large distribution from the LLC to pay the decedent's estate taxes, and the operating agreement required the LLC members to act unanimously in making decisions. *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249 (December 28, 2015) (Judge Goeke).

b. **Basic Facts of *Purdue***. Mr. and Mrs. Purdue owned substantial marketable securities held in five different accounts at three different brokerage firms. In 1995, Mr. Purdue sought the estate planning advice of one of the lawyers in his law firm, who recommended forming a family limited partnership "to centralize management and take advantage of valuation discounts." Apparently, the Purdues did not act on that advice and five years later, the attorney again advised the parents to create a family LLC and various trusts. The attorney sent a draft agreement which listed the following purposes (also contained in the final agreement): "to (1) consolidate the management and control of certain property and improve the efficiency of the management by holding the properties in a single, flexible entity; (2) avoid fractionalization of ownership; (3) keep ownership of the assets within the extended family; (4) protect assets from unknown future creditors; (5) provide flexibility and management of assets not available through other business entities; and (6) promote education of, and communication among, members of the extended family with respect to financial matters."

Before the LLC was created, the attorney sent a memorandum to the Purdues and their children summarizing five advantages—a tax advantage and four nontax business advantages. These five advantages included (1) limited liability, (2) passthrough income taxation, (3) minimal formalities, (4) an ideal entity for owning real estate, and (5) tax savings.

In November 2000 the Purdues contributed to a family LLC $22 million of marketable securities, a one-sixth interest in a commercial building in Honolulu (worth about $900,000), a $375,000 promissory note from one of their children, and an $865,523 certificate of deposit. The Purdues received 100% of the member interests in the LLC.

The Purdues had some health issues. Mrs. Purdue had significant leg injuries from an accident in 1984 and became semi-invalid. She had a stroke or transient ischemic attack (TIA) in October 2000 (her physician believed it was a TIA and not a stroke; she had no residual neurological impairment). She required in-home healthcare from August 2001 until her death. Mr. Purdue was in good physical health and enjoyed an active lifestyle when the LLC was funded, but he had memory problems and subsequently was diagnosed with Alzheimer's disease.

In April 2001 Mr. Purdue engaged Rainer Group as an investment manager. An Investment Policy Statement was signed by the Purdues and their children in July 2001, and all of the marketable securities were subsequently managed by the Rainier Group under an "overall, well-coordinated professional investment strategy." Beginning in June 2001, the Purdue children met regularly with the investment manager and have held annual meetings since 2001 to discuss the family assets and approve cash distributions from the LLC.

Mr. Purdue died unexpectedly in August 2001. His estate passed primarily to a family trust and two QTIP trusts under his will.

Mrs. Purdue made gifts of LLC member interests to an irrevocable Crummey trust from 2002 through 2007. From 2001 to 2007 the Purdue children received almost $2 million of cash distributions from the trust, about $1.95 million of which was from distributions to the trust from the LLC.

Mrs. Purdue died in November 2007. In August 2008 the estate planning attorney sent a letter to the Purdue children describing alternatives for paying estate taxes. The alternatives included a $6.2 million loan from the LLC to the estate and the QTIP trusts, or a large dividend distribution from the LLC. One daughter refused to approve the dividend from the LLC (as leverage in an attempt to get her siblings to approve a larger distribution that she wanted but they opposed). In light of the deadlock over distributions, some of the estate beneficiaries loaned about $1.2

million to the estate and the QTIP trusts to fund the shortfall in making estate tax payments.

The estate timely filed its estate tax return in March, 2009. The IRS issued an estate tax notice of deficiency (about $3.1 million) in February 2012 and gift tax notices of deficiency for various years between 2001-2 and 2003-2007 (totaling about $925,000) in September, 2012.

c. **Bona Fide Sale for Adequate and Full Consideration Exception to §2036–*Purdue***. The IRS maintained that the contribution of assets to the LLC was a transfer with a retained interest includible in Mrs. Purdue's estate under §2036. The estate contended that the transfer was covered by the bona fide sale for full consideration exception to §2036. The court analyzed the exception under a two-pronged approach: (1) bona fide sale; and (2) full consideration.

(1) ***Bona Fide Sale.*** The bona fide sale prong requires a legitimate and significant nontax reason for creating the LLC. The objective evidence must indicate that the nontax reason was a significant actual motivation and not just a theoretical justification. The court repeated a list of factors that have been stated in prior cases that are considered in deciding whether a nontax reason existed:

> (1) the taxpayer's standing on both sides of the transaction; (2) the taxpayer's financial dependence on distributions from the partnership; (3) the taxpayer's commingling of partnership funds with the taxpayer's own; (4) the taxpayer's actual failure to transfer the property to the partnership; (5) discounting the value of the partnership interests relative to the value of the property contributed; and (6) the taxpayer's old age or poor health when the partnership was formed.

The estate argued that the decedent had seven nontax motives (that are somewhat different than the purposes of the LLC stated in the operating agreement):

> (1) to relieve decedent and Mr. Purdue from the burdens of managing their investments; (2) to consolidate investments with a single advisor to reduce volatility according to a written investment plan; (3) to educate the five Purdue children to jointly manage a family investment company; (4) to avoid repetitive asset transfers among multiple generations; (5) to create a common ownership of assets for efficient management and meeting minimum investment requirements; (6) to provide voting and dispute resolution rules and transfer restrictions appropriate for joint ownership and management by a large number of family members; and (7) to provide the Purdue children with a minimum annual cash.

The court observed that simplifying the gift giving process and assuring transfer tax savings alone is not an acceptable nontax motive. The court focused particularly on the purpose of "consolidating investments into a family asset managed by a single advisor." The court noted the significant difference in management of the assets after the LLC was formed (the assets were moved to a single investment advisor, Mr. Purdue no longer handled all financial decisions, and the Purdue children made the LLC investment decisions jointly). The court concluded that "decedent's desire to have the marketable securities and the … [building] interest held and managed as a family asset constituted a legitimate nontax motive for her transfer of property to the PFLLC."

The court also addressed the miscellaneous other factors summarized above. The IRS argued that the decedent "stood on both sides of the transaction" because no negotiations occurred and no other parties than Mr. and Mrs. Purdue were involved. The court acknowledged that if a taxpayer stands on both sides of a transaction no arm's-length bargaining occurs and the bona fide transfer exception does not apply, BUT the court reasoned that "an arm's-length transaction occurs when mutual legitimate and significant nontax reasons exist for the transaction and the transaction is carried out in a way in which unrelated parties to a business transaction would deal with each other" (citing *Estate of Bongard v. Commissioner*). A legitimate nontax motive existed, and the decedent received an interest in the LLC proportional to the property contributed, so "this factor does not weigh against the estate."

The remaining miscellaneous factors all come out in the taxpayer's favor: the parents were not financially dependent on distributions; no commingling of personal and LLC funds occurred; formalities were respected; the LLC maintained its own bank accounts and held meetings at least annually with written agendas, minutes, and summaries; the parents transferred properties to the LLC timely; and the parents were in good health at the time of the transfer to the LLC.

(2) ***Adequate and Full Consideration.*** The court repeated the conclusion of prior cases that the full consideration prong is satisfied if "the transferors received partnership interests proportional to the value of the property transferred." No allegations were made that the Purdues failed to received interests proportional to their transfers, but the IRS argued, based on reasoning in *Estate of Gore v. Commissioner*, that the transaction represented a mere change of form and a circuitous "recycling" of value. The court rejected that argument, citing *Estate of Schutt v. Commissioner* for its conclusion that when a "decedent employ[s] his capital to achieve a legitimate nontax purpose, the Court cannot conclude that he merely recycled his shareholdings."

d. **Annual Exclusion–*Purdue***. The court's analysis is similar to the analysis of the Tax Court in *Estate of Wimmer.* To qualify as a gift of a present interest, the gift must confer on the donee "a substantial present economic benefit by reason of the use, possession, or enjoyment (1) of property or (2) of income from the property." In the context of a gift of LLC or limited partnership interests, this requires that the donees "obtained use, possession, or enjoyment (1) of the limited partnership interests or (2) of the income from those interests within the meaning of section 2503(b)."

The donees' rights as to LLC member interests were limited, however, because they could not transfer their interests without unanimous consent by the other members; accordingly, "the donees did not receive unrestricted and noncontingent rights to immediate use, possession, or enjoyment of the PFLLC interests themselves."

The court reasoned, however, that the donees did receive income from those interests to satisfy the present interest requirement. It applied a three-pronged test (citing *Calder v. Commissioner*): (1) the LLC would generate income; (2) some portion of that income would flow steadily to the donees, and (3) that portion of the income could be readily ascertained. Each of those three tests was satisfied. (1) The LLC held income producing real estate and dividend paying marketable securities. (2) The

LLC made distributions to the trust and the trust made distributions to the beneficiaries over eight years of almost $2 million. Furthermore, the operating agreement and applicable state law imposed a fiduciary duty on the LLC to make proportionate cash distributions sufficient for the members to pay their income tax liabilities. (3) The rent from the building was readily ascertainable and the marketable securities were publicly traded and the partners could therefore estimate the expected dividends.

e. **Deductibility of Interest on Loan from Beneficiaries–*Purdue*.** The estate deducted $20,891 in interest that had accrued on loans from the LLC members to the estate. For interest expense to be deductible as an administration expense under §2053, "the loan obligation must be bona fide and actually and necessarily incurred in the administration of the decedent's estate and essential to the proper settlement of the estate."

The IRS never contended that the loan was not bona fide and the facts prove that the loan was bona fide. (The attorney's memorandum to the family did not assure that the interest could be deducted and mentioned the possibility of taking a distribution from the LLC as opposed to the loan).

The loan was necessary because the LLC operating agreement required its members to vote unanimously to make decisions, and one daughter created deadlock by not voting for the recommended option, thus "making the loan necessary."

f. **Planning Observations from *Purdue*.**

(1) ***"IRS Radar Screen" Issues*.** The Purdue case addresses three of the IRS hot button issues that have been litigated frequently, and in this case, the court resolves all three of those issues in the taxpayer's favor.

(2) ***New FLP/LLC §2036 Case*.** This new FLP/LLC case coming at the end of 2015 was the first FLP or LLC §2036 case in over three years. (Two cases in 2012 addressed the §2036 issue. *Estate of Stone v. Commissioner*, T.C. Memo. 2012-48; *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73.)

(3) ***Bona Fide Sale Exception to §2036 Regarding Contributions to FLP/LLC*.**

Centralized Management. The court primarily relies on a nontax reason that has been recognized in various other FLP/LLC §2036 cases: centralized asset management. That reason was also cited as a primary nontax reason supporting application of the bona fide sale exception in the *Stone*, *Kimbell*, *Mirowski*, and *Black* cases. The court emphasizes the importance of an actual change in management activities to support that this is an actual purpose rather than just a "theoretical justification." (It cites the *Estate of Hurford* case as a contrary example, where the court found no advantage to consolidating asset management because the partner's relationship to the assets did not change after the formation of the limited partnership.)

Standing on Both Sides of Transaction. Various cases have repeated the "standing on both sides of the transaction" reason as one factor suggesting the absence of a bona fide sale. The reasoning of this case practically makes that argument irrelevant. It states that if a taxpayer stands on both sides of a transaction no arm's-length bargaining exists and the bona fide transfer exception does not apply, but further reasoning of the court makes this factor all but meaningless. This factor does not apply, according to the court, if a legitimate and significant nontax reason is present (which must exist in any event for the bona fide sale exception to apply) and if the transaction is carried out in the way unrelated parties to a business transaction would act—and the court reasons that last requirement is met because the decedent received interests proportional to the assets contributed (which is also a requirement to meet the full consideration prong of the exception). In effect, if other necessary elements of the bona fide sale for full consideration exception are met, the reasons for distinguishing the "standing on both sides of the transaction" factor will necessarily also be satisfied.

Evidence to Establish Motive. "Whether a transfer is a bona fide sale is a question of motive." How was the decedent's motive satisfied? The court looked to testimony at the trial, the attorney's memorandum describing the purposes and advantages of the LLC, and purposes described in the operating agreement itself.

Roadmap. The consolidation of asset management has now been accepted as a legitimate nontax reason in several of the more recent FLP/LLC cases. Beyond that, the court laid out a course of action to assist in meeting the bona fide sale exception:

> First, decedent and Mr. Purdue were not financially dependent on distributions from the PFLLC. Decedent retained substantial assets outside of the PFLLC to pay her living expenses. Second, aside from a minimal dollar amount across three deposits to the PFLLC account, there was no commingling of decedent's funds with the PFLLC funds. Further, the formalities of the PFLLC were respected. The PFLLC maintained its own bank account and held meetings at last annually with written agendas, minutes, and summaries. Third, Mr. Purdue and decedent transferred the property to the PFLLC. Lastly, the evidence shows that decedent and Mr. Purdue were in good health at the time the transfer was made to the PFLLC.

g. ***Holliday* Synopsis–FLP Assets Including Under §2036(a)(1).** In contrast to *Purdue,* there were no legitimate and significant reasons for creating an FLP in *Estate of Holliday v. Commissioner*, T.C. Memo 2016-51 (Judge Gerber). The decedent moved to a nursing home in 2003 and her financial affairs were managed by her son under a power of attorney. She created a limited partnership, under which she was the 99.9% limited partner, and her wholly owned LLC was the 0.1% general partner. A week later she contributed $5.9 million of marketable securities to the partnership and on that same day sold all of her membership interest in the LLC to her sons and gave a 10% limited partnership interest to an irrevocable trust. She retained significant assets outside the partnership. The partnership made one relatively small ($35,000) pro rata distribution. She died two years later, and her estate claimed a 40% discount for her remaining 89.9% limited partnership interest.

The IRS argued that the transfer of assets to the partnership triggered §2036(a)(1), requiring that the partnership assets be included in her estate without a discount. Section 2036(a)(1) requires that (i) the decedent made an inter vivos transfer of property, (ii) the decedent retained (either explicitly or by implied agreement) the possession or enjoyment of, or the right the income from the property, and (iii) the transfer was not a bona fide sale for adequate and full consideration. The contribution of assets to the FLP constituted an inter vivos transfer of property, satisfying the first required element. The court focused on the last two required elements.

Implied Agreement of Retained Enjoyment. The decedent by implied agreement retained possession or enjoyment of, or the right to income from the assets transferred to the partnership. The court emphasized that the partnership agreement required the distribution of "Distributable Cash" (in excess of its current operating needs) on a periodic basis. The court pointed to the son's testimony on this issue:

> When asked at trial what he believed the term "operating needs" meant, [the son] testified: "[I]t seemed to me when I reviewed this document, when it was signed, that it was created, that this seemed to come from some sort of boilerplate for Tennessee limited partnerships, this sort of gave you broad powers to do anything you needed to do, including make distributions. But that wasn't necessary. No one needed a distribution.

This testimony, the court reasoned "makes it clear that had decedent required a distribution, one would have been made."

[Some planners prefer to *require* the distribution of "Distributable Cash" to minimize a §2036(a)(2) or §2038 inclusion risk; this case, however, points out that doing so increases the risk of inclusion under §2036(a)(1) in a situation in which there are no needs to retain cash for operating purposes. Many partnership agreements, unlike this one, merely *allow* the periodic distribution of distributable cash.]

No Bona Fide Sale for Full Consideration. The court concluded that three nontax reasons asserted for creating the partnership were not legitimate and significant. (1) Protection from "extortion by trial attorneys"–the decedent had never been sued; because she lived in a nursing home her risk of vulnerability to trial attorney extortion was minimal; and she retained significant assets that could be reached by someone trying to extort something from her. (2) Protecting against undue influence of caregivers–while caregivers had taken advantage of or stolen from other family members, the decedent's situation was different because her sons managed her affairs and visited her often; this concern was not discussed with the decedent when the partnership was formed, and there was no evidence she was concerned about undue influence from a caregiver. (3) Preservation of assets for the decedent's heirs–other structures for preserving assets were "quickly dismissed" because they were difficult to manage, but that was unconvincing because the decedent's previously deceased husband's assets were being managed in trusts without difficulty; also the decedent was not involved in selecting the structure used to preserve her assets.

The court also mentioned several other factors that had been raised by the IRS.

(1) The decedent "stood on both sides of the transaction" and it was not an arm's-length transaction because there was no meaningful negotiation or bargaining associated with the transaction. [Planners argue that this "standing on both sides" argument should have no relevance because a transfer is "bona fide" as long as it is real and not a sham regardless of third party negotiation, but since this argument was first included in a case years ago, it gets repeated in almost every FLP §2036 case. Its relevance was severely questioned in *Purdue* (as discussed above).]

(2) Various formalities were not followed including the absence of books and records other than brokerage statements, formal meetings were not held and minutes were not kept, the requirement under the agreement to make distributions was not followed, and compensation was not paid to the general partner as required under the agreement.

(3) The marketable securities were not actively managed and were only traded on limited occasions. [The absence of any activity in the partnership gave the

appearance that assets were transferred to the partnership merely to get a valuation discount.]

h. **Contrast of *Purdue* and *Holliday*.** The court in *Purdue* found that §2036 did not apply to contributions to an LLC. In *Purdue,* the court was convinced that the LLC was created for various nontax purposes (other than just getting a valuation discount). These included consolidating investments with a single advisor, educating children about management of the family investment company, and creating common ownership of assets for efficient management and meeting minimum investment requirements. After assets were transferred to the partnership, a single investment manager was engaged to manage the assets, and the family met regularly with the investment advisor to discuss family assets and approve cash distributions. Formalities were followed. The critical factor is that the court believed the testimony that the LLP was formed for nontax reasons other than getting a discount, supported by a memo from an attorney describing the partnership agreement and the purposes stated in the partnership agreement itself.

   In contrast, in *Holliday*, there was little evidence supporting the alleged nontax reasons for the partnership. Nothing changed after assets were contributed to the partnership. Making changes in some manner and actually "doing something" after assets are transferred into an FLP seems to be important in establishing some legitimate and significant nontax motive—beyond just getting valuation discounts, especially when the partnership merely holds cash and marketable securities.

11. Sale to Grantor Trust Transaction Under Attack, Estate of Donald Woelbing v. Commissioner and Estate of Marion Woelbing v. Commissioner

a. **Overview.** A very effective method of "freezing" an individual's estate for federal estate tax purposes is to convert the appreciating assets into a fixed-yield, non-appreciating asset through an installment sale to a family member. Selling the appreciating assets to a grantor trust avoids the recognition of income on the initial sales transaction and as interest and principal payments are made on the note (at least as to payments made during the grantor's lifetime). The grantor's payment of the trust income taxes allows the trust to grow much faster (and depletes the grantor's estate that would otherwise be subject to estate tax).

   The IRS and Treasury have expressed their discomfort with sale to grantor trust transactions by making dramatic legislative proposals in the 2013 and 2014 Administration's Revenue Proposals (narrowed in the 2014 Proposal to target sale to grantor trust transactions specifically), as described in Item 2.d above.

   In order for the sale transaction to be effective for estate tax purposes, it is important that the note that is given to the seller is recognized as "debt" rather than "equity." If the seller transfers assets to a trust and retains a beneficial interest in those assets, as opposed to merely being recognized as a creditor of the trust, the assets transferred will be included in the seller's gross estate for estate tax purposes. Also, the IRS takes the position that if the sale is not recognized as a "bona fide transaction," the IRS may treat the sale transaction as a gift by the seller and afford little or no value to the note that the purchaser gives to the seller to offset the amount of the gift.

Estate and gift tax examiners on occasion have questioned whether sales for notes bearing interest at only the meager AFR should be recognized. (The *Karmazin* case [discussed below], which received a great deal of attention in 2003, may have arisen initially arose because of the examiner's concern over use of the AFR as the interest rate on an intra-family sale transaction.)

b. **Woelbing Estates Cases.** The IRS is attacking sale to grantor trust transactions in two companion cases that were filed December 26, 2013 in the Tax Court. *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13. (These are pronounced "WELL-bing.")

In 2006, Mr. Woelbing sold all of his non-voting stock in Carma Laboratories (a closely-held company located in Wisconsin) to a trust (presumably a grantor trust) in return for a promissory note having a face value of about $59 million, bearing interest at the AFR. The purchase price was determined by an independent appraiser. The sales agreement contained a defined value provision stating that shares having a value of $59,004,508.05 were being sold and that if the value of the stock is later determined by the Internal Revenue Service or a court to be different than the appraised value, the number of shares purchased shall automatically adjust so that the fair market value of the stock purchased equals the face value of the note.

The sale was made to an "Insurance Trust" that owned three life insurance policies on the lives of Mr. and Mrs. Woelbing. (The policies were subject to an "economic benefit regime" Split-Dollar Insurance Agreement, under which the trust was obligated to eventually repay Carma for its advances of premium payments.) Two Woelbing sons (who were beneficiaries of the trust) executed personal guarantees to the trust for 10% of the purchase price of the stock. The estate's position is that the trust-purchaser had substantial financial capability to repay the note even without considering the stock itself, and that this financial capability exceeded 10% of the face value of the promissory note. (It is not clear whether the 10% cushion included the personal guarantees or whether the trust's financial capabilities other than both the stock and the personal guarantees exceeded 10% of the note face amount.)

Mr. and Mrs. Woelbing filed gift tax returns for 2006, 2008 and 2009 making the split gift election; therefore, if the 2006 sale transaction had a gift element, the gift was treated as having been made one-half by each of the spouses for gift and GST tax purposes.

Mr. Woelbing died in July 2009 and Mrs. Woelbing died in September 2013 (interestingly, only two days after receiving the IRS's Notice of Deficiency for almost $32 million against Mrs. Woelbing for her gift tax). In the estate tax audit of Mr. Woelbing's estate, the gift tax returns for 2006 and several other years were also audited.

Gift Tax Issues. The IRS asserts that the note should be treated as having a zero value for gift tax purposes and is contesting the underlying value of the stock in 2006 (asserting a value in 2006 of $116.8 million compared to the $59 million purchase price). The IRS Notice of Deficiency asserts that for gift tax purposes, "Section 2702 requires inclusion of the entire value of nonvoting shares … as gifts when they were sold… in exchange for a note." Thus, the IRS position is that the note should be treated as having a zero value under §2702. (The §2702 argument seems to depend on the same general issue as the §2036 argument, discussed below—was the right to note payments a retained equity interest in the stock that was transferred or was it a separate debt obligation? That may depend on having sufficient cushion in the purchasing trust to support the note as a separate debt obligation and not as necessarily being a retained interest in the transferred stock.) Alternatively, if §2702 does not apply, the Notice of Deficiency alleges that "the donor made a taxable gift equal to the difference between the fair market value of the Carma Laboratories, Inc. shares transferred to the … Trust, and the note received in exchange." (That wording raises the interesting issue of what shares of stock were transferred. Under the terms of the sales agreement, only that number of shares equal to the face amount of the note was transferred.)

Estate Tax Issues. For estate tax purposes, the IRS position is that the note should not be included as an asset of Mr. Woelbing's estate, but the stock that was sold should be included in the estate under both §§2036 and 2038 at its date of death value. The value of the stock, according to the IRS, had increased to $162.2 million at the time of Mr. Woelbing's death. (The $162.2 million value is almost triple the value of the stock used for the sale transaction.) Perhaps the IRS raised the §2068/2038 issue because of a lack of "cushion" in the trust prior to the purchase. Having sufficient net value in the trust to support the purchase and payment of the debt obligation seems to be a critical element in avoiding the application of §2036/2038. *See Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958) ("the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made"). Why did the guaranties not provide that "cushion"? It seems that guaranties *should* meet the *Fidelity-Philadelphia* test, but they did not help in *Trombetta v. Commissioner*, T.C. Memo. 2013-234 (strange facts case, including that grantor retained enjoyment over all the trust assets, not just retained periodic annuity payments).

Tax and Penalties Deficiency. The Notices of Deficiency for both estates in the aggregate allege gift and estate tax liabilities over $125 million and penalties over $25 million (asserting both gift and estate tax understatement 20% penalties). A few other relatively minor valuation issues were involved for other properties in addition to the stock sale transaction.

Gift Tax Arguments Similar to Those in Karmazin and Dallas. In *Karmazin v. Commissioner,* the IRS made similar §2702 arguments in attacking a sale of family limited partnership units to a grantor trust. T.C. Docket No. 2127-03, filed Feb. 10, 2003. The IRS argued that the note payments should be treated as an equity interest in the trust, that the obligation of the trust to make the payments did not constitute a guaranteed annuity under the GRAT exception in §2702, and that the note should be treated as having a zero value for gift purposes. In addition, the sales agreement in that case conveyed "that number of units having an appraised value of $x million." (The examiner also claimed that the limited partnership was a sham and should be ignored.) The *Karmazin* case was settled later in 2003 on terms very favorable to the taxpayer. Under the settlement, the transaction was not characterized as a transfer of units followed by the reservation of an annuity from the trust, the interest payments paid by the trust were characterized as interest and not as an annuity, neither §§2701 nor 2702 applied, the valuation discount was reduced from 42% to 37%, and the defined value clause in the sales agreement was not given effect.

Settlement. Speculation arose that these cases had settled in March, 2015 on the eve of the first trial setting; if so, apparently that settlement fell through (or they did not resolve everything quickly enough for the judge, and the judge re-set the case to put pressure on the parties to finalize the settlement). On September 29, 2015, the judge set a new trial date of February 29, 2016.

A stipulated decision was entered on March 25, 2016 in the Estate of Donald Woelbing case indicating that no additional gift or estate tax is due. A stipulated decision was entered on March 28, 2016 in the Estate of Marion Woelbing case indicating that no additional gift tax is due, but it does not address estate tax. (The Notice Deficiency to Marion Woelbing addressed only the gift tax and not estate tax; she received that Notice two days before she died in September 2013. The statute of limitations for estate tax is still open on Marion's estate.) Reports from attorneys involved in the case indicate that the IRS recognized the "Wandry-like" provision in the sales agreement (selling that number of shares equal to $59 million), and that §§2702, 2036, and 2038 did not apply because 10% equity existed in the grantor trust that purchased the shares. The result apparently is that more shares were retained by Donald, and passed from his estate to Marion (qualifying for the marital deduction at Donald's death). Therefore, there will likely be more estate tax payable by her estate. The settlement likely included an agreement of the additional shares that were included in Marion's estate, and the date of death valuation of those shares–even though the pending Tax Court cases does not address her estate tax.

c. **Estate of Beyer.** John Porter reports that the IRS made a similar §2036 attack on a sale of limited partnership interests to grantor trusts. That case was tried in the Tax Court in December, 2013 and is still awaiting decision. See Item 8.c above.

d. **Planning Implications.** *Highly Significant Issues for Court Consideration.* The *Woelbing* cases presented very significant planning issues that could have been addressed by the Tax Court. "[A]mong other things, if the case does not settle, the Tax Court might be obliged to address the effectiveness of the value adjustment clause, the substance of the notes, the appropriate interest rate and value for the notes, and the possible reliance on life insurance policies and/or guarantees to provide 'equity' in the trust to support the purchase." Ronald Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2015,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2371 (Jan. 4, 2016).

Careful Planning Required. The *Woelbing* cases are a reminder that sale to grantor trust transactions require careful planning (and detailed planning occurred in the sale transaction involved in that case). Planners should be aware (and advise clients) that the IRS is alleging in some cases that the note has a zero value and that the seller makes a gift of the entire value that is transferred. Whether the IRS will prevail is another question altogether, but sales transactions with grantor trusts are clearly sophisticated transactions requiring careful detailed planning considerations. Some planners are reluctant to utilize sales to grantor trusts until more authority exists regarding the §2036 issues, but many other planners are continuing to use sales to grantor trusts with explanations to clients as described above.

Bona Fide Transaction. The planner should pay particular consideration to taking steps to cause the transaction to be treated as a "bona fide transaction" so that the note will be respected as debt rather than being treated as a retained equity interest in the trust. (If the note is treated as an equity interest in the assets that are transferred, the IRS argues that §2702 applies for gift tax purposes and that §§2036 and 2038 apply for estate tax purposes because those Code sections all involve interests retained in the transferred property itself.) Cases have listed a variety of factors that are considered by courts in determining whether intra-family loan or notes transactions are respected. E.g., *Miller v. Commissioner*, T.C. Memo. 1996-3. (As an analogy, debt/equity principles are applied under §385 in the context of shareholder loans.) No "safe harbor" regulations exist for intra-family sale transactions, in contrast to the objective rules that apply for GRATs.

Defined Value Feature. The defined value feature of the sales agreement may become more common, especially following the *Wandry* case (T.C. Memo. 2012-88). Two prior cases (*Petter* and *Hendrix*) have recognized sale transactions with a defined value element in which "excess value" over a stipulated amount passed to charity. The clause in *Woelbing* does not involve an excess amount passing to charity but, like the gift transaction in *Wandry* (though the 2006 transaction happened long before the *Wandry* case was decided in 2012), merely defines the amount transferred in terms of a specified value amount. *Woelbing* could have been the first Tax Court case addressing the validity of a "*Wandry*-type" clause in sales transactions. (*King*, *McLendon*, and *Harwood* addressed the validity of "price adjustment" clauses in sales transactions.) It is no secret that the IRS is very unhappy with the *Wandry* result, and the fact that the IRS recognized the *Wandry* transfer in the settlement is rather surprising:

> But this is a surprising settlement, substantively and procedurally. It is especially surprising that the IRS would effectively agree to the defined value clause, which IRS personnel are known to really dislike. The only plausible explanation may be that the IRS attorneys thought their position on the valuation issue itself was very weak, and the executors' attorneys thought so too, and this was the only way the IRS was able to credibly seek any concession on value. McGuireWoods Legal Insights Alert, *Parties Settle Closely Watched Tax Court Cases Involving Defined Value Clause*, (April 1, 2016).

Danger of Gift Splitting With Potential §2036 Issue. This case illustrates the danger of making the gift splitting election when the possibility exists that §2036 (or one of the other "string" statutes) may apply to the transfer. If the IRS is successful in its position that §2036 applies to the sale (part gift, under the IRS's position) transaction, all of the transferred stock will be included in Mr. Woelbing's estate, and §2001(b)(last sentence) provides that the gift element in his transfer will not be included as an adjusted taxable gift in his estate. However, no similar provision applies to "undo" the taxable gift of one-half of the gift element by Mrs. Woelbing.

In effect, all of the transferred asset is included in Mr. Woelbing's estate (at its date of death value) and one-half of the date of gift value is treated as a gift by Mrs. Woelbing.

Planning Implications of Settlement. Many planners have anticipated that this was primarily just a valuation case. (The IRS contended that the value of the transferred units was $116.8 million compared to the $59 million purchase price). The IRS settled (as it did in *Karmazin*) apparently dropping the §§2702, 2036 and 2038 arguments (it dropped a §2702 argument before trial in *Dallas*). If the case had proceeded as an attack on whether the note was disregarded for gift tax purposes under §2702 and whether the sold assets were included in the seller's estate under §§2036 and 2038, this case would have broken new ground and provided court guidance on the requirements for a valid sale to grantor trust transaction.

Many planners are continuing to use sales to grantor trusts with explanations to clients as described above, and the fact that the IRS did not treat these allegations as "go to the mat" issues in the *Woelbing* cases is welcome news.

Highly respected commentators from McGuireWoods have offered their view of the planning implications of the case (in a summary available on the McGuireWoods website authored by Ron Aucutt, Birch Douglass, William Sanderson, Dennis Belcher, and Skip Fox):

> In any event, as merely a settlement, the stipulated decision has no precedential value, even if we knew exactly what substantive trade-offs informed the outcome. The settlement, while very good for the parties, deprives the estate planning community of an opportunity to learn how the Tax Court might really decide difficult issues affecting the common estate planning technique of installment sales to grantor trusts, including relatively new issues like the possible reliance on life insurance policies and beneficiaries' guarantees to provide "equity" in the trust, the application of section 2702 to the sale, and the application of sections 2036 and 2038 after the sale, and even including the seemingly familiar yet still disputed issue of the use of defined value clauses.
>
> …
>
> It is impossible to overlook or downplay, and difficult to explain or excuse, what appears to have been a very aggressive approach on the part of the IRS. The total amount of gift tax, estate tax, and penalties at issue for both estates was $152 million, over 250% of the appraised value of the transferred stock at the time of the transaction and even almost 94% of what the IRS asserted to be the much higher date-of-death value of the stock. While there may be some double-counting in those numbers, the all-too-familiar drumbeat of valuation, section 2702, section 2036, section 2038, and "accuracy-related" penalties suggests a degree of overreaching that itself could be subject to penalties if employed by a taxpayer. We have noted this "everything-but-the-kitchen-sink" approach in the Woelbing cases before, as in the Comment on Development Number Three in the "Top Ten" Estate Planning and Estate Tax Developments of 2014. *Id.*

The McGuireWoods analysis also observes that perhaps the use of value imbedded in a split dollar life insurance policy and beneficiary guarantees to support the sale transaction, reinforced by an aggressive form of defined value clause, may have resulted in the failure to keep a low profile with the IRS. It also observes that the Woelbing cases involve an ongoing business (that produces Carmex lip balm), and the IRS may not have been as willing to settle had the case involved a family limited partnership holding marketable securities.

