BESSEMER TRUST

Heckerling Musings 2022 and Estate Planning Current Developments

June 2022

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Important Information Regarding This Summary

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Introduction

The 56th Annual Heckerling Institute on Estate Planning was held virtually March 28 - April 1, 2022. This summary includes observations from that seminar, as well as other observations about various current developments and interesting estate planning issues. The goal of this summary is not to provide a general summary of the presentations. Rather, this is a summary of observations of selected items during the week but primarily in the context of discussing estate planning current developments. This summary sometimes identifies speakers, but often does not (some topics are discussed by various speakers). This summary takes no credit for any of the outstanding ideas discussed at the Institute — it is simply relaying the ideas of others that were discussed during the week.

1. Summary of Top Developments in 2021

Ron Aucutt (Lakewood Ranch, Florida) lists the following as his top ten developments in 2021 in his report, "Top Ten" Estate Planning and Estate Tax Developments of 2021 (January 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**:

(1) Continued health challenges;

(2) Proposed increased income tax rates for trusts and estates (see Item 2.h(7) below);

(3) Playing with the basic exclusion amount, including anti-anti-clawback (see Items 5.b, and 7.a below);

(4) Bold proposals to coordinate transfer taxes and income taxes (see Item 2.h(3) below);

(5) Splitting gifts and bequests (*Smaldino* [see Item 20 below], *Estate of Warne* [see Item 13 below], *Buck* [see Item 19 below]);

(6) The donor's relinquishment of control over a donor advised fund (*Fairbairn*, *Pinkert*) (see Item 14 below);

(7) The weight to be given to post-death developments (*Estate of Michael J. Jackson*) (see Item 15 below);

(8) John Doe summons to a law firm (*Taylor Lohmeyer*) (see Item 12 below);

(9) Intergenerational split-dollar life insurance (*Estate of Morrissette*) (see Item 16 below); and

(10) Estate tax closing letter for a $67 user fee (Reg. §300-13, CCA 202142010) see Item 5.a(3)(b) below).

2. Legislative Developments

a. **Selected Legislative Enactments in 2020-2021.** Selected legislative enactments in 2020-2021 include the following.

(1) **CARES Act.** The Coronavirus Aid, Relief and Economic Security (CARES) Act (P.L. 116-136, 3/27/2020) provided for direct stimulus payments for certain taxpayers and various tax-related provisions for 2020, including (i) a waiver of RMDs for retirement accounts and IRAs in 2020 and deferring 2019 RMDs, (ii) a $300 above-the-line charitable deduction; (iii) an increased percentage limit from 60% to 100% for cash contributions to public charities (but not donor advised funds); and (iv) an increase of the corporate charitable deduction percentage limitation from 10% to 25%.

(2) **Consolidated Appropriations Act, 2021.** The Consolidated Appropriations Act, 2021, enacted on December 27, 2020, includes various COVID-related relief measures and tax-related measures including (i) an extension (and expansion) of the $300 non-itemizer charitable deduction ($600 for joint returns) for 2021; (ii) an extension of the 100% limit for cash contributions to public charities (for both 2020 and 2021); and (iii) an extension of the 25% limit for corporate charitable contributions in 2021.

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

(3) **American Rescue Plan.** The American Rescue Plan is a $1.9 trillion coronavirus rescue package passed under the reconciliation legislative process, signed by the President on March 11, 2021.

(4) **Infrastructure Investment and Jobs Act.** The infrastructure component of the American Jobs Plan is reflected in the Infrastructure Investment and Jobs Act (H.R. 3684), a $550 billion infrastructure package that was enacted with bipartisan support (not part of a reconciliation package) on November 15, 2021.

b. **The Made in America Tax Plan Proposal.** Also alongside the American Jobs Plan (for infrastructure) was The Made in America Tax Plan with proposed changes to the corporate tax code including (i) increases in the top corporate tax rate from 21% to 28%, (ii) various provisions to discourage shifting jobs and profits offshore, and (iii) a minimum tax on large corporations' book income.

c. **The American Families Plan Proposal.** Alongside The American Jobs Plan's proposed investment in infrastructure, The American Families Plan was proposed as a bold investment in the nation's children and families. It included various tax increases (many of which reverse the tax decreases in the 2017 Tax Act).

d. **FY 2022 Greenbook.** Detailed descriptions of the tax proposals in the Made in America Tax Plan (business provisions) and American Families Plan (individual provisions) are included in the Biden administration's "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (popularly called the "Greenbook," released May 28, 2021). When proposed, many of these measures were expected to be added to and included in a reconciliation package. For a brief description of individual tax proposals in the FY 2022 Greenbook, see Items 2.f and 2.g of Heckerling Musings 2021 and Estate Planning Current Developments (Sept. 10, 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

No transfer tax provisions were included. A paper previously written by current key Biden administration officials (David Kamin, current deputy director of the National Economic Council, and Professor Lily Batchelder, Assistant Secretary of the Treasury for Tax Policy) makes clear their disdain for various planning alternatives such as GRATs, valuation discounts, and family limited partnerships. Lily Batchelder & David Kamin, *Taxing the Rich: Issues and Options*, at 23 (Sept. 11, 2019) available at **https://ssrn.com/abstract=3452274**. While no transfer tax provisions were included in the FY 2022 Greenbook, measures to restrict such planning alternatives could be pursued legislatively or by administrative action at some point by the Biden administration. Indeed, the FY 2023 Greenbook, discussed immediately below, includes several transfer tax items.

e. **FY 2023 Greenbook.** The Greenbook for Fiscal Year 2023 was released March 28, 2022. Many of its provisions are similar to items in the FY 2022 budget proposal that were not included in the Build Back Better Act passed by the House of Representatives that is still pending in the Senate. The likelihood of many of these provisions being adopted in 2022 (obviously an election year) appears very remote, with near unanimous opposition among Republicans to many of these proposals and likely opposition from some Democratic Senators to some of the proposals. It is **possible** that some of the following proposals could be picked up and added to some pending bill for a number of reasons – including policy, revenue, conformity and balance, negotiation, inattention, or a combination of these. But it would not be easy.

(1) **Selected Business Taxation Provisions.**

(a) **Increasing Corporate Income Tax Rate.** The corporate income tax rate would be increased from 21% to 28%.

(b) **Preventing Basis Shifting.** The proposal would reduce the possibility of basis shifting by related parties through partnerships. "In the case of a distribution of partnership property that results in a step-up of the partnership's non-distributed property, the proposal would apply a matching rule that would prohibit any partner in the distributing partnership that is related to the distributee-partner from benefitting from the partnership's basis step-up until the distributee-partner disposes of the distributed property in a fully taxable transaction."

(2) **Strengthen Taxation of High-Income Taxpayers.**

(a) **Increased Top Marginal Income Tax Rate for High Earners.** The top income tax rate would increase from 37% to 39.6% for taxable income over $450,000 for joint returns, $400,000 of unmarried individuals (other than surviving spouses), $425,000 for head of household filers, and $225,000 for married individuals filing separate returns (indexed after 2023). (The levels of taxable income at which the top 39.6% rate would apply are lower than those in the FY 2022 budget proposal and substantially lower than the current brackets. For example, for joint returns, the top bracket would be $450,000 in the FY 2023 Greenbook proposal compared to $674,850 in 2022 for the top 37% bracket.)

(b) **Reform Taxation of Capital Income.** The capital gain reform provision is practically identical to the proposal in the FY 2022 Greenbook.

- **Tax Capital Income for High-Income Earners at Ordinary Rates.** The proposal would tax capital gains and qualified dividends as ordinary income (top rate of 39.6% plus the 3.8% "Medicare" tax) for taxpayers having taxable income (changed from adjusted gross income in last year's proposal) over $1 million ($500,000 for married individuals filing separately) for gains required to be recognized and dividends received on or after the date of enactment. (The FY 2022 proposal would have applied this change to gains recognized after the "date of announcement" (presumably April 28, 2021).)

- **Treat Transfers of Appreciated Property by Gift or On Death as Realization Events.** The bold proposal in the FY 2022 budget proposal to treat transfers by gift or on death as realization events (with a deemed realization for trusts every 90 years) is repeated in the FY 2023 proposal (but with some important tweaks). Various exceptions (also included in the FY 2022 proposal) apply for certain transfers between spouses and transfers to charity, gain on the sale of a residence (not just a principal residence) (up to $250,000 per person with portability for spouses), gain on the sale of tangibles (other than collectables), and gain on the sale of qualified small business stock. There would be an exclusion of $5 million (up from $1 million in the FY 2022 proposal) per person (portable between spouses), and deferred payment provisions would be available. A somewhat unclear sentence added to this year's Greenbook suggests that the $5 million general exclusion would apply only to the extent the donor had previously used all of her gift exclusion amount. Details of the FY 2022 Greenbook deemed realization proposal and planning implications are summarized in Items 2.j – 2.m of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

  This provision is not likely to pass this year, but the inclusion of the gain realization proposal in the administration's official policy position is quite significant.

  > ... the idea of taxing unrealized gains is likely to stick around. The concept has gone from a fringe idea popular only among very progressive lawmakers to a mainstream Democratic policy in only a few years. Davison & Basu, *Musk's Untaxed Wealth Opens a Path to Twitter, Riling Democrats*, BLOOMBERG DAILY TAX REPORT (April 26, 2022).

(c) **Impose a Minimum Tax on the Wealthiest Taxpayers.** This provision is new in the FY 2023 Greenbook. Senator Wyden's "Billionaire Income Tax" proposal was discussed (for **one** day, on October 27, 2021) as a possible addition to the Build Back Better Act. That system would have provided (i) mark-to-market annual taxation of income from tradable property (such as stocks and bonds), and (ii) lookback taxation of income from nontradable property (a lookback charge [referred to in a Senate Finance Committee news release as an interest charge on the deferred tax] would be applied to reduce incentives for the taxpayer to defer the sale of the assets). A taxpayer would be subject to the rules if she has either $100 million of income OR $1 billion of "applicable assets" in each of the prior three years (the income threshold could be satisfied in some years and the asset threshold could be satisfied for other years in the three-year test period). Proposing a tax on ultra, ultra-wealthy taxpayers may be a

matter of politically expedience. Turney Berry quips that proposals at campaign rallies for billionaires to pay extra tax "gets the crowd going." For a brief summary of the Billionaires Income Tax proposal and the similar (but less aggressive) Babies over Billionaires Act of 2022 proposal (H.R. 7502 introduced April 14, 2022), see Item 2.l below. For a more detailed summary of the Billionaires Income Tax proposal, see Item 2.s. of Estate Planning Current Developments (December 2021) found **here** and Part 2.e of Ronald D. Aucutt, Washington Update: Pending and Potential Administrative and Legislative Changes (May 5, 2022) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

The Greenbook FY 2023 proposes a somewhat similar but different approach of applying a minimum tax of 20% of total income, generally inclusive of unrealized capital gains, for taxpayers with "wealth" (i.e., assets minus liabilities) greater than $100 million. Taxpayers could choose to pay the minimum tax liability in equal annual installments over nine years for the first year of minimum tax liability and over five years for subsequent years. The minimum tax payments would be treated as a prepayment to be credited against subsequent taxes on realized gains to avoid taxing the same amount of gain more than once. Taxpayers with wealth over the $100 million threshold would have to report annually the total basis and total estimated value of assets in each of specified asset classes. Relief provisions would be included to avoid having to obtain annual valuations of non-tradable assets. Taxpayers treated as illiquid (with tradable assets constituting less than 20% of their wealth) could elect to include the unrealized gain only for tradable assets in determining the annual minimum tax, subject to a deferral charge upon, and to the extent of, the realization of gain on any non-tradable assets (not to exceed 10% of unrealized gains). No estimated payments would be required for the minimum tax. The proposal would be effective for tax years beginning after 2022.

According to the Credit Suisse Global Wealth Databook 2021, almost 30,000 families in the U.S. have assets more than $100 million. (That would seem consistent with the Biden administration's estimate that the Billionaire Minimum Income Tax would apply to .01% of Americans.) The administration estimates that the tax would raise $360 billion over ten years. Interestingly, Gabriel Zucman, an economist from the University of California at Berkeley, estimates that the top **ten** American billionaires would pay at least $215 billion in tax in total over the next decade under this new tax regime.

The constitutionality of such a new tax on unrealized growth would likely be challenged in court.

The "billionaire tax plan" gained little momentum and the plan announced in the FY 2023 Greenbook was shot down almost immediately by Senator Joe Manchin's objection to it. See Alexander Bolton, Manchin shoots down Biden's new billionaire tax plan, THE HILL (March 29, 2022), available at **https://thehill.com/homenews/senate/600282-manchin-shoots-down-bidens-new-billionaire-tax-plan/** ("Manchin says he doesn't support the president's plan to tax the unrealized gains of billionaires, which would set a new precedent by taxing the value an asset accrues in theory before it is actually sold and converted into cash. 'You can't tax something that's not earned.' ... Manchin's opposition means Biden's proposal is likely dead only a day after the White House unveiled it.")

(3) **Estate and Gift Proposals.**

(a) **Modify Income, Estate and Gift Tax Rules for Certain Grantor Trusts.**

- **GRATs.** Restrictions on GRATs would include (1) a 10-year minimum term, (2) a maximum term of life expectancy of the annuitant plus ten years, (3) a remainder value equal to at least the greater of 25% of the amount contributed to the GRAT or $500,000 (up to the value transferred to the trust) (the 25% remainder requirement would end the very common and effective technique of zeroed-out or nearly zeroed-out GRATs), (4) a prohibition on any decrease in the annuity during the GRAT term

(which otherwise might be used to reduce the amount includable in the grantor's gross estate if the grantor dies before the end of the GRAT term), and (5) a prohibition on the grantor's acquiring an asset from the GRAT in an exchange without recognizing gain or loss on the exchange. This provision would apply to trusts created on or after the date of enactment.

> **Observation:** Clients should not necessarily rush to create GRATs before a statute might be enacted, because the trust would recognize gain if the annuity payments could be satisfied only with appreciated assets of the GRAT, as discussed in the following paragraph. (The gain recognition risk could be minimized by using a longer term GRAT so the annuity amounts could be low enough to be satisfied out of income from the GRAT assets. Using a longer GRAT term adds mortality risk, in case the grantor should die before the end of the GRAT term, causing §2036 inclusion. Using a "split purchase GRAT" would be one alternative for reducing the mortality risk. See Blattmachr, Slade & Zeydel, BLOOMBERG ESTS. GIFTS AND TRUSTS. T.M. PORTFOLIO # 836-3rd, *Partial Interests – GRATs, GRUTs, and QPRTs (Section 2702)*, at IV.C (referring to a split purchase annuity trust, or SPLATsm).

- **Recognition of Gain on Sales Transactions With Grantor Trusts.** For trusts not fully revocable by the deemed owner, "the transfer of an asset for consideration between a grantor trust and its deemed owner" would result in the seller's recognizing gain. This proposal would apply both to sales and to transfers in satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property. It would apply to all transactions on or after the date of enactment, even if the grantor trust was **created before the date of enactment**. The FY 2023 Greenbook adds – "It is expected that the legislative language providing for such an immediate effective date would appropriately detail the particular types of transactions to which the new rule does not apply." And it would significantly overlap with the deemed realization proposals for trusts discussed in 2.f below.
- **Payment of Income Tax by Deemed Owner as Gift.** The deemed owner's payment of income tax on the grantor trust's income would be a gift by the deemed owner "unless the deemed owner is reimbursed by the trust during the same year" in which the tax is paid (but the annual reimbursement of such taxes under either a requirement or an exercise of discretion pursuant to an understanding or prearrangement would create a risk of including the grantor trust assets in the grantor's gross estate under §2036, as applied in Rev. Rul. 2004-64). If an individual sells an asset to a grantor trust, that could result in *both* an income tax *and* a gift tax on the same transaction. This provision would apply to all trusts created on or after the date of enactment (which could provide an incentive to create and fund grantor trusts before the date of enactment). The gain recognition and gift-on-payment-of-income-tax provisions would dramatically reduce the transfer planning effectiveness of grantor trusts.
- **Planning Implications of Grantor Trust Provisions.** The Greenbook FY 2023 proposal does *not* treat the value of grantor trust assets as included in the grantor's gross estate (as provided in the September 15, 2021, version of the House Ways and Means Committee version of the Build Back Better Act). (The estate inclusion provision resulted in vehement objections from the life insurance industry regarding the effect on existing life insurance trusts in light of the necessity for continuing contributions to the trusts to pay life insurance premiums.) While the value of grantor trust assets would not be included in the gross estate, the Greenbook proposal would remove the two huge tax advantages of grantor trusts – (1) the grantor's payment of income taxes as a gift tax free transfer and (2) the ability of the grantor to enter into sales, swaps, or other transactions with the trust without having them treated as income tax recognition events.

(b) **Consistent Valuation of Promissory Notes.** Loans with an interest rate equal to the AFR are not treated as gifts under §7872, but the lender may take the position that the note should be discounted for gift tax purposes on a later re-transfer or for estate tax purposes at death because the interest rate is lower than a commercial rate. Section 7872 authorized the issuance of regulations to address the estate valuation of notes, and proposed regulations were promulgated but have never been adopted.

The 2015-2016 Priority Guidance plan included this as a regulatory project, and it was continued in the Plans for 2016-2017, 2017-2018, and 2018-2019.

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

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

Rather than following through on the existing statutory authority to adopt regulations addressing the issue, however, the Treasury is now proposing a legislative solution that would limit the discount rate used to value the note for estate tax purposes "to the greater of the actual rate of interest of the note or the applicable minimum interest rate for the remaining term of the note on the date of death."

Subject to what such regulations might provide, it appears that valuing a note by discounting future payments of principal and interest at a discount rate equal to that interest rate would be tantamount to simply valuing the note at its face amount of unpaid stated principal plus accrued interest, the same as in Proposed Reg. §20.7872-1(a) (Aug. 20, 1985) (or for that matter, the general rule in Reg. §20.2031-4).

The provision would apply to valuations as of a valuation date on or after the date of introduction of legislation. That early effective date approach is typically reserved for particularly abusive matters requiring urgency, which would be a rather ironic position when the Treasury has had proposed regulations pending since 1985.

(c) **Miscellaneous Trust and Estate Tax Provisions.** The following items in the FY 2023 Greenbook were not included in last year's (FY 2022) Greenbook.