In conclusion of the planning implications of the *Woelbing* settlement, the McGuireWoods analysis points out the importance of planners balancing the features of the sale structuring with the resulting risks:

> The lesson is that levels of foreseeable risk, reward, complexity, delay, and expense need to be explained, understood, and balanced in a way that matches the client's tolerances and minimizes the possibility of surprises. Often this balancing will forgo the use of every imaginable feature,

even features that appear to be in common use, in favor of greater predictability and peace of mind and, yes, staying out of the Tax Court and out of alerts like this. *Id.*

Using Lifetime QTIP Trusts to Minimize §2036 Risk. Richard Franklin (Washington, D.C.) suggests that a client might make a gift to a lifetime QTIP trust (making the QTIP election). The QTIP could loan cash to a grantor trust that will purchase assets from the client. Section 2036 would seem not to apply, because the client has retained no note from the grantor trust and appears to have no retained interest whatsoever in the assets that are sold to the grantor trust. See Item 17.h below.

Best Practices for Sales to Grantor Trusts. See Item 8.f above for a discussion of other best practices planning strategies for sale to grantor trusts to avoid the §2036 and §2702 issues.

12. Self-Canceling Installment Notes (SCINs); CCA 201330033 and *Estate of William Davidson*; *Estate of Johnson*

a. **Brief Background.** A potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion, in the seller's estate, of the unpaid obligation at its fair market value on the date of the seller's death. One way to avoid this problem is to use a self-canceling installment note (SCIN), a debt obligation containing a provision canceling any future payments upon the death of the holder. Planning with self-canceling installment notes (SCINs) followed the seminal case of *Estate of Moss v. Commissioner.* 74 T.C. 1239 (1980), *acq. in result*, 1981-1 C.B. 2. The Tax Court held that the remaining payments that would have been due following the maker's death under a SCIN was not includable in the decedent's gross estate under §2033 because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock" and as such "it was an integral provision of the note."

Mortality Premium. For the value of the SCIN to equal the value of the property sold, the seller of the property must be compensated for the risk that the seller may die during the term of the note, and thus not receive the full purchase price. Universal agreement does not exist as to how payments under a SCIN are properly valued, for no clear answer is available concerning which mortality tables should be used and which discount rate should be applied to value the payments. The risk premium can be structured using a higher than "normal" interest rate, a higher principal face amount of the note, or a combination of the two.

Cases. Few cases have addressed SCINs. The *Musgrove* case (in 1993) did not recognize a SCIN as a bona fide debt transaction, the *Costanza* case (2001) was favorable to the estate, and the *Frane* cases addressed the income tax treatment of the canceled debt. These cases are briefly summarized in Item 15.a. of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

b. ***Estate of William Davidson v. Commissioner*, Tax Court Cause No. 013748-13 (filed June 14, 2013).**
General Background. William Davidson was the President, Chairman, and Chief Executive Officer of Guardian Industries Corp., one of the world's leading

manufacturers of glass, automotive, and building products. Before various gift and sale transactions in December of 2008, he owned 78% of the common stock of ***Guardian.*** He was a prior owner of the Detroit Pistons NBA team. The decedent (age 86) entered into various gift and sale transactions in December 2008 and January 2009, including large sale transactions for self-canceling installment notes. Soon after these transactions, he was diagnosed with a serious illness and he died on March 13, 2009 (before he received any payments on the notes). The IRS Notice of Deficiency alleges gift, estate, and GST tax deficiencies of well over $2.6 billion (although the IRS acknowledged in its answer that it "did not calculate certain deductions and credits to which [the estate] may be entitled."). The case involved a wide variety of issues, but the major issues were the valuation of the Guardian stock and whether the self-canceling installment notes constituted bona fide consideration that is considered as providing any value whatsoever, or if they are bona fide, whether they provide consideration equal in value to the stock transferred in return for the notes The IRS expressed its positions regarding this case in CCA 201330033.

Gift and Sale Transactions. Gift, sale and substitution transactions were entered into on three dates. All of the sales were for notes providing annual interest payments and balloon principal payments due in 5 years. The SCINs were secured by more Guardian shares than just the shares transferred in return for the SCINs. These transactions included sales of stock for hundreds of millions of dollars in two different SCIN transactions; one used five-year "principal balloon" SCINs with an 88% principal premium and the other used five-year "principal balloon" SCINs with an interest rate premium (13.43% over the §7520 rate). On that same day, Mr. Davidson gave the SCINs that he received from the Children's Trusts to a five-year SCIN-GRAT; at the end of the five-year GRAT term, if Mr. Davidson were still living, the balance of the SCIN-GRAT would be distributed to the Children's Trusts (the same trusts that owed the SCIN notes).

Mortality Information. The mortality tables under §7520 indicate that Mr. Davidson's life expectancy was 5.8 years at the time of the sale transactions. The estate and IRS disagreed over the actual life expectancy of the decedent at the time of the sale transactions. In connection with the estate tax audit the decedent's medical records were reviewed by four medical consultants, two of whom were selected by the estate and two of whom were selected by the IRS. All four medical consultants concluded that the decedent had a greater than 50% probability of living at least one year in January 2009.

Bona Fide Transaction Issue. The IRS argued that the SCINs were not bona fide loan transactions (perhaps reasoning that no reasonable expectation of repayment existed) and the SCINs should therefore be valued at zero. The government's answer in the case states that the burden of proof is on the estate to prove that the SCINs were bona fide debt, that the decedent intended or expected to collect all payments due under the SCINs, and that the trusts would be able to make payments on the SCINs when due.

Applicability of §7520 in Valuing SCINs. The IRS also argued that §7520 does not apply in valuing SCINs. Reg. § 1.7520-3(b)(3) indicates that the §7520 mortality tables can be used "to determine the present value of an annuity, income interest, remainder interest, or reversionary interest" or "any interest for life or a term of years" even if the individual who is a measuring life is in poor health as long as he or she is not terminally ill, defined to mean the person has a greater than 50% probability of living at least one year. All of the medical consultants agreed that the decedent had a greater than 50% probability of living at least one year on the date of the sale transactions, so if §7520 applies to SCINs and if the SCINs would be recognized as bona fide debt, the IRS's average life mortality factors presumably would have applied. The IRS reasoned that §7520 does not apply to SCINs because §7520 applies only in valuing annuities and life estates. The estate maintained that §7520 applies in valuing "any interest for life or a term of years," and that a SCIN requires valuing an interest that involves both a term of years and an interest for life.

Settlement of Tax Case. The parties have settled in *Davidson.* A stipulated decision was entered on July 6, 2015. The total federal estate and GST tax stipulated deficiency with respect to the Form 706 was about $152 million, which is a small fraction of the amount of deficiency alleged in the Notice of Deficiency (over $2.6 billion). The SCIN sale transactions were in January 2009; the additional gift and GST tax deficiencies for 2009 were about $178 million. (This was compared to the combined gift and GST tax deficiency asserted by the IRS of almost $876 million. Issues were present other than just whether §7520 applies to the calculation of the SCIN value (including the value of the underlying Guardian Industries closely-held stock).

Subsequent Malpractice Lawsuit. The Estate of William Davidson has sued Deloitte Tax LLP to recover $500 million in taxes, fees and penalties relating to the sale transaction. The complaint was filed in the New York Supreme Court in *Aaron v. Deloitte Tax LLP*, N.Y. Sup. Ct., No. 653203/2015 (filed September 24, 2015). The complaint indicates that the estate paid an additional $457 million in taxes, penalties and interest in the settlement with the IRS; the Estate seeks to recover approximately $500 million. The complaint is quite interesting in that it describes in detail the arguments made by the IRS in the audit and settlement discussions, and describes in detail the reasons that each accounting firm and the law firm that handled the tax litigation (Skadden Arps, Slate, Meagher and Flom, in New York) recommended that the estate accept the settlement, highlighting the weaknesses in the estate's tax case with the IRS.

A "Preliminary Statement" at the beginning of the complaint summarizes generally the failures of the accounting firm, being

> the failure to: (i) disclose all material risks and information; (ii) provide reasonable and appropriate advice given the then-existing state of estate and tax planning knowledge; and (iii) design and implement a *bona fide* and defensible plan that could withstand the inevitable IRS scrutiny that would occur.

The preliminary statement summary also states that "Mr. Davidson would 'win if he lived, or win if he died'—a phrase that Deloitte Tax repeated often." The statement also summarizes detailed failures (suggesting that these were arguments that the IRS emphasized in rejecting the plan's effectiveness):

> Besides failing to disclose the many risks, Deloitte Tax created an Estate Plan replete with flawed structures and inherent defects. These errors were so profound and so numerous that they reflect reckless indifference and gross negligence. They include failures to:
>
> - Design and implement bona fide economic transactions, conducted at arms' length – as opposed to purely tax driven transactions;

- Properly structure the SCIN transactions with appropriate capitalization, interest rates, and repayment terms;
- Use Mr. Davidson's actual anticipated life expectancy in creating the term for the SCINs, as opposed to the five (5) year term from mortality tables under Internal Revenue Code §7520 (the "§7520 mortality tables"), which could not be relied on, particularly in light of Mr. Davidson's poor health;
- Calculate the appropriate "risk premium" for the SCINs – instead of improperly relying upon the §7520 mortality tables;
- Provide for the actual payment of at least a portion of the risk premium to Mr. Davidson during the term of the SCINs;
- Provide appropriate amortization for the repayment of the SCINs, as opposed to, among other things, the use of a "balloon payment" due at the end of the SCINs' five (5) year term – which created the impression of having no realistic expectation of repayment to Mr. Davidson;
- Fund the trusts that were obligors under the SCINs with sufficient assets in order to be able to repay the holders of the SCINs upon maturity of the SCINs;
- Create defensible and acceptable transactions, instead of creating circular, illusory arrangements by which certain obligors under the SCINs would in effect owe themselves, in the event that Mr. Davidson survived their five (5) year term; and
- Separate out the various transactions in a manner that gave independent significance to each transaction – as opposed to effectuating all the various transactions within less than a month, and in some instances on the same day, making the Plan subject to challenge under the "step-transaction doctrine."

More Detailed Summary. For a more detailed discussion of the facts and legal issues in *Estate of Davidson* and planning implications for SCINs, see Item 39.g of the Current Developments and Hot Topics Summary (December 2013) found **here** and Item 14 of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

c. **Planning Implications for SCINs.**

- *Chill Effect.* Until some resolution is determined of the IRS's position that §7520 does not apply in valuing SCINs, considerable uncertainty about SCIN transactions will persist. At a minimum, the CCA and *Davidson* have placed a "chill" on SCIN transactions.
- *SCINs Will be Scrutinized If the Seller Dies "Early."* The CCA and *Davidson* clearly indicate that the IRS continues to view SCIN transactions in a negative light, particularly if the decedent has health issues or dies soon after the SCIN transaction. We can expect to see close examination of SCIN transactions in gift and estate tax audits.

Income Tax Consequences of SCINs. If the seller dies before all payments have been made, the planner must understand that while this may result in a decrease in the amount included in the seller's gross estate, income tax factors may offset some or all of that advantage. See Items 15.a and 15.d of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**

d. ***Estate of Johnson v. Commissioner*, Tax Court Cause No. 11708-16 (filed May 16, 2016)**. In a recently filed Tax Court case, the IRS has again questioned the valuation of a self-canceling installment note. *Estate of Johnson v. Commissioner*, T.C. No. 11708-16 (filed May 16, 2016). In 2005, Ms. Johnson sold shares of a closely-held company in exchange for a SCIN. The SCIN provided for current interest payments, but a balloon principal payment on April 28, 2013. Ms. Johnson died in January, 2012, about one year before the maturity date, and the principal payments were cancelled pursuant to the terms of the SCIN. The face amount of the SCIN was $5,532,589, of which $2,941,356 represented a principal premium to compensate for the actuarial risk of Ms. Johnson's premature death and the cancellation of the note. The risk premium "was determined by actuarial computations based on the life expectancy factors of Treasury Regulation Section 1.72-9 (Table V)." In addition, the interest rate on the note was 4.28% per annum, which was greater than the applicable AFR of 4.09%. According to the petition filed with the Tax Court, the IRS refused to treat the SCIN "as bona fide consideration equal in value to (i) the fair market value of such units, plus (ii) the fair market value of the risk associated with the possibility of cancellation in the event that Decedent did not survive the term of the SCIN."

An additional issue is that the estate reported the gain on the cancellation of the note as gain on the decedent's final income tax return rather than on the estate's first fiduciary income tax return. (Reporting the gain on the decedent's final income tax return resulted in a substantial debt deduction for estate tax purposes.) The IRS's position is that gain should be reported on the fiduciary income tax return, based on the Eighth Circuit Court of Appeal opinion in *Estate of Frane v. Commissioner* (998 F.2d 567), and the IRS's published position in Revenue Ruling 86-72. The taxpayer's position is that the Tax Court decision in *Estate of Frane* (98 T.C. 341) remains the controlling law in the Tenth Circuit, despite its reversal by the Eighth Circuit.

13. Portability

a. **Brief Background.** Section 303(a) of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("the 2010 Tax Act") allows portability of any unused "basic" exclusion amount (changed to "applicable" exclusion amount in ATRA) for a surviving spouse of a decedent who dies after 2010 if the decedent's executor makes an appropriate election on a timely filed estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount" (referred to as the "DSUE amount.") The surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse."

The IRS issued final regulations, effective June 12, 2015, which made relatively few revisions from the temporary regulations. Highlights of some of the more important provisions of the regulations include:

- The portability election is made by the executor's filing a timely and complete Form 706 (if the estate tax return is not timely filed and if the estate is small enough that no return would otherwise be required, Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014, and the IRS in the preamble stated that the IRS is considering whether to make these types of extensions permanent, as discussed below);

- In most cases no need to list values of assets passing to a surviving spouse or charity on the "timely and complete" Form 706 exists if the estate was not otherwise required to file an estate tax return (but the return must include an estimate of the total value of the gross estate within specified ranges, including assets passing to a spouse or charity);
- The surviving spouse's DSUE amount is not subject to being reduced if Congress later reduces the basic exclusion amount;
- The regulations adopt the "Example 3" approach of the Joint Committee Technical Explanation, negating any "privity" requirement in calculating the DSUE amount (an approach adopted legislatively by ATRA);
- If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUE amount;
- The surviving spouse can use the DSUE amount any time after the decedent's death, assuming the portability election is eventually made by the executor;
- Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the spouse's own exclusion amount to cover later transfers;
- DSUE amounts from multiple spouses may be used to the extent that gifts are made to utilize the DSUE amount from a particular spouse before the next spouse dies; and
- If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUE amount until the QDOT is fully distributed (or terminates at the surviving spouse's death).

For a detailed discussion of the temporary and proposed regulations see Item 6(h-q) of the December 2012 summary, "Estate Planning Current Developments and Hot Topics" found **here** and available at **www.bessemer.com/advisor**.

For a more detailed discussion of portability planning (including the advantages and disadvantages of various approaches) see Item 8 of the Current Developments and Hot Topics Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor**.

b. **Portability Decision is Complex.** Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. From the planner's perspective, this is a more complex decision involving a wide variety of factors that might apply at the first spouse's death (including the surviving spouse's age and life expectancy, whether assets will likely appreciate substantially, whether assets may be sold during the spouse's lifetime, whether assets will be held long-term even after the surviving spouse's death, whether the assets are those kinds that have larger than normal capital gains rates, the states where the beneficiaries live and their estate and income tax rates, whether net consumption of the estate will likely occur, whether it is important to use trusts that allow both the surviving spouse and children to be potential beneficiaries, etc.).

Clients living in states with state estate taxes may use a combination of a credit shelter trust (up to the state exemption amount) and portability.

A major tax disadvantage of routinely using bypass trust planning is failing to get a second basis adjustment at the surviving spouse's subsequent death with respect to assets in the bypass trust. If a client has no transfer tax concerns, a bypass trust can result in tax disadvantages. Other nontax reasons exist, however, as to why using bypass trust may be important, including blended family concerns, the desire to use trusts of which the surviving spouse and descendants are all discretionary beneficiaries, and the remarriage potential (which might result in losing the first decedent's exemption amount if the new spouse predeceases).

c. **Planning Is More Difficult for Planners**. Planners must discuss the portability concepts and various factors impacting the decision of whether to rely on portability rather than using credit shelter trusts with clients and document those discussions. While the portability concept is intended to simplify planning, it has not made life simpler from the planner's standpoint.

d. **Major Factors.** Unless the couple owns assets close to double the exemption amount and still have significant growth years ahead, the couple will likely not owe any federal estate tax, whether the credit shelter approach or portability approach is used. For these clients, the major issues are:

- Use a credit shelter trust up to the state exclusion amount (if the state has an estate tax and if the state does not recognize portability [Delaware and Hawaii (and Maryland beginning in 2019) do recognize portability for their state estate taxes]);
- Leave qualified retirement plan and IRA benefits outright to surviving spouses (to take advantage of the longer-term payout opportunities afforded to spouses);
- Trust vs. no trust planning is not the issue because trust planning can be used either with credit shelter trust or with portability and QTIP trusts;
- Blended family concerns–this is one reason to use the credit shelter trust to avoid complexities that might otherwise apply if conditions change such that estate taxes are owing at the surviving spouse's subsequent death (in which event the QTIP trust may end up substantially "underpaying" or "overpaying" the estate taxes and using a credit shelter trust would avoid that complexity);
- If trusts will be used, is it important for both the surviving spouse and descendants to be discretionary beneficiaries after the first spouse's death? (if so, use credit shelter trust planning unless the clients live in a "self-settled trust state" in which the surviving spouse could create a trust for himself/herself and the descendants without opening the trust to the spouse's creditor's claims–assuming domestic asset protection trusts work);
- Remarriage possibility–a significant possible disadvantage (especially for younger clients) is that the surviving spouse may remarry and the new spouse may die before the surviving spouse, resulting in a loss of the DSUE amount from the first deceased spouse (unless the surviving spouse made a gift utilizing that DSUE amount before the new spouse predeceased the surviving spouse);

- Asset protection significance–assets that are protected from creditor claims under state law (such as retirement accounts, homestead property and life insurance) can be left in those forms to maintain the asset protected status of the assets;
- Basis issues–the second basis step up is a major tax advantage of the portability approach (but ways of obtaining basis step up even with credit shelter trust planning may be possible); and
- State estate and income tax impact–If no state estate tax applies for the surviving spouse and a high state income tax applies for the children, portability may be favored; if a state estate tax applies for the surviving spouse and no state income tax applies for the children, the credit shelter trust may be favored; the results may be different for particular children depending on whether they are living in a high income tax state or not (some children may prefer the CST–at least up to the state exemption amount–and some may prefer portability).

For clients with estates substantially larger than the double the exemption amount, traditional creditor shelter trust planning is still appropriate.

For a more detailed discussion of the advantages and disadvantages of the credit shelter trust approach and the portability approach, as well as a detailed discussion of complexities and inequities that can arise in a blended family situation if a credit shelter trust is not used at the first spouse's death, see Item 5.d-f of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

e. **Planning Considerations.** For a detailed discussion of planning considerations, including major factors in bypass planning versus portability, the ability to use QTIP trusts in connection with portability in light of Revenue Procedure 2001-38, building in optimal flexibility, ways of using the first decedent-spouse's estate exemption during the surviving spouse's life, whether to mandate portability and whether to address who pays filing expenses to make the portability election, state estate tax planning considerations, and the financial impact of portability planning decisions, see Item 5 of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

Some of the ways to structure in flexibility to delay the decision until after the first spouse's death regarding whether to use a credit shelter trust or portability are (1) disclaimer plans (outright to spouse and if spouse disclaims, to bypass trust), or (2) QTIP trust plans (using a "Clayton provision," so that to the extent the QTIP election is not made, the assets would pass to a standard credit shelter trust with the spouse as a discretionary beneficiary). If the QTIP/Clayton trust approach is used, can the surviving spouse be the trustee with the authority to make the QTIP election? The IRS might argue that the surviving spouse would make a gift if he or she does not make the QTIP election, because his or her mandatory income interest would be converted to a discretionary interest as a beneficiary of the credit shelter trust. Richard Covey (New York, New York) believes the spouse can serve as trustee and that the IRS will not raise that issue (it is similar to an issue that could be raised about administrative expense election decisions by executors). He acknowledges, however, that attorneys cannot write an unqualified opinion letter about that issue in light of the absence of any cases directly addressing the issue.

14. Basis Adjustment Flexibility Planning

a. **Consider Importance In Each Particular Situation**. In many situations, clients will have no federal estate tax concerns, and a key tax planning item will be to take advantage of the basis adjustment under §1014 that occurs at the client's death. This can apply to assets that a client owns or to assets in a trust of which a client is a beneficiary. For some clients, this will be a key part of the tax planning to take advantage of what President Obama's 2015 tax proposal called "perhaps the largest single loophole in the entire individual income tax code."

   In other cases, however, basis adjustments will not be particularly important. For example, if an individual has a diversified managed investment portfolio, traditional turnover in the portfolio will mean that gains are realized through the years, and substantial unrealized gain from appreciation in the portfolio will not be present. In those cases, basis adjustment planning will not be a priority. The discussion below applies to situations in which basis adjustment planning is determined to be important in a particular client situation.

b. **Consider Using Zeroed Out Transfer Planning.** Consider using transfer planning strategies that minimize the use of the client's gift and estate tax exemption amounts. Leaving estate tax exemption available allows the client to retain appreciated assets until death to receive the benefit of a basis step-up under §1014. For example, consider using GRATs (or "leveraged GRATs") to transfer future appreciation without using any of a client's exemption amount, or making leveraged use of estate and GST exemptions with gifts and much larger sales to grantor trusts. For a description of the leveraged GRAT strategy, see Item 11.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

c. **Consider Using Third Parties' Exemption Amounts for Basis Adjustments.** A client may give/sell assets to a grantor trust for a third party (such as a modest-wealth parent of the client) who will have a testamentary general power of appointment in the trust. At the parent's death, the inclusion of the assets in his or her estate may generate no estate taxes but the assets would receive a basis adjustment (although issues could arise if the parent dies within a year of when the client creates the trust) and the parent could allocate his or her GST exemption to the assets. The assets might pass by default into a trust for the client's benefit but that would not be in the client's estate for estate tax purposes. For a discussion of what Melissa Willms has referred to as the "accidentally perfect grantor trust," see Item 7.2 of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

   Similarly, a beneficiary of a trust who has a limited power of appointment might appoint the assets to a trust in which a third party (such as a modest-wealth parent) has a testamentary general power of appointment. The assets would receive a basis adjustment at the parent's death, hopefully no estate taxes would be payable by the parent, and the parent could allocate his or her GST exemption to the assets.

d. **Preserving Basis Adjustment Upon Death of Donor/Settlor.** Various strategies are available for causing inclusion of assets in the settlor's estate to achieve basis adjustments at the settlor's death, see Item 1.f of the Current Developments and Hot Topics Summary (December 2015) found **here** and Item 10 of the Current

Developments and Hot Topics Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor**.

Jonathan Blattmachr suggests including **in most irrevocable trusts** a provision giving someone the authority to grant a testamentary limited power of appointment to the settlor in case estate inclusion to achieve a basis adjustment becomes desirable.

e. **GST Impact.** Basis adjustment planning considerations for trusts is important particularly for GST-exempt trusts. For non-exempt trusts, if a taxable termination occurs at a beneficiary's death (for example, when the last non-skip person dies), a GST tax is imposed and a basis adjustment is allowed. §2654(a)(2).

f. **Causing Inclusion of Assets in a Trust Beneficiary's Estate**. If a beneficiary has substantial excess estate exemption, causing inclusion in the beneficiary's estate (up to the beneficiary's excess estate exemption) may afford a basis adjustment at the beneficiary's death without resulting in any federal estate taxes. For example, if a credit shelter trust is used at the first spouse's death and the surviving spouse has excess estate exemption amount, these strategies could be used to cause some or all of the credit shelter trust assets to be in the surviving spouse's gross estate to achieve a basis adjustment at his or her subsequent death. The same strategies could apply to any other beneficiary of a trust who has excess estate exemption. Strategies that may be considered for these purposes are briefly listed below.

- Distributions to beneficiary (but if a trustee makes distributions beyond what is authorized in the instrument, the IRS may take the position that it can ignore the distribution. *See Estate of Lillian L. Halpern v. Commissioner*, T.C. Memo. 1995-352);
- Exercise of limited power of appointment to distribute assets to beneficiary;
- Independent party with power to grant general power of appointment to the beneficiary (which could be exercisable merely by the person's will, could possibly be exercisable only with the consent of a non-adverse party, or which could perhaps be removed by another party);
- Move trust situs to Delaware and under Delaware law a trust can be decanted to a trust with an added power of appointment, even a general power of appointment;
- Formula general power of appointment;
- Decanting to a trust that would be included in the beneficiary's gross estate (if that is permissible under the applicable decanting statute); or
- Exercising a limited power of appointment by the beneficiary in a manner that triggers the "Delaware tax trap" to include assets in the beneficiary's gross estate.
- These can get complicated. The "KISS" principle applies—keep these provisions as simple as possible; the more that is added for flexibility to trigger estate inclusion makes the document more difficult for the client (and future advisors) to understand.

Each of these strategies is addressed in considerably more detail in Item 7.c-f of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor** and in Item 7.f of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

Property Subject to Debt. Issues could arise as to the value that is included in the beneficiary's estate for assets subject to debt (for example, if the asset had been sold to a grantor trust and the trust still owes the note to the grantor). Unless the beneficiary is personally liable for the debt, the asset may be treated as an asset subject to nonrecourse indebtedness, such that only the net value is included in the beneficiary's gross estate and the basis adjustment would be limited to that amount. This result may be avoided if the beneficiary personally guarantees the debt.

QTIP Assets Subject to Debt. Similarly, issues can arise about what is included in the surviving spouse's estate under §2044 from a QTIP trust. What if a QTIP trust owns appreciated assets worth $5 million with outstanding debt of $3 million? Is $5 million of assets include in the gross estate under §2044 with a $2 million debt deduction? Section 2044(c) says: "For purposes of this chapter and chapter 13, property includible in the gross estate of the decedent under subsection (a) shall be treated as property passing from the decedent." Does this mean that $5 million is included in the estate (with a $3 million deduction) or just the net $2 million value? Furthermore, if the decedent does not owe the $3 million debt, it may not be deductible under §2053. Section 2053(b) allows the deduction of administration expenses for administering property not subject to claims (which would include expenses of administering QTIP property, *see* TAM 9121002), but no similar explicit provision applies regarding debt claims. The estate may be in a better position to argue for full inclusion and a debt deduction if the decedent guarantees the loan or if joint and several liability of the trust and the decedent exists for the debt.

Asset Protection Impact. Distributing assets to a beneficiary obviously subjects the assets to the creditors of that beneficiary. The law is unclear (and developing) as to whether merely granting a general power of appointment to a beneficiary subjects the assets to the claims of that beneficiary's creditors. It does under the position of the Restatement (Third) of Property, which position has been adopted in various states, including California, Michigan and New York. In addition, the Uniform Powers of Appointment Act, promulgated in July 2013, adopts this same position that merely holding (without exercising) a presently exercisable general power of appointment subjects the assets to the power holder's creditors. Turney Berry, who was the Chair of the Drafting Committee, now says changing the policy to adopt this position in the Uniform Act was probably a mistake; they were not thinking about the burgeoning use of granting general powers of appointment to obtain basis adjustments.) A possible solution is to require the consent of a third person (who would need to be a nonadverse party in order for the power of appointment to cause estate inclusion under §2041). For a detailed discussion of the creditor impact of powers of appointment, see Item 10.m of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

g. **Section 1014(e) Limitation if Donee of Gifted Appreciated Assets Dies Within a Year and the Assets Pass Back to the Donor**. Section 1014(e) provides that (1) if a gift of appreciated property is made to a donee (2) who dies within one year of the gift, and (3) if the property passes from the decedent "to" the original donor (or his or her spouse), no basis adjustment will occur at the donee's death. Section 1014(e) arguably does not apply if the assets do not return "to" the donor but remain in trust for the benefit of the donor.

In light of the indexed large estate tax exemption, most decedents will pay not estate tax. Gifts to a donee will receive a basis adjustment at the donee's death without causing any estate taxes to be paid (assuming the exemption covers all of that decedent's assets) unless the donee dies within a year and leaves the asset back to the donor. Even if the donee dies within a year, leaving the assets to a trust of which the donor may eventually become a beneficiary or in which the donor is only a discretionary beneficiary may still receive a basis adjustment at the donee's death.

One possibility is that only the percentage of the trust assets represented by the actuarial value of the donor's continuing interest would be caught by §1014(e). (*See* PLR 9026036, reversed as to other issues and reissued as PLR 9321050.) If the continuing interest is just a life interest in income, the life factor for a 65-year old is 31% and for a 75-year old is 21%.

For a detailed discussion of planning implications for avoiding §1014(e), see Item 8.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**. For another excellent resource regarding planning implications of §1014(e), see Jeff Scroggin, *Understanding Section 1014(e) & Tax Basis Planning,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2192 (Feb. 6, 2014).

h. **Community Property**. Spouses in community property states get a basis step-up on all community property regardless of which spouse dies first. Both halves of community property can qualify for receiving basis adjustments and are subject to the modified carryover basis system (i.e., subject to a potential reduction in basis for depreciated assets). If there is substantial appreciation in community property, being able to get both halves of the community property stepped-up regardless which spouse dies first can be critically important

Any separate property could be converted to community property (through a "transmutation agreement"). But a question arises as to whether that is a transfer that might trigger §1014(e) if the "recipient" spouse dies within one year.

For couples that do not live in community property states, the spouses might create community property by conveying assets to a "Community Property Trust" under Alaska, Tennessee, or (as of July 1, 2016) South Dakota law. Nonresidents of those states can establish a community property trust, and if the trust satisfies the requirements of the legislation, property transferred to the trust becomes community property under state law. The trustee must be a resident of the state (or a corporate trustee must have its principal place of business in the state), and the trustee must have certain minimum powers. In Tennessee, when property is distributed from the community property trust, it is no longer community property. The community property characterization will likely be recognized in other states, because choice of law provisions are generally respected unless they contradict a strong public policy of the domicile state. Conjuring up a strong public policy against having property owned equally by the spouses is difficult. The community property characterization will probably also be recognized under §1014(b)(6) because it refers to the law of "any state" (rather than just referring to the law of the state of domicile). The IRS has not confirmed that result; IRS Publication No. 555, "Community Property" (released March 2012) states that the Publication does not address the taxation of "income or property subject to the 'community property' election under Alaska state laws." The fact that the community property is created by a voluntary act rather than under a mandatory community property system should not make a difference. *See McCollum v. United States,* 58-2 U.S.T.C. ¶9957 (D. Okl. 1958) (distinguishing *Commissioner v. Harmon*, 323 U.S. 44 (1944)); Rev. Rul. 77-359 (recognizing community property created by a legally enforceable agreement between husband and wife that converted separate property into community property). For an excellent concise summary of using community property trusts for basis planning purposes, see Clary Redd, *Basis Bonanza: A Few Creative Ways to Generate Step-Up*, TRUSTS & ESTATES 11, at 12-14 (March 2016).

Owning assets as community property vs. separate property has real life consequences, including (1) ownership and disposition on death or divorce, (2) management rights, and (3) what property is liable for debts of a spouse. The South Dakota statute requires that the trust begin with a required statement, in all capital letters, advising of some of the extensive consequences of the trust.

15. Private Derivatives—Thinking Outside the Box

David Handler (Chicago, Illinois) describes some very creative and powerful planning strategies. These are "outside the box" strategies that must be viewed as being more aggressive than the tried-and-true strategies that we commonly use. But his creative ideas are very intriguing.

Do not be put off by the term "derivatives." This is nothing more than an intra-family contract. One family member (or trust) transfers assets (or pays cash) to another family member for the right to receive payments from the other family member if certain events happen in the future.

a. **Example Client Situations.** A planner might consider these transactions in unusual circumstances in which the tried-and-true strategies are not workable. Examples include a client that has the following asset situations:

   (1) Non-transferable assets;

   (2) Low-growth assets (so traditional GRAT or sale transactions would not transfer any wealth);

   (3) Non-cash flow generating assets (sale transactions would not be workable because of the inability to make note payments);

   (4) Unvested assets (Rev. Rul. 98-21 says that transfers of unvested options are not completed gifts);

   (5) Junior and senior equity interests (a transfer of just the common interest would trigger §2701); or

   (6) Buying opportunities (the client may be aware of an excellent buying opportunity, but is unwilling to take the economic risk of actually buying the asset).

b. **Derivatives – General Description**. *Public derivatives* are commonly sold on the open markets. For example, an investor may purchase a derivative that will make payments based upon the future performance of particular assets (e.g., tracking stocks, Dow Jones Industrial Average, industry-specific indices, prices of commodities, changes in the weather, etc.). These are commonly used in the commercial world (sometimes to hedge business risks), but they can be expensive to purchase and involve economic risk to the family.

A *private derivative* is an agreement entered into between family members (or trusts for their benefits). They can be used as a way to transfer wealth from one generation to another based on the performance of some asset (whether or not the family owns that asset). The family as a whole will neither make nor lose money; the net result will be that assets change hands among family members.

c. **"Virtual Asset" Private Derivatives**. As an example, the client might enter into a private derivative transaction based on the performance of a specific number of shares of Apple stock. The client's grantor trust might pay the client for rights that would essentially be equivalent to owning that number of shares of Apple stock. For example, the agreement might provide: (1) the trust can sell its "virtual Apple stock" back to the client at the prevailing market price at any time; (2) the client will pay to the trust all dividends paid on that number of shares of Apple stock; (3) the contract will account for stock splits, dividends, and corporate reorganizations; (4) the agreement would be closed in five years, at which time the trust will receive payment for any "virtual shares" it has not already sold back to the client. The value of this contractual right from the client would be equal to the current value of Apple stock (assuming the client has the financial ability to fulfill its part of the bargain).

The "virtual asset" could be a particular stock, a particular portfolio of stocks, a particular stock index, a private equity fund, etc.

In effect, this is a "sale to grantor trust" transaction. The trust might give a note to the client in return for the client's promise to pay the trust based on the future performance of the specified virtual asset or assets.

d. **Carry Derivative**. Clients owning "carried interests in hedge funds or other sophisticated assets might like to transfer the carried interests to younger generations, but doing so triggers the complexities of §2701. A grantor trust could purchase a contract from the client to make payments based on the performance of the carried interest. Will the IRS argue that in reality this is just a transfer of the carried interest and apply §2701? As discussed below, the IRS has issued favorable private letter rulings recognizing similar arrangements between charitable remainder trusts and university endowment funds in order to avoid the charitable remainder trust directly owning interests in the fund that would produce UBTI. (Furthermore, derivatives are not stock or partnership interests, and several private letter rulings have held that an *option* to acquire an equity interest is not an equity interest to which §2701 applies.)

e. **Tracking Units in Endowments**. As mentioned immediately above, the IRS has issued 10 favorable private letter rulings in which charitable remainder trusts for a university could not invest directly in the University's endowment fund, because it would produce unrelated business taxable income (UBTI), which would cause the trust to lose its tax-exempt status for that year. Instead, the CRT paid the University in return for the University's agreement to make payments back to the CRT based on the performance of the endowment fund. The IRS issued favorable rulings, fully realizing that the purpose of the transaction was to avoid the CRT from being treated as purchasing UBTI investments. *E.g.*, PLRs 201613015, 201408034, 201311036, 201218015, 200711037, 200711034, 200711025, 200704036, 200352019, 200352018 and 200352017.

f. **Consideration for the Derivative**. A legally binding contract requires offer, acceptance and consideration. This transaction should be implemented as a contractual investment or sale transaction rather than as a gift transaction (because of concern over whether one can make a completed gift currently by a promise to make a gift in the future). Furthermore, the receipt of consideration helps support that the client would be entitled to a §2053 debt deduction for any amount owed by the client at his or her death.

g. **Use Grantor Trusts**. Use grantor trusts in order to avoid income tax consequences upon the entry into the derivative transaction, or upon the receipt of any payments pursuant to the derivative contract. The grantor trust will need to have funds to pay for the contract from the client.

h. **Termination at Death**. The contract could last for a specified term of years, but should terminate at the client's death at the latest. Otherwise, a §2053 debt deduction would not be available to the estate for any payments the decedent owes under the contract at the date of death.

i. **Customization**. The contract can be customized as desired for the family situation. For example, the contract might be to provide the full value of the asset based on its performance, or that full value minus $1 million, or that full value capped at $5 million, etc. Adding these variables would require an appraisal of the private derivative contract – the limitations would decrease the initial value below the current value of the virtual asset being tracked.

j. **Private Stock Options**. Investors purchase stock options instead of buying stock directly, in the hope of paying a relatively small amount to receive the future growth of a stock. Commercial stock options, however, are risky. If the stock does not rise to the strike price, the investor receives nothing and lost what was paid for the option. On the other hand, if the stock increases in value, the investor can receive a huge multiple of the amount that was paid for the option.

   Private stock options can achieve the same benefits for the family trust as owning publicly traded options, but without overall financial risk to the family. Significant amounts of wealth can be transferred with a small increase in the underlying stock value that is the subject of the option. For example, if a private stock option is used in connection with a GRAT, a mere 2% increase in the underlying stock value would probably result in a successful GRAT. Because options can have unlimited upside, the client will probably want to build in a cap on the private option (so that she would not have promised to pay what could be an unlimited amount to the trust at the end of the option term). The option could be valued under the Black Scholes method, but a professional appraiser should typically be used.

k. **Avoiding Sham Argument**. The client should not loan money to a trust that the trust uses to make its payment to the client in return for the derivative contract. If that were done, the client would lose in any event – if the derivative is not successful, the trust may not receive enough money to repay the loan, but if the derivative is successful, the client would owe the trust the amount due under the derivative contract.

l. **Avoiding Reverse Transfer**. If the underlying tracked asset does not have good performance, the client may eventually pay the trust under the contract less than what the trust paid the client for the derivative contract at the outset. (But that is the case with any traditional sale to grantor trust transaction.) Is avoiding this kind of reverse transfer a possibility?

   The private option approach minimizes the possible reverse transfer because of the leverage involved – the trust pays the grantor a relatively small amount compared to the possible benefits that it will receive from the grantor.

   A possible approach is to use a GRAT to minimize the reverse transfer. For example, the client could sell a private option to his spouse, who would contribute it to a GRAT of which the family grantor trust is the remainder beneficiary. If the asset performs well and the option proceeds are more than sufficient to pay the annuities, the GRAT will transfer wealth to the children at the end of the GRAT term. If the GRAT loses money on the option, the trust will be unable to fully pay the annuity and it will eventually collapse. (A possible concern with this approach is if the sale to the spouse and the subsequent contribution from the spouse to the GRAT are aggregated under a step transaction doctrine. That may be subject to the potential "sham" argument of the grantor in effect standing on both sides of the transaction.)

   Another possible approach utilizes disclaimers. Husband might sell a private option to Wife who might give it to a grantor trust for children. If the option performs well, the trust receives the increased value and the transfer is a good use of Wife's gift exemption (or she may even pay gift tax). If the option does not perform well, it might eventually expire worthless, and to avoid wasting Wife's gift exemption (or needlessly paying gift tax) the trustee might disclaim before the option expires. The trust could provide that assets disclaimed by the trustee pass in some manner that would not have been a taxable gift by Wife if the transfer had originally been to that transferee (such as to Husband, a QTIP trust for Husband, a charity, a GRAT for Wife, or even to Wife directly). The gift tax return would report a transfer as if the grantor trust had never received the asset but it had passed directly to the individual or entity that received it as a result of the disclaimer.

m. **Section 2703**. Section 2703 should not apply, because it says to disregard an option or contract restricting the value of property. The derivative contract does not restrict the value of anything – it merely sets the value in return for rights that are due under the agreement.

n. **Contingent Private Annuity Strategy**. Rather than being tied to the performance of a particular asset, the private derivative could be tied to a person's life. For example, a grantor trust may own a $5 million life insurance on Wife's life (among other assets). Husband could enter into a contract to pay the trust in return for an annuity that would become payable if Wife dies within one year at a time that Husband is still living. In that event the trust would pay Husband $1 million annually for each of five years. The present value of that annuity would be calculated using the government's annuity valuation tables, taking into account the actuarial probability of Wife dying and Husband still being living within that one year. If Husband is age 70 and Wife is age 65, the present value of the five-year payment stream would be approximately $4.6

million, and applying the actuarial probability factors reduces the current value of the annuity promise to $72,000. Husband would pay $72,000 to the trust in return for the annuity promise. If Wife survives the one year, the trust pockets the $72,000. If Wife dies during that year, the trust would receive the $5 million of life insurance proceeds, which it could use to pay the annuity promise. This is a "bet to live" strategy; the trust wins if Wife survives the one year. This could be repeated year after year, and each year the trust would receive the net difference between the amount paid by Husband for the annuity promise and the premium to pay for the life insurance policy for that year. In the above example, the policy might cost approximately $25,000 per year, leaving the trust with a net of almost $50,000 per year.

This strategy was used for one trust as a way of accumulating amounts to fund a life insurance policy. The goal was to end up with the trust owning a $10 million policy. The strategy was used with an initial $50 million policy to get larger numbers to ramp up the value that would build up in the trust. Once the trust received enough funds to carry the $10 million policy, the $50 million policy was reduced to $10 million and the strategy was not repeated in future years.

The private annuity transaction would be subject to the various §2702, 2036, and exhaustion test that applies generally to private annuities with trusts. *See* Akers, *Private Annuities and SCINs: Disappearing Value or Disappearing Strategies*?, 49th ANNUAL HECKERLING INST. ON EST. PL. ch. 6 (2015). These issues are summarized at Item 16 of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

16. Rejuvenating Stale Irrevocable Trusts Through Trust-to-Trust Transfers; "Fixing Broken Trusts"

Nancy Henderson (San Diego, California) discussed creative planning strategies, including the potential tax effects, of dwindling "stale trusts" and increasing the value of more desirable "new trusts" over time. This is a significant problem; Nancy indicates that about 25% of her practice is dealing with these kinds of situations.

a. **Things That Can Make a Trust "Stale."** Provisions describing the beneficial interests in the trust that are no longer desirable, such as undesirable remainder beneficiaries, limited duration of the trust, divorced (or disliked) spouse, spendthrift behavior, substance abuse, undue influence, financially successful beneficiary, distribution standards that are now perceived as too restrictive, or the desire to include a beneficiary's spouse may make the trust "stale."

   Outdated administrative provisions could include the identity of the trustee and successor trustees or the lack of investment flexibility.

   Problems could arise from differences of opinion among multiple beneficiaries regarding things such as trustee selection, trust distributions, or trust investments.

   Other reasons could include that the trust is a non-grantor trust, will be included in the grantor's or beneficiary's estate, is a non–GST exempt trust, or has ambiguities or other drafting problems.

   Realize that the new trust that is created today may become a "stale trust" for various reasons at some point in the future.

b. **Fiduciary Duty Concerns in Trust-to-Trust Transfers.** This is hard for settlors to comprehend, but trust money no longer belongs to the settlor. Furthermore, the brother who is trustee may think of the trust money is still being the client's money. The trustee of the stale trust in particular must understand that it owes fiduciary duties to the beneficiaries (both current and remainder beneficiaries) of the stale trust.

Taking steps that diminish the value of the trust on a long-term basis may ultimately be questioned. Parties that may be affected include trustees, trust protectors, current beneficiaries, first-tier remaindermen, contingent remaindermen, creditors, and other third parties who have entered into transactions with the trust.

Duties that may come into play include the duty of loyalty to *each* beneficiary of the trust, duty of impartiality, duty to keep beneficiaries informed, and duty of care (the trustee must use skill and care to preserve the trust property).

Preferably, different trustees for the stale trust and the new trust will be present. The trustee acting on both sides of the transaction will face inherent conflict issues. Under the Uniform Trust Code §802(h), a transaction between two trusts with the same trustee will not be a breach of the fiduciary's duties to read the trust if it is "fair to the beneficiaries." In some states (such as Texas), transactions between trust with the same trustee are prohibited except in limited circumstances and unless waived in the trust instrument.

A trustee must always keep in mind that when it disregards fiduciary duties, it becomes the "low hanging fruit" if problems arise in the future. In addition, strictly fulfilling fiduciary duties will help if the IRS ever argues that the transactions were merely a muse to shift value to the new trust.

c. **Potential Transfer Tax Consequences**.

(1) ***Gift Tax.*** A trustee does not make gifts; it might violate fiduciary duties but does not make gifts. The IRS may argue, though, that beneficiaries make gifts by consenting (or arguably by merely acquiescing) to the transfers. (*Dickman* says that a gift may be made for transfer tax purposes if an individual gives up a property right for less than full consideration). Potential gift issues for beneficiaries include transfers causing a lapse of Crummey powers, lapse of an inter vivos general power of appointment, the exercise of a limited power of appointment that reduces the power holder's interest in the trust, a distribution by a beneficiary-trustee to another beneficiary, a third party-trustee's distributions to a beneficiary if another beneficiary holds the power to remove and replace the trustee with a beneficiary that is not related or subordinate to the beneficiary, or a disposal of an income interest in a QTIP trust that results in a deemed disposition of the reminder under §2519.

(2) ***GST Consequences.*** If a transfer ends an ETIP, the grantor could allocate GST exemption at that time. A transaction that is treated as a constructive addition to the new trust may cause the trust no longer to be fully GST exempt. If the transaction is treated as a modification that does not satisfy the "grandfather" rules, a grandfathered (or perhaps even a GST exempt) trust could lose its favored status. If the transaction results in a transfer of value to the new trust and the only current beneficiaries of the new trust are skip persons, the transaction could be treated as a taxable distribution. If the stale trust and new

trust are both GST exempt but have different transferors, separate shares will need to be maintained within the new trust for GST tax purposes. Reg. §§26-2654-1(a)(2) and (3).

(3) ***Estate Tax.*** These transactions typically do not trigger estate tax concerns. The settlor's consent, however, may be viewed as participation in the transaction by the grantor which could be deemed a power to control caught by §§2036(a)(2) or 2038 unless the transaction requires the consent of all parties having an interest in the property and if the settlor's consent adds nothing to the rights of the parties under local law. Reg. §20-2038-1(a)(2). In addition, consent of the settlor to a transaction involving life insurance on the settlor's life could be viewed as the exercise of a §2042 power which could trigger a three-year concern under §2035(a)(2).

d. **Depleting the Stale Trust to Preserve or Enhance the New Trust**.

(1) ***Consumption.*** One planning alternative is to "do nothing" and hope that distributions from the stale trust over time will deplete the trust. All distributions for a beneficiary's benefit may be made from the stale trust to preserve the new trust. This may result in a violation of fiduciary duties, however, if different beneficiaries (or even just different remainder beneficiaries) exist for the trusts. Other concerns include whether the standard is broad enough to authorize desired distributions from the stale trust (including whether the trustee must consider a beneficiary's other resources or interests in other trusts), whether distributions would be squandered or seized by creditors, and whether liquid assets are available in the stale trust for making needed distributions.

(2) ***Acquire Personal Use Assets in the Stale Trust for Beneficiaries.*** If the stale trust acquires assets for the beneficiary's use, that may reduce the need for distributions from the new trust. Issues include whether the stale trust authorizes such acquisition, whether the acquisition would impair the interests of mandatory income beneficiaries, whether the acquisition is a prudent investment, or whether it favors current beneficiaries to the disadvantage of remaindermen. As an example, the stale trust might purchase the existing residence of a current beneficiary and hold that residence as a trust asset. (A potential complication would be how the spouse would use the residence after the beneficiary dies.)

e. **Merger**. Merger of the stale trust into the new trust may be permissible under state law and under the terms of the trust instruments. Under the Uniform Trust Code §417, a trustee may combine two trusts "if the result does not impair the rights of any beneficiary." See Item 16.n.2 below regarding limitations on merger transactions.

f. **Exercise of Power of Appointment**. A power of appointment in the stale trust might be exercised to appoint assets to the new trust (if authorized under the terms of the power of appointment). Even if the power holder is also a trustee, fiduciary discretion over distributions should be viewed as completely separate from a personal non-fiduciary power of appointment held by the trustee. See Restatement (Third) of Trusts §50 (power of appointment "is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power").

g. **Termination of Stale Trust**. If permitted under applicable law or the terms of the stale trust, one possible strategy is to terminate the stale trust and have the distributee beneficiaries create and fund the new trust. If not authorized in the trust instrument, an early termination may be available under applicable state law. For example, various provisions of the Uniform Trust Code allow early termination of trusts in certain circumstances.

- § 410(a) allows an early termination "if no purpose of the trust remains to be achieved or the purposes of the trust had become unlawful, contrary to public policy or are impossible to achieve."
- §411(b) allows the trust to be terminated with the consent of all beneficiaries if a court finds that the continuation of the trust is not consistent with a material purpose of the trust.
- §411(a) allows a trust to be terminated with the consent of the grantor and all beneficiaries regardless of whether a material purpose continues to exist for the continuation of the trust.
- Under §411(e), even without the consent of all beneficiaries, the trust termination may be approved by a court if the interests of the non-consenting beneficiaries are adequately protected.
- Perhaps the broadest authority is under §412, which permits termination by court upon a showing that changed circumstances not anticipated by the grantor suggest that a termination is appropriate, and distribution would be in a manner consistent with the purposes of the trust.

States that have not adopted the Uniform Trust Code may not allow non-judicial modification of trusts. *See e.g.,* TEX. PROP. CODE §114.032(e).

This termination/distribution to a new trust approach will necessarily mean that the beneficiary becomes a grantor of the new trust. This would limit the ability of the beneficiary to be a beneficiary of the new trust without causing estate inclusion under §2036(a)(1) (unless the trust is created as a fully discretionary trust under the laws of a self-settled trust state). The assets could be contributed, however, into a trust having the beneficiary's spouse as a potential beneficiary (often referred to as a SLAT). In addition, beneficiary's creditors could reach the assets during the time they are held by the beneficiary or if the transfer to the new trust is a fraudulent transfer, even if the trust is created in a self-settled trust state.

h. **Loans From Stale Trust to New Trust**. If the stale trust has liquidity and a shared desire exists to freeze the value of the stale trust, it might loan assets to the new trust. Even if it does not have liquidity, it might provide secured or unsecured guarantees for loans to the new trust.

(1) ***Loan or Disguised Distribution*?** If the loan is not respected as a bona fide debt transaction, it would presumably be treated as a distribution to the new trust. (Two prime factors are whether a reasonable expectation of repayment exists and whether the lender will enforce the loan if it is not timely paid.)

(2) ***Fiduciary Duties.*** Does the trust instrument or state law allow the loan? Is it a good investment for the trust (taking into consideration the prudent investor rule)? For the remainder beneficiaries?

(3) ***Negotiating Loan Terms.*** Factors the trustee will need to consider include:

- Interest rate (the AFR may be a low rate compared to other investments);
- Length of the loan (is a long-term loan an appropriate long-term investment?);
- Is life insurance appropriate to make sure the loan can be repaid?;
- If the new trust owes a debt to its grantor (perhaps in a sale to grantor trust transaction) should the grantor subordinate its collateral interest to the stale trust's collateral interest?; and
- Should beneficiaries of the new trust guarantee the loan from the stale trust?

(4) ***Guarantee of New Trust by Stale Trust***. A similar strategy would be for the stale trust to guarantee debt of the new trust to allow it to take advantage of growth opportunity investments. The new trust should receive an appropriate guarantee fee. (One commercial lender indicated that the annual fee for standby letters of credit from their organization to a low risk borrower is in the range of 2-3% per year.)

i. **Purchases and Sales**. As an example, the new trust (containing more desirable terms) may wish to purchase the family business or other family heritage asset from the stale trust.

(1) ***Fiduciary Issues.*** Important fiduciary issues arise for the trustees of both trusts. Proper valuation is a paramount issue. The purchase of a "family legacy asset" will require careful due diligence by the trustee of the purchasing trust, perhaps involving reviewing financial statements and analyzing the advantages and disadvantages of owning that asset.

(2) ***Transfer Tax.*** Transfer tax issues could arise if the sale is for less than full consideration (for example, being treated as a constructive addition to a grandfathered or exempt GST trust). Formula clauses or *Wandry* clauses or price adjustment provisions might be used. If the adjustment is based on values as finally determined for transfer tax purposes, how will closure occur? Perhaps the stale trust could file a Form 706-GS(D) taking the position the transaction is not a taxable distribution. Perhaps beneficiaries could file Form 709s to report the transaction as a non-gift transaction.

(3) ***Income Tax.*** If the trusts are grantor trusts, no realization event will occur, and the purchasing trust will get the basis of the selling trust. If the purchasing trust had bought that asset from an outside party, it would have a cost basis in the asset (but that not might not matter if the asset is a "legacy asset" that will "never be sold"). If the trusts are not grantor trusts, the sale will be a realization event. The parties are probably "related parties" under §267(b)—the selling trust cannot take a loss but the purchasing trust adds to its basis the loss that was disallowed by the seller. (Will the stale trust's beneficiaries be happy with that? If the asset had been sold to a third party, the stale trust could have used the loss to offset its trust income.)

If the purchase is an installment sale between nongrantor trusts, a disposition of the installment note (including a distribution of the note from the new trust to its beneficiaries) triggers gain on the note. (For example, the exception under §435B(c) for the disposition of an installment obligation at death does not help because it applies only to installment obligations passing *from a decedent*, rather than installment notes arising after the decedent's death. Rev. Rul. 55-159, 1955-1 C.B. 391.)

(4) ***Sale For Annuity.*** A sale of an asset from the stale trust to the new trust in return for an annuity may make sense, if the annuity could provide desired cash flow for current beneficiaries of the stale trust. If the trusts are not grantor trusts, immediate income recognition will occur (at least that is the position of proposed regulations changing Reg. §§ 1.72-6(e), 1.1001(j) for transactions after October 18, 2006 when, and if, those regulations are ever finalized). This may be acceptable to the stale trust, however, if the new trust provides a down payment of a large enough amount to pay the income tax.

j. **Joint Ventures**. The stale trust and new trust may jointly buy an asset together. This may be done in a manner that would consume capital of the stale trust or other creative ways that could have the effect of increasing the value of the new trust over time. For example, the new trust might purchase real estate and lease it to the stale trust; at the end of the lease term the new trust would own the real estate. The stale trust would benefit from the income produced in excess of the rent payments during the term of the lease, but ultimately the property and all improvements would be owned by the new trust.

The trusts might conceivably enter into a split purchase transaction in which the stale trust receives all of the income or income up to X amount each year for some period of time. If no gifts are being made, §2702 would not apply.

The trusts could invest in a preferred partnership with the stale trust having the preferred interest and the new trust having the common interest that would benefit from the upside appreciation of the partnership assets. No gain or loss on funding will occur. The stale trust would be taxed when it receives its preferred coupon interest based on the character of the income of the partnership.

Appropriate buy-sell agreements between the trusts would probably be appropriate in many of these kinds of joint venture transactions between the trusts.

k. **Issues With Special Trusts**.

(1) ***Stale QTIP Trust.*** Assets remaining in the QTIP trust at the spouse's death will be included in his or her estate, so reducing or freezing the value the QTIP trust may be desirable. A key planning concern is that disposition of the income interest by the surviving spouse is deemed to be a gift of the remainder interest under §2519. For an outstanding detailed discussion of planning by a surviving spouse with QTIP trusts, see Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 ¶ 1202.3 (2010).

(2) ***Stale Trust with Estate Tax Inclusion Exposure.*** A trust may be a stale trust because of the risk of estate tax inclusion under §§2036, 2038, 2041, or 2042.

Inclusion risk for the grantor under §§2036, 2038 or 2042 might be addressed by a transfer to a new trust that did not include the problematic powers (which would probably give rise to retained estate tax inclusion risk for three years under §2035(a)). If the retained powers that cause estate inclusion also cause the transfer to be an incomplete gift, releasing the powers will complete the gift requiring current gift reporting. (If, however, the incomplete gift was improperly reported as a completed gift on a prior gift tax return, once the statute of limitations has run on that return, it is treated as a completed gift and the subsequent release of the power will not give rise to another taxable transfer. Reg. §301.6501(c)-1(f)(5).

Addressing inclusion risk for a beneficiary under §2041 is far more problematic. A release of a general power of appointment will likely be a gift to the new trust by the beneficiary. If the beneficiary is also a beneficiary of the new trust, the gift may not be offset by the value of the interest in the new trust if §2702 applies. If the beneficiary is also a beneficiary of the new trust, it will be a "self-settled" trust creating potential estate inclusion for the beneficiary under §2036.

(3) ***Stale ILITs.*** An irrevocable life insurance trust may contain trust terms that are no longer desirable. This is a frequent issue that arises for ILITs. One approach would be to stop paying premiums and simply allow the policy to lapse over time. If the family wishes to keep the policy in effect, however, transferring it to a new trust with more desirable terms creates problems. Careful navigation of the transfer for value rules under §101(a)(2) is critical. If the purchasing trust is a grantor trust, an exception to the transfer for value rule applies. §101(a)(2)(B) (transfer for value rule does not apply if the purchaser is the insured); Rev. Rul. 2007-13 (transfer for value rule does not apply under §101(a)(2) if the purchaser is the insured or a grantor trust with regard to the insured). *See also* PLR 200228019 (sale of policy between two grantor trusts is not a transfer for value).

A sale of the life insurance policy by the stale trust will generate taxable income in the equal to the amount of the sale proceeds in excess of the investment in the contract up to the amount of the inside built-up. The income will be taxed as ordinary income regardless how long the policy was held by the trust. *See* TAM 200452033.

Proper valuation of the policy will be critical–the policy value is not simply its cash surrender value. The law is unclear regarding how to value policies for transfer tax purposes. An independent appraisal of the policy's value will likely be necessary.

l. **Protecting Fiduciary from Liability for Engaging in a Trust-to-Trust Transfer.**

(1) ***Invoking Statute of Limitations.*** A breach of trust claim must be brought within the appropriate limitations period under state law. The trustee should provide beneficiaries with full information regarding the trust-to-trust transfer transaction so that they are put on notice causing the statute of limitations to begin running.

(2) ***Release Agreements.*** The trustee might request that all interested parties execute consent, release and indemnity agreements for the transaction. (Having consents or releases increases the likelihood that the IRS may take the position the consenting party has participated in the transaction, if that should have transfer tax consequences.)

(3) ***Virtual Representation.*** Some jurisdictions have virtual representation statutes that permit an adult beneficiary to virtually represent the interests of minor and unborn beneficiaries if they have substantially identical interests with respect to the particular question or dispute and no material conflict of interest exists between them. In other states, the virtual representation concept applies only in

judicial actions. See Item 16.n.(4) below for further discussion of the virtual representation doctrine.

(4) ***Judicial Approval.*** The trustees may seek judicial approval of the trust-to-trust transaction. If a transaction affects some beneficiaries differently from others, the trustee may not take sides and may not work to advance or oppose the position of one beneficiary over another.

(5) ***Same Trustee of Both Trusts.*** If the trustee serves as trustee of both trusts, court approval may be sought of the transaction involving a conflict of interest. Uniform Trust Code §802(b)(2). The best advice is for the trustee to resign as trustee of one (or both) trusts.

m. **Ethical Issues for Attorney Representing Trustees of Both Trusts**. Ethical rules apply regarding representation of clients with concurrent conflicts of interest. ABA Model Rules of Professional Conduct §1.7(a) (attorney shall not represent a client if the representation involves a concurrent conflict of interest, which exists where "there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person by a personal interest of the lawyer"). Comment 18 to §1.7 permits an attorney to represent clients with a concurrent conflict of interest if the attorney obtains written consent to the conflict.

The attorney must also be mindful of the requirement to keep client communications confidential under §1.6. If the parties want an open discussion format, the attorney should clarify in writing the scope of the authorization.

n. **Overview of Alternatives for Fixing Broken Trusts**. The various state law strategies for "fixing" an existing trust directly, rather than using the more intricate strategies described above for dwindling a stale trust and growing a new trust, are summarized.

(1) ***Division.*** Various state statutes authorize a trustee to divide a trust into separate trusts without a judicial proceeding if the result does not impair the rights of beneficiaries or adversely impact the purposes of the trust. *E.g.,* TEX. PROP. CODE §112.057(a). The statutes do not require that the separate trusts be identical to the original trust, but clearly beneficial interests (of *any* beneficiary) cannot be impaired in any manner. Under the Texas statute, beneficiary consent is not required, but the trustee must give notice at least 30 days before the division to all beneficiaries then entitled to distributions.

Key Elements

- No judicial involvement required.
- Beneficiary consent is not required.
- Cannot change beneficial interests (though some states may be a little more lenient). But division is a viable option for changing administrative provisions.
- The separate trusts can be created by the trustee.

(2) ***Merger.*** At least 35 states allow trust mergers without judicial involvement, and other states may permit merger via the state's common law. Merging one trust into another trust is permissible, generally "if the result does not impair the

rights of any beneficiary." UNIF. TRUST CODE §417; TEX. PROP. CODE §112.057(c) ("does not impair the rights of any beneficiary or adversely affect achievement of the purposes of one of the separate trusts"). Comments to §417 of the Uniform Trust Code explain that combining two or more trust may be permissible "even though their terms are not identical, [but the] more the dispositive provisions of the trust to be combined are different from each other the more likely it is that a combination would impair some beneficiary's interest, hence the less likely that the combination can be approved."

Accordingly, merger is not an appropriate vehicle for changing the beneficial interests of trust beneficiaries. As an example, adding a discretionary tax reimbursement clause to a grantor trust would likely be viewed as a change to the beneficial interests in the trust and would not be permitted by a merger action. (Some states have more liberal merger statutes that allow some changes in beneficial interests so long as the change is not material or otherwise violate a material purpose of the trust.)

Even if state law does not address or permit merger, many trust instruments authorize merger.

Merger is an underutilized planning alternative.

Key Elements

- No judicial involvement required.
- Beneficiary consent is not required.
- Cannot change beneficial interests (though some states may be a little more lenient). But merger is a viable option for changing administrative provisions.
- If the new trust is not in existence, the trustee may "declare" the terms of Trust 2, for the purposes merging Trust 1 into Trust 2. (Some state statutes specifically permit a trustee to create a trust for the purpose of merging the existing trust into the new trust.)

(3) ***Decanting.*** Three states have recognized a common law concept of decanting. *Phipps. v. Palm Beach Trust Company*, 142 Fla. 782 (1940); *Wiedenmayer v. Johnson*, 254 A.2d 534 (N.J. Super Ct. App. Div. 1969); *In Re: Estate of Spencer*, 232 N.W.2d 491 (Iowa 1975). The general premise is that a trustee that has the authority to make distributions to a beneficiary could instead make the distribution into a trust for the benefit of that beneficiary.

A number of states now have decanting statutes, and the Uniform Trust Decanting Act was approved in July, 2015. (See Item 20 below for a summary of the Uniform Act.) The state statutes vary, but many of them draw a distinction between trusts with unlimited distribution powers and those with some limitations.

Principal Invasion Right. The trustee must have the ability to invade principal for the benefit of one or more of the beneficiaries.

Limited Discretion. If restrictions on distribution standards are present, generally only administrative provisions can be changed in the new trust (the interest of each beneficiary must be substantially similar to that person's interest in the first trust). (In some states [Florida and Indiana are examples], decanting is not permitted at all unless the trustee has an absolute power to invade principal not limited by a standard.) Some state statutes are more lenient; for example Delaware's statute would allow the second trust to further restrict purposes for which distributions can be made, but the distribution standard could not be broadened.

Expanded Discretion. If the trustee has expanded distribution discretion (for example, "best interests," "welfare" or no standard), the second trust may have different dispositive provisions, with limits that protect "vested rights" and that protect qualification for various tax advantages. No acceleration of remainder interests can occur, and no new beneficiaries may result. Some changes are permitted with respect to adding or restricting powers of appointment.

Power of Appointment. Some decanting statutes (Delaware and Nevada are examples) allow giving a beneficiary of a power of appointment that was not in the first trust.

Removing and Adding Beneficiaries. In certain states, the decanting statute may be used to *remove* some beneficiaries in the existing trust. For example, this might be helpful to divide a pot trust into separate trusts for each beneficiary. (Although the trustee may have the *power* to remove a beneficiary, the trustee may breach its fiduciary duty in doing so unless sound reasons exist for that action.)

None of the state statutes allow *adding* beneficiaries by decanting. An indirect way of adding a beneficiary is to decant into a new trust giving a beneficiary a power of appointment (if that is permitted in the state statute), and the beneficiary can exercise the power of appointment to appoint the assets into a trust including a new beneficiary.

Cannot Eliminate Fixed Rights. The decanting may not be used to eliminate fixed rights (such as a mandatory income interest).

Notification and Consent. The decanting power can generally be exercised without court approval or beneficiary consent (except for a few specific modifications that may benefit the trustee personally). Some states require the trustee to notify beneficiaries that decanting has occurred (or will occur–for example, the Uniform Trust Decanting Act requires 60 days advance notice, Florida requires 60 days advance notice, and Texas requires 30 days advance notice before the decant occurs). The trustee may want to give notice to beneficiaries, though, to start the statute of limitations running on a claim by a beneficiary that the decanting was a breach of fiduciary duty. The trustee may seek court approval of a decanting.

The absence of beneficiary consent can be important for tax purposes. No gift consequences should apply to a beneficiary from a decanting because the beneficiary is not participating in the action. For example, the IRS recently refused to issue a letter ruling that a trust judicial modification to give a beneficiary a limited power of appointment (that could be exercised in favor of beneficiaries' spouses who were not currently beneficiaries) would not be gifts by other beneficiaries who might be adversely affected by the exercise of the power of appointment. The IRS was troubled because the beneficiaries' consents were required under the relevant state law for the judicial proceeding. The IRS suggested that it might view the situation differently if beneficiaries' consents were not required (for example, via decanting or merger).

Governing Law Considerations. The validity of the exercise of a limited power of appointment is governed by the law of the trust's situs at the time the power is exercised. Most state statutes treat the exercise of a decanting power as the exercise of a limited power of appointment, and under most state's laws, the law of the situs of the trust when the power is exercised governs the validity of the exercise of the power. If the original state does not recognize decanting, but the situs of the trust is moved to a jurisdiction that permits decanting, the decanting may be permitted even though the original state's law might continue to govern as to the validity and construction of the trust. For example, Delaware codified this concept in its decanting statute, which provides that Delaware's decanting statute is available to any trust that is administered in Delaware, notwithstanding that another jurisdiction's laws may govern the trust. 12 Del. C. 3528(f). (The *Peierls* decisions in Delaware concluded that even if the trust contains a choice of law provision that references "administration," the law governing the administration of the trust will change when the key place of administration changes via a proper appointment of a successor trustee, unless the settlor has specifically stated his or her intent that a state's laws shall always govern the administration of the trust. The concept was recently codified in Delaware. 12 Del. C. §§3332, 3340.)