- **Expanded Definition of Executor.** The definition of executor would move from §2203 to §7701 of the Code, and the authorized party could act for all tax purposes (including with respect to pre-death tax liabilities). This would apply after date of enactment regardless of a decedent's date of death.
- **Special Use Property.** As in the House Ways and Means Committee's version of the Build Back Better Act, the limit on the reduction in value of special use property would increase from $750,000 (indexed, $1.23 million in 2022) to $11.7 million, applicable for decedents dying on or after the date of enactment.
- **Extension of 10-Year Estate and Gift Tax Lien.** The automatic 10-year lien for estate and gift tax would be extended during any deferral or installment period for unpaid estate and gift taxes. This provision would apply for existing 10-year liens and for the automatic lien that applies for gifts made or estates of decedents dying on or after the date of enactment.
- **Reporting of Estimated Value of Trust Assets.** Trusts would be required to file with the IRS annual reports including the name, address, and TIN of each trustee and grantor of the trust, and general information with regard to the nature and estimated

total value of the trust's assets (which might be satisfied by identifying an applicable range of estimated total value on the trust's income tax return). The reporting requirement would apply to taxable years ending after the date of enactment for trusts valued over $300,000 or with gross income over $10,000. Cathy Hughes, a Treasury Department estate and gift tax attorney advisor, stated at an ABA Tax Section meeting that the purpose is not to "figure out which trusts to audit" but to provide statistical data to help guide the IRS's regulatory and legislative approach to large trusts. *See* David Hood, *Treasury Seeks More Data on Trusts to Inform Estate Tax Agenda*, BLOOMBERG DAILY TAX REPORT (May 13, 2022).

(d) **Limited Duration of GST Exemption.** GST exemption allocations would apply only to:

(1) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor (for example, to grandchildren but not to great-grandchildren of the transferor) and to younger generation beneficiaries who were alive at the creation of the trust; and

(2) taxable terminations occurring while any person described in (1) is a beneficiary of the trust.

Therefore, trusts would not continue to be exempt for the full life of the trust (i.e., throughout the applicable rule against perpetuities period), but only for the life of any first- or second-generation beneficiary or any younger generation beneficiary who was alive at the creation of the trust. The "reset" rule of § 2653(a) would not apply. "Pour-over trusts" (as described in §2653(b)(2)) created from a trust (whether under the trust instrument or under a decanting authority) would be treated as having the same date of creation as the initial trust for purposes of determining the duration of the GST exemption.

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

By allowing allocation of GST exemption and only limiting how long it lasts, the Greenbook proposal could be less harsh than the GST proposal in Senator Sanders' "For the 99.5 Percent Act" (discussed in Item 2.g below), which in effect would deny **any** GST exemption allocation if the trust **could** last longer than 50 years.

(e) **Not Included.** The FY 2023 Greenbook proposals do not include the following measures that were in the September 15, 2021, House Ways and Means Committee version of the Build Back Better Act:

- A reduction of the estate and gift tax exclusion amount prior to 2026;
- New §2901 including grantor trust assets in the grantor's gross estate; and
- Look-through valuation rules for nonbusiness assets in entities.

(4) **Other Selected Miscellaneous Provisions.** Other miscellaneous provisions include:

- Taxing "carried interests" as ordinary income;
- Eliminating real estate like-kind exchanges for gains in excess of $500,000 ($1 million for joint returns); and
- Limiting the use of donor advised funds (DAFs) to avoid the private foundation annual payout requirement (i.e., distributions from a private foundation to a DAF would not be a qualifying distribution unless the DAF makes a qualifying distribution of those funds by the end of the following taxable year).

The first two of those provisions are repeats from the FY 2022 Greenbook; the third provision is added in the FY 2023 proposal.

f. **Deemed Realization Proposals.** The FY 2022 Greenbook (at pages 62-64) clarifies the proposal for the "deemed realization" of capital gains on transfers by gift or at death foreshadowed by the Obama administration's Greenbooks for Fiscal Years 2016 (Feb. 2, 2015, pages 156-57) and 2017 (Feb. 9, 2016, pages 155-56), by President Biden's campaign, and by Representative Bill Pascrell's H.R. 2286 and Senator Van Hollen's "discussion draft" of the Sensible Taxation and Equity Promotion ("STEP") Act of 2021. The deemed realization proposal was a very bold proposal that would have had major planning implications for estate planning and trust structuring. Details of House and Senate deemed realization proposals by Representative Pascrell and Senator Van Hollen, the FY 2022 Greenbook deemed realization proposal, and planning implications are summarized in Items 2.j – 2.m of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

   Some of the changes made to the deemed realization proposal in the current (FY 2023) Greenbook are (1) the general exclusion amount would be $5 million, up from $1 million, and (2) there is the suggestion that the $5 million general exclusion would apply only to the extent the donor had previously used all of her gift exclusion amount.

g. **"For the 99.8 Percent Act" (2019) and "For the 99.5 Percent Act" (2021).** Senator Sanders on January 31, 2019 introduced S. 309, titled "For the 99.8 Percent Act," and on March 25, 2021 introduced S. 994, titled "For the 99.5 Percent Act." The 2019 and 2021 proposals are very similar (identical in most respects). Senator Sanders has introduced similar bills since 2010.

   This proposed legislation would make very bold transfer tax changes including (i) reducing the **basic exclusion amount** to $3.5 million (not indexed) for estate tax purposes and to $1.0 million (not indexed) for gift tax purposes, (ii) increasing the transfer tax **rate** from 40% to graduated rates ranging from 45% to 65%, (iii) increasing the potential reduction of the value for family farm and business property under the **§2032A** special use valuation rules, (iv) increasing the potential estate tax deduction for **conservation easements**, (v) disallowing a **step-up in basis** for property held in a grantor trust of which the transferor is considered the owner "if, after the transfer of … property to the trust, such property is not includible in the gross estate of the transferor…," (vi) valuing entities by treating nonbusiness assets and passive assets as owned directly by the owners (and valuing them without **valuation discounts**), with look-through rules for at least 10% subsidiary entities, (vii) eliminating minority discounts and lack of marketability discounts for any entity in which the family either controls or owns a majority ownership (by value) of the entity, (viii) restrictions on **GRATs** (including a 10-year minimum term, a maximum term, and a remainder value at least the greater of 25% of the amount contributed to the GRAT or $500,000 (up to the value of property in the trust), (ix) subjecting assets in **grantor trusts** to gift and estate taxes, (x) limiting **GST exemptions** to 50 years, and (xi) applying additional restrictions to qualify for the **annual exclusion** for transfers to trusts.

   This bill is significant; these are far-reaching proposals that have been suggested by others from time to time but now they are in statutory text that can be pulled off the "shelf" to incorporate into whatever other legislation happens to be popular at the time. Indeed, some of the provisions are included in the FY 2023 Greenbook, discussed in Item 2.e(3) above.

   For further detail of these proposals see Item 2.n of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** and Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2019 (January 2020), with detailed analysis, found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

h. **Summary of Selected Tax Proposals in H.R. 5376, Build Back Better Act (Using Reconciliation Process).** H.R. 5376, the Build Back Better Act, has undergone a series of revisions (and is still under negotiation with substantial revisions, as discussed in Item 2.h(13) below). Here's a brief summary of the journey so far.

   (1) **Reconciliation Process.** The 50-50 split in the Senate makes passing far-reaching legislation (including tax legislation) difficult with the general 60-vote requirement to override a filibuster in the Senate. While the budget reconciliation process offers the opportunity of passing certain

types of legislation with only a majority vote in the Senate, it has various limitations and can be quite cumbersome.

For a general summary of the reconciliation process including the statutory authority, the two-step process of a budget resolution and reconciliation act, examples of the use of reconciliation, and the Byrd rule (which limits reconciliations measures that would produce additional deficits outside the "budget window" set in the budget resolution), see Item 2.d. of Estate Planning Current Developments and Hot Topics (May 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(2) **Budget Resolution.** On August 24, 2021, the House of Representatives agreed to the Senate-approved Concurrent Resolution on the Budget for Fiscal Year 2022 (S. Con. Res. 14), establishing spending priorities of about $3.5 trillion for the fiscal year beginning October 1, 2021, and ending September 30, 2022. The votes were strictly partisan (with the exception of one Republican senator who did not vote). The resolution left the House Ways and Means Committee and the Senate Finance Committee with flexibility to develop tax changes to pay for the contemplated expenditures.

(3) **H.R. 5376, September 15, 2021; Surprising Inclusion of Sweeping Transfer Tax Proposals Including Early Sunset of Exclusion Amount, Grantor Trusts, and Valuation Discount Provisions.** On September 15, 2021, the House Ways and Means Committee approved the Build Back Better Act (H.R. 5376). That version included estate tax provisions with major planning implications, including the decrease in the estate and gift tax exclusion amount, grantor trust changes (§2902 and §1062), valuation of nonbusiness assets in entities, and increased benefit of special use valuation. Ron Aucutt provides this summary of the transfer tax provisions in the September 15, 2021 version of H.R. 5376.

(a) **No Deemed Realization.** The Ways and Means Committee omitted any deemed realization proposals like those made in the current Congress and in the administration's Fiscal Year 2022 Greenbook (see Item 2.f above).

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

(c) **Closer Alignment of Grantor Trust and Transfer Tax Rules.** The bill approved by the Ways and Means Committee would create a new chapter 16, consisting solely of a new section 2901, effectively linking the grantor trust rules and the transfer tax rules so that a trust designed as a grantor trust would continue to be exposed to gift or estate tax with respect to the grantor. Thus, the bill picks up, with some significant changes, the proposals in section 8 of Senator Sanders' "For the 99.5 Percent Act" (discussed in Item 2.g above), which in turn track the Obama administration Greenbooks. With respect to a trust or portion of a trust that is not otherwise includable in the grantor's gross estate and is funded **on or after the date of enactment** (either upon initial formation or by a contribution to an existing trust), section 2901 would:

i. include the value of such portion in the grantor's gross estate for estate tax purposes,

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

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

Unlike the "For the 99.5 Percent Act," this proposal would apply only to "any portion of a trust with respect to which **the grantor** is the deemed owner." It omits the additional explicit application in the "For the 99.5 Percent Act" to the extent a deemed owner engages in a leveraged "sale, exchange, or comparable transaction with the trust" that appears to have been aimed at the technique known as a "Beneficiary Defective Inheritor's Trust" ("BDIT"). (Compare Item 2.g above)

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

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

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

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

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

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

This provision and section 2901 together were estimated to raise $8 billion over ten years.

(e) **Valuation of Certain Nonbusiness Assets in Entities.** In a proposal traceable at least to the Reagan and Clinton administrations and virtually identical to section 6 of Senator Sanders' "For the 99.5 Percent Act" (see Item 2.g above), the Ways and Means Committee bill would in effect require the valuation of nonbusiness assets in an entity by **a look-through method**. The proposal would add a new section 2031(d) to the Code, **applicable to transfers (by gift or upon death) after the date of enactment**. Section 2031(d)(1) would read as follows:

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

Like the "For the 99.5 Percent Act," the proposal includes a detailed list of what are considered "passive assets," detailed rules about "passive assets" that might be used in a business and "look-thru rules" for entities that are at least 10 percent owned by another entity. The proposal also adds a broad grant of regulatory authority, specifically including the

issues of whether a passive asset is used in the active conduct of a trade or business or is held as part of the reasonably required working capital needs of a trade or business.

Unlike the "For the 99.5 Percent Act," however, the proposal does not include a general prohibition on "minority discounts" in family owned or controlled entities. This prohibition t in the "For the 99.5 Percent Act" (see Item 2.g above) is not limited to "nonbusiness" entities or assets and thus would arguably have a much broader and harsher impact on family businesses.

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

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

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

(f) **Increased Benefit of Special Use Valuation.** In contrast to the preceding provisions that would make the estate and gift tax more burdensome, the Ways and Means Committee bill, **effective January 1, 2022**, would increase the limit on the reduction under §2032A in the estate tax value of real property used in a family farm or other family business resulting from valuing the real property in that farm or business use, even if that is not its "highest and best use." Currently the limit on that reduction is $750,000 indexed for inflation since 1998 ($1,190,000 in 2021 and $1,230,000 in 2022). Such an increase in the limit has often been offered by lawmakers opposed to across-the-board repeal or reduction of the estate tax as a way to target relief to the family farms and businesses that are often cited as justifications for such repeal or reduction. Unlike section 3 of Senator Sanders' "For the 99.5 Percent Act" (see Item 2.g above), which would increase the limitation to only $3 million, indexed for inflation going forward, the Ways and Means Committee proposal would raise the limit to $11.7 million (which happened to be the 2021 basic exclusion amount), indexed going forward. Even so, the proposal would not really reduce the estate tax on a family farm or business as such; it would merely prevent a tax, for example, on a speculative prospect of development that is faced by such businesses very unevenly. Thus, this proposal should not be expected to be viewed by owners of family farms and businesses as much of a consolation. It was estimated to decrease revenues by $317 million over 10 years.

(g) **Planning Implications of Sweeping Transfer Tax Proposals.** For a detailed discussion of planning implications of these sweeping transfer tax proposals, see Item 4 of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(h) **Other Income Tax Proposals.** Other income tax proposals in H.R. 5376 as approved by the House Ways and Means Committee on September 15, 2021 include –

(i) increasing the individual income tax rates from 37% to 39.6% for taxable incomes over $400,000 ($450,000 for joint returns and surviving spouses) and $12,500 (indexed) for trusts and estates,

(ii) increasing the capital gains rate from 20% to 25% for those same individuals and trusts, effective September 14, 2021 with an exception for gains recognized in 2021 pursuant to written binding contracts entered before that date,

(iii) applying a 3% surcharge for "modified adjusted gross income" over $5 million for individuals and $100,000 for trusts and estates,

(iv) changing the 21% corporate income tax rate to 18% for taxable income up to $400,000, leaving it at 21% for taxable income from $400,000 to $5 million, and increasing it to 26.5% for taxable income over $5 million,

(v) expanding the 3.8% net investment income tax by eliminating the "trade or business" exception in §1411(c)(1)(A) for individuals with "modified adjusted gross income" over $400,000 ($500,000 for joint returns and surviving spouses) and for trusts and estates with AGI over the threshold for the highest income tax bracket, and

(vi) capping the qualified business income deduction under §199A at $400,000 for individuals ($500,000 for joint returns and surviving spouses) and $10,000 for trusts and estates.

(4) **Billionaires Income Tax, October 27, 2021.** Following Senator Sinema's objection to rate increases for individuals and corporations (which were responsible for much of the revenue raisers in the H.R. 5376) Senator Wyden released his Billionaires Income Tax mark-to-market proposal on October 27, 2021 (described in Item 2.l below).

(5) **Administration's Build Back Better Framework, October 28, 2021.** In an effort to reach consensus of Democrats in the Senate and House, the administration released a short document titled Build Back Better Framework on October 28, 2021. The document reflected ongoing negotiations and referred to "a new surtax on multi-millionaires and billionaires" but omitted many of the revenue provisions in the September 15 version of H.R. 5376 (including the estate planning related provisions discussed in Item 2.h(3) above). The administration's framework did not include any reference to the provisions of Senator Wyden's Billionaires Income Tax, which had met the immediate disapproval of some Democrats.

(6) **H.R. 5376, October 28, 2021.** That same day, on October 28, The House Rules Committee released a new version of H.R. 5376 reflecting the administration's framework. It omitted the estate tax, grantor trust, and valuation provisions discussed in Item 2.h(3) above. It **includes**

- the limitations under §1202 for qualified small business stock for high-income taxpayers, and
- the expansion of the 3.8% net investment income tax for active business income from passthrough entities for high-income taxpayers,

but it **omits**

- increases of the corporate and individual rates (other than the surcharge for high-income individuals discussed below),
- the limitation on the qualified business income deduction under §199A for high-income taxpayers, and
- limitations on ultra-large IRAs and Roth accounts (but some of those limitations were added back in the November 3 version, discussed below).

(7) **Surcharge in H.R. 5376, October 28, 2021.** Of particular note, the thresholds and surcharge rates on very high-income taxpayers in the September 15 version of H.R. 5376 were increased.

- **Threshold.** The "modified adjusted gross income" income threshold for individuals is doubled from $5 million to $10 million, including joint returns of married couples (half that amount for married individuals filing separately), and the threshold for trusts and estates is doubled from $100,000 to $200,000. For trusts and estates, "adjusted gross income" is determined under section 67(e), which is calculated after taking into consideration the distribution deduction, but without considering the charitable deduction under §642(c) (but the November 3 version of H.R. 5376, discussed below, does allow consideration of the charitable deduction).
- **Rate.** The surcharge rate above that threshold is increased from 3% to 5%. In addition, an 8% rate (rather than 5%) applies for income above a threshold of $25 million for

individuals (half that amount for married individuals filing separately) and $500,000 for trusts and estates.

- **Planning Observation.** Structuring trusts with the flexibility to cause capital gains to be included in distributable net income will be very important so that capital gains can be distributed to beneficiaries to decrease the trust's adjusted gross income if staying below the surcharge threshold is important for the trust. For a discussion of structuring alternatives, see Item 18 of Akers, Estate Planning Current Developments and Hot Topics (December 1, 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(8) **H.R. 5376, November 3, 2021.** An updated version of H.R. 5376, with both technical and substantive additions, was released on November 3, 2021. Revisions in the November 3 version include the following.

- As noted above, the surcharge threshold for trusts and estates is based on income after subtracting the charitable deduction under §642(c).
- Limitations for IRA or Roth accounts are reinstated for high-income taxpayers, including prohibitions of additional contributions after IRA and Roth accounts reach $10 million, requiring certain mandatory distributions from accounts exceeding $10 million, and requiring annual reporting of balances for accounts with at least $2.5 million. The prohibition on IRAs holding certain investments was not added back.
- The 5% and 8% surcharge for electing small business trusts (ESBTs) is determined by combining S corporation income and non-S corporation income to determine if the trust is over the threshold; this will require separate computations of taxable income – one for normal income purposes (treating the S and non-S portions as separate trusts) and a second for surcharge purposes (which coincidentally would appear to allow using S corporation losses to offset taxable income on the non-S portion).
- The $10,000 cap on state and local taxes through 2025 would be increased to $72,500 for 2021 – 2025, and the $72,500 cap would continue for 2026-2031 (as opposed having the cap removed entirely beginning in 2026 under current law).