Key Elements

- Non-judicial action.
- Generally only administrative provisions can be changed.
- If an unlimited invasion power applies, changing beneficial interests may be possible, including removing one or more beneficiaries (subject to appropriate exercise of the trustee's fiduciary duty).
- No beneficiaries may be added (other than perhaps by including a power of appointment that could be exercised by the power holder to add another beneficiary).
- In some situations, it may be possible to eliminate some beneficiaries or to restrict the interests of some beneficiaries (but a beneficiary later might question whether that is a breach of fiduciary duty).
- Beneficiary consent is not required.

(4) ***Nonjudicial Modification.*** The Uniform Trust Code permits nonjudicial settlement agreements and nonjudicial modifications. §§111 (settlement agreements), 411 (modifications).

If the settlor is alive, a non-charitable irrevocable trust may be modified (or terminated) with the consent of the settlor and all beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust.

If the settlor is deceased (or is alive but unwilling or unable to consent) nonjudicial modification is not possible–the trust may be modified or terminated with the consent of all of the beneficiaries if a court concludes that the continuance of the trust (or the modification of the trust) is not inconsistent with a material purpose of trust.

Virtual Representation. Unborn beneficiaries or minor beneficiaries are present. If so, implementing a nonjudicial modification will require that someone can virtually represent those beneficiaries under the virtual representation doctrine. Some states recognize the virtual representation doctrine in nonjudicial actions by a parent (even though not a beneficiary) who has no conflict of interest with respect to the represented minor beneficiary. *See e.g.,* UNIF. TRUST CODE §303 (parent may represent minor child or unborn child; comments add a no conflict of interest requirement with respect to the particular matter or dispute); TEX. PROP. CODE §114.032(c). Some states allow an adult beneficiary to represent and bind a minor or unborn beneficiary in the same beneficial class if they have a similar or identical beneficial interest and no material conflict exists with respect to the matter at issue. UNIF. TRUST CODE §304; TEX. PROP. CODE §114.032(d) (another beneficiary has a substantially identical interest who is an ascendant of the represented person). Comments to §411 of the Uniform Trust Code indicate that the requirement that no conflict of interest be present means that virtual representation will rarely be available for trust terminations, but "should be routinely available in cases involving trust modification, such as a grant to the trustee of additional powers.

Examples. Section 111 of the Uniform Trust Code gives a nonexclusive list of examples of matters that may be resolved by a nonjudicial settlement agreement: (1) construction of a trust; (2) approval of trustee's report or accounting; (3) direction to refrain from performing a particular act; (4) granting a necessary or desirable power to a trustee; (5) resignation or appointment of a trustee and determination of trustee's compensation; (6) termination of a trust's principal place of administration; and (7) liability of the trustee for any action relating to the trust.

If desired, any interested person may request that the court approve a nonjudicial settlement agreement, to determine whether the interested persons were properly represented and to determine whether the agreement contains terms and conditions the court could have properly approved. UNIF. TRUST CODE §411.

Key Elements

- Non-judicial action.
- Settlor must be alive, competent and willing to consent, or else the modification or termination must be consistent with the material purpose of the trust.
- All beneficiaries must participate in the agreement. For virtual representation to apply, another adult beneficiary (or perhaps a parent who is not a beneficiary) must have a substantially identical interest without a conflict of interest.

(5) ***Judicial Modification.*** A court may judicially modify the trust in broader circumstances (i.e., even if the modification would violate a material purpose of the trust). *See* UNIF. TRUST CODE §§ 412 (because of circumstances not anticipated by the settlor, modification will further the purposes of the trust and

must be made in accordance with the settlor's probable intention); 414 (termination of small trust less than $50,000); 416 (modification in a manner not contrary to settlor's probable intent to achieve the settlor's tax objectives, which modification may have retroactive effect).

In some states (not in the UTC provision), beneficiary consent may be required.

The examples of actions listed above for nonjudicial settlements would apply, and the court would have even broader authority to modify the terms and beneficial interests in the trust (assuming the appropriate standards listed above are satisfied)

Do not assume that a court will modify a trust just because all of the interested parties want to modify it. A recent Delaware case refused to modify a trust to add directed trust provisions, even though all interested parties consented to the change. The court reasoned that the document did not contemplate the position of an investment advisor or a directed trust [of course, those concepts were not even being discussed in 1934 when the will was executed]. "[T]his court should modify the Trust only if it is no longer possible to achieve [the settlor's] intent…. Delaware law does not countenance wholesale consensual modification and only departs from the settlor's intent in narrow circumstances." *In re Trust Under Will of Flint*, 118 A.3d 182 (Del. Ch. Ct. 2015).

Key Elements

- Judicial action required.
- Broader modification authority than all of the other alternatives.
- An attorney ad litem will likely be appointed to represent minors or unborn beneficiaries.
- Beneficiary consent may be required in some states.

(6) ***Reformation.*** A reformation is a judicial action reforming the trust because of a mistake of fact or law, often due to a scrivener's error in the original trust. *See* UNIF. TRUST CODE §415 (authorization for court to "reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement"); UNIF. PROB. CODE §2-805 (similar provision regarding reformation of will).

This is a deviation from the general common law rule that no remedy exists for mistake and that extrinsic evidence of intent is not even admissible absent ambiguity. This has been changed in various state statutes, and in some cases without legislative authority. *E.g.*, *Estate of Duke v. Jewish National Fund*, 352 P.3d 863 (Cal. 2015) (will reformed to provide residuary beneficiary when will addressed who beneficiary was in the event of simultaneous deaths of spouses but inadvertently listed no beneficiary if deaths of the spouses was not simultaneous; court reasoned that evidence showed mistake in expressing testator's intent when the will was executed).

A key advantage of a reformation proceeding is it relates back to the creation of the trust. It involves a situation with no ambiguity, and a construction (which would also relate back to the creation of the trust) will not achieve the desired result.

While finding a beneficiary who does not have a conflict with minor or unborn beneficiaries is not a prerequisite, an ad litem will likely be appointed in that circumstance. Michael Gordon (Wilmington, Delaware) described a reformation action in which the court was being asked to reform a trust that included all of the settlor's descendants as beneficiaries, to provide the trust was intended solely for the settlor's son (who was active in building the business owned by the trust) and his descendants, not a young daughter who was born decades later. The ad litem initially refused to go along with eliminating his client (the minor child) as a beneficiary, but ultimately proceeded with interviews and depositions of all of the parties involved and took the position in the court that he could find no evidence inconsistent with the contention that the son (who was the only child when the trust was created decades earlier) was the only intended beneficiary.

Key Elements:

- Judicial action required.
- Some scrivener will likely have to "fall on its sword."
- An attorney ad litem will likely be appointed to represent minors or unborn beneficiaries.
- Can have retroactive effect.
- Establishing the settlor's intent by clear and convincing evidence will be easier if the settlor is still alive to testify as to his or her intent.

17. Creative Planing Strategies with Lifetime QTIP Trusts

Richard Franklin (Washington, D.C.) explained a wide variety of creative uses of lifetime QTIP trusts.

a. **Funding Testamentary Use of Donee Spouse's Applicable Exclusion Amount.** Assume that Wife has substantial assets and Husband does not. Wife would like to enable the full funding of Husband's exemption amount if he predeceases her. She could give him assets, which he could leave into the bypass trust at his death, but she would lose control over those assets.

Description. Wife could create an inter vivos QTIP trust for Husband, with her children as remaindermen. Husband would have an income interest for life, and no one could appoint the property to anyone other than the spouse during his life. He could also be a discretionary beneficiary of principal in the trustee's discretion if that were desired. At Husband's death, the remaining assets would pass to a trust for Wife's descendants. Wife would make a QTIP election for the inter vivos QTIP trust, but not the reverse QTIP election (so she is not treated as the transferor for GST purposes). At Husband's death, the trust would be in his estate under §2044 and Husband could apply his GST exemption (because Wife did not make the reverse QTIP election when the trust was created).

Advantages. Wife maintains control of the ultimate disposition of the assets. In addition, the trust assets should be protected from Husband's creditors (because it is a spendthrift trust) as well as her creditors (assuming the transfer to the trust is not a fraudulent transfer).

b. **Lifetime Use of Donee Spouse's Applicable Exclusion Amount.** Assume Wife has already used her gift exemption amount and would like to make a lifetime gift using Husband's gift exemption and have the trust be a grantor trust as to Wife.

Description. Wife funds a lifetime QTIP trust for Husband with $5.45 million. Wife makes the QTIP election but not the reverse QTIP election. Later, Husband decides to release his income interest in the trust, which results in a deemed gift of the remainder under §2519. Husband will receive no further distributions from the trust, and at Husband's death the assets will pass to trusts for Wife's descendants and will not be included in his gross estate (because he is treated as having previously given them away without retaining any interest in the trust that would cause assets to be included in his estate under §2036 [see §2044(b)(2)]). In effect, a gift has been made to the trust using Husband's gift exemption, and following the release of his interest in the trust, all future income and growth of the trust assets will accumulate for Wife's descendants. Furthermore, the trust will continue as a grantor trust as to Wife. (The trust would not become a grantor trust as to Husband unless he exercised a general power of appointment over the trust. Reg. §1.671-2 (e)(5).)

Step Transaction Concern. If Husband immediately releases his income interest, the IRS might argue that Wife indirectly made a gift to her descendants. Minimize that argument by allowing a reasonable period of time to lapse, perhaps until the statute of limitations has run on the Form 709 reporting the gift to the inter vivos QTIP trust. Arguably, the step transaction doctrine does not apply at all because §2523(f)(1)(B) provides that "for purposes of subsection (b)(1), no part of such property shall be considered as retained in the donor or transferred to any person other than the donee spouse." Under the step transaction doctrine, Wife would be treated as having made a transfer to someone else; that "deeming" provision in §2323(f)(1)(B) says that cannot happen.

Advantages. Husband's gift exemption has been used to allow assets to pass to Wife's descendants. Wife has control over the ultimate disposition to her descendants. The trust is a continuing grantor trust as to Wife so that the trust will not pay income taxes directly and wife can swap low-basis assets to the trust as desired. Wife could sell assets or loan money to the trust without having a realization event. The trust could be an S corporation shareholder. (As discussed immediately below, this strategy could also make use of Husband's GST exemption.)

Spendthrift Clause. Husband's release of his income interest is not an assignment of any of his interest in the trust, and should not violate the provisions of a spendthrift clause in the trust. Nevertheless, the recommended approach is to use a customized spendthrift clause for QTIP trusts (see subparagraph o below).

c. **Using Donee Spouse's GST Exemption**. Assume the same facts as in the preceding scenario, but Husband is willing to use his GST exemption for assets in the QTIP trust that will ultimately pass to Wife's descendants. Because Wife did not make the reverse QTIP election, Husband is treated as the transferor to the trust for GST purposes. At Husband's death, or upon a deemed transfer under §2519, Husband can allocate his GST exemption to the trust. In this example, when

Husband decides to release his income interest in the trust, he would also file a Form 709 allocating his GST exemption to the trust.

d. **Using Donor Spouse's Applicable Exclusion Amount With Defined Value Authorized by Regulations**. Assume Wife wants to create a trust for Husband and for Wife's descendants (a "SLAT") of hard-to-value assets. To protect against the imposition of gift tax in light of the inherent valuation uncertainty, Wife could use a *Petter* or *Wandry* clause, but would prefer to use a "defined value" transfer authorized by regulations. Two possible approaches apply, (1) a formula partial QTIP election approach, and (2) a formula disclaimer approach.

***Description–Formula Partial QTIP Election Approach*.** Wife gives the entire interest that she thinks is worth the value she is willing to give to a QTIP trust and makes a formula QTIP election sufficient to reduce the federal gift tax to zero. The regulations provide that a taxpayer may make the gift tax QTIP election by means of a formula that relates to a fraction or percentage of the QTIP trust. Reg. §25.2523(f)-1(b)(3). The estate tax QTIP regulation has an example of such a formula partial election. Reg. §20.2056(b)-7(h) Exs. 7-8. Richard Franklin suggests the following formula election as an example:

> I elect to treat as qualified terminable interest property that portion of the gift, up to 100%, necessary to reduce the Federal gift tax to zero after taking into account the available gift tax exclusion amount and final gift tax values.

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

No "Clayton provision" will be included (which could remove Husband's mandatory income interest and allow other persons to become beneficiaries) with respect to any portion of the trust for which the QTIP election is not made. It is not clear that the Clayton provision applies to lifetime QTIP trusts. The regulation only addresses testamentary QTIP trusts. Reg. §20.2056(b)-7(d)(3). A key distinction between the formula QTIP election approach and the disclaimer approach (discussed immediately below), is that the disclaimer approach can result in a formula transfer to a trust including other persons as discretionary beneficiaries and that does not have a mandatory income interest for the spouse.

***Description–Disclaimer Approach*.** Wife makes a gift to a lifetime QTIP trust providing that any portion of the transfer disclaimed by Husband passes to a trust of which Husband and Wife's descendants are beneficiaries. Wife will make a QTIP election with respect to any of the trust assets that are not disclaimed. Husband may disclaim by formula assets as determined for federal gift tax purposes to have a particular value (the desired gift amount). An example in the §2518 disclaimer regulations specifically sanctions a formula disclaimer designed to result in no federal estate tax. Richard Franklin suggests the following formula disclaimer as an example:

> H irrevocably disclaims a fractional portion of all of his rights and interests in the QTIP Trust. The numerator of this fraction is (i) Three Million Five Hundred Thousand Dollars ($3,500,000), plus (ii) 5 percent (5%) of the excess, if any, of the fair market value of the Transferred Partnership Interest on January 31, 2015 as finally determined for federal gift tax purposes over Three Million Five Hundred Thousand Dollars ($3,500,000). The denominator of this fraction is the fair market value of the Transferred Partnership Interest on January 31, 2015, as finally determined for federal gift tax purposes.

(Sub-clause (ii) in the formula is an attempt to prevent a public policy argument by the Service that such clauses reduce their incentive to audit if any adjustment in value would result in no additional taxable gift. With this clause, any valuation adjustment on audit would increase the taxable gift by 5% of the increase in valuation. *See* Carlyn S. McCaffrey, *Formulaic Planning to Reduce Transfer Tax Risks*, 45 U. MIAMI HECKERLING INST. ON EST PL. ¶701.6 (2011). Even without this provision, the decision in the *Christiansen* case reduces the likelihood of a successful public policy argument.)

Out of caution, some planners may choose for Husband not to be a beneficiary of the disclaimed assets. Section 2518(b)(4)(a) refers to "spouse of the *decedent*;" accordingly, the statutory provision allowing a disclaiming spouse to continue to have a beneficial interest in the disclaimed property literally applies only to testamentary transfers to the spouse. Similarly, the regulation refers to a "surviving spouse" without referring to a lifetime QTIP. Reg. §25.2518-2(e)(2). Mr. Franklin has been through a tax audit with the situation in which the disclaiming spouse of a lifetime QTIP was a continuing beneficiary, and the arrangement presented no problems.

Timing Difference Between the Approaches. Wife has 15 months to make the partial QTIP election in the first approach, whereas Husband has only nine months to make the formula disclaimer under the disclaimer approach.

e. **Sale to Grantor Trust in *Petter* Transaction With Defined Value Authorized by Regulations**. Wife wants to make a sale of a hard-to-value asset to her grantor trust. To minimize the valuation uncertainty, Wife uses a *Petter* defined value approach, under which a formula portion of the transferred amount passes to trust for descendants, and the balance passes to a trust that does not have transfer tax consequences. The formula is the portion of the transferred asset having a value, as finally determined for federal gift tax purposes, equal to the face amount of the note.

Description. While the excess amount passed to a charitable entity in *Petter* (and in the analogous *McCord* and *Hendrix* cases), the sale will be made with a provision that the "excess assets" will pass to a lifetime QTIP trust for Husband.

Advantage. Some clients may not be willing to leave substantial amounts to charity. Perhaps more importantly, the lifetime QTIP trust is a grantor trust which simplifies income tax reporting.

Not a Contingent or Protective QTIP Election. Some commentators have expressed concern that the amount passing to the QTIP under a formula allocation clause is contingent, and that while the estate tax QTIP or regulations allow a protective QTIP election, no similar provision permits a protective gift tax QTIP election in the gift tax regulations. The election is not contingent, however. Valuation is the only uncertainty, and the transfer agreement would have a defined legal entitlement. It is that legal entitlement for which the QTIP election is made and the election is not subject to a contingency.

Form for Partial QTIP Election. Richard Franklin suggests the following as a formula to make such a formula partial QTIP election:

> The Taxpayer, JANE SMITH, elects QTIP treatment for the Doe QTIP Marital Trust under Section 2523(f)(4). [GST alternative: However, the Taxpayer makes a reverse QTIP election under Section 2652(a)(3) so that upon the death of the Taxpayer's spouse, [the donee spouse], the decedent

shall be deemed the transferor of the Doe QTIP Marital Trust.] The property passing to the Doe QTIP Marital Trust is described below.

The Taxpayer owned a 99% Class B membership interest (the "Transferred Interest") in NEWCO, LLC (EIN ___). Pursuant to the Transfer Agreement made on ___, 2015, by the Taxpayer, the Doe Family Trust ("Purchaser"), and the Doe QTIP Marital Trust, the Taxpayer sold a portion of the Transferred Interest (the "Purchased Interest") to the Purchaser. Pursuant to the Transfer Agreement, the Purchased Interest was the lesser of the Transferred Interest and a fraction of the Transferred Interest, the numerator of which was the Purchase Price and the denominator of which was the fair market value as of the date of the Transfer Agreement of the Transferred Interest as finally determined for Federal gift tax purposes. The Purchase Price is $XXX. The sale of the Purchased Interest to the Purchaser is disclosed as a non-gift transfer at Item __ of this return.

The Taxpayer gave the Doe QTIP Marital Trust all of the Taxpayer's right, title and interest in and to the portion of the Transferred Interest that is the difference between the Transferred Interest and the Purchased Interest (the "Gift Interest").

The value of the Transferred Interest was determined by an independent appraisal, prepared by ______. The Taxpayer hereto attaches a copy of the appraisal used for determining the value of the Transferred Interest consistent with Regs. § 301.6501(c)-1(f)(2)(iv) and § 301.6501(c)-1(f)(3). Pursuant to this appraisal, the Transferred Interest is valued on a noncontrolling, nonmarketable interest basis at $XXX. Based on values as returned, the Purchased Interest equals 100% of the Transferred Interest pursuant to the formula set forth in the Transfer Agreement and the Gift Interest is zero.

The values represented for the Transferred Interest, the Purchased Interest and the Gift Interest for purposes of this QTIP election are being made on the basis of the values reported on the return as filed. For purposes of the final amounts to be used, the values and the components of the formula shall be those finally determined for Federal gift tax purposes. Thus, if the values or amount of a component as so finally determined shall be different from the values or amount as reported on this return, the values and amount are changed accordingly.

f. **"Grantor" Bypass Trust**. At Husband's death, Wife wants the bypass trust that he creates for her and her descendants to be a grantor trust as to her.

Description. The Supercharged Credit Shelter Trust[SM] is a strategy under which a healthy spouse (say Wife) creates an inter vivos QTIP trust for a spouse expected to predecease (say Husband). Wife has a power to withdraw assets from the trust, but the withdrawal power lapses at Husband's death. The gift would be complete at Husband's death and Wife would file a gift tax return making the QTIP election. At Husband's death, the trust assets would remain in a credit shelter trust for Wife up to the amount of Husband's estate tax exemption, and the balance would pass to a QTIP trust for Wife (with Husband's estate making the QTIP election). Even though Wife made the original contributions to the trust, §2036 would not apply to the credit shelter trust at Wife's subsequent death because the QTIP regulations make clear that Husband is treated as creating the trust for transfer tax purposes, not Wife, so that §2036 does not apply. Treas. Reg. § 25.2523(f)-1(f) Ex. 11 ("because S is treated as the transferor of the property, the property is not subject to inclusion in D's gross estate under section 2036 or section 2038"). Even though Husband is treated as creating the continuing trust for Wife for transfer tax purposes, Wife is still treated as the grantor of the continuing trust for grantor trust purposes (as long as Husband does not exercise a general power of appointment), so the trust is a continuing grantor trust as to Wife. *See* Treas. Reg. §671-2(e)(5). *See generally* M. Gans, J. Blattmachr, & D. Zeydel, *Supercharged Credit Shelter Trust*[SM], 21 PROBATE & PROPERTY 52 (July/August 2007). For further discussion of this technique, see Barry Nelson, *Seeking and Finding You Silver Patterns in a Changed Estate Planning Environment: Creative Inter Vivos QTIP Planning*, ABA RPTE SECTION SPRING SYMPOSIA (Chicago May 2014).

g. **Minority Interest Planning**.

(1) ***Example 1 (Minority Interest to QTIP Trust).*** Wife owns 100% of Company and transfers 49% to an inter vivos QTIP trust for Husband. Wife dies leaving her remaining 51% to Husband outright. On Husband's subsequent death, the 49% of stock owned by the QTIP trust is included his estate under §2044 and valued as a minority interest. The 51% of the stock left to him outright is valued as a controlling interest. The assets in the QTIP trust are not aggregated with the directly owned assets for valuation purposes. *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999), *acq.*, 1999-35 I.R.B. 314, as corrected by Ann. 99-116, 1999-52 I.R.B. 763 (Dec. 27, 1999). *Advantage*: The 49% of the stock owned by the QTIP trust is valued as a noncontrolling interest.

(2) ***Example 2 (Increasing Portion Valued as Noncontrolling Interest).*** Same as in Example 1, but Wife recapitalizes the company to create a 5% voting and 95% nonvoting interest. Wife transfers nonvoting shares representing 80% of the equity of the company to the inter vivos QTIP trust for Husband. At Husband's death, 80% of the equity in the company is valued as a noncontrolling interest. *Advantage:* without the lifetime QTIP, the nonvoting and voting shares would be valued together, as a controlling interest. (If Wife had not used a lifetime QTIP Trust but merely left 80% of the nonvoting shares to a testamentary QTIP trust at her death, the full company value would have been in her gross estate but the 80% of the nonvoting shares would be valued as a minority interest for marital deduction purposes, and the "disappearing value" would be a taxable disposition at Wife's death.)

(3) ***Example 3 (Wife Has Backend Interest in QTIP Trust after Husband's Death).*** Wife owns 75% of Company. Wife creates a lifetime QTIP Trust for Husband's benefit and transfers 37.5% of the stock to the trust. Assume Husband predeceases Wife and that the assets remain in trust for Wife's sole benefit with a mandatory income interest (i.e., Wife has a "backend interest" in the QTIP trust) and Husband's estate makes the QTIP election for that continuing trust for Wife. At Wife's subsequent death, the 37.5% of the stock in the QTIP trust is included in Wife's estate under §2044, and her directly owned 37.5% is included in her estate under §2033. These interests are not aggregated and both are valued as minority interests. (Issues that arise if the donor-spouse keeps a "backend" interest in a lifetime QTIP trust are discussed in subparagraph k below.)

(4) ***Example 4 (Art Fractional Interest).*** A similar approach can be used with art. Assume Wife owns paintings valued at $10 million in the aggregate. She wants the paintings to remain in the family and would like to reduce estate taxes applicable to their transfer. She prefers that the paintings continue to hang in her house for Wife and Husband's enjoyment (regardless of which spouse dies first).

Wife gives an undivided 25% interest in each of the paintings to a spousal limited access trust ("SLAT") in which Husband and Wife's descendants are discretionary beneficiaries) and gives the remaining 75% undivided interest in each painting to a lifetime QTIP Trust for Husband. If Husband predeceases Wife, the paintings will remain in the QTIP Trust for Wife's benefit for the balance of her lifetime. At either spouse's death, the undivided interest in the QTIP Trust would not be aggregated with other undivided interests, and a discount for the fractional interests in the art should apply for valuation purposes. (In *Elkins v. Commissioner*, the court ultimately allowed about a 66% discount for undivided interests in art. See Item 8.k above for a brief discussion of *Elkins*.)

h. **Sale to Grantor Trust Avoiding §2036 Risk**. The IRS has taken the position into pending Tax Court cases (*Woelbing* and *Beye*r, as discussed in Items 8.f and 11 above) that §§2702 and 2036 apply. The following is a way to avoid the §2702 and 2036 arguments.

Description. Wife creates an inter vivos QTIP trust for Husband and transfers $3 million cash to the QTIP trust. Wife makes the QTIP election. The QTIP trust loans the cash to a separate Grantor Trust (perhaps a SLAT). The Grantor Trust purchases assets from Wife *for cash*. Wife receives no note in the sale, so no retained interest problems under §§2702 or 2036 will be present.

***Step Transaction*?** Could the IRS make a step transaction argument, treating Wife as having sold the asset for a $3 million note? Presumably not, because Wife does not end up owning a $3 million note from the Grantor Trust. A separate legal entity (the QTIP Trust) owns that note from the Grantor Trust. In addition, the deeming rules (as discussed in subparagraph b above) should help because §2523(f)(1)(B) provides that no part of the QTIP Trust "property shall be considered as retained in the donor or transferred to any person other than the donee spouse."

i. **Combinations**. These strategies can work in combination with each other. Once the lifetime QTIP Trust is created, it can be used for various purposes over time. Accordingly, the lifetime QTIP Trust could be created for the discounting advantage, and subsequently it could be frozen by selling assets to a SLAT.

j. **Elective Share Planning/ Pre-Divorce Planning.** Assume Wife would like to minimize the elective share that Husband might receive outright following Wife's death. (For example, the asset might be an interest in a closely held company, and Wife would not want him to have control of the company.) Wife might contribute assets to a lifetime QTIP Trust for Husband. Amounts in that trust (or at least some part of the assets in the trust, depending on the distribution standards) would likely be counted as part of what Husband would receive under an elective share statute or augmented share statute. This strategy does not deprive Husband of the benefit of the interest, but blocks him from having total control over management or disposition of the trust assets.

Similarly, in a pre-divorce planning situation, a spouse might transfer assets into a lifetime QTIP Trust for the other spouse. Those assets would likely be treated as marital assets, and the beneficiary spouse's interest in the trust would be counted toward considering that spouse's share of any equitable distribution.

k. **Backend Interest; Asset Protection for Donor-Spouse of Lifetime QTIP**.

(1) ***No Estate Inclusion Under §§2036, 2038.*** If Wife creates an inter vivos QTIP trust for Husband and keeps a "backend" interest in the Trust following Husband's death, the regulations make clear that Wife is not treated as the transferor of that continuing trust, so §§2036 and 2038 cannot apply to include the trust assets in Wife's estate at her subsequent death. Treas. Reg. § 25.2523(f)-1(f) Ex. 11 ("because S is treated as the transferor of the property, the property is not subject to inclusion in D's gross estate under section 2036 or section 2038").

(2) ***No Further Taxable Gifts.*** Furthermore, any transfer by Wife of the retained backend interest is not treated as a transfer by Wife for gift tax purposes. §2523(f)(5)(A)(ii); Reg. §25.23(f)-1(d)(1). Therefore, Wife could release her interest in the backend trust at any time without make a further taxable gift.

(3) ***Section 2041 Concerns if Donor's Creditors Can Reach.*** A potential problem arises, however, under §2041. In the above example, if Wife is the beneficiary of the trust following Husband's death and if Wife's creditors can reach the trust assets, she in effect has a general power of appointment includable in her estate under §2041 (which includes a power exercisable in favor of creditors). Thus, whether Wife's creditors can reach the trust following Husband's death becomes a tax issue as well. (To minimize the §2041 risk, some planners suggest including an ascertainable standard on distributions to the donor-spouse.)

(4) ***Creditor Concerns.*** The presumption for tax purposes that Husband is treated as creating the continuing trust for Wife does not necessarily hold for state law purposes. Can a creditor argue that the assets originally came from Wife, and that when they end up in a trust for her benefit, she should be treated as having created that trust, so that it is a self-settled trust reachable by her creditors? Indeed, that result is a possibility. If the assets pass to the trust for the original donor-spouse pursuant to the exercise of a limited power of appointment, the original spouse could be treated as the transferor for state law under what has been called the "relation back doctrine." *See* Barry Nelson, Asset Protection & Estate Planning – *Why Not Have Both?,* at 15-11 2012 UNIV. MIAMI HECKERLING INST. ON EST. PLANNING ch. 17, ¶ 1701.2[B] (2012) (citing RESTATEMENT (FIRST) AND RESTATEMENT (SECOND) OF PROPERTY and a 1977 Florida case, concluding "[N]one of the reported cases regarding the Relation Back Doctrine address its application to the donor of a QTIP or credit shelter trust who receives trust assets upon the death of the donee spouse through the exercise of a special power of appointment …."). If the client does not live in a self-settled trust states, an attempt to incorporate the laws of a self-settled trust state may not be effective for creditor purposes. The comments to the new Uniform Voidable Transfers Act take the position that if the law of the state of the settlor's principal residence does not recognize self-settled trusts, transferring assets to a trust under the laws of another self-settled trust state would be a voidable transfer. UNIF. VOIDABLE TRANSACTIONS ACT §4, Comment 2, ¶8 (last paragraph) (July 2014).

(5) ***State Statutes Providing Creditor Protection for Backend Interest.*** Various states have enacted statutes specifically dealing with lifetime QTIP trusts to provide that the continuing trust interest for the original donor spouse, following the death of the donee-spouse, is not treated as a self-settled trust. These states include Arizona, Delaware, Florida, Indiana (proposed), Kentucky, Maryland, Michigan, North Carolina, Oregon, South Carolina, Tennessee, Texas, Virginia and Wyoming. For example, the Texas statute provides:

> (g) For the purposes of this section, property contributed to the following trusts is not considered to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts may not be treated as a settlor:
>
> (1) an irrevocable inter vivos marital trust if:
>
> (A) the settlor is a beneficiary of the trust after the death of the settlor's spouse; and
>
> (B) the trust is treated as:
>
> (i) qualified terminable interest property under Section 2523(f), Internal Revenue Code of 1986; or
>
> (ii) a general power of appointment trust under Section 2523(e), Internal Revenue Code of 1986
>
> (2) an irrevocable inter vivos trust for the settlor's spouse if the settlor is a beneficiary of the trust after the death of the settlor's spouse; or
>
> (3) an irrevocable trust for the benefit of a person:
>
> (A) if the settlor is the person's spouse, regardless of whether or when the person was the settlor of an irrevocable trust of the benefit of that spouse; or
>
> (B) to the extent that the property of the trust was subject to a general power of appointment in another person.

TEX. PROP. CODE ANN. §112.035(g). Observe that subparagraphs (g)(2)-(3) extend the same protection for a similar backend interest of a donor spouse from a SLAT and from reciprocal/nonreciprocal SLATs.

(6) ***Creditor Protection For Backend Interest Following Release by Donee-Spouse.*** Whether the donor spouse can have a backend interest following a *release* by the donee spouse (as discussed in subparagraph b above) is not clear. Only the Maryland and Michigan statutes refer to creditor protection for the donor-spouse if the donee-spouse *releases* his interest during his lifetime. In addition, the provision in the regulations that §2036-2038 does not apply because the donee-spouse is treated as the transferor from the QTIP trust is only in the estate tax regulations, and not in the gift tax regulations.

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

distributions to the original donor spouse. If circumstances change, the independent trustee could make outright discretionary distributions to the donor spouse, who could then make adjustments in the ultimate distribution of the property. (If Husband does not make the QTIP election for the Wife's continuing trust, so that it is not included in her gross estate, an outright distribution to Wife would cause the assets to be back in her gross estate. That may or may not be desirable, depending on the size of her estate at that time. Indeed, it may be desirable to achieve a basis adjustment at her subsequent death.)

(8) ***Donor-Spouse as Trustee of Backend Interest.*** Similarly, cautious planners may want to avoid allowing the donor-spouse to serve as the trustee of the backend interest if it a QTIP trust. See subparagraph m below.

(9) ***Deathbed Transfers for Creditor Protection Purposes.*** In states with statutes that protect the backend interest from a QTIP trust, clients might even want to consider a having one spouse transfer substantial assets on the other spouse's deathbed to an inter vivos QTIP trust for the dying spouse, with a backend interest for the surviving donor-spouse that would be creditor protected.

l. **Taking Advantage of DSUE from First Spouse in Event of Remarriage and New Spouse Predeceasing**. Under the portability rules, DSUE received from a decedent-spouse will be lost if the surviving spouse remarries and the new spouse predeceases. A surviving spouse only has DSUE from the last deceased spouse. §2010(c)(4)(B)(i). Under the portability regulations, however, if the surviving spouse makes a gift during her life, it will first be covered by any DSUE that she has from her last deceased spouse at that time, and at her subsequent death, such DSUE that was used to cover gifts will be added to her applicable exclusion amount. Reg. §20.2010-3T(b). (At Wife's death, the gift is added as an adjusted taxable gift, but it would be covered by the DSUE added to her applicable exclusion amount.) In effect, a surviving spouse can take advantage of DSUE by making a gift during her life, without using her own applicable exclusion amount or causing additional estate tax at her death.

If a surviving spouse with DSUE is about to remarry but does not have assets that she wants to gift during her lifetime, and if the prior decedent-spouse created a QTIP trust for the surviving spouse, one way to avoid losing the DSUE in case her new spouse should predecease is to release 1% of her income interest in the QTIP trust. Under §2519, this will trigger a taxable gift on the entire value of the remaining interest in the QTIP trust (thus resulting in the desired current taxable gift). Because the surviving spouse still retains 99% of her actual life interest in the QTIP trust, she will have only be a nominal change in her economic position. The remaining 99% of the QTIP trust would be included in her gross estate under §2036(a)(1) (meaning that a basis adjustment under §1014 would be allowed), but no additional estate tax will result (assuming the assets do not increase in value) because her applicable exclusion amount is increased by the amount of the DSUE used to cover the prior taxable gift. Furthermore, the transferor for GST purposes does not change as to any retained interest and the reverse QTIP election made by the deceased spouse (i.e., Husband in our example) is preserved.

m. **Can Donor-Spouse Serve as Trustee of Inter Vivos QTIP**? If the donor-spouse is the trustee of the inter vivos QTIP trust, whether the transfer qualifies for the gift tax marital deduction may be questionable, and cautious planners may want to avoid having the donor-spouse as trustee with discretionary principal powers (but the donor-spouse could have administrative powers as trustee).