(9) **H.R. 5376, November 4, 2021 Amendment.** An amendment offered on November 4, 2021 would making various changes including increasing the SALT cap:

- The $72,500 cap on state and local taxes for 2021-2031 (under the November 3 proposal) would be increased to $80,000, except that the $10,000 cap would be reinstituted for 2031 (and the cap would be removed entirely beginning in 2032).

(10) **H.R. 5376, Passed House of Representatives, November 19, 2021; Relevant Tax Provisions Highlights.** The Build Back Better Act (H.R. 5376) passed the House of Representatives on a 220-213 straight party-line vote (except that Representative Jared Golden (Dem. ME) voted against the bill, reportedly because the SALT amendment would largely benefit high-income taxpayers).

(11) **Senate Action, Text From Senate Finance Committee.** The Senate Finance Committee released an unfinished version of the Committee's title (Title XII) of the Build Back Better Act on December 11, 2021, with a summary that "[t]he updated text includes both technical and policy changes, as well as modifications to ensure compliance with Senate budget rules." The tax provisions are very similar to the provisions in H.R. 5376 passed by the House on November 19, 2021. One of the major changes is that the SALT provision is left blank while it is still being negotiated (the Finance Committee text includes Section 127601 as a "placeholder for compromise on deduction for state and local taxes"); a major issue is whether the removal of the $10,000 limitation of the SALT deduction would be restricted to taxpayers with income below a specified threshold, and that income threshold is still being discussed (with the discussions ranging from about $400,000 to about $1 million). *See* Laura Davison, *SALT Talks Continue as*

Senate Democrats Release Tax Plan, BLOOMBERG DAILY TAX REPORT (Dec. 11, 2021). The bill is now being negotiated in the Senate, and various changes are still possible.

(12) **Overview Summary of Current Tax Provisions.** This is a brief overview of relevant tax issues in the Build Back Better Act as it stands now.

Included. The proposed legislation includes the following.

- A 5% income tax surtax applies to modified adjusted gross income for individual taxpayers in excess of $10 million (same as for single and married filing jointly individuals) and for trusts and estates in excess of $200,000, and an 8% surtax applies for income above a threshold of $25 million and $500,000. The threshold for trusts and estates is determined after taking into consideration the distribution deduction as well as the charitable deduction under §642(c).
- The 3.8% net investment income tax will apply to active business income from passthrough entities for taxpayers with greater than $400,000 in taxable income (single) or $500,000 (joint), and slightly over $13,000 for all non-grantor trusts and estates (under current law the 3.8% tax applies only to passive income).
- The 100% exclusion for qualified small business stock under §1202 is reduced to 50% as of September 14, 2021 for all non-grantor trusts and estates and for individuals with adjusted gross income above $400,000.
- Contribution limitations and minimum distribution requirements will apply to IRAs (including Roth IRAs) above $10 million, but proposed new limitations on accredited investor, qualified purchases, and closely-held investments are not included.
- The House-passed version provides that the $10,000 cap on state and local taxes for 2021-2031 would be increased to $80,000, except that the $10,000 cap would be reinstituted for 2031 (and the cap would be removed entirely beginning in 2032). The text released from the Senate Finance Committee leaves the SALT provision blank (while it is still being negotiated).

Not Included. H.R. 5376, as passed by the House and as in the text released by the Senate Finance Committee, does not include provisions addressing (among other things)

- increases in the individual rates or capital gains rates (other than the surcharge described above),
- increases of the C corporation rates,
- changes to the carried interest rules,
- the decrease in the estate and gift tax exclusion amount, grantor trust changes (§2902 and §1062), valuation of nonbusiness assets in entities, increased benefit of special use valuation,
- limitations on the §199A deduction for high-income taxpayers,
- the Billionaires Income Tax, or
- any deemed realization/carryover basis provisions.

But negotiations are ongoing, and more changes are possible (negotiations are continuing in the Senate).

(13) **Timing.** Timing of possible passage of H.R. 5376 is very uncertain at this point. Major negotiations continue in the Senate. Significant differences still exist among the Democrats in Congress on a variety of issues, including the overall cost of the plan, whether to add a work requirement for the expanded child tax credit, whether and how the limitations on SALT deductions will be eliminated or modified, and whether a paid family leave and medical leave, expanded Medicare to cover hearing care, and prescription drug pricing will be included (among other things). So far, Senator Manchin is still expressing concerns about passage of the Build

Back Better Act in light of its possible effect on inflation and has objected to including some programs for only several years to reduce the 10-year cost of the bill, although the programs might later be extended indefinitely. Some have quipped that the negotiations to whittle down the Act will result in a "Build Back Something" bill (and, seriously speaking, some have suggested changing the name from something that sounds like infrastructure back to "The American Families Plan"). *See* Doug Sword, *House Dems Envision Whittled-Down 'Build Back Something' Bill*, TAX NOTES (Jan. 12, 2021). Senator Manchin has suggested that he might back various climate provisions in the bill and wants to use some of the revenue from tax hikes to reduce the deficit. President Biden on January 19, 2022 endorsed getting "pieces, big chunks" of the bill passed and specifically noting that "we would be able to get support for the $500 billion plus for energy and the environment." Various Democrats in Congress have rallied round proceeding with the climate change provisions and any other parts of Build Back Better that have the votes as a new package for consideration. *See* Coral Davenport and Lisa Friedman, *'Build Back Better' Hit a Wall, but Climate Action Could Move Forward*, NEW YORK TIMES (January 20, 2022).

Consideration of the reconciliation act (whatever it is eventually called) appears to have dropped in priority at this point in deference to other concerns. However, negotiations are continuing, primarily to determine what provisions would be acceptable to Senators Manchin and Sinema, in an effort to obtain the affirmative vote of all 50 Democratic senators.

> "We're going to keep talking ...."
>
> Some Democrats, however, remain skeptical that the party can reach a deal after the failed efforts late last year. Manchin, for instance, supports raising the corporate tax rate, but Arizona Senator Krysten Sinema, another Democratic holdout, has been adamant in her opposition to increasing it.
>
> "There are varying levels of optimism among different colleagues in the Senate. I am the most skeptical," Senator Dick Durbin of Illinois, the chamber's No. 2 Democrat said. "I want to put two of my colleagues in a room with a blank sheet of paper and ask them, "What will you agree to?" Ed Wasson, *Manchin, Schumer Discuss New Tax Hike, Deficit Cut Proposal*, BLOOMBERG DAILY TAX REPORT (April 26, 2002).

(14) **Transfer Tax Provisions Omitted but Some Could be Implemented by Administrative Action.** The sweeping transfer tax provisions discussed in Item 2.h(3) above are omitted (and are extremely unlikely to be returned in further negotiations of H.R. 5376), but some of those concepts could be implemented in large part by administrative changes if the Biden administration should want to devote the considerable political will and resources that would be required.

> Legislative changes may be unlikely, but for the Biden administration, which proposed a host of reforms earlier in the year, administrative changes may turn out to be the fallback plan.
>
> The most recent priority guidance plan contains relatively noncontroversial items in the estate and gift tax area. But [Austin Bramwell of Milbank LLP] noted that Treasury has an assistant secretary for tax policy — Lily Batchelder — with an extensive scholarly background in wealth transfer tax issues. "If they want to do administrative changes in our area, Treasury certainly could," he said.
>
> The much-maligned grantor trust reform proposal didn't survive congressional negotiations, but even if the law isn't changed, the rules for grantor trusts could be changed administratively to accomplish essentially the same outcome as the legislative proposal, according to Bramwell. "It's a question of political will and resources, not of administrative law," he said.
>
> However, the amount of political will and resources needed to do something like that is considerable, Bramwell added. The IRS could begin by revoking Rev. Rul. 85-13, 1985-1 C.B. 184, but it may then have to comb through other existing regulations where the position of Rev. Rul. 85-13 is enshrined and go through the notice and comment rulemaking process to correct them.
>
> "It would unsettle so many areas of law that you'd need to get a whole bunch of very good tax lawyers together to figure out how to do it technically," Bramwell said.
>
> Treasury could also bring back a regulatory project limiting valuation discounts. The proposed regs were unpopular at the time, receiving more than 10,000 comments in opposition, and the Trump administration later withdrew them. But both [Justin] Miller and Bramwell said they wouldn't be surprised to see a regulatory crackdown on discounts.

i. **2022 Midterms.** Midterms are historically tough on the president's party.

> Since the end of World War II, the president's party has lost House seats in all but two midterms: 2002 and 1998, when Republicans were seen as overreaching with their impeachment inquiry into President Bill Clinton. In the average midterm election during this time period, the president's party has lost 26 House seats.
>
> ...
>
> [However,] the president's party doesn't always lose Senate seats.... This might sound counterintuitive given how often the president's party loses ground in the House, but House elections are simply more susceptible to the national electoral environment than Senate elections. This is, in part, because all 435 seats are up in each House election, whereas only about one-third of Senate seats (and roughly two-thirds of states) are up. As such, the partisan makeup of those Senate seats can more strongly influence the electoral chances of the two parties. Moreover, Senate elections are statewide contests where incumbents have sometimes had a larger edge than their House counterparts, in part because a distinct personal brand can still somewhat override trends running against the incumbent's party.
>
> ...
>
> Looking ahead to 2022, it's less likely we'll see the Senate and House move in different directions, as Republicans have only two Biden-won Senate seats to defend, Pennsylvania and Wisconsin, which are states Biden won by less than 2 points, meaning Democrats have little in the way of easy pickings. By contrast, the GOP will likely have more opportunities for pickups, as they can expect to challenge Democratic-held Senate seats in battleground states, such as Arizona, Georgia and Nevada, each of which Biden won by fewer than 3 points.
>
> ...
>
> Political science has offered a number of explanations for what's going on under the hood, all of which may contribute at least in part to the presidential party's midterm curse. These can largely be grouped into three categories: a midterm "reversion to the mean" after presidential elections, a "surge and decline" in voter turnout that changes the electorate from presidential years to midterm years and a broader "presidential penalty" where the party in the White House gets punished regardless of how the country is doing.
>
> ...
>
> All in all, though, the takeaway from history and political science literature is clear: The president's party is almost always cursed with midterm losses in congressional elections. This reality makes Republicans favorites to win full control of Congress in 2022 pretty much regardless of what happens over the next year — although the extent of the GOP's advantage could grow or shrink depending on how Biden is doing as president. Geoffrey Skelley and Nathaniel Rakich, *Why the President's Party Almost Always Has a Bad Midterm*, FiveThirtyEight by ABC News (Jan. 3, 2022).

Losing just one net Senate seat to Republicans would result in loss of control of the Senate for Democrats. In the 2022 Senate elections, Republicans will be defending 20 of the 34 open Senate seats, including two seats in states (Pennsylvania and Wisconsin) won by President Biden (but by less than two points), while Democrats will not be defending any Senate seat in a state won by President Trump. Three Democratic senators up for re-election in 2022 won their last race by less than 6% (Senators Hassan [NH], Mastro [NV], and Bennett [CO]), and three more Democratic senators up for re-election in 2024 are from states won by President Trump in 2020 (Senators Manchin [WV], Tester [MT], and Brown [OH]). Also, Senators Warnock and Ossof in Georgia won their 2020 races by less than 1% of the vote. Also, Democratic Senate seats in Arizona and Nevada are in states that Biden won by less than three points.

Accordingly, while the evenly split Congress may make sweeping changes harder to achieve, the possibility of a shift of control in the House or Senate (or both) in the 2022 midterms adds urgency for Democrats to do what they can now regarding tax legislation.

j. **Possibility of Retroactive Tax Changes; Constitutionality Issues; Planning Considerations.** Throughout 2020, some planners were concerned that clients should make transfers in 2020 in case legislation in 2021 reducing exclusions or increasing rates would be made retroactive to January 1, 2021. That obviously did not happen. Similarly, in early 2021 there was some concern that the gift exclusion amount might have been reduced retroactively to January 1, 2021. That could have resulted in millions of dollars of gift tax payments being owed by clients who made gifts of their $11.7 million exclusion amount thinking that no gift taxes would be due – an outrageous result.

Those clients concerned with the possibility of retroactive tax changes in 2021 could still be concerned in 2022. In light of the fact that the changes have been introduced and debated through the fall of 2021, applying those changes retroactive to January 1, 2022 is very unlikely but **not out of the question**.

The operation of the unified credit for federal gift tax purposes creates the possibility of an inadvertent retroactive gift tax change, as explained in Item 2.q(2) of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. That is a scary possibility—but transfer tax changes are typically made effective on January 1 of the year following the date of enactment; therefore, the exclusion amount would not be changed as of the date of the gift. In any event, in the very evenly divided Congress, the likelihood of a retroactive reduction of the gift exclusion amount is extremely low, particularly in light of the extreme unfairness of such a change.

If Congress were to enact a retroactive tax change, the legislation likely would be upheld if it were attacked as being unconstitutional. A long history exists of examples of retroactive legislation. Indeed, the Supreme Court has gone so far as to state that Congress "almost without exception" has given general revenue statutes effective dates prior to the dates of actual enactment. *United States v. Darusmont*, 449 U.S. 292, 296 (1981). Retroactive tax legislation is not absolutely barred by the U.S. Constitution, and is almost always upheld by the Supreme Court. For example, "corrective" retroactive estate tax legislation was upheld in *United States v. Carlton*, 512 U.S. 26 (1994). For various examples of and discussions about constitutional issues of retroactive tax legislation see Item 2.q(3) of Estate Planning Current Developments (December 2021) found **here** and Item 2.b(3) of Estate Planning Current Developments and Hot Topics (May 2021) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

For clients who are concerned (or perhaps obsessed) with the very unlikely risk of retroactive gift tax legislation, some planners have examined ways of making gifts that could be limited not to trigger gift tax or that could be "undone" in the event of subsequent legislation making the gift inadvisable. Alternatives include (1) formula gifts up to the available exclusion amount, (2) gifts to QTIPable trusts, (3) gifts to QTIPable trusts with a disclaimer provision that would pass assets to a trust for descendants (or possibly a SLAT although that is not clearly allowed) if the spouse disclaimed, (4) gifts to trusts providing that disclaimed assets would revert to the donor, (5) combinations of the above, (6) selling assets to delay the decision to make a gift by forgiving the note but shifting future appreciation beginning immediately, and (7) attempting to rescind the gift later based on changed circumstances. See Items 12-20 of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** for a more detailed discussion of these alternative approaches.

k. **Wealth Tax.** The proposed Ultra-Millionaire Tax Act, co-sponsored by Senators Sanders, Warren, and various others, proposes a 2% annual tax on the net worth of households and trusts ranging from $50 million to $1 billion and an additional 1% annual tax (for a 3% total tax) on assets above $1 billion. Estimates are that about 100,000 Americans (or fewer than 1 in 1,000 families) would be subject to the wealth tax in 2023, and that it would raise about $3 trillion over a decade, according to an analysis by University of California Berkeley Economics Professors Emmanuel Saez and Gabriel Zucman. Treasury Secretary Janet Yellen has confirmed that President Biden does not favor a wealth tax, and that a wealth tax would have significant implementation problems. *See Yellen Favors Higher Company Tax, Capital Gains Worth a Look*, BLOOMBERG DAILY TAX REPORT (Feb. 22, 2021). For a more detailed discussion of the wealth tax concept, including constitutionality issues and administrative complexities, see Item 2.d. of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

l. **Mark-to-Market Proposals; "Billionaires Income Tax" Proposal; Babies Over Billionaires Act of 2022 Proposal.** Senator Wyden (Chair of the Senate Finance Committee) has for some years been pushing a mark-to-market system rather than a wealth tax. Proposals by Senator Wyden in 2019 and 2020 would eliminate the preferential rates for long-term capital gains so that all income would be

taxed at applicable ordinary income rates. In addition, new "anti-deferral accounting rules" would apply to high-income taxpayers, providing (i) mark-to-market annual taxation of income from tradable property (such as stocks and bonds), and (ii) lookback taxation of income from nontradable property (a Senate Finance Committee news release on October 27, 2021 clarified that upon sale, a capital gains tax plus an interest charge, or "deferral recapture amount," corresponding to the amount that would have been due if the asset had been marked to market each year and the tax deferred until sale would be payable). The anti-deferral accounting rules would apply to taxpayers (including individuals, estates, or trusts) that meet certain income or asset thresholds. A taxpayer would be subject to the rules if she has either $1 million of income OR $10 million of "applicable assets" in each of the prior three years (the income threshold could be satisfied in some years and the asset threshold could be satisfied for other years in the three-year test period). This threshold means that the rules would apply to "only a fraction of the richest 1 percent of Americans." For a detailed description of the proposal, see *Treat Wealth Like Wages*, by Senate Finance Committee Ranking Member Ron Wyden, available at **https://www.finance.senate.gov/imo/media/doc/Treat%20Wealth%20Like%20Wages%20RM%20Wyden.pdf.**

The Mark-to-Market proposal arose again in the consideration of the reconciliation package considered in 2021 (the Build Back Better Act). After Senator Sinema indicated that she opposed raising corporate and individual income tax rates, Senator Wyden again on October 27, 2021, rolled out his mark-to-market regime in the "Billionaires Income Tax" proposal, as mentioned in Item 2.h(4) above. For a summary of the Billionaires Income Tax proposal, see Item 2.s. of Estate Planning Current Developments (December 2021) found **here** and Part 2.e of Ronald D. Aucutt, Washington Update: Pending and Potential Administrative and Legislative Changes (May 5, 2022) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

The FY 2023 Greenbook proposed a "Billionaire Income Tax," which would be a minimum tax of 20% of total income, generally inclusive of unrealized capital gains (with various exceptions), discussed in Item 2.e(2)(c)20.e(1)(c)20.e(1)(c) above.

The "Babies over Billionaires Act of 2022," introduced as H.R. 7502 on April 14, 2022, is similar to (but not as aggressive as) the Billionaires Income Tax proposal by Senator Wyden. It would annually tax 30% (rather than 100% in the Wyden proposal) of unrealized gains from publicly traded assets at the long-term capital gains rate, and it would tax 50% of unrealized gains of private capital assets at the long-term capital gains rate every five years, payable in five yearly installments. It would also mandate that the IRS manually audit filers reporting "net worth" in excess of $100 million.

m. **Accelerating Charitable Efforts (ACE) Act Proposal.** Sen. Angus King (I-ME) and Sen Chuck Grassley (R-IA) on June 9, 2021, introduced bipartisan legislation, the Accelerating Charitable Efforts (ACE) Act, to cause philanthropic funds to be made available to working charities within a reasonable time period by tightening restrictions on donor advised funds (DAFs) and private foundations. An essentially identical proposal, H.R. 6595, was introduced in the House on February 3, 2022, by Representative Chellie Pingree (D-ME).