The concern is that Reg. §25.23(f)-1(a)(1) provides in part: "Terminable interests that are described in section 2523(b)(2) cannot qualify as qualified terminable interest property." Section 2523(b)(2) says that no gift tax marital deduction is allowed "if the donor immediately after the transfer to the donee spouse has a power to appoint an interest in such property which he can exercise (either alone or in conjunction with any person)" to someone other than the donee spouse "even though such power cannot be exercised until after the lapse of time." If the donor-spouse as trustee has the discretionary authority to make principal distributions to the donee-spouse and does not make them, has she, in effect, diverted them to someone other than the donee-spouse after the donee-spouse's death?

That is the same technical reason why cautious planners will avoid giving the donor-spouse a limited power of appointment over any backend interest of the QTIP trust after the donee-spouse's death (unless the planner secures a letter ruling, because the IRS has issued various letter rulings allowing the donor-spouse to keep a power of appointment to appoint assets after the donee-spouse's death.

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

   Troublesome income tax issues with respect to the QTIP trust would also arise following divorce. Under §682, the income of the trust (which must be distributed to the donee-spouse) will be taxable to the donee-spouse even though the trust would continue as a grantor trust as to the donor-spouse as to trust income. The problem is that capital gain income would be taxed to the trust, or perhaps to the original donor spouse if the trust continues as a grantor trust as to the trust corpus. For planning considerations, see Nelson & Franklin, *Inter Vivos QTIP Trusts Could Have Unanticipated Income Tax Results to Donor Post-Divorce*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2244 (Sept. 15, 2014).

o. **Special Consideration–Spendthrift Clause**. Some of the strategies described above depend upon a release of some or all of the spouse's income interest in the QTIP trust. A "release" should not be considered an "assignment" that violates a spendthrift clause. Nevertheless, a customized spendthrift provision should be used for all QTIP trusts to clearly leave open the flexibility of income interest releases. Richard Franklin suggests the using a clause similar to the following to be inserted into the trust's spendthrift provision:

   > For purposes of this Section, a release of an interest in a trust hereunder, without any attempt to direct who is to receive the interest, shall not be considered a form of prohibited alienation pursuant to Paragraph (a) above.

p. **Not Simple.** An obvious disadvantage of all of the strategies discussed in this Item is that they are not simple. They involve the creation of irrevocable trusts with special provisions. The planner must consider what happens in the event of a divorce or other unforeseen circumstances. (Might the donee-spouse be able to keep the QTIP trust as a gift and also be entitled to an equitable share of the remaining marital assets, or is the interest in the QTIP trust treated as part of his or her equitable portion of the marital estate? Is a post-nuptial agreement necessary to document that intent?) In addition, if the spouse has a backend interest, a formula provision may be desirable to assure that any of the original donee-spouse's available exemption amount would pass to a bypass trust rather than into a QTIP trust.

18. Charitable Set-Aside Deduction, Estate of Belmont v. Commissioner and Estate of DiMarco v. Commissioner

a. **Statutory Rule**. Section 642(c)(1) provides that an estate or trust may take a charitable deduction (not subject to percentage limitations that apply to charitable gifts by individuals) "for any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a [charitable] purpose." Furthermore, the executor or trustee may elect to treat a contribution made in one taxable year as having been made in the prior taxable year. §642(c)(2).

An estate or trust may also be entitled to an income tax charitable deduction for amounts of gross income that are permanently set aside for charity even though the income has not actually been distributed to charity during the current taxable year. §642(c)(2). The regulations provide that an amount is not "permanently set aside" for a charitable purpose "unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible." Reg. §1.642(c)-2(d).

b. **Estate of Belmont v. Commissioner**. The Tax Court in *Estate of Belmont v. Commissioner*, 144 T.C. 84 (2015), denied a set-aside deduction because of the possibility that some portion of the funds would be used for litigation expenses. The decedent's residuary estate passed to a charitable foundation. The decedent's condominium had been used by her brother, but her executor ordered him to leave. He refused and filed a claim alleging his sister orally granted him a life estate. The estate claimed a $219,580 charitable deduction for the portion of the estate's net income (primarily from an IRA distribution) that was "set aside" for the charitable beneficiary (although that amount was not segregated from the other estate funds in its checking account). Subsequent litigation expenses resulted in the estate being unable to pay the entire $291,580 amount to charity. The court denied the charitable set aside deduction in its entirety, because at the time of taking the deduction, the estate knew a substantial possibility of a prolonged and expensive legal fight existed, and the possibility was not "so remote as to be negligible."

c. **Estate of DiMarco v. Commissioner.** The Tax Court again addressed the charitable set-aside deduction later in 2015 in *Estate of DiMarco v. Commissioner,* T.C. Memo. 2015-184. The decedent's will left the residuary estate to the church that he regularly attended. Confusion arose because he attended two churches. Various cousins alleged that the residuary bequest was unenforceable because of its ambiguity and that the estate should pass to them as the decedent's heirs. The parties discussed settling the case, and the discussion had a reached a point that the estate felt sure that a certain amount of its gross income (apparently from an IRA distribution) would pass to charity. On April 19, 2012 it filed the estate's 2010 income tax return (late) claiming a $319,942 charitable deduction from gross income as an amount permanently set aside for charitable purposes. On April 26, 2012 the court approved a settlement, with one-third passing to each of the two churches and one-third passing to the heirs. After selling the last asset, the parties reached a further settlement regarding the payment of all attorney's fees and executor commissions, which was filed with the court on December 28, 2012 and approved by the court in January 2013.

The estate's position was that the parties' settlement discussions had reached a point that by the time it filed the return on April 19, 2012 "it could determine and account for all of its final administrative expenses" and "the possibility of prolonged legal controversies over estate matters was so remote as to be negligible." The IRS argued that "in view of the uncertainties and legal controversy the possibility that the estate's assets might go to noncharitable beneficiaries was not so remote as to be negligible." Furthermore, it took the position that "the estate cannot permanently set aside funds as a matter of caselaw when there is a pending will contest or active litigation, the result of which might distribute the estate's funds to noncharitable beneficiaries." The Tax Court (Judge Laro) denied the set-aside deduction, pointing out that even the first settlement left the issue of legal fees and executors' commissions unsettled. The estate claimed that it accounted for the commissions and attorney's fees in a proposed distribution schedule, but the court observed that schedule omitted possible future fees for the estate's own attorney and the Attorney General, suggesting that the fee schedule did not account for the final administrative expenses. The court also noted that no funds had physically been segregated to pass to the churches, but reasoned that fact favored the IRS position "to a small degree, taking into consideration the overall circumstances." The court's final conclusion casts doubt over whether a set-aside deduction could be taken during the continuance of an outstanding will contest until the dispute has been *finally* resolved:

> At the time the estate filed its income tax return, it was not known how long it would take to validate the will, reach a settlement, or conduct probate. Only after the surrogate's court approved the second settlement on about January 28, 2013, were the estate's funds finally dedicated to the respective parties, thereby eliminating the opportunity to challenge the will. [Citation omitted] By virtue of the fact that the settlements pertaining to designation of the beneficiaries and consequential legal and administrative expenses were not finalized until after the year at issue and the estate filed this income tax return, we find that the possibility that the funds would go exclusively to noncharitable beneficiaries was not so remote as to be negligible.

d. **Planning Considerations.** These cases, and the increased IRS attention to the charitable set-aside deduction for estates and trusts, create significant uncertainties in being able to claim charitable set-aside deductions whenever ongoing estate litigation continues that might impact the amounts passing to charity.

(1) ***Segregate Funds.*** If the estates had segregated funds for charity in these cases, the taxpayer would have had a better chance of prevailing (although Judge Laro in *DiMarco* said the failure to segregate funds helped the government's position only "to a small degree"). How are funds segregated into a separate account if a charity is the only beneficiary of the residuary estate?

Some attorneys respond to transfer funds to a separate account anyway to provide a better argument.

(2) ***Delay Deduction Until Later Year.*** The estate or trust could always claim the deduction in a later year when amounts from gross income are actually distributed to charity, but the estate or trust typically will not want to pay income tax on gross income received in one year when that amount will ultimately be passing to charity (and the estate or trust may not have sufficient income to be offset by the deduction in a later year). The estate or trust can treat the contribution as having been made in the prior year under §642(c)(1). For example, if gross income is received in year one that the estate would like to offset with a charitable deduction, if the amount is actually paid to charity in year two, a deduction could be claimed for year one under §642(c)(1) rather than as a set-aside deduction under §642(c)(2).)

(3) ***Manage Receipt of Gross Income.*** If the estate owns IRAs, do not withdraw money from the IRAs (other than minimum required distributions) until the dispute is resolved.

19. Trust Income Tax Charitable Deduction for Distribution to Charity of Asset With Unrealized Appreciation; Correction of Clerical Error Does Not Deny Flow-Through Charitable Deduction For Trust's Percentage of Partnership That Made Contribution (As Corrected), *Green v. United States*

a. **Trust Deduction for Distribution to Charity of Asset With Unrealized Appreciation**. A federal district court addressed, as a matter of first impression, whether a trust could claim an income tax charitable deduction for the full fair market value of appreciated property (rather than just the basis of such property) that it contributes to charity. *Green v. United States*, 116 AFTR 2d 2015-6668 (W.D. Okla. 2015). The trust agreement authorized the distributions to charity of "such amounts from the gross income of the Trust" as the trustee deems appropriate. The trust owned an interest in a partnership, which in turn owned many Hobby Lobby stores. The trust made charitable donations of appreciated real estate, and filed its income tax return claiming a deduction just for the adjusted basis of those properties. It later filed a claim for refund, claiming a deduction for the full fair market value of the properties, which the IRS denied.

The court granted summary judgment to the trust allowing the refund. The court cited that the purpose of Congress in allowing charitable deduction was to encourage charitable gifts, that statutes regarding charitable deductions are "expression[s] of public policy," and that a liberal construction of charitable deduction statutes in favor of taxpayers is appropriate. The court observed that §170 imposes limitations on the amount of a charitable deduction for individuals, based on whether the gift is cash or appreciated property, but noted that §642(c) has no such limitation for estates and trusts.

Section 642(c) limits the income tax charitable deduction for an estate or trust to "any amount of gross income … paid," but the court reasoned that section does not require the distribution be made in the same year in which the gross income was realized. The IRS argued that a distribution must be "sourced from and traceable to" gross income to generate a charitable deduction. The court responded that the properties were bought with the proceeds of income distributed from the partnership to the trust in prior years that was gross income of the trust in the year the distributions were received; therefore the real estate properties were purchased by the trust with the trust's gross income.

The IRS next argued that the trust agreement only authorized distributions to charity from the trust's gross income, and the properties had become principal by the time they were distributed to charity, so the distributions were not made "pursuant to the terms of the governing instrument" as required by the charitable deduction statute. The court responded that "conflating … fiduciary accounting principles with the federal tax concept of gross income unnecessarily muddies the water – here, there can be no serious question that the donations were made 'pursuant to the terms of the governing instrument.'"

The government also argued that gross income does not include unrealized appreciation and that only the adjusted basis of the property could be deducted, not the full fair market value of the appreciated properties. The court responded that §642(c) does not limit the trust's charitable deduction to the basis of distributed property, and allowed a charitable deduction based on the full fair market value of the distributed property.

The holding of this case of first impression is rather surprising, "[b]ut allowing a deduction of fair market value puts the trust in the same position as if it had sold the property and donated the cash proceeds, while allowing a charitable donee to receive property it can use for its charitable purposes." Ronald Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2015,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2371 (Jan. 4, 2016). Until contrary case law arises, trusts will likely claim charitable deductions based on the full value of appreciated properties that are distributed to charity if the charitable gifts are authorized by the trust agreement.

b. **Clerical Error Does Not Deny Flow-Through Charitable Deduction for Trust's Percentage of Partnership That Made Contribution (As Corrected).** A subsequent opinion addressed another issue that arose in this case. *Green v. United States*, 117 AFTR 2d 2016-700 (W.D. Ok.2015). The parties intended that $4.75 million of cash gifts would be made in 2004 by a partnership (Hob-Lob Limited Partnership) that was owned 99% by the trust. Instead, the cash was paid from a separate corporation (Hobby Lobby Stores, Inc.) as a result of a bookkeeping error (the corporation and partnership shared the same accounting system). When the mistake was discovered, it was corrected: "letters of correction were sent, affidavits were signed, books were corrected, and most importantly, Hob-Lob reimbursed Hobby Lobby's account for the full amount of the Subject Contributions." In addition, the donations "were properly accounted for on Hob-Lob's audited 2004 financial statements." The court allowed a refund to the trust based on this charitable contribution. "To disallow a charitable deduction simply because of a clerical error goes against the liberal policy of encouraging charitable giving and distorts the Supreme Court's holding in *Nat'l Alfalfa Dehyrating & Million, Co.*" (That Supreme Court case did not involve a charitable deduction, but disallowed another deduction that might have been possible if the parties had structured the transaction in a different way. Instead, the Supreme Court said that "a transaction is to be given its tax effect in accord with what actually occurred." 417 U.S. 134, at 148 (1974).)

20. Decanting; Uniform Trust Decanting Act

a. **Decanting Authority May Provide Needed Flexibility.** Judicial modification can be expensive and invasive of privacy. Nonjudicial modification by settlement agreement is permitted by statute in at least 33 states, but (i) the statutes may not allow dispositive changes, (ii) using the statutes may result in adverse tax consequences (in part because they require beneficiary consent), (iii) necessary consent may not be possible on behalf of minor, unborn, or incapacitated beneficiaries, and (iv) some of the required beneficiaries may be unwilling to consent.

Twenty-three states have decanting statutes, permitting a trustee to exercise its discretionary distribution authority to make a distribution from the "first trust" to a "second trust" for trust beneficiaries without court approval or beneficiary consent (many statutes allow differing dispositive provisions in the second trust, depending on the circumstances, but sometimes only administrative provisions can be changed). The state statutes vary dramatically, and some are so permissive that the mere existence of the statute may conceivably cause tax issues.

See Item 16.n.(3) for a discussion of practical planning issues regarding the use of decanting or other strategies to make needed changes to trusts.

b. **Should Decanting Provisions be Drafted Into Trust Agreements**? If a client does not want to allow decanting, the trust agreement should specifically prohibit distributions in further trust (at least to trusts that are not substantially identical) because the applicable state statute may otherwise allow decanting or the trust administration may move to a state that allows decanting.

If a client wishes to allow decanting flexibility, including a decanting provision in the trust allows decanting if the relevant state does not have a decanting statute, or in case the trust moves to a state without a decanting statute. In addition, the clause could draft around permissive provisions in some state statutes that could cause adverse tax consequences. (The new Uniform Decanting Act can be a drafting guide because it includes various provisions designed to guard against adverse tax issues.)

c. **Brief Overview of Uniform Trust Decanting Act**.

The Uniform Law Commission formed a Trust Decanting Committee in early 2013.

At the core of the Uniform Act is the general scope of changes that may be made by decanting.

Limited Distribution Discretion. If the trustee has limited distributive discretion (for example, an ascertainable standard), generally only administrative provisions can be changed in the new trust (the interest of each beneficiary must be substantially similar to that person's interest in the first trust).

Expanded Distribution Discretion. If the trustee has expanded distributional discretion (for example, "best interests," "welfare" or no standard), the second trust may have different dispositive provisions, with limits that protect "vested rights" and that protect qualification for various tax advantages. The decanting cannot accelerate of remainder interests or add beneficiaries. With some limitations, the new trust can restrict powers of appointment or grant new powers of appointment.

For a more detailed summary of the Uniform Trust Decanting Act, see Items 11-17 of the ACTEC 2015 Fall Meeting Musings (November 2015) found **here** and available at **www.Bessemer.com/Advisor**.

21. Digital Assets; Revised Uniform Fiduciary Access to Digital Assets Act

This Item very briefly describes the Uniform Act promulgation, opposition to the Act by internet service providers (ISPs), and the renegotiated revised Uniform Act. For a more detailed summary of these issues, see Items 5-10 of the ACTEC 2015 Fall Meeting Musings (November 2015) found **here** and available at **www.Bessemer.com/Advisor**.

The Revised Uniform Fiduciary Access to Digital Assets Act has been enacted in at least fifteen jurisdictions and has been introduced in a variety of other states.

a. **Significance.** Americans routinely use the Internet and have many forms of digital assets. Few states have enacted laws specifically granting some type of fiduciary access to digital assets. Federal privacy and computer fraud and abuse laws create confusion regarding fiduciary access, but do not specifically address fiduciaries.

   Accessing digital information after an individual's death or disability is very important, not only to obtain the information in that account, but also because the information may lead to valuable information about other accounts or assets.

b. **Uniform Act Promulgation**. The Uniform Fiduciary Access to Digital Assets Act (UFADAA) drafting committee was approved in 2012 and the UFADAA was approved in the summer of 2014.

c. **Challenges Without State Law**. Federal privacy laws (Stored Communications Act), federal criminal laws (Computer Fraud and Abuse Act), state criminal laws, and "term of service" agreements all create possible roadblocks to fiduciaries being able to access digital assets.

d. **UFADAA Approach and Major Provisions**. After contentious negotiations with service providers over provisions of the Act, the general approach is to (i) define digital assets, (ii) provide default rules for fiduciary access with specific provisions for personal representatives, conservators/guardians, agents and trustees, (iii) defer to the account holder's intent and privacy desires, (iv) encourage custodian compliance, and (v) protect fiduciaries, custodians and content providers.

e. **The War**. The UFADAA was introduced in 26 states. That is a blockbuster for a Uniform Act (most Uniform Acts have 5-6 introductions in the first year). None of those 26 bills were enacted. (Delaware enacted a version in 2014 before the UFADAA was final and before the opposition was readied for battle.)

   Lobbyists for many larger providers of electronic communications to the public (Yahoo!, Facebook, AOL, and Google were the most commonly seen, often with a representative of their trade association, NetChoice) vehemently opposed UFADAA in nearly every state in which it was introduced. These efforts were well funded; some estimate that the groups were spending about $250,000 in every state in which the legislation was introduced.

f. **PEAC Act.** The service providers' major complaints are that UFADAA is too broad, it raises serious privacy concerns, it potentially conflicts with federal and state law, and it implicitly overrides TOS Agreements. To address these concerns, NetChoice drafted a model act offered as an alternative to UFADAA—the Privacy Expectation Afterlife Choices Act (PEAC Act), pronounced as the "peace act." It was proposed as a legislative alternative in roughly half the states where UFADAA was introduced. A key element is that it applies only to executors (not other fiduciaries), a court order would be required in all circumstances to access either the catalog or content of electronic communications, and both a court order and express authorization in the owner's will or in an online tool would be required to view the contents.

g. **Stalemate.** The ISPs were not successful in getting legislatures to pass the PEAC Act, and in May 2015, ISP representatives asked to "re-group" with representatives from the Uniform Law Commission. After about a dozen drafts, a consensus emerged, and was introduced as the Revised Uniform Fiduciary Access to Digital Assets Act (RUFADAA) at the July 2015 meeting of the Uniform Law Commission.

h. **RUFADAA.** The Uniform Law Commission approved RUFADAA on July 15, 2015. One of the major changes is that the *default* rule for personal representatives is for *privacy* of the contents of an account rather than for access; access to contents of the account is not permitted unless the decedent consented to disclosure (but restrictions on access in an online tool setting of an account will override a consent to disclosure in an estate planning document). The revised UFADAA continues to apply to fiduciaries beyond just executors and administrators.

- RUFADAA grants a fiduciary full access to digital assets ***other than content*** of electronic communications unless the user opts out or the court directs otherwise. More specifically, the fiduciary has access, except that (i) the custodian of the digital asset may require specific identification of the account and evidence linking the account to the principal (via documentation or court order); and (ii) any TOS restricting fiduciary access will be upheld, absent a conflicting provision in the user's estate planning documents or an online tool/setting, §§4(c) & 5(c). *E.g.*, §8 (personal representative's access to content for a deceased user).

- For a fiduciary to access the ***content*** of electronic communications, the governing document must expressly authorize fiduciary access, or the account holder must otherwise consent to fiduciary access via an online tool. *E.g.,* §7 (personal representative's access to content for a deceased user).
- If a conflict exists between the online tool/account setting and the estate planning documents, the online tool/account setting prevails. §4(a). This was a very important and significant concession by the ULC representatives.

i. **Importance of Online Tools Under UFADAA**.

Description. RUFADAA defines an "online tool" as an electronic service provided by a custodian of a digital asset, distinct and separate from the TOS required to open the account (*i.e.*, not a "click through"). Google's Inactive Account Manager and Facebook's Legacy Contact features are two examples of such online tools. Google's Inactive Account Manager allows a user to designate up to 10 individuals to receive the contents of the user's account if it is inactive for a period of time designated by the user, or the user could choose to have the account terminated after the designated period of inactivity.

Compromise. Giving priority to online tools over provisions in estate planning documents was necessary or else ISPs would have no incentive to provide those tools. The online tools may provide a way for ISPs to handle access issues automatically rather than hiring attorneys to interpret wills or other estate planning documents. The concession to the priority of online tools over estate planning documents was granted in order to obtain the concession by ISPs that the estate planning documents (and online tools) would have priority over the "click through" TOS. That was a strongly negotiated issue that the ISPs conceded very reluctantly.

Significance Going Forward. Whether more providers will develop online tools regarding account access is unknown. If these tools become more prevalent, **estate planning attorneys will have to caution clients that decisions that they made, perhaps unwittingly, years ago about their account settings will override provisions in their estate planning documents granting fiduciary access to digital assets** (analogous to life insurance or retirement plan beneficiary designations overriding provisions in wills and trust documents).

j. **Planning Issues and Sample Document Providing Fiduciaries With Access to Digital Assets.** Before the Act is passed by states, account holder should provide as specific an authorization as possible to agents and fiduciaries to access digital assets (if that is desired). Even with consent, service providers may balk at providing access to agents and fiduciaries. Passage of the Act will help with authorizing fiduciary access; even then, having specific provisions in trust agreement acknowledging a fiduciary's rights to access digital assets (with any desired limitations) will be helpful in convincing service providers.

Planning considerations include (i) identify and create an inventory of digital assets and passwords, (ii) authorize agents under a power of attorney to access digital assets (which could be specific to certain types of digital assets or broadly apply to all digital assets), and (iii) add provisions to wills and trusts authorizing fiduciary access to digital assets. *See* Sasha Klein and Mark Parthemer, *Where Are Our Family Photos—Planning for a Digital Legacy*, 29 PROBATE & PROPERTY 45 (January/February 2015).

The importance of maintaining an inventory of digital accounts and passwords is illustrated by a recent situation (relayed by Jim Lamm, Minneapolis) in which a 72–year-old Canadian woman whose husband had recently died was told by Apple that she needed to obtain a court order in order to be able to continue playing a card game on the couple's iPad device. She knew the password for the iPad but did not know the password her husband used for the Apple ID associated with the iPad. When she contacted Apple to reset the Apple ID password, Apple told them a court order was required. CBS News contacted Apple to ask its official policy for users seeking to reset Apple ID passwords or to obtain data on family members who have died, and Apple said it would not comment.

The following is a form clause provided by Jim Lamm (Minneapolis, Minnesota) that is designed as a stand-alone document that a person could sign to authorize disclosure of the content of electronic communications (and other digital assets) to all of the person's fiduciaries. Jim has graciously given me permission to include the document in this summary.

Authorization and Consent for Release of Electronically Stored Information

I hereby authorize any individual or entity that possesses, custodies, or controls any electronically stored information of mine or that provides to me an electronic communication service or remote computing service, whether public or private, to divulge to my then-acting fiduciaries at any time: (1) any electronically stored information of mine; (2) the contents of any communication that is in electronic storage by that service or that is carried or maintained on that service; and (3) any record or other information pertaining to me with respect to that service. The terms used in this authorization are to be construed as broadly as possible, and the term "fiduciaries" includes an attorney-in-fact acting under a power of attorney document signed by me, a guardian or conservator appointed for me, a trustee of my revocable trust, and a personal representative (executor) of my estate.

This authorization is to be construed to be my lawful consent under the Electronic Communications Privacy Act of 1986, as amended; the Computer Fraud and Abuse Act of 1986, as amended; and any other applicable federal or state data privacy law or criminal law. This authorization is effective immediately. Unless this authorization is revoked by me in writing while I am competent, this authorization continues to be effective during any period that I am incapacitated and continues to be effective after my death.

Unless an individual or entity has received actual notice that this authorization has been validly revoked by me, that individual or entity receiving this authorization may act on the presumption that it is valid and unrevoked. An individual or entity may accept a copy or facsimile of this original authorization as though it were an original document.

Date: ___________________________ ____

Signature

____

Printed Name

STATE OF ____________________

COUNTY OF __________________

This instrument was acknowledged before me on ____________________ (date) by ____________________ (name of person).

____

Notary Public

22. Unbundling Requirements for Expenses of Trusts and Estates, Final Regulations to §67(e)

a. **Statutory Provision**. Under §67(a) miscellaneous itemized deductions may be deducted only to the extent that they exceed 2% of adjusted gross income. Under §67(e) the same rules apply to estates and trusts, except that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" are allowed in full. This exception has been analyzed under a two-prong test: (1) costs paid or incurred in connection with the administration of the estate or trust, and (2) which would not have been incurred if the property were not held in such trust or estate.

b. **Case Law; Knight v. Commissioner.** Following a tortured history of inconsistent treatment by circuit courts of whether trust investment advisory fees are subject to the 2% floor, the Supreme Court spoke to the issue in *Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner*, 552 U.S. 181 (2008). The Supreme Court held in favor of the government, adopting the "unusual or uncommon" test used by the Fourth and Federal Circuits and concluding generally that "§67(e)(1) excepts from the 2% floor only those costs that it would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur."

c. **Proposed and Final Regulations**. Regulations regarding the application of §67(e) to trusts, following the Supreme Court's decision in Knight v. Commissioner, were finalized on May 9, 2014, with very few changes from revised proposed regulations that were published in response to the *Knight* case. The final regulations apply to any taxable year of any trust or estate that begins on or after January 1, 2015. **Accordingly, the regulations apply to returns for trusts and estates that will be filed in 2016.**

   For a summary of the highlights of the final regulations, see Item 25.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

d. **Unbundling Requirement**.

   - Bundled fees (such as a trustee or executor commissions, attorneys' fees, or accountants' fees) must be allocated between costs that are subject to the 2% floor and those that are not.
   - A safe harbor is provided in making the allocation of bundled fees. If a bundled fee is not computed on an hourly basis, only the portion of the fee that is attributable to investment advice is subject to the 2% floor. The balance of the bundled fee is *not* subject to the 2%. Reg. §1.67-4(c)(2). (This exception may seem overly broad as applied to attorneys' and accountants' fees, but the exception is explicit. If attorneys or accountants charge on a project basis rather than on an hourly basis, fees do not need unbundling if none of them relates to investment advisory expenses.)
   - If the recipient of the bundled fee pays a third party or assesses separate fees for purposes that would be subject to the 2% floor, that portion of the bundled fee will be subject to the 2% floor.
   - Any reasonable method may be used to allocate the bundled fees. The Preamble to the proposed regulations provides that detailed time records are not necessarily required, and the IRS requested comments for the types of methods for making a reasonable allocation, including possible factors and related substantiation that will be needed. The IRS was particularly interested in comments regarding reasonable allocation methods for determining the portion of a bundled fee that is attributable to investment advice — other than numerical (such as trusts below a certain dollar value) or percentage (such as 50% of the

trustee’s fee) safe harbors, which the IRS suggested it would not use. The Service received only one comment about allocating bundled expenses-stating that no single standard could be applied to multiple trusts or even to the same trust in different years. The final regulations provide three facts that may be considered (among others) in making a “reasonable” allocation:

> Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to, the percentage of the value of the corpus subject to investment advice, whether a third party advisor would have charged a comparable fee for similar advisory services, and the amount of the fiduciary’s attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions. Reg. §1.67-4(c)(4).

e. **Mutual Fund Investments for Trusts**. In the future, trustees may tend to make investments through mutual funds rather than through common trust funds or by direct investments, because the investment expense of administering a mutual fund is netted out before the taxable income from the fund is determined. Thus, the issue of having a separate expense that is not fully deductible (or that is subject to the alternative minimum tax) does not exist.

f. **Impact of §67(e) 2% Floor for Trusts and Estates.** For many trusts, the most substantial impact of having expenses subject to the 2% floor is that all of the expenses subject to the 2% floor (not just the amount within 2% of adjusted gross income that cannot be deducted) is a tax preference item for alternative minimum tax purposes.

   If the 2% limitation applies, the effect will be to increase DNI — so beneficiaries of the DNI carryout will be hit harder.

   Trust distributions reduce trust AGI and minimize the impact of §67. The distribution deduction is subtracted in arriving at the adjusted gross income of the trust (and the 2% limit under §67 is based on the adjusted gross income).

   Unlike individuals, estates and trusts are not also subject to an overall limitation on itemized deductions under §68 (generally reducing overall allowable itemized deductions by 3% of adjusted gross income over an “applicable amount,” but not to exceed 80% of the itemized deductions).

   Calculating the 2% floor is a complicated interrelated calculation if the trust pays the beneficiary more than its DNI. The AGI depends on the distribution deduction, which is limited by DNI, which depends on the trust’s allowable miscellaneous itemized deductions (AMID), which depend on its AGI.

23. Distribution Planning New Paradigms

a. **Distributions**. Distributions from an estate or trust may reduce the income subject to the top 39.6%/20% rates on ordinary and capital gains income, respectively, as well as reducing the income subject to the 3.8% tax on net investment income. The top brackets are reached for estates and trusts at $12,400 in 2016, compared to the top brackets for individuals, $466,950 joint/$415,050 unmarried.

   In making decisions about the tax impact of distributions, keep in mind that if the trust is in a state that does not have a state income tax on the trust, making the distribution to a beneficiary who lives in a state with a state income tax may generate enough state income tax to the beneficiary to more than offset the federal income tax savings to the trust by making the distribution.

This may present additional pressure on fiduciaries to make distributions. Of course, the fiduciary must look to the distribution standards in the trust agreement to determine the extent to which these tax considerations come into play. If the distribution is based solely on the health, education, support, and maintenance of the beneficiary, the trustee may not have the authority to take into consideration tax effects of distributions. *Drafting Tip:* Giving a non-beneficiary trustee the authority to consider tax implications may broaden the ability of the fiduciary to consider these tax implications of distributions. Even so, the fiduciary would generally treat taxes as merely one factor to be considered in the overall factors that the fiduciary considers in determining the appropriateness of distributions.

These additional income tax implications may also factor into the trustee's investment decisions—for example, whether to include allocation to tax-exempt investments.

b. **Capital Gains in DNI**. Capital gains ordinarily are excluded from DNI (so that capital gains are ordinarily taxed at the estate or trust level). Reg. §1.643(a)-3(a). However, the regulations provide that capital gains will be included in DNI if they are, pursuant to the terms of the governing instrument and applicable law or pursuant to the trustee's discretion (1) allocated to income, (2) allocated to corpus and consistently treated as being a part of distributions, or (3) allocated to corpus and actually distributed or taken into consideration in determining what is distributed. Reg. §1.643(a)-3(b).

For a discussion of planning opportunities for each of these three possibilities, see Item 18.b of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor** and Item 9.n of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**

Example Clauses. An example clause giving the trustee discretion to utilize the flexibilities afforded by the regulation to cause capital gains to be in DNI is as follows:

> The Trustee may allocate realized short term capital gains and/or realized long term capital gains to either trust income or trust principal, and such gains shall be includable in distributable net income as defined in I.R.C. § 643 and the regulations thereunder (1) to the extent that such gains are allocated to income and distributed to the trust beneficiary; or (2) if such gains are allocated to principal, to the extent they are consistently treated as part of a distribution to the trust beneficiary, actually distributed to the trust beneficiary, or used by the Trustee in determining the amount distributable to the trust beneficiary.

Gregory Gadarian, *Including Capital Gains in DNI,* ACTEC 2014 Fall Meeting of Fiduciary Income Tax Committee.

Another very simple sample clause, utilizing just the first of the alternatives (of allocating capital gains to income) is provided by Susan Bart:

> **Allocation of Capital Gains to Income.** The Trustee may allocate to income all or part of the gainsfrom the sale or exchange of trust assets as the Trustee considers appropriate.

24. Material Participation by Trusts

a. **Significance—For Net Investment Income Tax as Well as Passive Losses**. Whether a trust's losses are subject to the passive loss rules depends on whether the trust materially participates in the activity that generates the losses. §469. More importantly, §1411(c)(1)(A)(ii) has a non-passive trade or business income exception from the 3.8% tax on net investment that applies if the taxpayer materially participates in the business, as determined under the §469 rules. For a discussion of the net investment income tax, see Item 9 of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**, and in particular, for a considerably more detailed discussion of the issues regarding material participation by trusts, including the *Aragona Trust* case, see Item 9.g-h of that 2014 Summary.

b. **General Rules for Material Participation**. Section 469(h)(1) defines material participation as an activity in which the taxpayer participates on a "regular, continuous, and substantial basis."