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

(1) **Additional Restrictions on DAFs.** Four restrictions would apply to contributions to "nonqualified" DAFs in order to receive an income tax charitable deduction: (i) no deduction would be allowed for non-cash contributions unless the fund sells the asset for cash; (ii) no deduction would be allowed until the fund makes a qualifying distribution of the contribution (or

the sale proceeds of the contribution); (iii) the deduction would be limited to the qualifying distribution amount; and (iv) contribution must be distributed within 50 years to avoid the imposition of a 50% excise tax on the undistributed portion of the contribution and attributable earnings.

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

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

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

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

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

3. Corporate Transparency Act Overview

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

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

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

The publication of the "Pandora Papers" disclosed information about a number of foreigners who have chosen to keep assets held in U.S. trusts. Many of them are connected to people or companies accused of fraud, bribery, or human rights abuses in some of the world's most vulnerable communities. *See* Debbie Cenziper, Will Fitzgibbon & Salwan Georges, *Foreign Money Secretly Floods U.S. Tax Havens. Some of It Is Tainted*, WASHINGTON POST (Oct. 6, 2021). This development may create pressure on the U.S. to agree to more complete disclosure about private trusts and perhaps the beneficial owners of private trusts in the United States.

See generally Kevin L. Shepherd and Edward M. Manigault, *Beneficial Ownership Disclosure and the Corporate Transparency Act: Overdue or Overwrought?*, 35 PROB. & PROP. No. 4 (July/Aug. 2021); Brooke Tansill, *The Corporate Transparency Act: What Practitioners Need to Know*, ABA REAL PROP. TRUST & ESTATE LAW SECTION EREPORT (Summer 2021).

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

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

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

For a trust that is a Beneficial Owner of 25% or more of an entity, planners had anticipated that regulations would adopt an approach, like the approach of the CDD Regulations, treating the trustee as the deemed beneficial owner (and not the individual beneficiaries). *See* John A. Terrill & Michael Breslow, *Congress Passes Corporate Transparency Act to Require Disclosure of Beneficial Owners of Entities and the Creation of a National Registry of Entities*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #218 (Jan. 21, 2021). Proposed regulations unfortunately have not adopted that approach, but generally treat as Beneficial Owners (i) trustees, (ii) a trust beneficiary who is the sole permissible recipient of income and principal or who can demand distribution of or withdraw substantially all of the trust assets, and (iii) the trust grantor or settlor who has the right to revoke the trust or otherwise withdraw all of its assets. The preamble to the regulations explains as follows and requests comments.

> Proposed 31 CFR 1010.380(d)(3)(ii)(C) specifies that an individual may directly or indirectly own or control an ownership interest in a reporting company through a trust or similar arrangement. The proposed language aims to make clear that an individual may own or control ownership interests by way of the individual's position as a grantor or settlor, a beneficiary, a trustee, or another individual with authority to dispose of trust assets. In relation to trust beneficiaries in particular, FinCEN believes that it is appropriate to consider an individual as owning or controlling ownership interests held in trust if the individual is the sole permissible recipient of both income and principal from the trust, or has the right to demand a distribution of, or withdraw substantially all of the assets

from, the trust. Other individuals with authority to dispose of trust assets, such as trustees, will also be considered as controlling the ownership interests held in trust, as will grantors or settlors that have retained the right to revoke the trust, or to otherwise withdraw the assets of the trust. FinCEN believes that these circumstances comport with the general understanding of ownership and control in the context of trusts and furthers the CTA's objective of identifying true beneficial owners regardless of formalities that may vary across different jurisdictions. However, FinCEN acknowledges that these concepts do not map easily onto every trust or similar arrangement. Accordingly, FinCEN is seeking comment on its general approach to the attribution of ownership interests held in trust to certain individuals, as well as the particular circumstances in which individuals may be considered to own or control ownerships interests held in trust. More broadly, FinCEN seeks comments on whether these and the other proposed examples of how one might own or control ownership interests are clear and useful, and which, if any, require elaboration. FEDERAL REGISTER 69920, at 69935 (Dec. 8, 2021).

d. **Regulations and Effective Date.** The Treasury Secretary has broad regulatory authority and was required to promulgate regulations by January 1, 2022. The CDD Regulations must be conformed with the CTA to eliminate duplicative burdens. The regulations will "use risk-based principles for requiring reports of beneficial ownership information." The reporting requirements take effect on the effective date of the regulations. Proposed regulations promulgated by Treasury's FinCEN were published in the Federal Register on December 8, 2021. Those proposed regulations have been controversial in various respects, including the reporting company, beneficial ownership, and filing due date provisions. ACTEC has filed comments regarding the proposed regulations, available at **https://www.actec.org/assets/1/6/22.02.04_Corporate_Transparency_Act_Letter_and_Comments.pdf**.

e. **Filing Due Dates.** The statute provides that existing companies when the regulations become effective must file the required information within two years of the effective date of the final regulations, but the proposed regulations change the reporting date to no later than one year after the effective date of final regulations. Proposed 31 CFR §1010.380(a)(1)(iii). The proposed regulations add that any company formed subsequently must file the report within 14 calendar days of the formation of the entity and that a Reporting Company must correct inaccurate information within 14 days of when the company becomes aware or has reason to know that any required information was inaccurate when filed. The proposed regulations also require that every Reporting Company file a report within thirty days of certain specified changes of Beneficial Ownership (including any Beneficial Owner's exceeding or falling below 25%). (The statute merely requires that changes be reported "in a timely manner, and not later than 1 year after the date on which there is a change.") The short deadlines in the proposed regulations for newly formed entities and for reporting corrections or changes of Beneficial Ownership have been criticized as unrealistic and unduly burdensome for small businesses, "setting the stage for widespread noncompliance." Thomas Sykes *New FinCEN Reporting Will Challenge Small Companies*, TAX NOTES (Jan. 10, 2022) (recommending that the due dates for filings coincide with federal tax return due dates to substantially reduce compliance burdens and noncompliance; questioning whether regulations that change the precise deadlines found in the very statute that the regulations purport to interpret are lawful under *Chevron* standard for administrative guidance).

f. **Penalties.** Failure to file a timely required report with FinCEN will result in civil and criminal fines (penalties of $500/day the report is outstanding, up to $10,000) and up to two years imprisonment. Any person who willfully provides false ownership information is subject to similar penalties. The preamble to the proposed regulations makes clear that individuals who supply information to Reporting Companies may have liability if that information is false or fraudulent:

> The accuracy of the database may therefore depend on the accuracy of the information supplied by individuals as well as reporting companies, making it essential that such individuals be liable if they willfully provide false or fraudulent information to be filed with FinCEN by a reporting company.

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

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

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

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

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

Status as an EDB is determined at the participant's death. A DB who later satisfies one of the five categories of EDBs does not become an EDB for purposes of being able to use an adjusted lifetime payout rather than being subject to the 10-year rule. (Planners had thought that a special rule applied for minors – that if the minor is disabled upon reaching majority, the minor exception continues through the period of disability -- but the proposed regulations say that is not the case, as discussed in Item 4.d(11) below.) A modified life expectancy payout is allowed for EDBs, but the plan must be distributed within 10 years after such EDB's death or cessation as an EDB (even if the next successor beneficiary has become an EDB at that time).

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

(1) **Conduit Trusts Generally Not As Desirable.** A "conduit trust" is a trust that must immediately pay any distribution from a qualified plan or IRA to the trust beneficiary. They were often used because they do not have many complexities that apply to "accumulation trusts" (that permit plan or IRA distributions to be "accumulated" in the trust). They worked fine when plan or IRA distributions were made over the beneficiary's lifetime because the distribution each year was relatively small. But when the entire plan benefits must be distributed within 10 years, they would have to be distributed from the trust to the beneficiary, and therefore would not serve the purposes for which the owner wanted to use a trust in the first place. Natalie Choate summarizes, "Almost invariably, conduit trusts will not work the way the client anticipated or wants."

(2) **Conduit Trusts Still Appropriate for Surviving Spouse (and a Beneficiary Not More Than 10 Years Younger).** A distribution to a trust for a surviving spouse (or for a beneficiary not more than 10 years younger than the participant) generally has to be made to a conduit trust, rather than an accumulation trust, to qualify as an EDB (a possible exception is if all other "countable" beneficiaries are EDBs). See Item 4.d(13) below. For example, a standard QTIP trust generally does not qualify as an EDB and the 10-year rule would apply after the participant's death. A QTIP trust that also requires such distributions to the spouse of all plan distributions would constitute a conduit trust that is an EDB and would also qualify for the spousal special treatment (such as waiting until the decedent would have reached age 72 before distributions must begin and recalculating life expectancy each year, see Item 4.d(14)(c) below).

Planners have believed that a trust for a minor would probably have to be a conduit trust in order to qualify for the minor child exception, but the proposed regulations allow using accumulation trusts for minor children. See Item 4.d(10)4.d(10) below.

(3) **Accumulation Trusts Generally Used.** Other than for surviving spouses (and not-more-than-10-years-younger beneficiaries), accumulation trusts will probably be used if the owner wants a trust to receive plan distributions. Accumulation trusts for minor children or for disabled or chronically ill individuals will qualify for the lifetime payout exception under the proposed regulations.

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

The IRS issued proposed regulations (275 pages, no less!) to update the minimum distribution rules, including guidance regarding the SECURE Act, on February 23, 2022. REG-105954-20 (published in the Federal Register on February 24, 2022). ACTEC filed extensive comments with the IRS regarding the proposed regulations on May 24, 2022 (available at **https://www.actec.org/resources/government-relations/**. A few highlights of the proposed regulations are summarized. References in this discussion to the "Preamble" are to the preamble of REG-105954-20.

(1) **Overview.** The proposed regulations reflect statutory amendments since the required minimum distribution regulations were last issued, clarify issues that have been raised in public comments and private ruling requests, and replace the question-and-answer format of the existing regulations. Among other clarifications, the regulations "clarify and simplify" the minimum distribution rules where trusts are beneficiaries.

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

Thus, whether the owner dies before the RBD or on or after the RBD is critically important under the proposed regulations as to whether distributions must be made during the 10-year period following the owner's death. (As discussed in Item 4.e below, for a Roth IRA, the owner is deemed to have died before the RBD, so no annual payments are required during the 10-year period even if the owner actually died on or after the RBD.)

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

One of the commenters to the IRS regarding the proposed regulations has pointed out that the statute can be interpreted to mean that §401(a)(9)(B)(i) cannot apply for owners who die after 2019 (causing §401(a)(9)(H) to apply). The commenter reasons that §401(a)(9)(H), added

by the SECURE Act, causes §401(a)(9)(B)(ii) to apply when the beneficiary is a designated beneficiary, whether or not the owner died before the required beginning date.

Section 401(a)(9)(B)(i) applies when the owner has reached the RBD. It states, in pertinent part:

> (i) Where distributions have begun under subparagraph (A)(ii).[i.e., the owner has died after the RBD]—A trust shall not constitute a qualified trust under this section unless the plan provides that … the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used … as of the date of his death. [Regulations interpret the "at least as rapidly rule" to provide that distributions be made over the life expectancy of either the owner – as if she had not died – or of the oldest designated beneficiary.]

That is the section that suggests that annual "life expectancy payments" must be made.

Section 401(a)(9)(B)(ii), which generally applies when the owner dies before the RBD, states, in pertinent part:

> (ii) 5-year rule for other cases.—A trust shall not constitute a qualified trust under this section unless the plan provides that … the entire interest of the employee will be distributed within 5 years after the death of such employee.

This 5-year rule has consistently been interpreted to require that the entire amount be distributed by the end of the 5th year, with no distributions being required in years 1-4.

Section 401(a)(9)(H), added by the SECURE Act, provides that §401(a)(9)(B)(ii) "shall be applied by substituting '10 years' for '5 years.' It also adds that subparagraph (B)(ii) "shall apply whether or not distributions of the employee's interests have begun in accordance with subparagraph (A)."

Thus, §401(a)(9)(B)(i), standing on its own, applies where distributions have begun at the owner's death (and requires annual "life expectancy payments") and §401(a)(9)(B)(ii), standing on its own, applies where distributions have not begun (and does *not* require annual payments). However, the SECURE Act provides that subparagraph (B)(ii) applies whether or not the owner survived the RBD if there is a designated beneficiary. A comment filed with the IRS by Robert Hickok (posted by the IRS on April 22, 2022) provides this statutory analysis:

> IRC § 401(a)(9)(B)(i) and (ii) are mutually exclusive. Only one can apply to any given situation. Nominally, (i) applies where distributions have begun prior to the employee's death and (ii) applies where distributions did not begin prior to the employee's death. They cannot both apply to both situations. Because IRC § 401(a)(9)(H) causes IRC § 401(a)(9)(B)(ii) to apply to both situations in the case where the beneficiary is a designated beneficiary of a defined contribution plan, it follows that IRC § 401(a)(9)(B)(i) cannot apply when IRC § 401(a)(9)(H) applies.
>
> In summary, in the case of designated beneficiaries of defined contribution plans, the Code has removed the "at least as rapidly" requirement, replaced it with the 5 year rule, and changed the 5 year rule to the 10 year rule. The 10 year rule applies regardless of whether distributions began prior to the employee's death. The "at least as rapidly" requirement cannot apply when the 10 year rule applies, as it could not have applied in the past when the 5 year rule applied. Since the 5 year rule allowed all distributions to be made in the 5th year, so too must the 10 year rule, as the Code language in that regard is the same, except for "10" replacing "5." It is incorrect to apply IRC § 401(a)(9)(B)(i) to any situation where IRC § 401(a)(9)(B)(ii) applies, as the two provisions are mutually exclusive.

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

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

(c) **Minimum Annual Distribution to a DB For Death On or After RBD.** The proposed regulations state the general rule that minimum distributions are determined by dividing the account balance by an "applicable denominator." Prop. Reg. §1.401(a)(9)-5(a)(1). If the Participant (sometimes referred to below as the owner) dies after the required beginning date (age 72) and if the account has a DB, the applicable denominator is the greater of the DB's remaining life expectancy and the owner's remaining life expectancy. Prop. Reg. §1.401(a)(9)-5(d)(1)(ii).

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

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

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

In light of the position taken by the IRS in the May 13, 2021 version of IRS Publication 590-B and the Draft as of February 25, 2022 of Publication 590-B (described immediately below), a reasonable position should be that no distribution was required in 2021, but uncertainty exists until the IRS provides further guidance.

An example on page 12 of the initial 2021 version of IRS Publication 590-B, Distribution from Individual Retirement Arrangements (IRAs) (March 25, 2021), suggested that payments would have to be made each year (based on a life expectancy payout) during the general 10-year period for making distributions from qualified plans and IRAs following the participant's death. Commentators believed the example was simply a mistake and that the only distribution requirement is that the entire account must be distributed by December 31 of the tenth year. *See* Natalie Choate, *IRS Publication 590-B Offers Preview of Treasury Guidance on Post-SECURE RMD Rules … and Some Bloopers*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #757 (April 26, 2021). The IRS issued a statement revising that example on May 13, 2021, and a revised version of Publication 590-B, dated May 13, 2021, making that change was posted. (The 2021 version of that Publication is no longer available for download; the IRS website states that an updated revision of the form is being finalized.) The May 13, 2021, revised version includes this revised statement:

> The 10-year rule requires the IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31 of the year containing the 10th anniversary of the owner's death. For example, if the owner died in 2020, the beneficiary would have to fully distribute the plan by December 31, 2030. The beneficiary is allowed, but not required, to take distributions prior to that date.

The IRS released a draft of the 2021 Tax Year IRA Publication 590-B on January 7, 2022. (The version of that draft last reviewed by the author says "DRAFT AS OF February 25, 2022.") It has the following statement (on page 11):

> The 10-year rule requires the IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31 of the year containing the 10th anniversary of the owner's death. For example, if the owner died in 2021, the beneficiary would have to fully distribute the IRA by

> December 31, 2031**. The beneficiary is allowed, but not required, to take distributions prior to that date.** [Emphasis added.]
>
> The 10-year rule applies if . . . the beneficiary is a designated beneficiary who is not an eligible designated beneficiary, regardless of whether the owner died before reaching his or her required beginning date.

Further guidance from the IRS is needed regarding 2021 distributions. The IRS could take the position that no distributions are required for 2021 if the 10-year rule applies (because that is how the IRS interpreted the rule in 2021, so either that is a "reasonable interpretation" of the rule or the IRS acted unreasonably is misleading taxpayers about the rule). Alternatively, the IRS could take the position that the beneficiary must take a "catch-up" distribution in 2022 for the missed 2021 required distribution but waive any excise taxes for late payment of the 2021 minimum distribution. (Taxpayers should be prepared to make the 2022 and 2021 minimum distributions by the end of 2022, and hopefully we will have guidance from the IRS before the end of 2022 about the 2021 minimum distribution requirement for this situation.) *See* Natalie Choate*, New Proposed RMD Regs: Effect on Beneficiaries Who Did Not Take an RMD in 2021*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #782 (April 4, 2022).

(3) **Death Before RBD.** Under the proposed regulations, whether the owner dies before or after the RBD is more important than ever. The minimum required distribution rules in the proposed regulations for deaths on or after the RBD are in Prop. Reg. §1.401(a)(9)-5(d)(1) and for deaths before the RBD are in Prop. Regs. §1.401(a)(9)-3(c) and §1.401(a)(9)-5(d)(2).

If the owner dies *before* the required beginning date with a DB, there is no requirement that *any* payments be made until the end of the outer limit (December 31 of the tenth year). Prop. Reg. §1.401(a)(9)-3(c)(3). If an EDB is named, the proposed regulations rather surprisingly state that the plan may give the EDB the option of using the 10-year rule or having payment made over the life expectancy of the EDB. Prop. Reg. §1.401(a)(9)-3(c)(5)(iii)

(4) **Under 10-Year Rule, Payments Required by End of December of Tenth Year.** The proposed regulations confirm, as anticipated, that under the 10-year rule, payments must be made by December 31 of the year in which the 10-year period ends. Prop. Reg. §1.401(a)9)-3(c)(3).

(5) **"Age of Majority" for the Minor EDB Exception Means Age 21**. The statute describing the EDB exception for minor says it applies until the "age of majority" as defined in §401(a)(9)(F) and the regulation for that provision states that a child may be treated as having not reached the age of majority if the child has not completed a specified course of education and is under the age of 25. The IRS determined that applying the "specified course of education" rule would be difficult to implement for various reasons and takes the position that the age of majority occurs on the child's 21st birthday. Prop. Reg. §1.401(a)()-4(e)(3).

(6) **Can Use Beneficiary's Life Expectancy If Owner Dies On or After Required Beginning Date Despite "At-Least-As-Rapidly" Statutory Requirement.** Section 401(a)()(B)(i) states that if the owner dies after the required beginning date (so that distributions have begun), the account shall be distributed "at least as rapidly as under the method of distributions ... as of the date of his death" – which would generally be over the owner's remaining life expectancy. However, the beneficiary is generally younger (and often a generation younger) than the owner, and the proposed regulations continue the position in existing regulations that the distributions may be made over the longer of the owner's life expectancy or the beneficiary's life expectancy. Prop. Reg. §1.401(a)(9)-5(d)(1)(ii).

If the beneficiary is an EDB (so benefits can be paid over a life expectancy and the 10-year rule does not apply until the EDB ceases to qualify or dies) and is older than the account owner, distributions may be made over the deceased account owner's longer life expectancy, but at the end of the beneficiary's life expectancy (determined at the date of the owner's death) all of the account must be distributed. Prop. Reg. §1.401(a)(9)-5(e)(5).

(7) **General Descriptions for Trusts as Beneficiaries.** In a dramatic improvement, the proposed regulations restate and substantially improve the minimum distribution rules when a trust is a beneficiary and for the first time use and describe the very commonly used terms see-through trust, conduit trust, and accumulation trust.

A DB must be an individual and a trust is not an individual, so what happens if a trust is the beneficiary of a plan? If a trust meets certain requirements, the IRS has agreed following its stated position in the 2002 regulations that the beneficiaries of the trust could be treated as if they had been named directly as beneficiaries of the plan if the trust meets four requirements: : (1) the trust is valid under local law; (2) the trust is irrevocable or becomes so at the participant's death; (3) the beneficiaries are identifiable; (4) certain documentation is provided to the plan administrator by October 31 after the year of the participant's death. Prop. Reg. §1.401(a)(9)-4(f)(2). The proposed regulations eliminate the requirement of identifying the beneficiary with the shortest life expectancy. A trust that meets these requirements is referred to as a "**see-through trust**."

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

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

(8) **General Rules for Testing Trusts to Determine "Countable" Trust Beneficiaries That Are Treated as Plan Beneficiaries.** If any of the beneficiaries of a plan is not an individual, the plan is treated as having no DB, even if individuals are also designated as beneficiaries. Prop. Reg. §1.401(a)(9)-4(b). How does that general rule apply for trusts as beneficiaries? The approach for analyzing trusts as plan beneficiaries can be broken into three steps: (1) Who are the "countable" beneficiaries; (2) are those countable beneficiaries all individuals (the plan can be treated as having DBs if all the countable trust beneficiaries are DBs); and (3) are the countable beneficiaries DBs that qualify as EDBs? (The general rule is that all countable beneficiaries must be EDBs to treat the plan as having EDBs as a beneficiary, but there are exceptions for trusts with certain types of beneficiaries (or that require all distributions to be made before age 31), as discussed below.

Natalie Choate describes the approach of the proposed regulations as establishing a three-tier system (though that term is not used by the proposed regulations).

(a) **First-Tier.** A first-tier beneficiary is any beneficiary who could receive amounts in the trust attributable to the plan that are "neither contingent upon, nor delayed until, the death of another trust beneficiary who did not predecease (or is treated as predeceasing) the participant.

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

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

Example: "income to spouse for life and remainder to children." The children are second-tier beneficiaries because their interest is delayed until spouse's death.

(c) **Third-Tier Beneficiary.** A third-tier beneficiary is one who could receive amounts attributable to the plan "solely because of the death" of a second-tier beneficiary – i.e., a beneficiary who receives anything only following the death of a second-tier beneficiary. (As discussed in subparagraph (e) below, third-tier beneficiaries generally are not counted.)

Example: "income to spouse for life and remainder to children, but if all children have predeceased at spouse's death, to charity." The charity is a third-tier beneficiary because it can receive a distribution only following the death of a second-tier beneficiary.

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

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

(e) **Application of Tier System to Determine Countable Beneficiaries.**

- First-tier beneficiaries are always counted.
- Second-tier beneficiaries are ignored for conduit trusts.
- Second-tier beneficiaries are counted in accumulation trusts with one exception -- if the trust requires full distribution to a beneficiary by age 31 (who does not have to be a child of the owner). Prop. Reg. §1.401(a)(9)-4(f)(3)(ii)(B), Preamble at 33 (example).
- Third-tier beneficiaries are not counted.
- Beneficiaries who predecease the owner or are treated as having predeceased are not counted as beneficiaries. Prop. Reg. §1.401(a)(9)-4(c)(2).
- Several special rules apply for third-tier beneficiaries. First, a third-tier beneficiary is counted if a second-tier beneficiary "predeceased (or is treated as having predeceased)" the owner. Prop. Reg. §1.401(a)(9)-4(f)(3)(ii)(A)(1). Second, a third-tier beneficiary is counted if a second-tier beneficiary also falls into the class of a first-tier beneficiary (in effect, moving the third-tier beneficiary up to the class of a countable second-tier beneficiary). Prop. Reg. §1.401(a)(9)-4(f)(3)(ii)(A)(2). For example, if the first-tier beneficiaries predecease the owner, the second-tier beneficiaries become first-tier beneficiaries. (Observe: this means that in drafting trusts, having a charity as a third-tier beneficiary could cause the plan not to have a DB if the first-tier beneficiary should predecease the plan owner – because the second-tier beneficiary would become a first-tier beneficiary and the charity would become a "countable" second-tier beneficiary.)
- The mere possibility of post-death changes does not result in additional countable beneficiaries until such a change is actually made. See Item 4.d(9)(b)-(c) below.

(f) **Determining Whether Plan Has EDBs.** Once the countable beneficiaries have been identified, a determination can be made whether the plan has an EDB as beneficiary (so that an EDB exception applies and the 10-year rule does not apply until the death or ceasing to qualify of the EDB). As a general rule, if a plan has multiple designated beneficiaries, only some of whom are not EBDs, the plan is treated as not having an EBD. Some important exceptions apply: (1) for a conduit trust, only the beneficiary of the conduit trust is treated as a beneficiary; (2) for an accumulation trust with a minor child (or children) of the owner or a disabled or chronically ill individual or individuals as the only current beneficiaries, other DBs are ignored for purposes of determining if the plan has an EDB. See Item 4.d(10) and 4.d(12) below.

(9) **Rules for Accumulation Trusts Simplified.** The general rules described in Item 4.d(8) above about the countable beneficiaries of trusts have a dramatic impact on the planning and drafting of accumulation trusts. Various complexities have arisen in drafting accumulation trusts as an account beneficiary under the existing regulations. To avoid those complexities, conduit trusts

have often been used as plan beneficiaries if a trust is needed, but conduit trusts generally provide no trust protection after the 10-year period for making distributions (unless all trust beneficiaries are EDBs). One of the complexities for accumulation trusts is a requirement that payments may be made over only the *oldest* beneficiary's life expectancy if there are multiple beneficiaries. Another is a requirement that all beneficiaries must be DBs or else there is no DB of the account (and the entire account must be distributed over five years). These requirements have led to gyrations in drafting accumulation trusts to be able to verify with certainty who is the oldest possible beneficiary and to make sure that there is no possible recipient who is not an individual qualifying as a DB. Determining which contingent remainder beneficiaries of trusts and what possible recipients under powers of appointment or pursuant to a decanting or trust modification are counted for this purpose becomes very important, and accumulation trusts have been drafted around those uncertainties.

(a) **Limitations on What Beneficiaries Are Considered.** Determining which beneficiary's life expectancy could be used is not nearly as important under the SECURE Act, because all of the account must be distributed within ten years in any event (unless the beneficiary is an EDB). Accordingly, the proposed regulations simplify the rules significantly and limit the trust beneficiaries who are "countable" as beneficiaries for purposes of applying these rules. **First**, to briefly summarize the "countable beneficiaries" rules described in Item 4.d(8) above, only current beneficiaries and secondary beneficiaries following the death of the initial current beneficiary are counted; beneficiaries following the death of a secondary beneficiary are not counted. For example, following the owner's death, assume the account is paid to the owner's spouse for life, and remaining benefits are paid to the owner's sibling, but if the sibling predeceases the spouse, the account is paid to a charity. The charity is not considered because it receives benefits only following the death of a secondary beneficiary. Prop. Reg. §1.401(a)(9)-4(f)(3)(ii)(A), -4(f)(6)(ii), Ex.2. (Under the existing regulations, the IRS position has been that "mere potential successor beneficiaries" are not considered, but significant uncertainty remains over how far that exception extends. Some uncertainty remains under the proposed regulations, but the clarification that beneficiaries following the death of the secondary beneficiaries are not countable certainly helps.) **Second**, if the trust requires full distribution to a beneficiary by age 31 (who does not have to be a child of the owner), any other recipient who would receive benefits if the beneficiary dies before reaching age 31 is not counted. Prop. Reg. §1.401(a)(9)-4(f)(3)(ii)(B), Preamble at 33 (example).

(b) **Limitations Regarding Powers of Appointment.** If a power of appointment is *exercised* before September 30 of the year after the owner's death (sometimes referred to as the "beneficiary finalization date"), the recipients of the exercise are treated as beneficiaries. If a power of appointment is *restricted* before September 30 of the year after the owner's death so that it can only be exercised in favor of two or more identifiable beneficiaries, only those permissible recipients are treated as beneficiaries. If a power of appointment is not exercised or restricted by September 30 of the following year, possible recipients under the power of appointment apparently are not considered at all, but the takers in default of the exercise are treated as beneficiaries. Prop. Reg. §1.401(a)(9)-4(f)(5)(ii). An example describes a trust with the owner's spouse (G) as the current beneficiary, the spouse has a power of appointment to name residual beneficiaries (and there are no stated limits as to who are permissible appointees), and in default of exercise of the power of appointment the assets will pass to the owner's two children (K and L) who are not EBDs. If the power is not exercised, G, K, and L are treated as beneficiaries of the plan (and because they are not all EBDs, the 10-year rule applies). Prop. Reg. §1.401(a)(9)-4(f)(6)(v), Ex.5. (The example does not explicitly say that G, K, and L are treated as the *only* beneficiaries of the plan, but concludes that because G, K, and L are not all EBDs, the 10-year rule applies. But the fact that the permissible appointees under the power of appointment are *not even listed* suggests that permissible appointees are not relevant.)

If a power of appointment is exercised after September 30 of the year after the owner's death, the recipients of the exercise are treated as beneficiaries of the plan beginning in the year in which the exercise occurs. Prop. Reg. §1.401(a)(9)-4(f)(5)(ii)(B).

(c) **Limitations Regarding Decantings and Reformations.** Another very helpful innovation under the proposed regulations is that the mere possibility of changing the beneficiaries of a trust by modification allowed under state law (such as a court reformation or permitted decanting) will not cause the trust to fail the requirement to identify beneficiaries. Prop. Reg. §1.401(a)(9)-4(f)(5)(iii)(A). If the modification occurs before September 30 of the year after the year of the owner's death (sometimes referred to as the "beneficiary finalization date"), the change is effective as of the owner's death. This could allow the flexibility of "cleaning up" problems, for example to modify the trust to add additional beneficiaries in a manner that would cause a charity to drop to a being an "uncountable" third-tier beneficiary. But state law and fiduciary obligations may limit the ability to rewrite the trust, especially if the change would impact minor, unborn, or charitable beneficiaries. Even so, this position in the proposed regulations allows great flexibility for planning before the beneficiary finalization date:

> "We were never sure before whether you could do this," [Alan] Gassman said. "Well, now you can completely change a trust, you can completely change the beneficiaries, you can even decant it into a different trust and change the trust that is the beneficiary, and the IRS will allow us to do that. That doesn't work in most areas of income tax or estate tax, or in any other area of the income tax or the estate tax that I'm aware of."
>
> "I would even take that a step further — I would say that now, with these looser power of appointment rules, there's a whole new door open as to what flexible things can happen in the future," [Christopher] Denicolo said.
>
> Gassman warned, however, that planners should be careful not to name trust protectors that have any fiduciary duties because that could affect who is considered a beneficiary under the rules. Chandra Wallace, *Proposed SECURE Act Regs Include an Unwelcome Wrinkle*, TAX NOTES (April 18, 2022).

If the modification occurs after the beneficiary finalization date, the beneficiary changes are taken into consideration as of the beginning of the calendar year after the calendar year in which the change is made. Prop. Reg. §1.401(a)(9)-4(f)(5)(iii)-(iv). Beneficiary changes resulting from modifications after the beneficiary finalization date may result in a shortening of the distribution period but cannot lengthen the distribution period. Prop. Reg. §1.401(a)(9)-4(f)(5)(iv)(C) (beneficiaries "counted" include any new beneficiaries added as a result of the modification and all beneficiaries that were counted before the modification).

(10) **Minor Child and Others as Designated Beneficiaries.** As a general rule, if a plan has multiple designated beneficiaries, some of whom are not EBDs, the plan is treated as not having an EBD. An exception applies if there are multiple DBs and one of them is a minor child of the owner; in that case the plan is treated as having an EBD (but this exception does not apply if the remainder beneficiary following the death of the minor is also a current beneficiary of the trust). Accordingly, no payment would have to be made from the plan until the child reaches age 31 if the owner died before the required beginning date. If the owner died after the required beginning date, while there is no specific example in the proposed regulations, payments apparently would be based on the oldest minor beneficiary's life expectancy with no requirement of distributing all of the plan balance until the end of the year in which the child reaches age 31. *See* Prop. Reg. §1.401(a)(9)-4(e)(2)(ii); Preamble at 39.

This means that an **accumulation trust** can be used for a minor child (or minor children). Planners have previously assumed that a conduit trust would be required to qualify a trust for a minor child for the minor child exception. The life expectancy plan distributions for a minor child would be very small, but being able to use an accumulation trust avoids the administrative inconvenience of having to distribute the small amounts distributed from the plan every year to or for the minor child.

If there are multiple minor beneficiaries, planners have wondered whether the final required distribution is 10 years after the oldest minor beneficiary reaches age 21 or 10 years after all minor beneficiaries have reached age 21. The proposed regulation clarifies that the full distribution is required 10 years after the *oldest* minor child reaches age 21 (or, if earlier, the tenth calendar year following the calendar year of that child's death). Prop. Reg. §1.401(a)(9)-5(f)(2)(ii)(A); Preamble at 50. Contrast a somewhat analogous provision for multiple disabled or chronically ill beneficiaries saying that the final required distribution is 10 years after *all* disabled or chronically ill beneficiaries have died. Prop. Reg. §1.401-5(f)(2)(iii)(A), discussed in Item 4.d(12) below.

(11) **Minor Child Becomes Disabled Before Reaching Age of Majority.** Section 401(a)(9)(F) for many years has addressed payments made to a minor child being treated as paid to the surviving spouse for an obscure purpose. The existing regulations provide that for this purpose "a child who is disabled ... when the child reaches the age of majority may be treated as having not reached the age of majority so long as the child continues to be disabled." Reg. §1.401-(a)(9)-6, A-15. Many planners have assumed that a similar exception would apply for purposes of determining whether the child is an EDB if the minor child should become disabled after the owner's death but before reaching the age of majority. The proposed regulations, though, take the contrary position that the child would cease to be an EBD when the child reaches age 21, even though the child has become disabled by that time. Prop. Reg. §1.401(a)(9)-4(e)(9), Ex. 3; Preamble at 26.

(12) **Trust for Disabled or Chronically Ill Individuals.** The proposed regulations provide rules to determine if a beneficiary is disabled or chronically ill. Prop. Reg. §1.401(a)(9)-4(e)(4)-(5).

The statute, §401(a)(9)(H)(v), describes an "applicable multi-beneficiary trust" (AMBT) as a trust having only DBs as beneficiaries, at least one of which is a disabled or chronically ill individual. The proposed regulations provide two exceptions for AMBTs from the general rule that if a plan has multiple designated beneficiaries, some of whom are not EBDs, the plan is treated as not having an EBD. They are referred to as Type I and Type II trusts. A Type I trust is one that, under the terms of the trust agreement, is to be divided immediately upon the death of the owner into separate trusts for each beneficiary. A Type II trust is one that has one or more beneficiaries who are disabled or chronically ill and for which no other individual has any interest in the plan until the death of the disabled or chronically ill beneficiaries. Prop. Reg. §1.401(a)()-4(g)(2)-(3). Disabled or chronically ill beneficiaries of a Type II trust are treated as EDBs even though there are other beneficiaries who are not EDBs.

The statute is not clear as to whose life is used for the life expectancy payout if there are multiple disabled or chronically ill beneficiaries. The proposed regulations make clear that DBs other than the disabled or chronically ill beneficiaries are not considered and that the life expectancy of the oldest disabled or chronically ill beneficiary is used. Prop. Reg. §1.401(a)(9)-5(f)(1)(ii). The rule requiring that all plan benefits must be paid in the year in which the oldest beneficiary reaches his or her life expectancy (determined at the death of the owner) does not apply for a Type II trust. Prop. Reg. §1.401-5(f)(2)(iii)(B). The entire plan benefits must be paid within 10 years of the death of the *last to die* of the disabled or chronically ill beneficiaries of the AMBT. Prop. Reg. §1.401-5(f)(2)(iii)(A).

Planners have questioned whether provisions that are often used in supplemental needs trusts could be used in AMBTs, such as (i) backstop provisions (allowing distributions to other beneficiaries of amounts that would cause the disabled beneficiary not to qualify for government assistance programs), (ii) provisions allowing excess assets to be distributed to non-disabled beneficiaries (for tax planning in light of the high rates applied to undistributed trust income or if the special needs beneficiary no longer qualifies for public benefits), and (iii) provisions allowing the payment of travel expenses of a travel companion for a disabled beneficiary. None of those provisions would be allowed under the proposed regulations (the trust would not meet the definition of a Type II trust), but the Preamble invites comments regarding supplemental needs trusts.