Individuals can use one of seven tests (one of them being the 500-hour rule) to establish material participation to avoid passive income treatment. Reg. §1.469-5T(a). In addition, a separate exception exists for real estate professionals (if the taxpayer performs more than 750 hours in real property trades or businesses). §469(c)(7)(B). The §1411 regulations indicate (in an extremely round-about way) that a **100-hour test** may generally apply, with some exceptions, for purposes of the active business interest exception. Reg. §1.1411-5(b)(2). *See* Richard Dees & Jeffrey Ekeberg, *Participation of 100 Hours May Be Sufficient to Generate Active Income Exempt from the 3.8 Percent Health Care Tax on Net Investment Income*, McDermott Will & Emory Website, On the Subject Newsletter (April 14, 2014). (If the 100-hour test applies and the business has associated tax credits, complications may arise; the credits may be suspended until the company has passive income at some point (i.e., a year in which the taxpayer flunks the 100-hour test). *See* Steve Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications,* (2015) (available from author). For a detailed discussion of the 100-hour test, see Item 9.f of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

Various cases have addressed whether particular activities rise to the level of material participation. As an example, *Leland v. Commissioner*, T.C. Memo. 2015-240 discussed whether a landowner (a practicing attorney) who leased farmland under a cropshare arrangement materially participated in the conduct of the business for purposes of §469. The landowner leased the land to a Mr. Pigg, and the landowner had to spend time controlling the wild hog population on the land as well as maintaining farm equipment. The court determined that the taxpayer met the 100-hour test. In supporting his activities in maintaining the farmland, the taxpayer offered the following explanation:

> Wild hogs are a continuing problem at the farm. They dig underneath fences to get to edible crops and have dug up and broken water lines on the farm. In a year before the tax years 2009 and 2010, wild hogs ate 250,000 pounds of peanuts that petitioner and Mr. Pigg had grown on the farm. As a result, petitioner has to spend significant time controlling the wild hog population, which he accomplishes through hunting and trapping. Petitioner usually hunts hogs for three hours each morning and afternoon while at the farm, for a total of six hours per day. In addition, he spends time building traps and baiting them with corn millet and Kool-Aid to lure hogs to a

> specific area, where he waits in a tripod stand with semiautomatic weapons in order to eradicate them.

(Mr. Pigg eradicating hogs?? Who says the material participation rules are dry and boring?)

c. **Authority Prior to Aragona Trust Regarding Material Participation by Trusts or Estates.** No guidance exists regarding how a trust or estate "materially participates" in a trade or business, under either the §469 or §1411 regulations.

(1) ***IRS Position.*** The IRS position is that trusts and estates are not treated as individuals for this purpose (so, for example, the 500-hour rule does not apply), and that the real estate professional exception does not apply to trusts. The IRS position is that the trustee must be involved directly in the operations of the business on a "regular, continuous, and substantial" basis. The IRS points to the legislative history of §469, which states very simply:

> Special rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity if an executor or fiduciary, in his capacity as such, is so participating. S. Rep. No. 99-313, at 735.

(While these have been the historic positions of the IRS, Service personnel have indicated informally that they are not necessarily taking that same approach in new regulations that they are considering.)

(2) ***Activities of Non-Trustee Agents of Trust Constituted Trust Material Participation, Mattie K. Carter Trust v. U.S.*** A 2003 federal district court was the first to address in a reported case what activities can qualify as material participation under the passive loss rules for trusts and estates. *The Mattie K. Carter Trust v. U.S.*, 256 F. Supp.2d 536 (N.D. Tex. 2003). The District Court concluded that material participation should be determined by reference to all persons who conducted the business on the trust's behalf, including employees as well as the trustee. *Aragona Trust* (discussed below) in footnote 15 said that it was not faced with and did not address whether activities by non-trustee employees are considered in determining a trust's material participation.

(3) ***IRS Rulings Rejecting Material Participation Efforts by Trustees.*** Various private rulings have generally rejected attempts to show material participation by trustees. *See* TAM 200733023 (rejecting *Carter Trust* reasoning; treatment of special trustee); PLR 201029014 (no strict application of "in such capacity" clause in legislative history); TAM 201317010 (activities of co-trustee who was president of business not counted in determining trust's material participation). For a more detailed discussion of these rulings, see Item 1.f of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.Bessemer.com/Advisor**.

d. **Frank Aragona Trust v. Commissioner**. In a case of major importance, the Tax Court addressed the requirements for material participation by a trustee for purposes of the passive loss rules. *Frank Aragona Trust v. Commissioner,* 142 T.C. 165 (2014). (March 27, 2014) (Judge Morrison). This case directly addresses the "real estate professional exception" in §469(c)(7), but one of the requirements of that exception is material participation by the taxpayer. The case states that (1) trusts can qualify for the real estate professional exception and (2) activities of three of the six co-trustees as employees of the manager of the business are counted in determining material participation by the trust. The court reasoned that the activities of the three co-trustees who were full-time employees of the business counted because (1) Michigan statutory law requires trustees to administer the trust solely in the interests of the beneficiaries, and (2) a Michigan case makes clear that trustees are not relieved of their duties of loyalty by conducting activities thorough a separate entity controlled by the trust. The case, which is a "regular" Tax Court decision, repudiates the "hard-nosed" position taken by the IRS in TAM 201317010.

Prof. Sam Donaldson's summary of the material participation by trusts issue is as follows: "Until we get regulations that codify the Service's litigation position, to which the courts must give deference, the only authority that we have is *Aragona*. It is very helpful authority. It's right. It's the correct result. Fortunately, we have authority that we can rely on without risk of penalty."

e. **Treasury Project.** No guidance exists regarding how a trust or estate "materially participates" in a trade or business, under either the §469 or §1411 regulations. The IRS is considering regulations to address this issue; the Treasury Priority Guidance Plan for 2014-2015 issued August 26, 2014 includes the following new item: "Guidance regarding material participation by trusts and estates for purposes of §469." Various groups have submitted comments to the IRS regarding material participation by trusts and estates.

ACTEC filed comments on September 24, 2015. Among other things, the ACTEC comments suggest that (i) work done by fiduciaries should count as work of the trust or estate even if done in another capacity as long as the person is bound by fiduciary duties, (ii) activities of fiduciaries whose responsibilities for the trust or estate are solely ministerial (e.g., transmitting information concerning claims) or unrelated (e.g., management of a trust's non-business assets) would not count as material participation of the trust or estate, (iii) the fiduciary's power with respect to the business need not be a controlling power, (iv) the activities of multiple fiduciaries would generally be aggregated, (v) whether the fiduciary is an individual or an entity is generally not relevant in determining the trust or estate's material participation, (vi) work done by independent contractors generally would not count but work done by employees would count as work of the trust if the fiduciary-employer is responsible to the beneficiaries for the employees' work under the same fiduciary obligations that apply to work performed directly by the fiduciary, (vii) for grantor trusts, ignore the trust and look to whether the grantor materially participates, and (viii) characterization of the trust as materially participating or not generally carries through to the beneficiary level, but if the trust or estate does not materially participate but makes a distribution to a beneficiary who is active, "fairness requires that the beneficiary's participation in the business count and serve to recharacterize the income as nonpassive."

f. **Multiple Trusts**. If a trustee serves as trustee of multiple trusts, and if the 750-hour (for real estate) or 500-hour or 100-hour rule applies for determining material participation, must the trustee meet the hour requirement separately for each trust? Rob Romanoff (Chicago, Illinois) handled a trust audit in which nine trusts owned a business. The trustee of all nine trusts was also a key employee. For real estate, a 750-hour rule applies. The IRS position was that the trustee had to meet the 750-hour rule for *each* trust separately, and that activities as an employee did not count. When asked about the *Aragona* case, the IRS agent repeatedly responded "we decided not to appeal *Aragona* based on the facts of that case. We are looking for another case." Mr. Romanoff filed a petition with the Tax Court, but the IRS backed off and never filed an answer in the case.

Until this issue is resolved regarding multiple trusts, a single pot trust may be preferable for trusts owning a business interest. (Of course, this factor must be balanced against the various other reasons that may favor having separate trusts for each beneficiary. A possible strategy is to use a pot trust together with powers of appointment to be able easily to divide into separate trusts when appropriate.)

g. **Trustee Selection Issues**.

- Activities of the trustee, and not the beneficiary, are relevant in determining whether a trust materially participates.
- If a trust has multiple co-trustees, whether the activities of one or more co-trustees is sufficient is unclear.
- Perhaps provide that a co-trustee who is active in the business cannot be out-voted regarding business issues.
- For institutional trustees, presumably the activities of all employees of the corporate trustee can be considered. The ACTEC Comments to Treasury took that position.
- Consider using directed trustees and appoint a director with respect to business interests.
- Plan trustee succession carefully, considering active participation in the business by one or more co-trustees.
- Consider dropping the business interests of a trust into a sub-trust and appoint a co-trustee who is active in the business as trustee of that sub-trust.

25. State Income Taxation of Trusts

a. **Background.** All of the 43 states plus the District of Columbia that impose an income tax on trusts tax the undistributed income of a non-grantor trust as a "resident trust" based on one or more of the following five criteria: (1) if the trust was created by a resident testator (for a testamentary trust), (2) if the trust was created by a resident trustor (for an inter vivos trust), (3) if the trust is administered in the state, (4) if the trust has a resident fiduciary, and (5) if the trust has a resident beneficiary. Observe that the governing law of the trust is not one of those criteria (except in Louisiana; also in Idaho and North Dakota that is a factor considered along with other factors). A trust included in one of the first two categories is referred to as a "founder state trust" (i.e., the trust is a resident trust if the founder of the trust was a resident of the state).

See Item 20.d of the 2012 Heckerling Musings found **here** and available at **www.Bessemer.com/Advisor** for a summary of the court cases that have addressed the constitutionality of state tax systems that tax trusts based on the testator of a testamentary trust or settlor of an inter vivos trust residing in the state. Based on those cases, most commentators believe that taxing a nonresident trust solely because the testator or settlor was a resident is probably unconstitutional.

However, if that state's court system is utilized, for example, because of a probate proceeding in that state, chances are better that the state does have the authority to tax the trust.

b. **Significance**. This issue is arising more frequently as (1) states are strapped for revenue and are getting more aggressive, and (2) beneficiaries and individual trustees are more mobile, which may have the effect of changing the tax situs. Beware of naming family members as trustee without considering whether the appointment could cause the trust to be subject to income tax in the state of the trustee's residence. These issues are exacerbated by the use of splitting up trustee functions among co-trustees, increasing the possible likelihood of having at least one co-trustee in a state that uses the trustee's residence as a basis for taxing trusts.

c. **Recent Trend of Cases Treating "Founder" Test as Unconstitutional.** Four state court cases in 2013 held or suggested that Illinois, New Jersey, North Carolina (the 2013 North Carolina case merely allowed the taxpayer's case attacking the constitutionality of the tax to proceed past summary judgment), and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created. *Linn v. Dep't of Revenue*, 2013 IL App (4th) 121055 (2013); *Kassner v. Division of Taxation*, 2013 N.J. Tax LEXIS 1 (2013); *Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 2013 NCBC 9 (2013 denying state's motion for summary judgment allowing case to continue); *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (2013). For further discussion about the details of each of these cases, see Item 22.a of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.Bessemer.com/Advisor**.

d. **2015 Cases Rejecting State's Authority to Tax Trusts.** Two of the 2013 cases have been addressed further in 2015. *Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 12 CVS 8740 (N.C. 2015) was the case addressing the substantive unconstitutionality issue, following the court's earlier rejection of the state's motion for summary judgment in 2013. The trustee did not reside in North Carolina and no trust administration activities occurred in North Carolina, but one of the trust beneficiaries of the trust moved to North Carolina in 1997. The court, on summary judgment, determined that the trust through the activities of its trustee had insufficient contacts with North Carolina to support state taxation of the trust income. The trust sought a determination that the North Carolina statute is unconstitutional on its face, but the opinion merely concluded the statute is unconstitutional as applied to the particular trust. The opinion specifically observes that "the beneficiary's residence in North Carolina, standing alone, is not a sufficient contact by [a trust] with this State to support the imposition of the tax at issue," citing the Due Process Clause and the Commerce Clause of the U.S. Constitution. The case was appealed by the Department of Revenue, but the North Carolina Court of Appeals has affirmed the lower court order refunding all taxes and penalties paid by the trust with interest, finding the state tax unconstitutional on the grounds that the minimum contacts criteria of the Due Process Clause were not satisfied, (N.C. Ct. App. July 5, 2016).

Residuary Trust A u/w/o Kassner v. Director, Division of Taxation, 2015 N.J. Tax LEXIS 11, 2015 WL 2458024 (N.J. Sup. Ct. App. 2015), *aff'g* 27 N.J. Tax 68 (N.J. Tax

Ct. 2013) is the appellate case affirming the 2013 lower court opinion. The case dealt with trust income in 2006, following the Division of Taxation's change of position in 2011 regarding undistributed income if the trustee was not a New Jersey resident and the trust had no New Jersey assets. The trust's only connection to New Jersey was that it was a shareholder of an S corporation that owned New Jersey assets. The trust paid tax on its portion of the flow through income from the S corporation's New Jersey assets but not on its other income. The court concluded that the announcement in the Division of Taxation's official publication that the trust income would not be taxed under certain circumstances and then changing that position retroactively was fundamentally unfair. The court did not address constitutional issues.

e. **Supreme Court-Credits for State and County Taxes From Other States.** In *Comptroller of the Treasury of Maryland v. Wynne,* 135 S. Ct. 1787 (2015), Maryland residents had taxable income from an S corporation that was sourced in several other states. They paid taxes to those states and sought a credit for the taxes paid against their Maryland state and county income taxes. They received a credit against their state income tax, but not the county level tax. This Supreme Court affirmed the Maryland Court of Appeals finding that the failure to provide the credit at the county level unconstitutionally discriminated against interstate commerce. The failure to provide the credit violates the dormant Commerce Clause by burdening out-of-state business with double taxation.

26. Overview of Significant Fiduciary Law Cases in 2015

Every day, Dana Fitzsimons (Bessemer Trust in Atlanta, Georgia) reviews cases from across the country to identify developments or trends in the law, or to learn valuable lessons about fiduciary practice and administration. This is a brief overview of selected fiduciary cases from 2015 (prepared by Dana Fitzsimons).

a. **Charity; Cy Pres**. The court exceeded the proper scope of its *cy pres* power by adding conditions to trust distributions, but could properly require a health care system to restrict distributions from charitable trusts so that the funds were applied for the specific benefit of the hospital named in the trusts, which had been acquired by the health care system. *In re: Geisinger-Bloomsburg Hospital,* 2015 Pa. Super. LEXIS 245 (2015). In *In re: Perelman Charitable Remainder Unitrust*, 2015 PA Super 53 (2015), the court held that the executor of the estate of a deceased trustee has standing to seek information about charitable trusts to determine whether the estate is entitled to claim back compensation and to determine the extent of potential tax liability for alleged mismanagement of trusts. In a case that may only be of interest to attorneys who specialize in representing wealthy members of the clergy, the court held that a nun's possible violation of her vow of poverty is not a reason to deny probate of a will that gives property to both charitable and non-charitable recipients. *Matter of Sister George Marie Attea,* 2015 NY Slip Op (Erie County Surrogate, 2015).

b. **Business Interests.** The long-running *Rollins* dispute in Georgia continued into 2015. While the court of appeals felt a jury trial was needed to determine which actions by the defendants were trustee actions and which were corporate level actions, the Georgia Supreme Court reversed, categorized and assigned a defined standard of care to each of the actions criticized by the plaintiffs, and remanded the case again to the Court of Appeal to apply those standards. The plaintiffs, some of the settlor's grandchildren, complained that the trustees (who also had control of the business entities held in the trusts) had abused their power to extend their control over the family wealth, restrict beneficiary control, and impose a family code of conduct as a condition of receiving otherwise mandatory distributions. *Rollins v. Rollins*, 2013 Ga. App. LEXIS 332 (March 29, 2013); 20 Ga. LEXIS 179 (March 3, 2014); 329 Ga. App. LEXIS 780 (2015); 2015 Ga. LEXIS 230 (2015); 2015 Ga. LEXIS 904 (2015). The case is also an example of the economic and personal toll that can be inflicted by family disharmony.

In a case that is a good reminder of the importance of reviewing buy-sell and other corporate documents when estate planning with closely-held business interests, the court held that a gift of an LLC interest to a trust, with one-half of the LLC distributions payable to girlfriend (and not to estranged wife of 60 years), violated the operating agreement that prohibited distributions to "paramours" and resulted in the non-probate transfer of the LLC interest to the decedent-member's heirs at law under default provisions of operating agreement. *Blechman v. Blechman,* 2015 Fla. App. LEXIS 4808 (2015).

c. **Trust Protectors**. Courts this year respected the power of a trust protector, but an absence of common law persists on the nature of the duties of protectors.

In a dispute between the trust protector (who was also the drafting lawyer) and the children serving as trustees about whether the trustees could distribute all $95 million of the trust assets to themselves, the court recognized the power of the trust protector to amend the trust terms and restrict the children's ability to remove the trust protector from office. *Schwartz v. Wellin,* 2014 U.S. Dist. LEXIS 143644 (Charleston South Carolina Division, October 9, 2014); *Schwartz v. Wellin,* 2014 U.S. Dist. LEXIS 1528 (January 7, 2014); 2014 U.S. Dist. LEXIS 172610 (December 15, 2014); No. 2:13-cv-3595-DCN (February 11, 2015). The protector amended the trust to change the trust terms that would permit the children, after the settlor's death, to freely remove and replace the trust protector. Under the amended provisions, the children could only remove and replace the trust protector: (a) once every 5 years; (b) with the approval of a committee made up of three independent ACTEC fellows from different law firms, one appointed by the protector, one by the children, and one jointly appointed or selected by the court; and (c) with the committee being required to consider "whether any attempted change in Trust Protector may have been initiated for the purpose of seeking a Trust Protector who may not be as likely to honor the Settlor's intent or whether there are genuine" issues involved in seeking the change.

In *Minassian v. Rachins,* No. 4D13-2241 (December 3, 2014), the drafting lawyer serving as trust protector amended trust in the middle of litigation between the widow-trustee and the children from a prior marriage over widow's distributions to herself. The amendment favored the widow, and purportedly carried out the settlor's intent to provide his wife with the lifestyle of horse racing and legal gambling that they enjoyed together.

In *In re Eleanor Pierce Marshall Stevens Living Trust,* 2015 La. App. LEXIS 284 (2015), a case involving J. Howard Marshall, II (of Anna Nicole Smith infamy), the court held that trust protectors are not inherently a violation of Louisiana's public policy.

d. **Investments.** The importance of fiduciary process, communication with beneficiaries, equities, and the duty of loyalty were examined through several cases.

In *Moss v. Northern Trust Company,* No. 07 CH 24749 (Cook County, Illinois, Circuit Court, 2015), the corporate trustee had extensive procedures and frequent communication with the beneficiaries, and actively managed the printing and community newspaper company owned entirely in a long-term trust. While the court found that the trustee breached its duty in failing to diversify 100% ownership of family printing and newspaper businesses because the trustee did not adequately consider the effect of selling the company and investing in a diversified portfolio, the trustee was not subjected to liability because the court found that the beneficiaries failed to adequately prove damages.

In *Mennen v. Wilmington Trust Company,* 2013 Del Ch. LEXIS 204 (2013); C.A. No. 8432-ML (January 17, 2014); Final Master's Report (April 24, 2015), the special master recommended judgment against a trustee in the amount of $97 million, plus pre- and post-judgment interest at a rate of 7.75%. The court found that the trustee invested the trust assets in insolvent, unproven, and unsuccessful private companies with no record of profitability, most of which were motivated by his desire to earn recognition as a skilled investor in the business community.

A successor trustee was found not to have breached its duty from delay in diversifying a concentration of J.P. Morgan bank stock where the prior trustee delayed in providing tax basis information, and where the delay in selling stock was justified by the financial crisis in 2008. *Matter of Mary Moeder,* 2015 Ind. App. LEXIS 131 (2015). The plaintiff relied on a TV interview with Jamie Dimon as proof of her claims.

In *Matter of Wellington Trusts,* 2015 NY Slip Op 31294(U) (Nassau County Surrogate, 2015), the court found that a bank co-trustee did not breach its duties by retaining concentrated positions in U.S. large-cap securities during a market downturn, where the family co-trustee refused diversification, had the power to remove bank trustee, and was not clearly incapacitated, the trust terms permitted the investments, and the investments were part of a successful long-term family investment philosophy. The complaining beneficiary received regular and increasing distributions while the trust grew from $2 million to $36 million, converted to a unitrust to the beneficiary's benefit, and made large discretionary distributions. Still, the beneficiary attempted to sue during a temporary downturn in the investment markets. The court noted that the trust had a long-term investment strategy.

In *In re Morriss Trust,* Case No. 12SL-PR03035 (St. Louis, Missouri Probate Court, September 30, 2015), the court found that all co-trustees breached their fiduciary duties by enabling a beneficiary co-trustee, who was prohibited by the trust terms from making trust decisions for his own benefit, to pledge all of the trust assets as collateral for a personal loan to finance his personal private equity investments.

e. **Revocable Trusts.** In recent years, courts have grappled with the issue of whether and to what extent the remainder beneficiaries of a revocable trust may challenge the actions of a trustee during the settlor's lifetime and while the trust was revocable (i.e.

in cases such as *Longmeyer* (Kentucky), *Fulp* (Indiana), *Giraldin* (California), *Trimble* (Iowa), and *Pennell* (Arizona)). Compelling facts may be leading courts to deviate from the common law principles that would limit the trustee's duties to only the settlor in those circumstances. In *Trzop v. Hudson,* 2015 IL App. (1st) 150419 (2015), the court recognized standing by remainder beneficiaries of revocable trust to bring tort claims against a daughter during settlor's lifetime, arising out of the settlor-father's trust amendment, despite the father's motion to dismiss claims for lack of standing. The case had overtones of elder financial abuse.

In *Tseng v. Tseng,* Case No. 120891165; A153639 (Oregon Court of Appeals, 2015), the court held that under the Oregon Uniform Trust Code (UTC), after the death of the settlor, the beneficiaries have the right to certain information about the administration of the trust before the settlor's death. The settlor had left China during the rise of communism and believing his family had died. He remarried and had two children in the U.S., then 25 years later discovered his family in China was alive. He created a trust for both his Chinese and American children with the American children as trustees, but at his death the trust had no assets. His Chinese children were seeking information about the trust.

f. **Damages and Remedies**. The court in *Miller,* 2014 NMCA 053 (New Mexico Court of Appeals 2014); 2015 N.M. LEXIS 159 (2015) demonstrated the application of Will Rogers's First Law of Holes to trust administration ("If you find yourself in a hole, stop digging"). The trial court found that the trustee breached its duties by investing in nonproductive commercial real estate, but reduced the damages owed by the trustee for the "phantom income" distributed to the beneficiaries from the sale of other trust assets (despite the trust terms prohibiting the distribution of principal). On appeal by the trustee, the court increased the measure of damages to include both inflation adjustments and prejudgment interest without reduction for the phantom interest distributed to the beneficiaries (under a "two wrongs don't make a right" approach). On further appeal by the trustee, the state supreme court expanded the damages to also include disgorgement of profits, which the court of appeals had rejected.

g. **Trustee Fees.** Beneficiary challenges to trustee fees were unsuccessful in two recent cases. In *In re Trusts under Deeds of Louise E. W. Jones,* 2015 Phila. Ct. Com. Pl. LEXIS 110 (2015), the beneficiaries who either consented in writing to trustee fee increase, or were barred by laches for failing to seek an accounting or object for decades, cannot object to trustee fee changes that deviated from the trust terms. A 1923 trust limited trustee fees to 4% of trust income, which became incompatible with modern trust administration and investing and led to a change to a published fee schedule in 1989.

In *Matter of Speyer*, 2014 N.Y. Misc. LEXIS 4870 (N.Y. Sup. Ct. Nov. 13, 2014), the court held that a corporate trustee who had facilitated settlement of 20 years of litigation was entitled to have its attorneys' fees paid out of trusts, but a co-trustee who acted for personal benefit through numerous lawyers was not.

h. **Trustee Disclosure**. In *Wells Fargo Bank v. Cook,* 332 Ga. App. 834 (2015), the court found that the trustee was not liable for the exhaustion of CRAT assets from the payment of the annuity to settlors. No evidence of breach of duty was present, the depletion came from the annuity payments and market conditions, and the trust terms negated the claim of the settlors (one of whom had an MBA and was a certified financial planner) that the trustee had contractually guaranteed that the 7.5% annuity payments would last for the lifetime of the settlors. In the most potentially significant aspect of the decision, the court held that the bank trustee's detailed trust statements were a "report" that starts the short statute of limitations on the claims under the Georgia code provision that mirrors the UTC.

In *Corya v. Sanders*, 2015 Fla. App. LEXIS 1846 (Fla. Dist. Ct. App. 4th Dist. 2015), the court held that statutory laches provisions apply to limit a suit against the trustee for failure to file required accountings. A grandson waited 30 years before suing his grandmother as trustee, and the court clearly did not think it was very nice to sue one's nana.

i. **Fiduciary Succession**. Despite repeated letters declining trusteeship, a trustee is deemed to accept a trusteeship under the UTC where it exercises the powers of the trustee and disbursed assets. The trustee's actions went beyond the UTC safe harbor for acting merely to preserve assets until a trustee is appointed. *Bank of the Ozarks v. Cossey,* 2015 Ark. 367 (2015).

j. **Removal Power**. Following *McKenney* where as a matter of first impression the court applied the UTC "no fault" removal of trustee statute, Pennsylvania courts in 2014 refused in *Conti* and *Taylor* to allow trust modification to give the beneficiaries a nonjudicial power to remove a bank trustee where the settlor did not include the power, the court preferring to retain its role over the removal. This past year, however, a divided Pennsylvania superior court allowed beneficiaries to petition under UTC Section 411 (modification by consent) to modify a trust to give the beneficiaries power to remove and replace the corporate trustee. *Trust U/A Edward Winslow Taylor,* 2015 PA Super 199 (2015). A New York court, however, refused a similar modification. *In re Rutgers Trust*, 2014 NY Slip Op 32863(U) (2015).

k. **Powers of Appointment**. Powers of appointment are now a commonly used, and very useful, part of estate planning. Their exercise gave rise to some interesting disputes this year.

In *Estate of Zucker,* 2015 PA Super 190 (2015), the court reminds us that the donee of a power of appointment does not have a fiduciary duty to exercise the power in good faith. A child that was excluded by the exercise of the power felt that mother had acted in bad faith by cutting her out.

In *BMO Harris Bank, N.A. v. Towers,* 2015 IL App (1st) 133351 (2015), the court held that the exercise of a limited power of appointment to a donee's revocable trust, where the assets could be used to pay the donee's debts, was an invalid exercise of the power, and trustee correctly sought instructions to resolve dispute over validity of the exercise. The case is a good cautionary tale on the care required in exercising powers.

Under a 1966 testamentary trust, a testator gave his son a power to appoint among his issue, which he exercised in a way that excluded a child who sued challenging the validity of the exercise. Under a 1935 case that applied to the trust (which line of cases has since been reversed by statute), the power of appointment was "non-exclusive" meaning that the son was required to make at least a substantial distribution of the trust estate to each permissible object, including the child he had attempted to exclude. The court held that the invalid exercise of a non-exclusive power of appointment results in the assets passing in default of appointment, and the appointive property passed according to the donor's testamentary scheme, without regard for the donee's attempted appointment. *Thomas W. Sefton, Jr., Plaintiff and Appellant, v. Harley K. Sefton, as Trustee, Defendant and Respondent; Wells Fargo Bank, N.A., as Successor Trustee, Objector and Respondent*. Court of Appeal, Fourth Appellate District, Division One, State of California. No. D065898. Even though most modern trust law is statutory, so long as older trusts remain this case reminds us of the importance of understanding the common law.

l. **Decanting**. A trust for a disabled beneficiary was turned over to the neighbor, Badger, as trustee. Badger paid himself and his wife to provide the beneficiary with care, used his wife as a realtor to sell the beneficiary's house out of the trust without court approval, and decanted the trust into a "pooled special needs trust" set up and run by an attorney and the attorney's husband that was purportedly designed to qualify the beneficiary for government benefits, but with the remainder passing to the pooled trust for the benefit of other disabled beneficiaries and not the original trust beneficiaries. The pooled trust was a scam and the attorney was sent to prison and disbarred. The court held that the decanting to the fraudulent pooled trust, without notice to the beneficiaries and changing the remaindermen, was void and a breach of fiduciary duty. The trustee was removed and surcharged as well. *Harrell v. Badger,* 2015 Fla. App. LEXIS 11183 (2015).

Similarly, the court rejected a decanting that broadened the class of successor and remainder beneficiaries in *Petition of Katharine A. Johnson to Nullify the Decanting of the Trust Created under an Agreement made by Michael L. Johnson*, 2015 NY Slip Op 30017(U); 2015 N.Y. Misc. LEXIS 51 (2015). Following a divorce, father as trustee attempted to decant trusts for the benefit of a daughter to add his own issue as permissible appointees under powers of appointment and make them takers in default (in place of his ex-wife's family and the New York City Ballet).

In *Ferri v. Powell-Ferri,* 2013 Conn. Super. LEXIS 1938 (2013); 2015 Conn. LEXIS 161 (Ct. Supreme Court, 2105), the court invalidated the decanting of a trust to take away vested rights of a beneficiary and thereby protect the trust assets from claims of a divorcing spouse of the beneficiary, where the trust terms did not grant trustee absolute discretion over trust distributions and the beneficiary had the right to withdraw trust assets. Apparently not satisfied with her victory, the divorcing spouse that successfully contested the decanting also attempted to (1) sue the trustee for intentional interference with an equitable interest and (2) sue her ex-husband for breaching the alleged duty to preserve marital assets by failing to take affirmative steps to stop the decanting. Both of these claims were dismissed.

m. **Modification**. In *Trust U/W Wallace B. Flint FBO Katherine F. Shadek,* 118 A. 3d 182 (Del. Chancery Court, 2015), the court refused to modify an unambiguous testamentary trust holding a concentration of IBM stock to create a Delaware directed trust with the remainder beneficiaries as investment directors. The original trust did not contemplate any beneficiary serving as trustee, let alone having the power to totally direct trust investments (it was modified by a New York court before moving to Delaware), which may have led the court here to push back against the desired result by the beneficiaries as being a "bridge too far." In seeking a modification, even when all beneficiaries agree, the moving party should be prepared to demonstrate to the court how the modification carries out the settlor's intent.

Courts in California and Mississippi considered whether an unambiguous will that fails to make a complete disposition of property could be reformed, but under very different circumstances that likely impacted the divergent results. In *Radin v. Jewish National Fund,* Ct. App. 2/4 B227954 (Cal. S. Ct. 2015), a case construing the will of Irving Duke, the California Supreme Court reversed the rule in *Estate of Barnes,* 63 Ca. 2d 580 (1965) barring extrinsic evidence to reform an unambiguous will, held that the categorical bar on reformation of unambiguous wills is not justified, and held that reformation is permissible if clear and convincing evidence establishes an error in the expression of the testator's intent and establishes the testator's actual specific intent at the time the will was drafted. At issue in the case was whether the assets would pass through reformation to the charities named in the will despite a drafting error, or to heirs at law that were not mentioned in the will.

The court found the claims for reformation less compelling in *In re Estate of Regan,* 2015 Miss App. LEXIS 179 (April 7, 2015), and held that a will that fails to name beneficiaries is unambiguous and not subject to reformation. The operator of a personal care home arranged for a pre-printed will for one of the residents under her care, but the will failed to name a beneficiary. The care provider claimed she was the intended beneficiary and sought to reform the will. The court, however, ordered the distribution of the assets to the heir at law (Aunt Elsie).

In *Megiel-Rollo v. Megiel,* No. 2D14-4037 (2nd Dist. Florida Court of Appeals, 2015), the court concluded that reformation under the UTC is available to supply missing remainder beneficiaries of revocable trust that were omitted by scrivener's error. A schedule listing the beneficiaries was inadvertently omitted by the settlor's husband, who was also the drafting attorney.

Many practitioners have experienced the problems of gifts of vacation or "family legacy" real estate to children with instructions to come to an agreement on its shared use and splitting of the costs. In *Trupp v. Naughton,* No. 320843 (Mich. Court of Appeals, unpublished, 2015), the complete unwillingness of the children as co-trustees to follow the trust terms on co-ownership of a lake house was cited by the court as adequate justification to terminate a trust.

n. **Issue**. In *Mary K. Kaull, as Trustee of the Barbara B. Kaull Trust v. Sarah Kaull*, 2014 IL App (2d) 130175; 20144 Ill. App. LEXIS 913 (App. Ct. Ill. Dec. 22, 2014), the appellate court held that a trial court may compel DNA testing to determine trust beneficiaries, and that by conditioning the exercise of the power on the issue of paternity being in controversy and relevant was enough to meet constitutional requirements.

In *Sanders v. Sanders,* 2015 Cal. App. LEXIS 662 (2015), a California court held that an adopted adult under Texas law should be included as a beneficiary of a California trust, regardless of legal differences in the post-adoption relationship between parent and child under Texas and California law. The court deferred to the state of adoption, and stated that the mere fact that a sister state does not impose the exact same rights and duties in parent-child relationships as California does is irrelevant, and California cannot devalue a parent-child relationship simply because it was created in a sister state.

o. **Tax Clauses**.