> The Treasury Department and the IRS request comments on whether under applicable law a trust for a disabled individual (for example, a supplemental needs trust) could include terms providing that the disabled individual would lose the individual's interest in the trust in the event the interest would disqualify the individual for means-tested government benefits and still satisfy the requirements under the Code to be a type II applicable multi-beneficiary trust. Specifically, comments are requested on whether this type of provision may be included in a trust (thereby allowing a disabled individual to continue to qualify for means-tested government benefits), while not providing for trust payments to any other beneficiary until the death of the disabled individual. Preamble at 38.

Until further guidance is provided, no distributions should be allowed to any beneficiaries other than the disabled or chronically ill beneficiaries.

(13) **No Similar Exception For Spouses or Persons Not More Than Ten Years Younger.** If a trust has as the only current beneficiary(ies) a minor child or children or a disabled or chronically ill person or persons, the plan is treated as having an EDB or EDBs even though other DBs are successor beneficiaries of the trust. See Items 4.d(10) and 4.d(12) above. There is no similar exception for an accumulation trust that has a surviving spouse or persons not more than 10 years younger as the beneficiary. Therefore, if the plan names a trust for a spouse or person not more than 10 years younger as the beneficiary, the plan generally must be a **conduit trust** in order for the plan to have an EDB.

A possible exception to this general rule is if all of the "countable" beneficiaries of the trust (see Item 4.d(8) above are EDBs. Prop. Reg. §1.401(a)(9)-4(e)(2) implies that a plan has EDBs as beneficiaries if the beneficiary is a trust that has only EDBs as countable beneficiaries. (That proposed regulation actually addresses the reverse situation; if a trust-beneficiary has any countable beneficiary who is *not* an EDB – other than the exceptions for trusts with minor children, disabled, or chronically ill beneficiaries, or if the plan qualifies for separate account treatment – the plan does *not* have an EDB.) Such a situation would be relatively rare though. For example, a QTIP trust for a spouse that has the owner's sibling who is not more than 10 years younger than the owner as the successor beneficiary at the spouse's death would have only EDBs as countable beneficiaries and would be treated as qualifying for EDB treatment.

This is critically important if someone wants to name a trust for the surviving spouse as beneficiary of a plan or IRA rather than having the spouse as a direct beneficiary. In that situation, a QTIP trust is typically used, but **a standard QTIP trust does not qualify as an EDB**, and the 10-year rule would apply after the owner's death. A QTIP trust that also requires such distributions to the spouse of all plan distributions would constitute a conduit trust that is an EDB and could be paid over the spouse's life expectancy. Furthermore, a conduit trust having the spouse as the only beneficiary would qualify for the special payment provisions for spouses (for example, the Single Life Table is used, but the life expectancy is recalculated annually). However, in some rare situations the owner may prefer using an accumulation trust for a spouse with a not-more-than-10-years-younger-beneficiary as the successor beneficiary; a conduit trust for the spouse would risk that the life expectancy payments to the spouse (even with annual recalculation of life expectancy) would substantially deplete the trust if the spouse has a long life, leaving little for the successor beneficiary.

(14) **Distribution Effects of Various Alternatives for Naming Spouse as Beneficiary.**

(a) **Spousal Rollover.** The most favorable treatment is often for the spouse to rollover the plan into her own IRA (a spousal rollover). The minimum distribution rules applicable following the death of the owner (including the 10-year rule) do not apply at all, but the rollover IRA is treated as the spouse's IRA. *See* Chandra Wallace, *Proposed SECURE Act Regs Include an Unwelcome Wrinkle*, TAX NOTES (April 18, 2022) ("[Alan] Gassman expressed surprise that spousal rollover IRAs – allowing a surviving spouse to roll the IRA of a deceased spouse into their own IRA without having to tangle with the new rules – are still an option, calling it 'great news.'") When the spouse reaches her RBD, distributions are based on the Uniform Life Table, which is based on the life expectancy of an individual and someone 10 years younger (permitting a significantly slower payout). The spouse may name her beneficiary following her death.

(b) **Outright to Spouse.** If the spouse is the outright beneficiary of the plan, she is an EDB, so the outer limit on distributions is the year that contains the 10th anniversary of the spouse's death. The annual distribution limitation is adjusted by two special rules available for surviving spouses:

(1) distributions can be delayed until the later of the year after the year of the owner's death or the end of the calendar year in which the owner would have reached age 72 (age 70½ if the owner was born before 7/1/1949); and

(2) The Single Life Table is used but the surviving spouse's life expectancy is recalculated annually (so the full amount will not have to be withdrawn while the spouse is living until the spouse reaches age 120).

(c) **Combination Conduit/QTIP Trust for Spouse.** For a conduit trust, the plan is treated as having been distributed directly to the beneficiary of the conduit trust, so the rules described immediately above for naming a spouse as the outright beneficiary apply. The spousal EDB exception applies for the outer limit, the start of distributions may be delayed until the owner would have reached age 72, and life expectancy is recalculated annually. The trust would have standard QTIP terms (including the required marital deduction provision that the trustee must at a minimum withdraw all income from the plan each year) AND require that the trustee distribute to the spouse all amounts received from the plan (to qualify as a conduit trust).

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

(15) **Application of SECURE Act to Pre-2020 Deaths**. The anti-stretch provisions of the SECURE Act generally apply to owners who die after 2019, EXCEPT that if the initial DB dies after 2019 and before the plan assets have been totally distributed, the remaining benefits must be paid within 10 years of when such DB dies (even though the owner died before 2020). Section 401(b)(5) of the SECURE Act. (Under prior law, when the DB died, the DB's beneficiary could continue to receive benefits over the DB's remaining life expectancy.)

The statutory effective date provisions are unclear about what happens if the participant had multiple DBs. For example, the beneficiary may have been an accumulation trust with various individuals as permissible current or remainder beneficiaries, and each of them is a DB, even though only the oldest DB's life expectancy is used to determine the payout period. The statute is unclear when the 10-year period begins—when the oldest DB has died, when any DB has died, or when all DBs have died. Planners have hoped that the 10-year period would not begin until all DBs had died, but the proposed regulations state that the 10-year period will begin when the oldest DB dies if that beneficiary was still alive on January 1, 2020. Prop. Reg. §1.401(a)(9)-1(b)(2)(iii)(B).

(16) **Effective Date of Proposed Regulations.** As described above, the proposed regulations regarding required minimum distributions are proposed to apply for calendar years beginning in 2022, and for 2021 "taxpayers must apply the existing regulations, but taking into account a reasonable, good faith interpretation of the amendments made by sections 114 and 401 of the SECURE Act. Compliance with these proposed regulations will satisfy that requirement." Preamble at 77-78.

e. **Roth IRAs.** The 10-year rule anti-stretch provisions in the SECURE Act apply to Roth IRAs, but even if the owner dies after the required beginning date, annual life expectancy payments do not have to be made during the 10-year period. Prop. Reg. §1.408-8(b)(1)(ii) ("the required minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before his or her required beginning date"). The accelerated payments from the Roth IRA following the owner's death would not bear a 37% immediate tax, but the opportunity for future tax-free buildup over a long period of time would be lost.

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

g. **New Life Expectancy Tables for Retirement Plan Required Minimum Distributions.** The Single Life and Uniform Life tables for calculating required minimum distributions are in Reg. §1.401(a)(9)-9(b)-(c).

The Uniform Life table, which is based on the life expectancy of an individual and someone 10 years younger and that recalculates life expectancy each year, may be used only while the account owner is living or for a spousal rollover IRA. Otherwise, the Single Life (or Joint Lives) Table must be used. The Uniform Life Table allows taking withdrawals at a substantially slower rate. For example, using new tables that apply in 2022, the life expectancy of a 72-year-old person under the Single Life Table is 17.2 years, and under the Uniform Life Table is 27.4 years. (The respective life expectancies under the same tables that applied before 2022 were 15.5 and 25.6.)

The tables had not been modified for two decades, but proposed regulations containing revised tables were issued in November 2019, and the revised tables would have applied to distribution calendar years beginning on or after January 1, 2021. Final regulations were issued November 4, 2020 (T.D. 9930, published in the Federal Register on November 12, 2020), and the effective date was moved back to plan years beginning on or after January 1, 2022. The final regulations (which include the new tables) are located at **https://www.regulations.gov/document/IRS-2019-0050-0057**.

The preamble to the proposed regulations stated that the "life expectancy tables and applicable distribution period tables in the proposed regulations reflect longer life expectancies than the tables in the existing regulations that are generally between one and two years longer than under the existing regulations." Professor Chris Hoyt (Kansas City, Missouri) concludes that "[m]ost individuals will experience reduced RMD amounts of between 0.3% and 0.5% of what they would have had to receive under the prior tables." Christopher Hoyt, *Reduced RMDs From Retirement Accounts*, TRUSTS & ESTATES at 46 (June 2021). For example, the required minimum distribution for a 72-year-old person decreases from 3.9% (applicable in 2021) to 3.7% under the 2022 tables.

The mechanics of applying the tables are summarized below.

- For RMD distributions during the participant's lifetime after the required beginning date, use the life expectancy factor under the Uniform Life Table for the age that the participant will be in a particular calendar year, and divide the account balance as of December 31 of the prior year by that divisor.
- For a surviving spouse receiving post-death RMD distributions, use the life expectancy factor under the Single Life Table for the age that the spouse will be in a particular calendar year, and divide the account balance as of December 31 of the prior year by that divisor. (This approach reflects that the surviving spouse's life expectancy is recalculated each year.)
- For a non-spouse beneficiary receiving post-death RMD distributions, the life expectancy is not recalculated every year. For the first post-death payment to the beneficiary, which is due in the year following the participant's death, the account balance as of December 31 of the year of death is divided by the beneficiary's life expectancy using the Single Life Table, based on the age the beneficiary will be in the year after the year of the participant's death. In each subsequent year the life expectancy table is no longer used, but the divisor is one less than the divisor for the prior year; the account balance at the end of the prior year is divided by that divisor.
- For a non-spouse beneficiary who began receiving RMDs before 2022 (and whose life expectancy was determined using the old tables), Reg. §1.401(a)(9)-9(f)(2) describes the following process for distributions in and after 2022:

(1) Determine the beneficiary's life expectancy using the new Single Life Table, based on the beneficiary's age as of the beneficiary's birthday in the year following the participant's death.

(2) From that number, subtract the number of years that have passed since the first year RMDs begun.

Example. Assume the participant died in 2016, and that RMD's began in 2017, and assume the beneficiary's life expectancy divisor in the year following the date of death (2017) using the new Single Life Table is 53.4. In 2022, five years have passed since the year in which RMDs were initially paid to the beneficiary, and the life expectancy divisor for 2022 will be 53.4 – 5, or 48.4.

For an excellent discussion of using the new life expectancy tables in connection with changes made by the SECURE Act, see Vanessa L. Kanga & Natalie B. Choate, *New Life Expectancy Tables – An Opportunity to Provide Value to Clients*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #776 (January 21, 2022).

h. **New Life Expectancy Tables for Pre-Age 59½ Distributions.** Notice 2022-6 updates the life expectancy tables used for calculating a series of substantially equal periodic payments ("SOSEPP"), a popular method of avoiding the 10% tax on pre-age 50½ distributions. Notice 2022-6 replaces Rev. Rul. 2002-62 for any series of payments beginning on or after January 1, 2023, and may be used for a series of payments commencing in 2022. For a discussion of planning considerations for planning SOSEPP distributions using the new tables, see Vanessa L. Kanga & Natalie B. Choate, *New Life Expectancy Tables – An Opportunity to Provide Value to Clients*, LEIMBERG EMPLOYEE BENEFITS AND RETIREMENT PLANNING NEWSLETTER #776 (January 21, 2022).

i. **SECURE 2.0.** The House of Representatives passed H.R. 2954, the Securing A Strong Retirement Act of 2022 (commonly referred to as "Secure 2.0") on March 29, 2022 by an overwhelming bipartisan vote of 414 to 5. Among other things, this proposed legislation covers expanded automatic enrollment in retirement plans, increase in the required beginning date for distributions, enhancements to the age 50+ catch-up provisions, permitting SIMPLE IRAs to accept Roth contributions, treatment of catch-up contributions as Roth contributions, and allowing employer matching contributions as Roth contributions.

The increase in the required beginning date for contributions would be age 73 (for those who reach age 72 after 2022), age 74 (for those who reach age 73 after 2029), and age 75 (for those who reach age 74 after 2032).

The bill is now pending in the Senate, where the Committee on Finance and the Committee on Health, Education, Labor and Pensions are working on their own retirement packages. Also, the committees will likely take into consideration S. 1770, The Retirement Security and Savings Act of 2021, introduced by Senator Ben Cardin (D-MD) and Senator Rob Portman (R-OH).

5. Miscellaneous Guidance From IRS; Treasury-IRS Priority Guidance Plan

a. **2021-2022 IRS Priority Guidance Plan.** The 2021-2022 IRS Priority Guidance Plan released on September 9, 2021 contains a few changes from the 2020-2021 Plan regarding estate planning related issues. For a general discussion of and commentary about the 2020-2021 Priority Guidance Plan, see Ronald D. Aucutt, *2020-2021 Treasury-IRS Priority Guidance Plan*, ACTEC CAPITAL LETTER NO. 50 (Nov. 25, 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(1) **2021-2022 IRS Priority Guidance Plan; No Deadline.** The Plan sets the priority for guidance projects during the Plan year (from July 1, 2021 to June 30, 2022). Several years ago, the IRS said that the Priority Guidance Plan had been pared so that only projects anticipated to be completed during the Plan year were included. That statement no longer appears; instead, it states "the plan does not provide any deadline for completing the projects."

(2) **Omission from 2020-2021 Plan – Basis of Assets in Grantor Trust at Death.** The 2021-2022 omits this item from the 2020-2021 Plan: "Guidance on basis of grant trust assets at death under § 1014." IRS representatives informally indicated in 2017 that the intent of this project was to address broadly when grantor trust assets get a step up in basis in a wide variety of situations including under exercises of substitution powers, sales to grantor trusts, sales to grantor trusts for self-cancelling installment notes, and elective community property for residents in other states. For further discussion of this project, see Item 6.c of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(3) **Continuations from 2020-2021 Plan.** Items in the 2020-2021 Plan that carry over into the 2021-2022 Plan include:

> 1. Final regulations establishing a user fee for estate tax closing letters. Proposed regulations were published on December 31, 2020.
>
> 2. Final regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016.
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> …
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> 4. Regulations under §2032(a) regarding imposition of restrictions on estate assets during the six-month alternate valuation period. Proposed regulations were published on November 18, 2011.
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> 5. Regulations under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
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> …
>
> 7. Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption.
>
> …
>
> 9. Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests.

(c) **Items 2 (Basis Consistency), 4 (Alternate Valuation Date), 5 (§2053), and 7 (§2642(g)).** Numbers 2 and 7 in that list, the basis consistency provision and the §2642(g) GST exemption allocation extension provision, were in "Part 3. Burden Reduction" of the 2020-2021 Plan and have been moved to the "Gifts and Estates and Trusts" section of the 2021-2022 Plan. For further details about the (i) basis consistency, (ii) alternate valuation date, and (iii) §2053 personal guarantees and present value concepts, see Item 6.c of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

When the basis consistency regulations are finalized, among other things planners hope the final regulations relax the requirement to file reports for subsequent transfers. Interestingly, the Form 8971 does not specifically address the reporting of subsequent transfers.

Cathy Hughes (with the Treasury Department's Office of Tax Policy) at the American Bar Association Tax Section meeting in May 2022 discussed the §2053 and basis consistency projects. She thinks that proposed regulations would be coming out "fairly soon" regarding the deductibility of personal guarantees and the application of present value concepts under §2053. In addition, she said that basis consistency final regulations may be coming soon. "We haven't forgotten about" them, she said. "I'm hoping that we'll be able to get those out soon." *See* Jonathan Curry, *Treasury and IRS Teeing Up Proposed Regs on Personal Guarantees*, TAX NOTES TODAY FEDERAL (May 16, 2022).

(b) **Number 1, Estate Tax Closing Letter User Fee.** On December 28, 2020, the IRS released a proposed regulation (published in the Federal Register on December 31, 2020) that would impose a new $67 user fee to request an estate tax closing letter (IRS Letter 627). Prop. Reg. §300.13. The regulation was finalized on September 27, 2021, effective October 28, 2021. Reg. §300.13 (T.D. 9957). Requests are made through Pay.gov. Planners have hoped this

would resolve the delays in obtaining closing letters following an announcement by the IRS in 2015 that closing letters would be issued only on request. For a summary of that history, see Item 8.a(3)(b) of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. Anecdotal evidence, though, suggests that planners are still experiencing delays obtaining closing letters even after making the request and paying the $67 user fee. The IRS strongly requests that the closing letter not be requested until nine months after the estate tax return is filed, and if the estate is being examined, not until 30 days after the examination is completed.

(c) **Number 9, New Actuarial Tables.** The actuarial tables project, added in the 2019-2020 Plan, is to update the §7520 actuarial tables based on updated mortality information, which must be done every ten years and was last done effective May 1, 2009. The tables were not updated by May 1, 2019, as was required by §7520, but proposed regulations were released on May 4, 2022 and published in the Federal Register on May 5, 2022 implementing new updated actuarial tables based on new Table 2010CM. (The tables effective beginning in 2009 were based on data from the 2000 census reflected in Table 2000CM.)

i. **Background; Updated Lx Table.** IRS officials informally indicated that the IRS had been waiting on data from another agency. That data became available on August 7, 2020, when the National Center for Health Statistics at the Centers for Disease Control and Prevention issued the decennial life table for 2009-2011, which apparently is the underlying data for the IRS actuarial tables. The new Lx table lists the number of individuals, out of a total of 100,000, who will be alive at each of ages 0-110, based on data from the 2010 census (which obviously is already more than 10 years old). The new data reflects a somewhat remarkable increase in life expectancies compared to the existing Lx table (based on 2000 census data). For example, at age 84 the number of individuals, out of the 100,000 starting pool, expected to be surviving has increased from 37,837 to 44,809, an 18.4% increase in just 10 years. Larry Katzenstein summarizes:

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

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

ii. **Updated Tables; Proposed Regulations.** Proposed regulations were published in the Federal Register on May 5, 2022. REG-122770-18. The lengthy proposed regulations update a wide variety of regulations impacted by actuarial factors. Those included regulations dealing with valuation issues for Sections 2031, 2032, 2036, 2055, 2056 (QDOTs), 2512, and 7520. Examples throughout those regulations are updated to apply the new actuarial data from the 2010 census.