Reformation of Formula Bequest Outdated Because of Estate Tax Repeal. In *Nancy Crowe et al. v. Leonard M. Tweten*, 2014 Cal. App. Unpub. LEXIS 9292 (Ct. App. Cal. December 29, 2014), reformation was permitted to address unintended result of a funding formula where the wife died in 2010. Because the formula did not include a savings clause for 2010 (during the temporary repeal of the estate taxes), the husband was unintentionally disinherited. The wife signed a corrective amendment just before she died, but it was not notarized as required under the trust terms to become effective. The daughter, whom had already been gifted $6 million during life, attempted unsuccessfully to contest reformation of the trust to carry out the intent to support the husband (who in that one year lost his wife, his son, his brother, and both of his dogs).

Tax Apportionment. Despite his originality as a writer during life, Tom Clancy's estate devolved into a very cliché dispute between surviving spouse and children from a prior marriage. At issue was whether $6 million in estate taxes would be apportioned to a QTIP trust for the wife's benefit or a trust for the children from prior marriage (which gave rise to the tax). The court held that a savings clause in a codicil intended to qualify the QTIP trust for the marital deduction takes precedence over a tax clause (not amended by the codicil) that would otherwise apportion taxes to the trust despite its valid QTIP election. The court found it would not be appropriate to separate qualification for the marital deduction and the benefits of the marital deduction that the savings clause was intended to protect. *Matter of Thomas L. Clancy, Jr.,* Estate Number 101962 (Baltimore, Maryland Orphan's Court, 2015).

Exercise of Substitution Power. *Benson v. Rosenthal,* 2015 U.S. Dist. LEXIS 89238 (E.D. La. 2015) concerned Texas trusts created by Thomas Benson funded with his interests in the New Orleans Saints and other assets significant to the city. He attempted to exercise his power to reacquire the assets by substituting an unsecured promissory note, and the Texas trustee objected. At issue was whether the Texas trustee had sufficient contacts with New Orleans to allow the Louisiana court to hear the dispute. Not surprisingly, the Louisiana court found sufficient contacts so that it could retain the case that would decide ownership of the Saints. Who dat!

p. **Divorce of Beneficiary**. In *Pfannenstiehl v. Pfannenstiehl,* 2015 Mass. App. LEXIS 123 (2015), the court held that an interest in a spendthrift trust created by father should be included in the marital estate of a son incident to his divorce. The couple had two children, one with dyslexia and the other with Down syndrome, and were largely supported by the trust. Wife had left a career as an Army Reserves officer just before obtaining her 20-year pension under pressure from the husband's family to care for the children. The court found that the trust was controlled by family members without meaningful involvement of an independent trustee, and that the trust's ascertainable standard gave the husband a present and enforceable right to trust distributions in view of the prior administration of the trust and regular distributions.

q. **Elective Share**. In *Beren v. Beren,* 2015 CO 29 (2015), the appellate court held that the trial court could not change the date of calculation of the elective share as a result of a sharp increase in estate assets during protracted litigation over estate, but spelled out other equitable principles the court could apply to increase the elective share where the payment of the share was delayed during 9 years of contested litigation during which time the estate assets sharply increased in value.

r. **Attempt to Invalidate Prior Gifts**. In *Reed v. Grandelli,* C.A. No. 8283-VCG (Del. Chancery Court 2015), the court largely rejected a son's attempt, after his father's death, to compel the father's much younger romantic partner to return gifts received from the father during lifetime. The court found no evidence of abuse, that George received the physical and emotional attention he wanted from a younger partner in the relationship, the gifts were not unusual for gifts to a desirable younger partner inspired by romantic and physical interest, and that it would be simple paternalism to hold that mere advanced age prevents an individual from indulging in pleasures at his own expense, even if the expense appears foolish to others.

s. **Collection of Curiosities**.

Mere perjury and obstruction of justice, in connection with your husband's killing of your mother, is not enough to bar your own inheritance from your mother under the slayer statute. *Estate of Opalinska,* 2015 Ill. App. LEXIS 847 (2015).

A paranoid schizophrenic who kills his mother with a crochet-covered brick, repeatedly stabs her, and then bleeds the body to prepare it for burial, might still inherit, since a willful killing under the slayer statute requires not being completely insane. *Armstrong v. Armstrong,* 2015 Miss. LEXIS 378 (2015).

Physical, emotional, and financial elder abuser may not be able to prove "excusable neglect" when trying to file late pleadings, especially after stealing the ring off his mother's hand in the Alzheimer's wing of the nursing home. *Evan Auld Susott, as Trustee, Plaintiff and Respondent, v. Daniel C. Susott, Defendant and Appellant*. No. H040321. Court of Appeal of California, Sixth Appellate District. 2015 Cal. App. Unpub. LEXIS 3653 (2015).

In a case involving control of Archie Comics, the court can compel a trustee to submit to a mental examination to determine fitness for office, where the trustee was expelled and banned for life from ComicCon. *Matter of Levitin,* 2015 NY Slip Op 25184 (Westchester County Surrogate, 2015).

A large gun collection, part of which was kept in the kitchen, bedroom, and living room, is not tangible personal property. *In re Estate of Gary Roberts*, 2015 Ind. App. LEXIS 146 (Ct. App. IN, March 11, 2015).

Trust terms conditioning inheritance on survivorship do not condition inheritance on survivorship. *Dennis J. Kelly, Jr. v. George W. Duvall, Jr., et al.,* Court of Appeals of Maryland 2015 Md. LEXIS 11 (Jan. 27, 2015).

Beneficiary under an unexecuted online will has standing to bring tort claims against Legalzoom arising out of alleged incorrect instructions accompanying the online will. *Litevich v. Legalzoom,* 2015 Conn. Super. LEXIS 1702 (2015).

27. Intergenerational Split Dollar Life Insurance Plan Qualified for Economic Benefit Regime Under Split Dollar Regulations, *Estate of Morrissette v. Commissioner*

a. **Synopsis**. The Tax Court, in a "regular" opinion of the full court, approved an intergenerational split dollar life insurance arrangement in which Mrs. Morrissette (actually her revocable trust) paid large lump sum premiums ($29.9 million) for

Dynasty Trusts to purchase universal life insurance policies on the lives of her three children. Under the split dollar agreement, as each of the children died, the revocable trust was entitled to receive the aggregate premiums paid (without added interest) on the policies on that child's life (or the cash surrender value of such policies, if greater [but the cash values may be lower than the aggregate premiums paid, because the cost of insurance and other costs of maintaining the policies in force would be charged against the policies each year]). Following Mrs. Morrissette's death, her estate included her reimbursement rights under the split dollar arrangements in her estate, at a value of about $7.5 million (compared to the $29.9 million lump sum premiums she had paid), in light of the fact that her revocable trust would not receive the payments for many years in the future (as her children died--actuarially expected to be about 15 years later). The IRS maintained that the full $29.9 million premium advance should be treated as a gift.

The split dollar regulations provide that split dollar arrangements can be taxed under either a loan regime (detailed in Treas. Reg. §1.7872-15) or economic benefit regime. The parties had not structured the arrangement as a loan (with a note bearing interest); that approach would not have resulted in as large of a discount in valuing the receivable at the parent's death because the loan would have been entitled to interest during the delay before the repayment was made at the children's subsequent deaths. Instead, the parties had relied on the economic benefit regime applying. Under that system, the parent is treated as making a gift each year of the current value of the life insurance coverage in that year (either from the carrier's actual rates or Table 2001), less the amount of any premiums paid by the trust-owner of the policy in that year. The court rejected the IRS's position that the economic benefit regime did not apply; the IRS position was based on an argument that the structure failed to satisfy the technical requirements in the regulations for the economic benefit regime to apply.

The court granted partial summary judgment, holding that the technical requirements in the regulations for applying the economic benefit regime were satisfied. The court's analysis waded through the hyper-technical details of the split dollar regulations. The loan regime generally applies if the donee is the owner of the policy (assuming the parties properly treat the transaction as a loan), or otherwise "general tax principles" apply. However, the donor will be the deemed owner of the policy (in which event the economic benefit regime applies, Treas. Reg. §1.61-22(d)(1)) if the only economic benefit provided to the donee is current life insurance protection. Reg. §1.61-22(c)(1)(ii)(A)(2). The central issue under the court's analysis is its conclusion that the Dynasty Trusts had no current access to the cash values of the policies and received no additional economic benefit other than current life insurance protection. *Estate of Morrissette v. Commissioner,* 146 T.C. No. 11 (April 13, 2016) (opinion by Judge Goeke).

The court did not address the valuation issue; it will be addressed following this partial summary judgment decision.

This is the first court case addressing intergenerational split dollar insurance arrangements; it is a taxpayer victory in recognizing that the economic benefit regime applies to this intergenerational split dollar agreement. Larry Brody (St. Louis, Missouri) says he is aware of" at least a half dozen of these inter-generational arrangements where the IRS argued that because a single premium was paid up front," the loan regime applied. McManus, *IRS Stretched Too Far in Split-Insurance*

Estate Planning Case, BNA DAILY TAX REPORT (April 14, 2016). Many questions remain regarding the tax treatment of intergenerational split dollar insurance; it is not widely used (just by some very wealthy families), and the IRS may continue to address other ways to fight the overall result of a transfer with a huge discount (the IRS's brief characterized the plan as an effort to "minimize the taxable estate"). Nevertheless, this initial decision is a significant development regarding intergenerational split dollar agreements.

b. **Facts.**

(1) **Issues Regarding Closely-Held Business**. Mr. Morrissette formed a moving company that grew into a large conglomerate, Interstate Van Lines, which eventually was owned by Interstate Group Holdings, Inc. (IGH). The stock was owned by various family members including Mrs. Morrissette's revocable trust, trusts created under Mr. Morrissette's revocable trust following his death, and three sons (as well as others). Mr. Morrissette managed the company to place his three sons in competition with other, which resulted in "deep-seated antipathies among them. They had differing goals for the company and do not get along with each other." In order to prevent two brothers from ganging up on the third brother, the corporate documents adopted a "fourth brother" provision requiring that if two sons disagreed with the third son regarding a decision, an independent trustee of trusts that owned shares would review the decision, with the expectation that the trustee would side with the minority sibling unless the position of the majority siblings was compelling. Mrs. Morrissette (apparently while she was still competent) was concerned that the "fourth brother" provision may cause deadlock detrimental to the company, and was concerned with the sons' disagreements regarding their goals for the company. In light of this background, Mrs. Morrissette (through her conservator and agents) created Dynasty Trusts for the three sons (and presumably transferred stock to those trusts), and entered into a Shareholders Agreement regarding the shares. [Observation: These business succession planning aspects of the factual background are included to point out that this overall arrangement had business purposes beyond just reducing the value of Mrs. Morrissette's estate.]

(2) **September 2006 Transactions; Dynasty Trusts and Shareholders Agreement**. All of the following happened in September 2006, when Mrs. Morrissette was age 93.

- The three sons became the successor trustees of Mrs. Morrissette's revocable trust.
- An employee of the company served as conservator for Mrs. Morrissette from August-October, 2006.
- Mrs. Morrissette (presumably through the conservatorship) created Dynasty Trusts for each of the three sons, and apparently conveyed company stock to those trusts.
- The revocable trust was amended to permit the trust to pay premiums on life insurance policies under a split dollar arrangement to fund a business succession plan. In addition, the amendment permitted the revocable trust to transfer each receivable from the Dynasty Trusts under the split dollar arrangement back to the Dynasty Trust owing the receivable or directly back to each son.

- The Dynasty Trusts, the sons, and various other family shareholders entered into a Shareholders Agreement placing various restrictions on the shares, imposing transfer restrictions, and implementing a cross purchase agreement under which the shares owned by or for a deceased son would be purchased by Dynasty Trusts for the surviving brothers.

(3) **October 2006 Transactions; Purchase of Life Insurance on Sons' Lives Under Split Dollar Arrangement**. In October 2006, each son's Dynasty Trust purchased life insurance on the other sons' lives to fund the buy-sell provisions in the Shareholders Agreement. Mrs. Morrissette's revocable trust advanced $29.9 million to the three Dynasty Trusts, which they used to pay lump-sum premiums on the policies to purchase of the life insurance policies under a "non-equity economic benefit regime split dollar" arrangement. The lump sum premiums were large enough to maintain the policies for the insureds' respective life expectancies (about 15 years). The following applied under the split dollar agreement.

- When the insured died under each of the policies, the revocable trust had the right to receive the greater of (1) the aggregate premiums advanced, or (2) the cash surrender value of the policies. The revocable trust would not be reimbursed any of the premiums advanced for a particular policy until the insured for that policy dies. The Dynasty Trust that owned a policy would receive the balance of the death benefit payable under the policy (which would be available to fund the purchase the deceased son's shares as required in the Shareholders Agreement).
- If the split dollar arrangement terminates during the life of a son, the revocable trust would get repaid and the Dynasty Trust owning the policy would receive nothing from the policy.
- No one had the right to borrow against the policies.
- The Dynasty Trusts collaterally assigned the policies to the revocable trust to secure the repayment of amounts due to the revocable trust under the split dollar agreement.
- The split dollar agreement expressly stated the parties' intent that the arrangement be taxed under the economic benefit regime as described in the split dollar regulations and that the only economic benefit to the Dynasty Trusts regarding the life insurance policies was the current life insurance protection.

(4) **Gift Tax Reporting in 2006-2009**. In 2006-2009, Mrs. Morrissette reported gifts each year to the Dynasty Trust consistent with the economic benefit regime of the split dollar regulations. She reported as a gift each year the cost of the current life insurance protection as determined using Table 2001 (less the premium paid by each Dynasty Trust during that year [apparently, the Dynasty Trusts paid some premiums in addition to the large single premium paid at the outset]).

(5) **Estate Tax Reporting**. Mrs. Morrissette died September 25, 2009. Her estate tax return reported the receivables from the Dynasty Trusts as having a value of $7.479 million (based on an appraisal of the receivables).

(6) **Notices of Deficiency**. The IRS treated all of the $29. 9 million transferred to the Dynasty Trusts as gifts, and assessed a Notice of Deficiency for substantial

additional gift tax and penalties. In addition, the IRS issued a Notice of Deficiency for additional estate tax, increasing the value of the receivables from $7.479 million to almost $32.061 million. It characterized the split dollar arrangements as loans under the loan regime of the regulations (but it did not calculate the value of the loans).

(7) **Court Documents**. Steve Gorin (St. Louis, Missouri) has assembled many of the court documents (including the parties' briefs, the gift and estate tax notices of deficiency, and the split dollar agreement) that have been filed with the Tax Court in *Morrissette*. They can be accessed at the following link: **http://tcinstitute.com/rv/ff0027b41763b2585644fea38b4d98e739cece38**.

c. **Issues, Holding, and Basic Significance**. The only issue addressed in this partial summary judgment decision is whether the arrangement should be taxed under the economic benefit regime or the loan regime of the split dollar regulations. This decision does not address the valuation of the receivables at the time of the decedent's death.

The Tax Court (in a regular decision of the full court) held that the arrangement was governed by the split dollar final regulations and that the economic benefit regime applied to the arrangement.

This holding is very significant. Taxing "intergenerational split dollar insurance" under the economic benefit regime is helpful to support placing a substantial discount on the value of the receivable at the date of the death of the senior family member holding the receivable (or at the date of a gift or other transfer of the receivable by the senior family member) based on the fact that the repayment would not be made for what could be decades (at the death of the younger insured family member). If the loan regime applied, the loan would be valued under the assumption that interest would be paid on the loan, rather than just paying the aggregate premiums made (or the cash surrender value if greater). Alternatively, if the economic benefit regime did not apply and if the loan regime also did not apply because the parties did not properly treat the advance as a loan, the entire advance may have been treated as a gift under general tax principles. (Whether the loan regime treatment could apply is problematic under the Morrissette facts. The Morrissette split dollar agreement stated in two different places that the intent was that the arrangement be treated as an economic benefit transaction for federal tax purposes, but the Agreement also stated that if for any reason the Agreement was deemed to be a promissory note, the Dynasty Trust as maker promised to pay an amount equal to the total premiums paid by the donor together with an annual rate of interest "that reflects the prevailing market interest rate for both income tax and gift tax valuation purposes, as determined by a qualified independent appraiser.")

d. **Brief Background About Split Dollar Life Insurance and Discount Intergenerational Split Dollar Insurance**.

Split dollar life insurance has been used historically as a way that employers (or senior family members) could help pay for premiums on life insurance to benefit employees (or junior family members). In 1964, the IRS began taxing the death benefit portion of the policy as an economic benefit under Revenue Ruling 64-328. Split dollar arrangements have traditionally be structured as either endorsement arrangements (in which the employer or senior family member owns the policy and endorses some of the death benefits to employees or junior family members) or collateral assignment arrangements (in which the employee or junior family member owns the policy and assigns an interest back to the employer or senior family member to secure the right to be repaid the premium advances). The endorsement or collateral assignment arrangements could be structured as either equity or non-equity arrangements. (In equity arrangements, the employee or junior family member might share in some portion of the cash value of the policy.) Under the traditional treatment of split dollar policies, changing the structure of the party that owned the policy (i.e., endorsement or collateral assignment) did not fundamentally change the tax treatment of the arrangement. (This would change in 2003 under split dollar regulations, which provide that the tax treatment of the arrangement depends largely on who is the owner of the policy.)

Notice 2002-8 provided transitional rules for the treatment of split dollar arrangements entered into before September 18, 2003. The Notice (1) addressed valuation issues, allowing alternate rates to be used to value the current value of life insurance coverage (i.e., either Table 2001 rates [using a Table included in the Notice] or the insurer's one-year term rates in certain circumstances), and (2) provided certain safe harbors for avoiding tax on the transfer of the equity element of split dollar policies (either (i) treating the premium advances as a loan arrangement or (ii) continuing to apply the economic benefit approach of treating the current value of life insurance coverage as a transfer each year and not imposing additional taxes as long as the cash value was not accessed).

The split dollar regulations, applicable to split dollar arrangements entered into or modified after September 1, 2003, establish two alternative regimes for taxing split-dollar life insurance arrangements, depending on who owns the policy. Previously, the key factor impacting the tax treatment was whether the arrangement was an equity or non-equity structure. Under the regulations, the key is who owns [or is deemed to own] the policy. If the employer (or senior family member) owns the policy, as in a typical endorsement arrangement, the economic benefit regime applies, taxing the employee (or treating as a gift to the junior family member) on all economic benefits provided through the arrangement. If the employee (or junior family member or trust for a junior family member) owns the policy, as in a typical collateral assignment arrangement, the loan regime will apply under the §7872 rules for below-market loans and the OID rules in §§1271-1275, if the obligation is most appropriately treated as a loan under federal income tax principles (for example, using a note that is intended to be repaid unconditionally). A special ownership rule applies to non-equity arrangements; if the employee or donee is the owner of the policy but has no current access to the cash values of the policies and receives no additional economic benefit other than current life insurance protection, formal ownership designations will not control but the employer or donor will be treated as the owner of the contract, so that the arrangement can be taxed under the economic benefit regime rather than the loan regime. (Life insurance on a donor's life may be held in an irrevocable life insurance trust (ILIT) to avoid estate inclusion of the insurance proceeds under §2042. In effect [and oversimplified], this special exception provides that life insurance that is held in an ILIT can be taxed under the economic benefit approach that has historically been used for the tax treatment of split dollar insurance as long as the structure is a "non-equity" arrangement.)

Under traditional split dollar arrangements, a donor funds premiums on a policy on the *donor's* life, and the premium advances are repaid at the donor's death from the policy death proceeds. In contrast, under intergenerational split dollar arrangements, a parent pays premiums on a policy insuring a *child* (or *grandchild's* life), and the premium advances are not repaid until the insured's death, which could be decades in the future. If the reimbursement right is transferred by the parent (by gift or sale or as an asset of the donor's estate at her death), a substantial discount may apply in determining the *present* value of the reimbursement right, which might not be repaid for decades. (The *present value* of the right to a set dollar amount, to be paid decades in the future, would obviously be much smaller than the aggregate payment that would be made many years in the future.) Taxing intergenerational split dollar insurance under the economic benefit regime is helpful in supporting a substantial discount on the value of the receivable; under the economic benefit regime the parent just receives the aggregate premiums paid (or cash surrender value if greater), but under the loan regime the reimbursement right would be for the premiums paid *plus interest* that would accrue over the many years before the repayment is made. (If the advance is a loan but the note does not provide for interest at the AFR, the IRS may argue that under the §7872 regulations, the person advancing the premiums makes a current gift of the present value all of the foregone interest for the life of the loan. *See* Alan Jensen & R. Brent Berselli, *Estate of Morrissette: Unfinished Business,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2418 (May 23, 2016) (hereinafter "Jensen & Berselli, *Unfinished Business*") (citing Treas. Reg. §1.7872-15(e)(5)(iv)(D)).

Alternatively, if neither the economic benefit regime nor loan regime applies (see the discussion below of the requirements to treat the arrangement as a loan), general tax principles apply to the arrangement. In that event, the donor is treated as making a gift of the full amount paid as premiums less the economic benefit that the donor received (and Treas. Reg. §1.61-22(d)(2)(ii) looks to whether the donor has current access to the cash value), and if, as would be typical, the donor does not have current access to the cash value, the donor's economic benefit is zero and the full amount of premiums paid is a gift. Treas. Reg. §1.7872-15(a)(2) has three requirements for the arrangement to be treated as a loan: (1) payment is made by the non-owner to the owner (including a payment directly to an insurance company with respect to a policy held by the owner); (2) the payment is a loan under general tax principles, or if it is not (for example because of the nonrecourse nature of the obligation or otherwise), "a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest)"; and (3) repayment of the advance is to be made from or is secured by the policy's death benefit, the policy's cash surrender value, or both. Furthermore, Treas. Reg. §1.7872-15(d) provides that a nonrecourse payment under a split-dollar loan [and the repayment right is typically nonrecourse under split-dollar agreements] is a "contingent payment," which causes further significant complications under Treas. Reg. §1.7872-15(j), unless the parties represent in writing (by the time for filing the federal income tax return for the borrower or lender for the taxable year in which the lender makes the split dollar loan) that a reasonable person would expect that all payments under the loan will be made (and that representation must be attached to the income tax returns for all parties [which is frequently overlooked]). Thus, in the typical split dollar arrangement, if the economic benefit regime does not apply, the loan regime will apply if the parties have treated the advance as a loan, if there is a reasonable expectation that the premium advance will be repaid, and if the required written representations have been timely made and filed.

Life insurance experts Donald O. Jansen (Austin, Texas) and Charles L Ratner (Cleveland, Ohio) have summarized the application of these general rules regarding split dollar life insurance under the split dollar regulations to intergenerational split dollar insurance in the context of a grandparent funding the purchase of a life insurance policy on a grandchild's life to be owned by an irrevocable life insurance trust:

> Unless the insured is very elderly, the term premium under the economic benefit regime is almost always lower (sometimes significantly lower) than the applicable federal interest rate (AFR) used for a loan regime split-dollar arrangement. With regard to the split-dollar arrangement between the grandparent and the trustee, the economic benefit regime involves smaller payments/gifts than the loan regime. But, to avoid a current gift of cash value of the policy to the trust, the economic benefit regime split-dollar contract must give all of the cash value to the premium payer (the so-called "non-equity split-dollar.")
>
> The split-dollar economic benefit regime normally requires the premium payer (the grandparent in our example) to be the owner of the insurance policy with the pure insurance allocated to the insurance trust by an endorsement to the policy (the so-called "endorsement split-dollar.") Generally, if a person other than the premium payer (for example, the trust) owns the policy, the loan regime with its higher AFR would apply. But if the grandparent owned the policy and all of its cash value, the full cash value of the policy, without discount, would be in the grandparent's gross estate at death or would be the value of the sale or gift if the policy were later sold or given by the grandparent to the trust.
>
> Discount private split-dollar solves this problem by taking advantage of a special provision in the split-dollar regulations allowing non-equity private split-dollar collateral assignment arrangements. Under the regulations, even though the life insurance policy lists the trustee as the owner, it's the grandparent who's treated as the owner—so long as the only economic benefit that the arrangement ever provides the trust is life insurance protection.
>
> Thus, a split-dollar contract between the trust that owns the policy and a grandparent/collateral assignee qualifies as an economic benefit regime arrangement as long as the arrangement gives all of the cash value (a non-equity arrangement) to the grandparent. The favorable basic tax economics of the arrangement then can be strategically customized by (1) obligating the grandparent to pay at least a certain number of premiums, and (2) expressly forbidding the grandparent from unilaterally terminating the split-dollar contract or accessing the policy's cash value. The hope is that these restrictions will result in a steep discount to the value of the grandparent's interest when he dies, or gives or sells that interest to the trust (or to another party).

Donald O. Jansen & Charles L. Ratner, *Discount Private Split-Dollar Does It Work?*, TRUSTS & ESTATES 19, at 19-20 (May 2008) (hereinafter "Jansen & Ratner, *Discount Private Split-Dollar*").

e. **Court Analysis**.

For excellent analyses of the court's decisions see Howard Zaritsky, *Morrissette v. Commissioner: Tax Court Holds That Economic Benefit Regime Applies to a Family Split-Dollar Life Insurance Arrangement Between Trusts,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2408 (April 19, 2016); Steve Gorin & Howard Zaritsky, *Tax Court Approves Some Key Issues with Intergenerational Split-Dollar Arrangements*, 28 PROBATE PRACTICE REPORTER 1 (June 2016).

(1) **2003 Split Dollar Regulations Apply**. These split dollar arrangements are governed by the 2003 split dollar regulations because they were entered into after September 17, 2003.

(2) **Tax Treatment Depends on Owner of Policy**. The 2003 split dollar regulations adopted a new approach of basing the tax treatment on who is the owner of the underlying life insurance policy.

- **Economic Benefit Regime.** The economic benefit regime applies in a donor-donee context if "the donor is the owner of the life insurance contract (or is treated as the owner of the contract…" Treas. Reg. §1.61-22(b)(3)(ii)(B).

- **Loan Regime**. If the conditions for applying the economic benefit regime do not apply (based on whether the donor is the owner or deemed owner of the policy), the loan regime may apply if the arrangement is treated as a loan under Treas. Reg. §1.7872-15(a)(2).

[BACKGROUND COMMENTARY NOT IN COURT ANALYSIS: The loan regime does not apply automatically merely because the donor is not the owner or deemed owner of the policy. If neither the economic benefit regime nor loan regime applies, general tax principles apply to the arrangement and the full amount of the premium payment may be treated as a gift. (See the discussion in the Brief Background Regarding Split Dollar Life Insurance Section above.)]

(3) **Owner of Policy**.

(a) **General Rule**. The person or entity named as the owner in the insurance contract is generally treated as the "owner," and any other person with a direct or indirect interest in the contract is the "non-owner." Treas. Reg. §1.61-22(c)(1)-(2). Under this general rule, the Dynasty Trusts would be considered the owners of the policies.

(b) **Exception—Donor as Deemed Owner**. A special rule applies if the split dollar arrangement involves the performance of services or "is entered into between a donor and donee" if the arrangement provides only death benefit protection (generally thought of as a non-equity arrangement). More specifically, in the donor-donee context:

> "A donor is treated as the owner of a life insurance contract under a split-dollar insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section." Treas. Reg. §1.61-22(c)(1)(ii)(A)(2).

If the donee receives any additional economic benefit, other than current life insurance protection, the donee will be considered the owner and the loan regime will apply.

(c) **Key Question—Any Additional Economic Benefit**? Thus, the key question in the case is whether the lump-sum payment of premiums made on the policies generated any additional economic benefit other than current life insurance protection to the Dynasty Trusts.

(d) **Example to Preamble to Regulations**. The preamble to the final regulations includes an example suggesting that a non-equity split dollar arrangement would satisfy the "no additional benefit" requirement so that the economic benefit regime would apply. (The example concludes: "Thus it follows, that where a donor is to receive the greater of the aggregate premiums paid or the CSV of the contract, the possibility of the donee receiving an additional economic benefit is foreclosed.") Preambles to regulations are afforded little weight, but they do reflect the IRS's interpretation of its own regulations.

The court hinted that it would give greater weight to a statement in a Preamble that supports a taxpayer's position than a self-serving statement that supports the government's position that is not supported by the actual substantive terms of the regulation itself.

(e) **Current Access to Cash Values**. One way a policy could afford "additional economic benefits" is if the trust that owns the policy (but that is deemed to be the non-owner) has current access to any of the policy cash value. Treas. Reg. §1.61-22(d)(2)(ii). This could include having a current or a future right to some of the cash value, or if the cash value is "directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors." Treas. Reg. §1.61-22(d)(4)(ii). The IRS argued that the receivable would pass to the Dynasty Trust or to Mrs. Morrissette's sons under the terms of her revocable trust. The court concluded that that the Dynasty Trust had no legally enforceable right to the receivables, and that the revocable trust could be revised. Furthermore, the court reasoned that it would look only to what the split dollar documents provide and whether they *require* that some of the cash value will pass to the non-owner (citing Treas. Reg. §1.61-22(d)(1), which refers to "[t]he value of economic benefits provided to the non-owner for a taxable year *under the arrangement*").

(f) **Any Other Economic Benefit?**

(i) **Notice 2002-59**. The IRS argued that Notice 2002-59 prohibits the economic benefit regime from applying in some circumstances and that it evidences that that the pre-paid premium represents an "additional economic benefit." However, Notice 2002-59 deals with "reverse split dollar" arrangements, in which a trust owns the policy; the insured has the right to receive the policy's death benefit for a particular year, and the insured pays for that current coverage by paying "P.S. 58 rates" that were substantially greater than actual mortality charges incurred by the trust. The arrangement was typically terminated after several years (i.e., the insured stopped "renting" the current coverage), and the trust could pocket the excess cash value that built-up in the trust due to the excessively large premium payments. The court rejected that analogy to an arrangement in which the insured made large upfront premium payments, because this situation was the reverse in that the insured kept the sole access to the cash surrender value of the policies.

(ii) **Prepaid Premium as an Additional Economic Benefit**. The IRS argued that prepaid premiums "pay not only for current insurance protection, but also for future protection, which is a benefit other than current life insurance protection." The government's memorandum in support of its position in response to the motion for summary judgment maintains that "the prepayment of the policy provides funds for additional years of coverage, effectively, a permanent fund to pay the cost of insurance." It draws an analogy to a parent that "irrevocably funds an account to pay current and future property taxes on a child's house,' and observes in that situation "the gift is not a gift each year that the tax becomes due and payable, but rather a gift up front. As in this case, the prepayment is a benefit to the Dynasty Trusts distinct from current life insurance protection." The court rejected this argument, first observing that the government relied on Notice 2002-59 for its position that a premium prepayment confers policy benefits other than current life insurance protection (and the court previously disagreed that the rationale of Notice 2009-59 applied to this totally different situation), and also reasoning that the Dynasty Trusts were not otherwise required to pay the premiums but the revocable trust was obligated to pay all premiums; therefore, the premium prepayment "would not relieve the Dynasty Trusts of any obligation to pay premiums because the Dynasty Trusts were not required to pay any premiums."

OBSERVE: The argument that the payment of any premium in excess of current year cost of coverage would suggest that almost all split dollar arrangements would have to be treated as owned by the person with legal title (in which event the economic benefit regime would not apply if the donor does not own the policy) because split dollar arrangements almost always involve the advance of premium amounts greatly in excess of just the cost of current year coverage under the policy. Alan Jensen and Brent Berselli (both of Portland, Oregon) indicate they have had a somewhat similar intergenerational split dollar case in which the IRS also made this "prepaid premiums" argument:

> The IRS advanced this same "prepaid premiums" argument in our recent litigation, and this was a point that the Service's appellate conferee made repeatedly during settlement negotiations. Specifically, the IRS asserted: "The permanent setting aside of money in the life insurance policy to pay future life insurance costs is an economic benefit to the donee. The value of the economic benefit is to be determined but might approximate the value of the life insurance policy." *Morrissette* addressed this "prepaid premium" argument directly and issued the correct opinion that single premium policies do not provide an additional economic benefit. This is an accurate analysis, as in our case and in *Morrissette*, the only benefit provided to the donees was current life insurance protection. In each instance, the donees had no current or future access to cash value, and all cash value was pledged to the donor under the respective [split dollar agreements].
>
> …
>
> The fact that policies subject to [split dollar agreements] are structured as single premiums does not, and should not, change the result that the only benefit afforded to the donee in any given year is "current life insurance protection" as defined in Treas. Reg. § 1.61-22(d)(3).

Jensen & Berselli, *Unfinished Business*.

(iii) **Dividends**. Not mentioned in the opinion, presumably because the IRS did not raise the issue, is that §2.02 of the split dollar agreement used in the *Morrissette* situation allowed the trust to apply policy dividends as the trust deems appropriate. Even though §6.01 of the agreement said that it was to be interpreted such that the only economic benefit is the current life insurance protection, the trust's right to take dividends in cash would seem to be a right other than current insurance protection, which would preclude using the economic benefit regime in a situation like in *Morrissette.* In structuring an intergeneration split dollar arrangement using the economic benefit regime, the agreement should restrict the trust's use of policy dividends and require that dividends be used to provide paid-up additions.

(g) **Conclusion**. "Because the Dynasty Trusts receive no additional economic benefit beyond that of current life insurance protection, the [revocable trust] is the deemed owner of the life insurance by way of the special ownership rule under section 1.61-22, Income Tax Regs. Thus the economic benefit regime under section 1.61-22, Income Tax Regs., and not the loan regime of section 1.7872-15, Income Tax Regs., applies to the split-dollar insurance arrangements."

(4) **Valuation Not Addressed**. The court specifically noted that it was not addressing the valuation of the receivable.

f. **Planning Considerations**. For an overview of planning issues regarding intergenerational split dollar life insurance, see Lee Slavutin, *A Post-Morrissette Roadmap for Drafting Intergenerational Split Dollar Agreements*, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2414 (May 12, 2016); Jensen & Berselli, *Unfinished Business;* Lee Slavutin & Richard Harris, *Intergenerational Split Dollar Life Insurance; What Can We Learn from* Morrissette, Levine *and* Neff?, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2443 (August 9, 2016); Espen Robak, *Intergenerational Split Dollar Valuation Issues,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2444 (August 9, 2016).

(1) **Only One Narrow Issue in *Morrissette***. *Morrissette* is important because it is the first court case addressing intergenerational split dollar insurance, and it is a taxpayer victory by the full Tax Court. But the court addresses only one narrow issue (on the taxpayer's motion for partial summary judgment as to that narrow issue), and the IRS is no doubt advancing a variety of other issues in the case (in addition to the valuation issue). The Notice of Deficiency treated most of the approximately $30 million advance of premiums as a gift. That would not have been the case under either an economic benefit regime or loan regime treatment. Apparently, the IRS position is that almost all of the premium advance was a gift because the Dynasty Trusts were the owners and Mrs. Morrissette's interest in the cash value was disregarded under Treas. Reg. § 1.61-22(d)(2)(ii).

(2) **Other Potential IRS Attacks**. A variety of potential issues, other than whether the economic benefit regime applies, exist regarding intergenerational split dollar arrangements. Some of these other issues are as follows.

- **Treatment of Insurance Coverage Following Premium Payer's Death**. What is the tax treatment of the economic benefit regime arrangement after the client dies (who advanced the premium payments) but before the insured's death? Is the benefit of current life insurance coverage somehow treated as a future transfer each year by the estate or its successors in interest under the economic benefit regime? (The IRS noted this issue in its memorandum in response to the summary judgment motion: "One taxpayer has argued that a deceased parent continues to make gifts each year as the cost of insurance became due and payable, irrespective that the parent had died. The National Office has found no authority supporting the position that a deceased person can make gifts, 20 or 30 years after he or she is dead." Respondent's Memorandum of Points and Authorities in Opposition to Petitioner's Motion for Partial Summary Judgment, at 20 n.3 (filed Feb. 11, 2015).)

- **Section 2703**. Are restrictions on repayment rights under the split dollar agreement treated as restrictions on the right to sell or use property that must be ignored in determining the value of property that has been transferred? A counter argument is that the right to the receivable under the terms of the split dollar contract is the very property that is transferred and the terms of the contract are not merely a restriction on the property transferred. This is similar to the courts' analysis in rejecting the IRS's argument that §2703 applies to value the transfer of interests in a partnership. However, the split dollar situation may have more difficulty meeting the comparable arm's length test under the §2703(b) exception–would an individual enter into one of these split dollar arrangements "with you or me if we weren't relatives?" Jansen & Ratner, *Discount Private Split-Dollar*, at 23. The IRS made this §2703 argument in a relatively recent intergenerational split dollar cases handled by Alan Jensen and Brent Berselli:

  > The Service sought to value the [split dollar receivable] without considering any of these limitations, arguing that under IRC § 2703, G-1's restricted access to the life insurance policies and their cash surrender values are disregarded. The Service's IRC § 2703 analysis was incorrect. IRC § 2703 disregards certain rights and restrictions in valuing an asset, but it was inapplicable in our case. The assets to be valued in G-1's estate were the [split dollar] receivables, which contained no restrictions. G-1 could have freely sold or granted options with respect to those receivables. All of the restrictions were contained in the [split dollar agreement] itself and related to G-1's rights with respect to the policies. The [split dollar agreements] themselves were not valued on G-1's estate tax return, and IRC §2703 is not relevant to the valuation of the … receivables as G-1 had unfettered control of those assets.

  Jensen & Berselli, *Unfinished Business.*
- **Sham Transaction; Lack of Business Purpose**. Is the full amount of the premium payment a gift on the creation of the arrangement under the theory that the arrangement is a "sham" transaction that lacks a business or non-tax purpose (other than generating a valuation discount on the ultimate transfer of the receivable)? In *Morrissette*, the life insurance arrangement had a clear business purpose of funding a buy sell agreement. In other situations, the taxpayers may be able to point to the life insurance as a way to provide necessary liquidity at the death of the insured.
- **Step Transaction**. If the client makes a gift or sale of the receivable under a planned arrangement, the IRS might argue that the client had intended all along to make a gift or sale of the receivable. The client-premium payer may be treated as gifting the premium payment or the life insurance policy directly to the donee. The step transaction argument may be weaker if the client holds the receivable until his or her death (perhaps unless the client is very elderly at the time of the advance under the split dollar arrangement). *See* Jansen & Ratner, *Discount Private Split-Dollar*, at 23. Even aside from a gift, sale or bequest of the receivable, the IRS may use a step transaction theory to argue that the entire amount of premiums advanced constitutes a gift. This is the position that it is taking in *Estate of Marion Levine v. Commissioner,* T.C. No. 9345-15 (petition filed April 8, 2015) ("transfer … constituted gifts … in a series of interrelated steps with a value equal to the cost of the … premiums paid"). The Tax Court entered summary judgment in favor of the taxpayer on July 13, 2016 in *Estate of Levine,* resulting in no gift tax deficiency or penalties, on the basis of the *Morrissette* opinion.

- **Modification Under Split Dollar Regulations**. A gift or sale of the receivable might be treated as though the donor transferred the entire life insurance policy that had been deemed to be owned by the donor. The split dollar regulations provide that if the split dollar arrangement is modified and the donor is no longer the owner under the split dollar arrangement, the donor "is treated as having made a transfer of the entire life insurance contract to the [trust] ras of the date of such modification." Treas. Reg. §1.61-22(c)(1)(ii)(B)(2); *see* Jansen & Ratner, *Discount Private Split-Dollar*, at 23-24.
- **Section 2036 and 2038**. Is the transfer of the premium a transfer with a retained right of enjoyment or the retained right to control beneficial enjoyment? (The IRS is making that argument, as well as the §2703 argument, in *Cahill v. Commissioner*, discussed below.) In the case handled by Messrs. Jensen and Berselli, the "appellate conferee analogized the valuation of a [split dollar] receivable to that of a family limited partnership or limited liability company holding cash or marketable securities." Jensen & Berselli, *Unfinished Business.* The IRS's primary argument in the FLP/LLC cases has been under §§2036 and 2038. A sale of the receivable during the donor's life should avoid the §2036/2038 risk at the donor's death (assuming §2035 does not apply).
- **Duty of Consistency.** The IRS may argue, under the "duty of consistency" analysis used in some cases, that the taxpayer owes a duty of consistency in valuing the receivable for gift and estate tax purposes. The IRS made this argument in the recently settled intergenerational split dollar insurance case that was handled by Messrs. Jensen and Berselli:

  > The Service contends that, if the taxpayer, under the economic benefit regime, reports a relatively minor gift amount at the outset of the arrangement, then the remaining value of the premiums advanced, without discount, should be included in the decedent's gross estate.
  >
  > Whereas, the Service's consistency argument has the benefit of simplicity, it fails to account for the economics of the arrangement. In our litigation, we continually pressed the appellate conferee to tell us how the split dollar agreements] failed to comply with the Regulations. Our appellate conferee dismissed these questions out of hand without authority. In our view, provided that we complied with the Regulations (which we did), the valuation standard should be that of a debt instrument with no fixed term, not subject to payment on demand, and with no annual principal or interest payments.

  Jensen & Berselli, *Unfinished Business.*

(3) ***Estate of Cahill v. Commissioner***. A new case that has been filed in the Tax Court is illustrative of additional issues that arise with intergenerational split dollar insurance. *Estate of Cahill v. Commissioner,* T.C. No. 10451-16 (petition filed May 3, 2016). Issues raised by the IRS in that case include:

- Property paid to the trust (to pay premiums) is included in the decedent's gross estate under §2036(a)(1) and 2036(a)(2), and the transfer was not a bona fide sale for adequate and full consideration;
- Certain provisions of the split-dollar agreement constitute a restriction on the right to use or sell the decedent's property, or an option, agreement, or other

right to acquire or use decedent's property at a price less than fair market value under §2703;

- Property paid to the trust is included in the gross estate under §2038;
- Under §2043, the excess of the fair market value at the time of death of property otherwise included under §2038 or §2035 over the value of the consideration received by decedent was included in the gross estate;

(4) **Valuation of Receivable**. The court in *Morrissette* made clear that it was not addressing the value of the receivable in the partial summary judgment decision; that will be addressed subsequently. However, at least one commentator predicts that "*Morrissette* will not proceed to a decision on the merits of the valuation of the [split dollar] receivable. There is simply too much at stake to be wrong–for the taxpayer and the IRS. We faced a similar dilemma and ultimately settled on a discount of 35% as opposed to our claimed 95%." Jensen & Berselli, *Unfinished Business.*

In the case referenced by Jensen and Berselli, G-1 advanced premiums to life insurance trusts to purchase life insurance on the lives of G-1's children (G-2). The split dollar receivables were reported on the decedent's estate tax return on the basis of independent valuations of the split dollar receivable, which considered the decedent's restricted access to repayment as well as the actuarial life expectancy of each of the insureds. The receivables were reported with a 95% discount–and the parties settled at a 35% discount.

In *Cahill,* the values reported on the estate tax reflected about a 98% discount compared to the value asserted by the IRS. An independent appraiser (WTAS, LLC, now Anderson Tax) valued the receivable using the discounted cash flow method using a discount rate of 15%.

As mentioned in the in sub- paragraph (5) below, some planners have reported settlements with discounts of 65%-90%.

One appraiser examines empirical data from lottery prize transactions, private note transactions, structured settlement transactions, and life settlement transactions to determine an appropriate discount factor for valuing intergenerational split dollar loans. He observes that one company that manages a portfolio of 600 policies acquired in life settlement transactions reports discounts rates ranging from 15.0% percent to 24.5%, with a weighted average discount rate of 17%. Espen Robak, *Intergenerational Split Dollar Valuation Issues,* LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2444 (August 9, 2016).

(5) **Loan Regime Arrangements**. Some intergenerational split dollar arrangements are structured using the loan regime with notes documenting the advances with an AFR interest rate. The discounts may not be as large as under the economic benefit regime, but planners suggest that significant advantages may still be available. (For example, significant discounts may still apply because the interest rate on the loan may be much lower than the discount rate that an appraiser will apply in valuing the note.) One planner reports settling an intergenerational split dollar loan under the loan regime with a 65% discount. Other planners acknowledge that discounts are lower under the loan regime approach, but only nominally so (about 90% discount under economic regime vs. about 80% discount under loan regime). The *Morrissette* holding will not be directly relevant to loan regime split dollar arrangements (because

it addresses how the loan regime can be avoided if that is what the parties prefer in structuring the arrangement).

The IRS so far has not been auditing loan regime arrangements. A general trend is emerging among planners using intergenerational split dollar to prefer the loan arrangement for various reasons. *See* Lee Slavutin & Richard Harris, *Intergenerational Split Dollar: What Can We Learn from* Morrissette, Levine *and* Neff?, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2443 (August 9, 2016) (loan treatment can be assured, loan can be for life of insured allowing lock in of low interst rate, easier to understand, all variables locked in at outset, large history of loan receivables being valued at a discount, and no report of any intergenerational split dollar loan regime cases being audited).

(6) **Endorsement vs. Collateral Assignment Arrangement**. Under the classic endorsement split dollar arrangement in a family (donor-donee) context, the donor owns the policy, pays some or all of the premiums, and endorses to a donee the right to the death benefit to the extent that it exceeds the greater of the premiums paid by the donor or the cash surrender value of the policy. The endorsement approach is not typically used in a family context with a classic split dollar arrangement for a policy on the *donor's life* because the donor's rights as owner of the policy would constitute incidents of ownership under §2042 causing the insurance death proceeds to be in the donor's gross estate. Using a collateral assignment approach, with an irrevocable life insurance trust owning the policy and the donor merely having a "bare-bones" right to be reimbursed for the premium advances, avoids estate inclusion of the policy proceeds. (*See* Rev. Rul. 76-274.)

Eliminating incidents of ownership in the donor is unnecessary when the donor is not the insured. Therefore, intergenerational split dollar arrangements could be structured as endorsement plans, with the donor owning the policy, and thereby avoid the issues raised in *Morrissette* (as to whether the donor is the deemed owner of the policy, because the donee has *no* benefits other than current life insurance protection, so that the economic benefit regime can apply) without risking estate inclusion of the policy death proceeds in the donor's estate.

The collateral assignment approach may result in greater discounts on the value of the receivable than with an endorsement approach under which the donor owns the policy. For example, in an endorsement approach, the donor can control investments (which is very important for a variable life policy), and may have rights to borrow the cash value (with the caveat that the donor cannot borrow enough to endanger the policy). Those rights may blunt the "lock-in" aspect of the arrangement that supports very large discounts in a collateral assignment approach. Perhaps that is the reason that some planners continue to use the collateral assignment approach even though the endorsement approach is safer from a gift tax risk standpoint (although the gift tax risk has been greatly ameliorated by the *Morrissette* decision).

(7) **Sale of Receivable**. A sale of the receivable during the donor's life may reduce the likelihood of the IRS raising other arguments summarized in Paragraph 2 above on an audit of the donor's estate tax return if the return merely includes cash or another note that makes no reference to a life insurance policy.

(8) **Summary by Steve Leimberg.** The following excellent summary by Steve Leimberg summarizes current practices and suggests best practices from a planning standpoint.

In my opinion the summary judgment granted the taxpayer in *Morrissette* was a relatively minor issue that the IRS had very little hope of winning. The pre-eminent issue concerns the appropriateness of the discount taken. That issue has yet to be decided, and my guess is that it's likely that issue isn't settled and we will see no formal opinion on the valuation issue. Having said that, my understanding is that the other [generational split dollar] cases I've been following have been settled on this issue (sometimes with pretty generous results). I've heard there are around 20 or so [generational split dollar] cases currently under audit, with several on the tax court docket. All of these cases currently under audit were apparently done using the economic benefit regime. (It does not appear the Service is challenging cases done under the loan regime.) … That makes the safer course of action use of the loan regime.

Inter-generational split-dollar may be troublesome to some insurance carriers - mainly because of the persistency risk. As we've seen so many times in the past, insurance purchases that are not intended to meet a legitimate life insurance need of the younger generation, but rather, are designed to move money from the older generation to the younger generation with minimal transfer tax consequences generate problems. In too many instances, the funds are being paid into the policy as a single premium (even ignoring the fact that putting a collateral assignment on a MEC policy is a bad idea due to Code sections 72(e)(10) and 72(e)(4)). In addition, the policies were designed to have a high early cash surrender value, oftentimes utilizing riders to accomplish this. Once the split dollar receivable was transferred (either by gift or at death) and the discount taken, then the policies were generally immediately surrendered for their cash value by the younger generation. This surrender generally took place within 2-5 years. … The persistency risk is that a carrier's breakeven point may not be until year 8 or 9, and carriers are in business to make a profit, not merely to break even. So the [generational split dollar] arrangement described above would be bad business" for carriers, and clients and producers are profiting using a "sham transaction" to the detriment of life insurance carriers.

Bottom Line:

I believe there is still significant tax and legal risk involved in inter-generational split-dollar. I do not believe *Morrissette* changed that. I do feel that risk can be alleviated somewhat by using the loan regime, holding the receivable until the death of the second generation rather than gifting it, structuring the policy as a non-MEC, and ensuring that there is a legitimate need for the insurance.

Caution: Even those precautions may not be adequate in situations where the arrangement is entered into primarily as a means to transfer funds from one generation to the next with minimal transfer tax consequences and the intent is to surrender the policy after the transfer of the split dollar receivable. Such abusive uses of [generational split dollar] remain subject to IRS attack as a sham transaction. In addition, insurance carriers generally have no appetite for such bad persistency business and are increasing screening for such arrangements in an attempt to prevent the use of their products with them.

Comments by Steve Leimberg appearing in Jensen & Berselli, *Unfinished Business*.

28. Valuation–Consideration of Asset Value If No Intent to Liquidate, *Giustina v. Commissioner*

a. **Basic Facts and Initial Tax Court Opinion, T.C. Memo. 2011-141 (2011)**. The only issues before the Tax Court were (1) the valuation of the decedent's revocable trust's 41.128% limited partnership interest in a partnership running forestry operations, and (2) whether the reasonable cause/good faith exception to the 20% undervaluation penalty applied.

The court (Judge Morrison) valued the 41.128% limited partnership interest at $27.5 million, determined with a 75% weighting to a cash flow method and 25% to an asset method. The cash flow method value was determined using a 12.25% rate to discount future cash flow to present value [reduced from 16.25% to reflect an assumption that cash flows would increase by 4% per year], and a 25% discount for lack of marketability. The asset method value was determined after applying a 0% discount for lack of control and lack of marketability; the court's view was that applying a percentage weighting to the asset method already accounted for lack of control and an assumed 40% "absorption discount" used in determining the stipulated value of timberland owned by the partnership accounted for lack of marketability concerns.

Because the partnership's asset value ($150.7 million) is so substantially larger than the cash flow method value ($52 million, before applying a 25% marketability discount), placing a 25% weight on the asset value dramatically increases the value of the estate's limited partnership interest. This was done even though no evidence suggested that a sale or liquidation was anticipated or likely, and despite the fact that "[t]he Giustina family had a long history of acquiring and retaining timberlands." The court assumed the owner of the 41.128% limited partnership interest is a hypothetical third-party who would seek to maximize the economic advantage from its assets. While the owner of a 41.128% limited partnership interest "could not alone cause the partnership to sell the timberlands," it could join with other limited partners to form a two-thirds voting block that could replace the two general partners or could vote to dissolve the partnership. The uncertainty in determining how many partners would share the view that the timberland should be sold does not prevent estimating the probability of sale. While some family members may prefer to retain the forestry operations, "people also tend to prefer $143 million [the timberland alone was worth $143 million] to $52 million, or in this case, a share of $143 million to a share of $52 million."

The 20% undervaluation penalty under §6662(a) did not apply even though the value reported on the estate tax return was less than 50% of the determined value. The reasonable cause/good faith exception in §6664(c) applied because the estate's reliance on an appraisal based entirely on a cash flow valuation approach, a distribution approach, and a comparable sale approach (but not including an asset value approach) was reasonable.

b. **Ninth Circuit Reversal and Remand, 586 Fed. Appx. 417 (9th Cir. 2014)**. The Ninth Circuit reversed the case in a brief unpublished memorandum opinion. The case was remanded to the Tax Court to recalculate the value based solely on the going concern value. (The Ninth Circuit denied the taxpayer's motion to have the opinion published.)

Assuming 25% Probability of Liquidation is Improper. The Ninth Circuit observed that the Tax Court concluded there was a 25% likelihood of liquidation of the partnership even though the decedent could not unilaterally force liquidation, reasoning that the owner of that 41% interest could form a two-thirds voting-bloc with other limited partners to do so. The Ninth Circuit said that conclusion was contrary to the evidence. For a liquidation to occur, (1) a hypothetical buyer would somehow have to obtain admission as a limited partners from the general partners, who have repeatedly emphasized the importance upon continued operation of the partnership, (2) the buyer would seek dissolution of the partnership or the removal of the general partners who just approved his admission; and (3) the buyer would manage to convince at least two (or possibly more) other limited partners to go along, despite the fact that "no limited partner ever asked or ever discussed the sale of an interest." The Ninth Circuit pointed to an earlier case in the same circuit [*Estate of Simplot v. Commissioner*, 249 F.3d 1191 (9th Cir. 2001)], which similarly reasoned that the Tax Court engaged in "imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect" with the existing partners.

Discount for Company-Specific Risk. In determining an appropriate rate for discounting future cash flows to present value under the cash flow method, the Estate's appraiser used an 18% discount rate. Of that 18%, 3.5% was attributable to a partnership-specific risk because the partnership's operations were not diversified and because the timberlands were not geographically dispersed. The Tax Court cut that 3.5% in half because "investors can eliminate [unique risks of the partnership] by holding a diversified portfolio of assets." The Ninth Circuit concluded that the Tax Court did not consider the wealth that a potential buyer would need in order to adequately mitigate risk through diversification. After observing that the Tax Court is "obligated to detail its reasoning," the court held that the Tax Court did not adequately explain its reasons for cutting the company-specific risk premium:

> We recognize that diversification of assets is a widely accepted mechanism for reducing company-specific risk. However, the Tax Court stated only that "[i]nvestors can eliminate such risks by holding a diversified portfolio of assets," without considering the wealth a potential buyer would need in order to adequately mitigate risk through diversification.

c. **Tax Court Decision on Remand, T.C. Memo. 2016-114 (June 13, 2016)**.

Zero Weight Assigned to Asset Method. The Tax Court (Judge Morrison) viewed the 9th Circuit's instruction to value the estate's partnership value as a going concern as requiring the court to determine the "present value of the cashflows the partnership would receive if it were to continue its operations." Accordingly, the court placed a zero weighting on the asset value, and gave 100% weighting to the cash flow method of the valuation. (This had a dramatic effect on the overall valuation, because of the very high liquidation value as compared to the cash flow value.)

Partnership Specific Risk Premium. The court explained its rationale for reducing the partnership specific risk premium assigned by the estate's expert. The 9th Circuit said the initial opinion failed to consider whether a prospective buyer would need to be wealthy enough to diversify the partnership-specific risk. Judge Morrison explained that the buyer could be an entity owned by multiple owners (such as a publicly-traded timber company, a real-estate investment trust, or a hedge fund). In that case, the unique risk associated with the estate's 41% limited partnership interest would have been diversified, because investors in the purchasing investment entity may own many assets other than the investment in that investment entity. The court observed that the 9th Circuit had "held that the hypothetical buyer must be a buyer to whom a transfer of a limited-partner's interest is permitted under section 9.3 of the partnership agreement" (which limits transfers to another limited partner or someone approved by the two general partners). The court believed that the two general partners "would not permit a multiple-owner investment entity to become a limited partner." Therefore, the court concluded that a hypothetical buyer would be unable to diversify the individual risks associated with the partnership, and the court allowed the full 3.5% risk premium assigned by the estate's expert. (This factor reduced the value somewhat, but not nearly as much assigning a zero weighting to the liquidation value. The value of the full partnership– not just the estate's interest– was reduced from about $51.7 million to about $45.2 million as a result of this adjustment to the partnership-specific risk.)

Overall Result. The overall result was to reduce the estate's 41% partnership interest from about $27.5 million in the initial Tax Court opinion to about $14.0 million. This is close the estate's valuation position. The estate valued its 41% partnership interest at $12.7 million on the estate tax return, increased at trial to $13 million – as compared to the IRS's position that the partnership interest was worth $35.7 million (decreased at trial to $33.5 million).

29. Interesting Quotations

a. ***Nothing Changes About Change.*** "I hate to sound like my parents, but the world is different and everything is changing." – Josh Rubenstein

b. ***Stability of Estate Planning Laws.*** John Rubenstein's father, who was an estate planning lawyer, told him that being an estate planning lawyer had a lot of ramp-up time, but once you learned it, it did not change. His father experienced few changes from the Code of 1919 to the Code of 1954. But now there is change constantly, sometimes in the middle of the game, and sometimes even retroactively." – Josh Rubenstein

c. ***Technology Changes.*** Josh Rubenstein's son (now age 12) several years ago wanted an iPhone and MacBook Air. He tried to put Josh on the spot by demanding to know "how old were *you* when you got *your* first iPhone?"– Josh Rubenstein

d. ***The Biggest Change.*** "The biggest change is the Yankees have not won the World Series since 2009. I would have thought with all the tax savings from avoiding the estate tax, Steinbrenner's estate could have bought a better team." – Josh Rubenstein

e. ***Ultra Concentrated Wealth.*** "We can have great concentration of wealth in the hands of a few, or we can have democracy, but we cannot have both." – Justice Louis Brandeis, as quoted by Josh Rubenstein

f. ***Reducing Number of "Regular" Tax Court Opinions.*** Over 100 "regular" Tax Court cases (with a "T. C." citation) used to arise every year. This year, late in the year, the *Edward Redstone* case was just number 11. – Jeff Pennell

g. ***General Powers of Appointment Growing Usage.*** "Our office sprinkles general power of appointments around like pixie dust."– Turney Berry

h. ***Predictions.*** "The longer we practice, the more humbled we are to know that we really cannot predict. We've been around long enough to know that most every prediction we've ever made has turned out to be false – including the prediction about the Cubs in the World Series last fall. – Rob Romanoff

i. ***Predicting Law Changes.*** Anyone who predicts what changes will occur in the law is either naïve, lying or consuming substances not typically available to members of professional service firms. – Rob Romanoff

j. ***Silence is Golden.*** "Silence does not mean agreement. Just ask the parents of teenagers." – Rob Romanoff in commenting on the IRS's decision not to appeal *Aragona Trust*

k. ***Don't Even Wink.*** Governor Earl Long from Louisiana, on being perturbed over what some staffer had written that had become public, scolded the staffer with this mantra: "Don't write anything you can phone. Don't phone anything you can talk. Don't talk anything you can whisper. Don't whisper anything you can smile. Don't smile anything you can nod. Don't nod anything you can wink." – Stacy Eastland

   Apparently, Governor Long expanded on a famous saying by Martin Lomasney [a Boston political boss in the late 1800s-early 1900s] who said "Never write if you can speak; never speak if you can nod; never nod if you can wink."

   Eliot Spitzer expanded on this again, saying "Never talk when you can nod and never nod when you can wink and never write an e-mail, because it's death. You're giving prosecutors all the evidence we need."

l. ***Taxes.*** "The avoidance of taxes is the only intellectual pursuit that still carries any reward. – John Maynard Keynes, as quoted by Mark Parthemer

m. ***Death and Taxes.*** "The only difference between death and taxes is that death doesn't get worse every time Congress meets." – Will Rogers, as quoted by Mark Parthemer

n. ***The Rich and Famous.*** "I always want to say to people who want to be rich and famous: 'try being rich first.' See if that doesn't cover most of it. There's not much downside to being rich, other than paying taxes and having your relatives ask you for money. But when you become famous, you end up with a 24-hour job." – Bill Murray, as quoted by Mark Parthemer

o. ***Make It Real.*** Nancy Henderson (Rancho Santa Fe, California) uses relatively long trusts, repeating various provisions covered by the trust code. If a provision is in the trust agreement, the client thinks that it really applies. The client thinks that matters that are not specifically covered in the trust agreement are just "lawyer stuff." – Nancy Henderson

p. ***Net Investment Income Tax Repeal?*** "Whether or not we continue to have the net investment income tax at this time next year – we'll decide that on November 8." – Rob Romanoff

q. ***Tax Complexity.*** "Our income tax code of four pages originally is now over 70,000 pages." – Suzanne Shier

r. ***Relative Significance of Income Tax and Estate Tax.*** The income tax funds 46% of the budget. You add on to that another 24% for payroll taxes, and 80% of the tax revenue is generated by the income tax and the payroll tax—compared to less than 1% for the estate tax." – Suzanne Shier

s. ***Astounding Wealth Transfer Anticipated in Coming Years.*** "$41 trillion worth of wealth is expected to be transferred by 2050." – Suzanne Shier

t. ***Relationships Rule.*** "Rules without relationship equals rebellion. Applied to trust relationships—rules without relationship equals litigation risk." – Suzanne Shier

u. ***Misfeasance.*** "Misfeasance is the wrongful exercise of lawful authority." – Suzanne Shier

v. ***Exercise Caution.*** "Let's be careful out there." – Sergeant Esterhaus on Hill Street Blues, as quoted by Rob Romanoff

w. ***The Draftsman's Goal.*** Be clear, be concise, be flexible, and enjoy it." – Suzanne Shier

x. ***Too Much.*** Dennis Belcher's father once told him: "I like a woman with spunk, but son, sometimes your mother has a little too much." – Dennis Belcher

y. *Look at the Bright Side.* "Where there's lack of clarity, there's opportunity." – Dennis Belcher

z. ***Just Lucky.*** "There's the caught and the uncaught." – Dennis Belcher

aa. ***Practice Approach.*** "Come up with something that is reasonable and that you can live with. Ask yourself, if you are being audited by the IRS, do you have a good explanation for what you did." – Carol Harrington

bb. ***Overconfidence.*** Michelle's law partner counseled an extremely overconfident first-year attorney who "knew it all": "Son, you are driving with your headlights off." – Michelle Graham

cc. ***Plan of Action.*** "If you don't know what harbor you're sailing to, any wind will do." – Ann Cohen, paraphrasing a quote by Seneca the Younger (I like Ann's paraphrase better than the more formal version: "If one does not know to which port one is sailing, no wind is favorable.")

dd. ***One Size Fits All.*** "When asked his fee or giving a speech, Holmes replied: "If I choose the topic, it's $50; if you choose the topic, it's $100—but you get the same speech either way." – Conrad Teitell, quoting Oliver Wendell Homes (physician and poet, the father of Justice Oliver Wendell Holmes, Jr.)

ee. ***Questions.*** In addressing presentation skills, Conrad observed that audience questions can make a speech more interesting, but sometimes, audience members are reluctant to start asking questions. "How do you get questions? That's a good question." – Conrad Teitell

ff. ***Politicians.*** Politicians campaign in poetry, but govern in prose." – Conrad Teitell

gg. ***Speak Up.*** A son wanted to get his mother a special gift for her birthday. He decided to get her a parrot to keep her company. He called his mother later to ask how she liked her birthday present. She said, "It was delicious. My friend, Louise, and I got together and …" The son exclaimed, "Mother that was a rare parrot, taught by an interpreter at the United Nations, and could speak 14 languages." His mother quietly responded, "He should have said something." – Conrad Teitell

hh. ***Executor Selection.*** "The Executor, by Edgar A. Guest

I had a friend who died, and he
on earth, so loved and trusted me
that er' he quit this earthly shore
and made me his executor.

He tasked me through my natural life
to guard the interest of his wife
to see that everything was done
both for his daughter and his son.

I have his money to invest,
and though I try my level best,
to do that wisely, I'm' advised
my judgment oft is criticized.

His widow once so calm and meek,
comes hot with rage three times a week
and rails at me because I must
to keep my oath appear unjust.

His children hate the sight of me
although their friend I've tried to be
and every relative declares
I interfere with his affairs.

Now when I die I'll never ask
a friend to carry such a task.
I'll spare him all such anguish sore
and have a hired executor."

– Conrad Teitell

ii. ***Favorite Justice.*** Jeffrey Toobin is often asked who his favorite Supreme Court Justice is. He had a favorite for many years – Justice David Souter. He admires his jurisprudence and "that he was just so weird." Justice Souter led a 19th century existence into the 21st century. He did not use a computer, cell phone, or answering machine; indeed, he did not even like electric lights, preferring to move throughout the day to sit in natural sunlight. He eats the same thing for lunch every day—a cup of yogurt and an apple, including the core (which is disgusting, but lovable).

For some reason that remains obscure, Justices Souter and Stephen Breyer tended to be mistaken for each other (though they look nothing alike). One time, nearing the end of his tenure on the Supreme Court, Justice Souter was driving from Washington D.C. to his home in New Hampshire. He stopped at a restaurant in Massachusetts. In the restaurant a gentleman said to him "I know you. You're on the Supreme Court – you're Stephen Breyer, right?" He said yes because he did not want to embarrass the man in front of his wife. They chatted a while, and eventually the man asked, "So Justice Breyer, what is the best thing about being on the Supreme Court?" The Justice responded "I have to say it is the privilege of serving with David Souter." How can you not love that guy? – Jeffrey Toobin

jj. ***Experience.*** "Experience is what you get when you don't get what you want."
– Michael Breed (of "The Golf Fix" fame)

Appendix A

FLP/LLC Discount Table of Recent Cases (prepared by John Porter, Houston, Texas)

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Strangi I	securities	Tax	31%
Knight	securities/real estate	Tax	15%
Jones	real estate	Tax	8%; 44%
Dailey	securities	Tax	40%
Adams	securities/real estate/minerals	Fed. Dist.	54%
Church	securities/real estate	Fed. Dist.	63%
McCord	securities/real estate	Tax	32%
Lappo	securities/real estate	Tax	35.4%
Peracchio	securities	Tax	29.5%
Deputy	boat company	Tax	30%
Green	bank stock	Tax	46%
Thompson	publishing company	Tax	40.5%
Kelley	cash	Tax	32%
Temple	marketable securities	Fed. Dist.	21.25%
Temple	ranch	Fed. Dist.	38%
Temple	winery	Fed. Dist.	60%
Astleford	real estate	Tax	30% (GP); 36% (LP)
Holman	dell stock	Tax	22.5%
Keller	securities	Fed. Dist.	47.5%
Murphy	securities/real estate	Fed. Dist.	41%
Pierre II	securities	Tax	35.6%
Levy	Undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Giustina	Timberland; forestry	Tax	25% with respect to cash flow valuation (75% weighting to cash flow factor and 25% weighting to asset method)
Gallagher	publishing company	Tax	47%
Koons	cash	Tax	7.5%
Richmond	C corporation; marketable securities	Tax	46.5% (37% LOC/LOM & 15% BIG)