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

As discussed above, the life expectancies are considerably longer than under Table 2000CM. For example, various examples throughout the proposed regulations provide the life estate factors from Table S for single life calculations. The table below lists the life estate factor from the old tables (based on Table 2000CM) and the new tables (based on

Table 2010CM) for various ages and for interest at 3.2% (The §7520 rate for June 2022 is 3.6%.)

Age	Life Estate Factor (based on Table 2000CM)	Life Estate Factor (based on Table 2010CM)	Percentage Increase
31	.75086	.76267	1.57%
46	.62356	.64047	2.71%
62	.44317	.46762	5.52%
68	.36860	.39217	6.39%
75	.28029	.30097	7.38%

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

The updated actuarial tables are available, at no charge, via the IRS website at **https://www.irs.gov/retirement-plans/actuarial-tables**. IRS Publications 1457 "Actuarial Valuations Version 4A" (forthcoming 2022), 1458 "Actuarial Valuations Version 4B" (forthcoming 2022), and 1459 "Actuarial Valuations Version 4C" (forthcoming 2022) will provide additional references and explanations to the actuarial tables that are published on the IRS website. These publications will be available after the applicability date of the Treasury decision adopting final regulations. Of course, actuarial tables for a fixed term of years are not dependent on mortality factors, and they have not changed.

Effective Date. It is proposed that the new actuarial tables would generally apply for annuities, interests for life or a term of years, and remainder or reversionary interests that are valued as of a date on or after the first day of the month after final regulations are published in the Federal Register. The proposed regulations are subject to a period of public comment and perhaps (if requested) a public hearing. Comments are due July 5, 2022. Thus, there is no clarity as to when the final regulations will be issued or will be effective.

Transition Rules. The proposed regulations provide transition rules. Although the new tables were supposed to be finished by May 2019, transition relief is allowed only back to January 1, 2021. Taxpayers who would have benefitted from the updated tables during the 20 months from May 2019 through December 2020 are out of luck; they must use the existing tables based on over 20-year-old census data (i.e., from the 2000 census). For gifts or estates of decedents dying on or after January 1, 2021, and before the final regulations are effective, the donor or executor may choose to value the interest (including any applicable charitable deduction) based on either Table 2000CM or Table 2010 CM. The donor or executor "must consistently use the same mortality basis with respect to each interest in the same property." The §7520 interest rate to be utilized is the appropriate rate for the month in which the valuation date occurs, but special rules apply for charitable transfers. For charitable transfers, §7520(a) allows using the rate for the month of or either of the two months preceding the month in which the transfer is made, and if the donor or executor elects under §7520(a) to use the §7520 rate for a month prior to January 1, 2021 (i.e., November 2020 or December 2020), the donor or executor *must* use tables based on Table 2000CM. If the §7520 interest rate is elected for a month on or after January 1, 2021, and before the applicability date of final regulations, the donor or executor *may* use tables based on either Table 2000CM or Table 2010 CM, but if the transfer occurs on or after the applicability date of final regulations, the Table 2010CM *must* be used even if a prior month's interest rate is elected under §7520(a).

iii. **Planning Implications.** The new tables result in a larger charitable deduction for CLATs for the life of an individual, but a lower deduction for a CRAT (and more difficulty in

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

(4) **Additions to 2021-2022 Plan.** The 2021-2022 Plan includes the following new items:

> 3. Regulations under §2010 addressing whether gifts that are includible in the gross estate should be excepted from the special rule of § 20.2010-1(c).
>
> …
>
> 6. Regulations under §2632 providing guidance governing the allocation of generation-skipping transfer (GST) exemption in the event the IRS grants relief under §2642(g), as well as addressing the definition of a GST trust under §2632(c), and providing ordering rules when GST exemption is allocated in excess of the transferor's remaining exemption.
>
> …
>
> 8. Final regulations under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates. Proposed regulations were published on September 10, 2015.

(a) **Number 3, Clawback Regulation Exception.** Number 3 addresses the anti-abuse exception to the clawback regulation. The IRS released proposed regulations on April 26, 2022, discussed in Item 5.b below.

(b) **Number 8, §2801 Gifts From Expatriates.** This item first appeared in the 2008-2009 Plan, and proposed regulations were issued in 2015. The item was dropped from the 2017-2018 Plan and has not been in the Plan since then. For a discussion of this issue, see Item 29.g of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (May 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(5) **Other Notable Omissions.** Among new items added to the Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015 were the following.

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

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

Number 3 remained in the Plan until this year. For further discussion of that project, see Item 6.c of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**..

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

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

For a detailed discussion of these important items that previously appeared in Plans, see Item 29.i(1)-(3) of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (May 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(6) **Future Bold Projects Suggested by Tax Law Center at NYU Law (or "What Far Reaching Projects Might We See in the Future?").** In response to Treasury's annual request for recommendations for future projects (in Notice 2021-2), the Tax Law Center at NYU Law (the "Center") submitted a broad range of far-reaching projects on June 2, 2022. Recommendations regarding gifts, estates, and trusts include the following.

(a) **Require Recognition for Transactions Between a Grantor and Certain Grantor Trusts.** The Center proposes that Treasury and the IRS revoke Rev. Rul. 85-13 for grantor trusts other than what would be described in new regulations as "wholly disregarded trusts" over which the grantor has a particularly high degree of control over trust property. The grantor would be treated as directly owning the assets of such wholly disregarded trusts, which could include investment trusts, "rabbi trusts," liquidating trusts, environmental remediation trusts, and fully revocable trusts. (This suggestion is a narrow version of Prop. Treas. Reg. §1.671-2(f).) For other grantor trusts, "the revocation of Rev. Rul. 85-13 would cause common estate planning techniques (like sales to grantor trusts, deathbed basis planning, and perpetuities planning with expiring trusts) to be recognized for federal income tax purposes."

(b) **Limit Efficiency of GRATs for Transfer Tax Avoidance.** The Center recommends that the IRS propose regulations clarifying that a "qualified interest" under §2702 has a minimum and maximum term. (This proposal would have the IRS adopt regulations to achieve what has been proposed legislatively; for example, the FY 2023 Greenbook proposes (1) a 10-year minimum term and (2) a maximum term of life expectancy of the annuitant plus ten years, as discussed in Item 2.e(3)(a) above.)

In addition, a regulation could prohibit a GRAT from converting a substantial portion or all of its assets into debt obligations through a sale of such assts to trusts created by the grantor or related parties. Also, analogous to the rule prohibiting the grantor from swapping or selling trust property in a QPRT, a regulation should clarify the prohibition on additional contributions in Treas. Reg. §25.2702-3(b)(5) to treat asset sales and substitutions with a GRAT as prohibited additional contributions.

Regulations should also make explicit that the transfer of a remainder interest that is not a "qualified remainder interest" is valued without subtracting the grantor's retained interest.

(c) **Republish Section 2704 Proposed Regulations With Technical Clarifications.** The IRS should consider republishing the §2704 proposed regulations that were withdrawn in 2017, with some technical revisions designed to deter the most abusive uses of FLPs for tax planning purposes. Specific technical revisions are suggested by the Center, including clarifying the effect of a "disregarded restriction," clarifying the meaning of "member of the family," reconsidering the treatment of lapses in voting or liquidation rights, and clarifying the meaning of "same type of entity" as that phrase was used in Prop. Treas. Reg. §25.2704-2(b)(4)(ii). (Interestingly, there is no reference to an active business exception.)

(d) **Adopt Required Valuation Assumptions.** Regulations addressing "value" for transfer tax purposes should impose rebuttable assumptions for intrafamily transfers of FLP interests. Those assumptions could include (i) any discretionary liquidation, conversion, dividend, or put rights retained by the donor or the donor's spouse will not be exercised in a manner adverse to the donee's interest unless the transfer is made pursuant to a divorce or other type of judicial settlement, (ii) in applying the "willing buyer willing seller" test, the willing buyer and seller will be limited to individuals designated as permissible transferees in the governing documents if the governing document limits transferability of interests to family members, and (iii) "non-tax benefits" of forming an FLP ("such as keeping legacy investments in the family, permitting centralized and efficient investing, facilitating transfers of interests in real

estate, and protecting assets from claimants and spendthrifts and intra-family disagreements") would be considered as a valuation premium before any discount for lack of marketability or control could be imposed.

(e) **Clarify Reporting Requirement for U.S. Persons Receiving Assets From Foreign Trusts** Under §6048(c). A U.S. person must report "any distribution from a foreign trust." §6048(c). Regulations should clarify that replacing a foreign trustee with a U.S. trustee will be treated as a distribution from a foreign person to the U.S. trustee for purposes of §6048(c) and would require reporting of the conversion of the foreign trust to a domestic trust.

(f) **Basis of Grantor Trust Assets at Death Under §1014.** Regulations should be adopted to clarify that assets in a grantor trust do not receive a basis adjustment under §1014 when the grantor dies. If Rev. Rul. 85-13 is not revoked, regulations should also "treat the termination of grantor trust status at the grantor's death is a recognition event if certain liabilities of (or deemed to be of) the trust exceed the basis in the trust assets." Regulations could provide that the grantor is treated as having transferred assets to the trust the moment before death or that a transfer occurs on the moment after the grantor's death. (However, the report acknowledges in a footnote that *Crane v. Commissioner*, 331 U.S. 1 (1947), indicates that death is not a recognition event.)

(g) **Clarify the Bona Fide Sale Exception of §2035 Through §2038.** Regulation §20.2043-1(a) clarifies that to satisfy the bona fide sale for full consideration exception in sections 2035 through 2038 the transfer must be made in good faith. The Center recommends that the IRS revise that regulation so the good faith requirement would be satisfied in a sale to grantor trust situation only if the trust owns other assets with a value equal to at least 10% of the value of the assets sold. Also, the IRS should limit the use of specific parties as guarantors for purposes of determining whether a sale was bona fide (for example, guaranties by the grantor, the grantor's spouse, or "an entity involved in the sale transaction" would be disregarded in determining whether the trust had sufficient economic substance for a sale to be respected).

(h) **Limit Availability of Discounts on Gift Loans at Death.** Under §7872, a lender is not treated as making a gift if the note bears interest at a rate at least equal to the applicable federal rate ("AFR"). However, at the lender's death, the estate may take a valuation discount on the note under the theory that the note bears an interest rate that is below a commercial market rate. The Center recommends that the IRS republish Prop. Treas. Reg. §20.7872-1 (Aug. 20, 1985), which provides that the estate tax value of a term loan made with donative intent is the lesser of (i) the unpaid principal and accrued interest or (ii) the sum of the present value of all payments due under the note using the AFR in effect on the decedent's death. In addition, the IRS should broaden its application to demand and term loans regardless of donative intent. (This resembles the FY 2023 Greenbook proposal to limit the discount rate on notes for estate tax valuation purposes to the greater of the note's actual interest rate and the AFR in effect on the date of the decedent's death, as discussed in Item 2.e(3)(b) above.)

b. **Limitation on Anti-Clawback Special Rule, Proposed Regulations.** The IRS released proposed regulations on April 26, 2022. REG-118913-21 (published in the Federal Register on April 27, 2022). The preamble to the anti-clawback final regulations (published on November 26, 2019) stated that further consideration would be given to the issue of whether gifts that are not "true inter vivos transfers," but rather are includible in the gross estate would be excepted from the anti-clawback relief provisions. Two and a half years later, these proposed regulations answer that question affirmatively.

(1) **Rationale.** The preamble to the proposed regulations (referred to hereafter in this discussion as the "Preamble") reasons that the Code and existing regulations distinguish between (i) gifts that are not included in the gross estate (and are "adjusted taxable gifts") and (ii) "completed gifts that are treated as testamentary transfers for estate tax purposes and are included in the donor's gross estate (includible gift)." Preamble, citing: §2001(b) (flush language) (excluding includible

gifts as "adjusted taxable gifts" for purposes of the estate tax calculation); Reg. §25.2701-5 & §25.2702-6 (excluding from adjusted taxable gifts transfers includible in the gross estate that were subject to the special valuation rules of §2701 and §2702, respectively); Rev. Rul. 84-25 (excluding from adjusted taxable gifts completed transfers, such as an enforceable gift of a promissory note, that will be satisfied with assets includible in the gross estate). Similarly, the proposed regulations deny the benefit of the anti-clawback provision to includible gifts, reasoning that including the date of death value of the transfer in the gross estate, but not also including the gift as an adjusted taxable gift in the estate tax calculation, results in subjecting those transfers "to estate tax with the benefit of only the BEA [basic exclusion amount] available at the date of death." Preamble at p. 7. The general rationale of the "string" statutes (§2036, 2038, 2037, and 2042) is to treat certain transfers in which the donor retains "too much" interest or control as if the transferred assets are still subject to the estate tax, and the anti-abuse rule achieves that purpose.

(2) **General Anti-Clawback Rule.** If a client makes a $12 million gift in 2022 (when the gift exclusion amount is $12.06 million) but dies in 2026 after the basic exclusion amount has sunsetted to $5 million indexed (say $6.8 million), the $12 million is added into the estate tax calculation as an adjusted table gift, but the estate exclusion amount is only $6.8 million. So will estate tax be owed on the difference? The special anti-clawback rule in Reg. §20.2010-1(c)(1) allows the estate to compute its estate tax credit using the higher of the BEA applied to gifts made during life or the BEA applicable on the date of death. Therefore, in the example above, if the donor dies when the BEA is $6.8 million, the $12 million gift would be included in the estate tax calculation as an adjusted taxable gift, but the available exclusion amount would be the larger of the $6.8 million BEA at the date of death or the $12 million of BEA applied to gifts made during life, or $12 million. For a detailed discussion of the estate tax calculation process and the operation of the anti-clawback special rule, see Item 4 of Estate Planning Current Developments and Hot Topics (December 2019) found **here**, and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(3) **General Anti-Abuse Exception.** Proposed §20.2010-1(c)(3) provides that the special anti-clawback rule (which allows applying a BEA equal to the greater of the BEA at death or the BEA allowed against taxable gifts) does not apply to "transfers includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b)" including, without limitation:

- Transfers includible in the gross estate under §2035, 2036, 2037, 2038, or 2042 (whether or not any part of the transfer was allowed a gift tax marital or charitable deduction);
- Transfers made by enforceable promise to the extent they remain unsatisfied at death;
- Transfers described in Reg. §25.2701-5 and §25.2702-6; and
- Transfers that would have been those types of transfers but for the elimination by any person of the interest, power, or property within 18 months of the decedent's death.

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

(4) **Example of Transfers Includible in Gross Estate.** The exception to the general anti-clawback rule applies if the donor retained the beneficial use of or the control of the transferred property, such as a transfer with a retained life estate or subject to other powers of interests as described in §2035-2038 and §2042.

The following example is based on an example in Aucutt, *Washington Update: Pending and Potential Administrative and Legislative Changes*, 45-46 (May 2022) found **here** and available at

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

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

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

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

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

(6) **Example of Gift Subject to Section 2701.** This example is based on Example 2 in Reg. §25.2701-5(d) Ex.2. An individual owns preferred stock with an aggregate value of $7.5 million and makes a gift of all of the common stock in 2022, which has a value of $2.5 million. The total value of the individual's interest in the corporation is $10.0 million. The preferred stock is treated as having a value of zero under §2701, so the donor made a taxable gift of $10 million. The individual dies in 2026, when the BEA is $6.8 million, owning $15 million of other assets in

addition to the preferred stock (or the proceeds of selling the preferred stock to someone other than an "applicable family member"), and the preferred stock still has a value of $7.5 million at the date of death. In computing the estate tax, the value of the preferred stock is reduced by $7.5 million, so it is valued at zero for estate tax purposes, under Reg. §25.2701-5(a)(4). In calculating the estate tax, the $10 million gift is included as an adjusted taxable gift, but the preferred stock is treated as having a value of zero in the gross estate.

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

(7) **Example of De Minimis Rule; Gift to a GRAT.** The special anti-clawback rule continues to apply if the taxable amount of a gift is 5% or less of the total amount of the transfer. The Preamble describes this as a bright-line exception "in lieu of a facts and circumstances determination of whether a particular transfer was intended to take advantage of the increased BEA without depriving the donor of the use and enjoyment of the property." In Example 4 of the proposed regulations, a donor transfers $9 million to a GRAT. The retained annuity was valued at $8,550,000, and the taxable gift was $450,000. The donor died in 2026 (when the BEA is assumed to be $6.8 million) during the term of the GRAT, and an amount equal to the full value of the GRAT corpus is included in the donor's gross estate under Reg. §20.2036-1(c)(2). The taxable value of the transfer was 5% of the total transfer, so the 5% de minimis exception applies under the proposed regulation and the general anti-clawback rule applies. That makes no difference under these facts because the $450,000 gift is less than the $6.8 million BEA at the date of death, and the available BEA under the anti-clawback rule is the greater of the BEA applied against gifts ($450,000) or the BEA at death ($6.8 million). Prop. Reg. §20.2010-1(c)(iii)(D) Ex.4. That will generally be the case for GRATs, because the taxable gift is typically a very low number.

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

(8) **Example of Use of DSUE Amount.** The proposed regulation includes a detailed example of a gift by a donor who has DSUE from a predeceased spouse. The example walks through the mathematical details for determining the amount of the **donor's** BEA that was applied against gifts. The example confirms the position in the anti-clawback final regulation that the DSUE must be applied to the gift before the donor's BEA.

(9) **Deathbed Planning.** The proposed regulations address deathbed planning alternatives to avoid the exception by removal of the donor's beneficial use or control of the transferred property before death in a way that would avoid §2035 in order to prevent the transferred asset from being included in the gross estate (which is what generally causes the exception to apply). The proposed regulation specifically refers to actions taken by third parties, in contrast to §2035, which requires affirmative action by the transferor to relinquish interests or powers that would trigger estate inclusion. Examples in the proposed regulations include elimination by a third party of an interest or power that would trigger estate inclusion or payment of a gifted promissory note. The exception to the general anti-clawback rule would apply if such elimination occurs within 18 months of the date of death. Such "pre-death" planning to eliminate a problematic power in a way that would not trigger §2035 could still be attempted if an individual finds he is seriously ill but may survive 18 months after such elimination. Prof. Mitchell Gans describes this sort of planning as "nothing ventured, nothing lost." *See* Jonathan Curry, *Proposed Regs Add Guardrails to Estate Tax Anti-Clawback Rules*, TAX NOTES (April 27, 2022).

(10) **Durational Periods of Retained Interests or Controls.** If the donor is willing to retain the problematic interest or control for a limited period of time that would be stated in the trust agreement, the anti-abuse rule could be avoided if the period of time ends before the donor's death, even if it is within 18 months of the donor's death. Planners may consider increased use of such durational periods of retained interests or powers in drafting trust instruments.

Effective Date. Once the regulations have been published as final regulations, they are proposed to apply to estates of decedents dying on or after April 27, 2022 (the date of publication of the proposed regulations in the Federal Register). The rationale of this special effective date provision is that it is "the best way to ensure that all estates will be subject to the same rules" in case the BEA should be reduced before the regulations are finalized. Preamble at 11-12. Accordingly, the proposed regulation applies to gifts made at any time by a decedent who dies on or after April 27, 2022.

c. **Inflation Adjustments.** Inflation adjustments for 2021 and 2022 were announced in Rev. Proc. 2020-45 and Rev. Proc. 2021-45, respectively. Some of the adjusted amounts are as follows:

- Basic exclusion amount and GST exemption-$12,060,000 in 2022 (the Joint Committee on Taxation had estimated $12,020,000 for 2022), $11,700,000 in 2021 (observe, this $360,000 increase is a larger than typical increase over the prior year's exclusion amount);
- Gift tax annual exclusion-$16,000 in 2022, $15,000 in 2018-2021;
- Estates and trusts taxable income for top (37%) income tax bracket-$13,450 in 2022, $13,050 in 2021;
- Top income tax bracket for individuals-$647,850/$539,900 (married filing jointly/single) in 2022, $628,300/$523,600 in 2021;
- Taxable income threshold for §199A qualified business income-$340,100/$170,050 (married filing jointly/single) in 2022, $329,800/$164,925 in 2021;
- Standard deduction-$25,900/$12,950 (married filing jointly/single) in 2022, $25,100/$12,550 in 2021;
- Non-citizen spouse annual gift tax exclusion-$164,000 in 2022, $159,000 in 2021;
- Section 6166 "two percent amount"-$1,640,000 in 2022, $1,590,000 in 2021; and
- Special use valuation reduction limitation-$1,230,000 in 2022, $1,190,000 in 2021.

d. **No-Rule List, Rev. Proc. 2022-3.**

(1) **ING Trusts.** The no-ruling revenue procedures for the last several years have included various provisions about certain trusts that are typically structured to be non-grantor trusts as an alternative for saving state income taxes (these types of trusts are often referred to as DINGs or NINGs – Delaware incomplete non-grantor trusts or Nevada incomplete non-grantor trusts. Rev. Proc. 2022-3, §5.01(9), (10), (15), & (18); Rev. Proc. 2021-3, §5.01(9), (10), (15), & (17); Rev. Proc. 2020-3, §3.01(93). See Item 8.c of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

A very significant issue with ING trusts is whether the gift is incomplete; above all, the grantor does not want to pay a huge gift tax by creating a trust to save some annual state income taxes. Consider adding a statement of settlor intent in the trust instrument that the settlor's primary intent is that the trust be interpreted so that transfers to the trust are not completed gifts. *See generally* Zeydel, *When is a Gift to a Trust Complete—Did CCA 201208026 Get it Right?*, 117 J. TAX'N 142 (Sept. 2021).

(2) **Charitable Remainder Trust with Lead Payments to Spouse and Charity**. The 2022 no-rule list adds the following new item in Section 5.01(areas under study for which rulings will not be issued):

(16) Section 2056.—Bequests, etc., to Surviving Spouse.—Whether an estate is entitled to an estate tax marital deduction for any portion of the annuity or unitrust interest of a charitable remainder trust (as described in § 664) that may be distributed between the decedent's spouse and an organization described in § 170(c) at the discretion of a trustee. Rev. Proc. 2022-3, §5.01(16).

The scope of this new provision is unclear. Perhaps it relates to a situation similar to the facts addressed in PLR 201117005, in which the trustee had the discretion to distribute a portion of the annual unitrust amount either to the surviving spouse or to a charity. Ron Aucutt summarized this ruling in his Top Ten Developments of 2011:

Number Nine: A Deductible Whole with Undetermined Marital and Charitable Parts: Letter Ruling 201117005 (Jan. 5, 2011)

This letter ruling involved, among other things, a proposed testamentary charitable remainder unitrust (CRUT) that was to be distributed under a somewhat unusual formula. While one-fifth of the unitrust amount each year would go to the surviving spouse, four-fifths of the unitrust amount would be distributed either to the spouse or to a private foundation (which was also the charitable remainder beneficiary) in the trustees' discretion. If the surviving spouse remarried, the spouse was to receive only the one-fifth portion of the unitrust amount and any amount of the remaining four-fifths portion of the unitrust amount that was necessary to ensure that the amount received by the spouse was not de minimis.

The Service held that upon the taxpayer's death the entire value of the assets distributed to the CRUT would be deductible in calculating the taxable estate, because all the value of the CRUT would pass to either charity or the surviving spouse, even though the respective values passing to charity and the surviving spouse could not be determined. In looking at the legislative history, the Service concluded that when a taxpayer establishes a testamentary CRUT in which the surviving spouse is the only non-charitable beneficiary, the estate tax marital deduction will completely offset the value of the assets distributed to the CRUT after deducting the value of the remainder interest passing to the charity, so there will be no estate tax attributed to the CRUT.

This common sense result opens up an opportunity for flexibility without creating tax uncertainty.

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

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

An IRS memo dated November 18, 2021, with an expiration date of October 31, 2023, allows taxpayers and representative to use electronic or digital signatures when signing a large number of forms, including the various Form 706s and Forms 709, 3520, 3520-A, 4421, 4768, and 8283.

f. **Private Letter Ruling Fee Increase in 2021; No Further Increase in 2022.** Revenue Procedure 2021-1, 2021-1 I.R.B. 1 (Jan. 4, 2021) covers the procedures for obtaining private letter rulings, including in Appendix A the fee schedule for letter rulings. The fee varies for various types of letter rulings, but the fee for ruling requests not otherwise listed with other specific fees has increased from $30,000 (for requests received prior to February 4, 2021) to $38,000 (for requests received after February 3, 2021), representing a 26.7% increase. The fee for extension requests under §301.9100-3 for those same periods has increased from $10,900 to $12,600. (The user fee is significantly less for taxpayers with gross income under $250,000 [$3,000 after February 3, 2021], and for taxpayers with gross income from $250,000 to $1 million [$8,500 after February 3, 2021].) Those amounts were not changed in the 2022 procedure. Rev. Proc. 2022-1, Appendix A.

g. **Re-Emergence of Section 2704 Proposed Regulations Addressing Valuation?** Neither the FY 2022 Greenbook not the FY 2023 Greenbook includes a regulatory project to restrict valuation discounts under §2704. Apparently, there is no intent by the Biden administration, at this point, to re-open the §2704 regulation project. (The highly controversial proposed regulations released August 2,

2016 were withdrawn on October 20, 2017 during the Trump administration. For a detailed discussion of the history of the proposed regulations, see Item 18 of Ronald Aucutt, *Estate Tax Changes Past, Present, and Future* (May 5, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.)

6. Estate Planning for Moderately Wealthy Clients

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

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

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

b. **Important Planning Issues.**

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

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

7. Transfer Planning Issues

The discussion below includes observations from John Porter (Houston, Texas) at the 2022 Heckerling Institute on Estate Planning.

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

available only through 2025. Future legislation may decrease the large exclusion amount even before 2026, though that seems unlikely (Republicans are likely to regain control of either the House or Senate, or both, in the 2022 elections. Democratic control of the Presidency, House and Senate following the 2024 elections is not guaranteed, and at that time an acceleration of the sunset by only one year or less might not be worth the trouble).

The anti-clawback regulation clarifies that the donor can benefit from using the increased gift exclusion amount even if the donor should die after the estate tax exclusion amount has been reduced. The anti-clawback regulation provides a special rule that allows the estate to compute its estate tax credit using the higher of the BEA [basic exclusion amount] applicable to gifts made during life or the BEA applicable on the date of death. Reg. §20.2010-1(c)(1). See Item 5(2) above. For a discussion of various issues regarding the anti-clawback regulation, see Item 7.a of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

b. **Preparation for Audit Begins at Planning Stage.** John Porter emphasizes that preparation for the transfer tax audit begins at the planning stage. The IRS often issues broad requests for documents in discovery, including emails. The attorney may have to testify about reasons for certain entities, so the attorney-client privilege may not be available regarding communications about the planning. In every case that John Porter has tried regarding §2036, someone (usually the attorney) has testified about reasons for creating the entity. In that vein, planning communications can discuss the tax attributes of entities but should also discuss the non-tax effects.

c. **Formula Transfers.** In light of inherent valuation uncertainties, planners are now frequently using defined value formula transfers. John Porter reports that he has had a lot of success in upholding transfers made under defined value formulas.

(1) **Types of Value Formula Transfers.** Five basic types of these clauses exist.

(a) **Allocation Based on Agreement** – Formula allocation clause allocates portions of a transferred asset between taxable and non-taxable transfers based on the subsequent agreement of the parties (*McCord, Hendrix*);

(b) **Allocation Based on Finally Determined Value for Gift Tax Purposes** – Formula allocation clause allocates portions of a transferred asset between taxable and non-taxable transfers based on values as finally determined for federal gift tax purposes (*Christiansen, Petter*; both were full Tax Court cases approving these clauses and they were affirmed by the Eighth and Ninth Circuits, respectively) (Example: "I hereby transfer 100 shares of the Company to [taxable transferee] and [charity/QTIP/GRAT] to be allocated between the transferees as follows: (1) that number of shares with a fair market value as finally determined for federal gift tax purposes equal to $ [specific dollar amount] to [taxable transferee]; and (2) the remainder of the shares to [charity/QTIP/GRAT]");

(c) **Assigned Value** – Clause defining the amount transferred based on values as finally determined for federal gift tax purposes (*Wandry*) (Example: "I hereby transfer to _____ that number of shares of the Company with a fair market value as finally determined for federal gift tax purposes equal to $ [specific dollar amount]");

(d) **Price Adjustment** – Price adjustment clause adjusts the price rather than the amount transferred in a sale transaction (*King;* but *McLendon* and *Harwood* did not recognize price adjustment clauses; an advantage of price adjustment clauses is that a "re-transfer/re-titling" of assets is not required after the correct value is determined) (Example: "I hereby sell 100 shares of the Company in exchange for a promissory note with a principal amount of $[X] (which the parties believe to be equal to the fair market value of the shares). The term of the

promissory note shall be [add note terms/interest]. If the fair market value of the shares as finally determined for federal gift tax purposes is greater or less than $[X], the principal amount of the note shall be adjusted to the finally determined value effective as of the date of the transfer. The parties intend for the sale to be at fair market value and that no gift result from the sale."); and

(e) **Reversion** – 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. That said, the *Procter* doctrine does not invalidate all formula transfers. Since the 1944 *Procter* case, many other types of formula clauses have been blessed by the IRS and the courts (marital deduction clauses, GST formula allocations, split interest charitable trust clauses, GRAT annuity payments, and formula disclaimers, to name a few).

(2) **Potential Donees of "Excess Amount" Under Formula Allocation Clauses.** Potential donees of the "excess amount" under a formula allocation clause are:

- Public Charity/Donor Advised Fund – John Porter likes this alternative; it is a donee with a fiduciary obligation; this type of donee was blessed in *McCord*, *Hendrix*, *Petter*, and *Christiansen;*
- Private Foundation – This is more cumbersome because the self-dealing and excess benefit rules apply;
- Lifetime QTIPs;
- GRAT (for both lifetime QTIPs and GRATs, consider having different trustees and some differences in the beneficiaries than of the trust that is the initial recipient of the formula transfer so that independent fiduciary obligations exist).
- Significant Value – John Porter much prefers that significant value pass to the "excess amount" back-end beneficiary. That helps contravene an IRS argument made in *Petter* and *Christiansen* that the charitable gift was subject to a condition precedent. In *McCord*, *Hendrix*, *Petter* and *Christiansen*, the charities received 6-figure values. The charity should have "skin in the game" to review the transaction closely.

(3) ***Wandry* Clause.** The *Wandry* approach is simpler because it does not involve a third-party recipient, but it loses the benefit of a third-party trustee with independent fiduciary obligations and it could result in fewer shares being transferred.

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

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

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

(7) **Some Planning Issues.**

- The IRS looks at these cases closely, but largely to determine whether the clause was implemented properly. No pre-arrangements should exist.
- 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.
- The recipient trusts should be grantor trusts; if adjustments are made following an audit, no income tax return amendments should be necessary because all of the income is taxed to the grantor in any event.

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

d. **Sales to Grantor Trusts.**

(1) **Gift Tax Issues.**

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

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

- Sufficient Seeding. The IRS should lose this argument if the trust is seeded with significant value or if the trust has a guarantee backed by a guarantor who can pay the guarantee if necessary. *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), was a private annuity case which did not result in estate inclusion where the promise to pay the annuity was a personal obligation, not just payable out of earnings, and the size of payments was not based on the amount of income from transferred assets. The government made similar arguments in the *Woelbing* and *Beyer* cases. The IRS is now making that argument in a pending Tax Court case being defended by John Porter.
- Collapsing Gift and Sale. If the gift and sale happen the same day (or are deemed to be part of an integrated transaction) the IRS may argue that all the transferred assets have some gift element, so the bona fide sale for full consideration exception in §2036 and §2038 is inapplicable.

e. **GRAT Audits.** John Porter reports that the IRS is increasingly auditing GRATs and is raising the following issues.

- Do terms of the GRAT agreement comply with the §2702 regulations?
- Has the GRAT been operated in accordance with its terms?
- Are the assets contributed to the GRAT (see *Grieve v. Commissioner*) and assets used in making annuity payments properly valued? Is a consistent valuation methodology being used for the initial valuation and for annuity payment valuations or exercises of substitution powers? (Consider using a *Wandry* type formula approach for annuity payments or exercises of substitution powers.)
- Have all annuity payments been made timely?
- The IRS is taking hard line on operational issues. John Porter had a case several years ago where the IRS representative argued that the GRAT was not a qualified interest under an

Atkinson analysis, similar to the position publicized in CCA 202152018 (which is discussed in Item 21 below).

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

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

For a detailed discussion of SLATs and "non-reciprocal" SLATs, including a discussion of the §2036 and §2038 issues and creditor issues, see Items 78 and 80 of the ACTEC 2020 Annual Meeting Musings (March 2020) found **here**, Item 10.i. of Estate Planning Current Developments and Hot Topics (December 2019) found **here**, and Item 16 of the Current Developments and Hot Topics Summary (December 2013) found **here**, all available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. For a discussion of potential conflicts of interest between spouses and creditor concerns with SLATs, see Item 10.e of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

h. **Section 2036**. John Porter believes that whether §2036 applies to assets transferred to entities is the most litigated issue in the transfer tax area. Section 2036(a)(2) and the "alone or in conjunction with" analysis has been the focus in the last several years following the *Powell* case. The bona fide sale for full consideration defense is the best defense to any §2036 attack. Planners should accordingly consider documenting the purposes of transfers to entities at the time of the creation of the entities.

i. **Valuation Penalties; *Morrissette.*** *Morrissette* applied undervaluation penalties even though the taxpayer secured appraisals from a reputable appraiser. The court did not question the credentials of the appraiser but said that the taxpayer was unreasonable in relying on the appraisal. The "legal advice defense" was waived by asserting attorney-client privilege. The court observed that the intergenerational split-dollar transaction was marketed as a way to undervalue rights and noted that the taxpayer recommended changes to the appraiser's report.

j. **Gifts to "Lock In" Use of Increased Gift Exclusion and GST Exemption.**

(1) **Planning Alternatives; Anti-Abuse Proposed Regulation.** Planning alternatives that some planners have suggested to take advantage of the "window of opportunity" with the large exclusion amount while minimizing the current impact on the client's access to assets have been dramatically curtailed by the anti-abuse proposed regulation discussed in Item 5.b above. (Those alternatives included using: (i) an "enhanced grantor retained income trust;" (ii) a promise to make a gift or a gift of a legally enforceable note; (iii) a transaction that does not satisfy §2701 or §2702; (iv) a §2519 deemed transfer; or (v) a retained income trust. *See* Katie Lynagh, *Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion*, BNA ESTATES, GIFTS & TRUSTS J. (May 14, 2020). For a brief summary of these alternatives, see Item 10.f(1)-(5)

of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.)

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

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

Adding flexibility to irrevocable trusts can be very helpful given the existing substantial legislative uncertainty. Some of the ways of adding considerable flexibility are:

- using nontaxable powers of appointment;
- providing broad standards for distributions by independent trustees;
- granting substitution powers to the settlor;
- authorizing trust decanting (which may be available under state statutes); and
- providing special modification powers to trust protectors.

l. **Transfers With Flexibility to "Undo" the Transfer.** At the time of making a transfer, the possibility exists of future tax legislation that would make the transfer inadvisable for some reason. Some planners have examined ways of making gifts that could be limited not to trigger gift tax or that could be "undone" in the event that subsequent legislation made the gift inadvisable. Alternatives are discussed in considerable detail in Items 12-20 of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

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

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

8. Family Limited Partnership (FLP) and LLC Planning Developments; Planning in Light of *Estate of Powell v. Commissioner* and *Estate of Cahill v. Commissioner*

Some of the discussion below regarding FLP and LLC developments include observations at the 2022 Heckerling Institute on Estate Planning from John Porter (of Houston, Texas), who has litigated many of the family limited partnership cases.

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

(1) **Bona Fide Sale for Full Consideration Defense.** The bona fide sale for full consideration defense is the key for defending both §2036(a)(1) and §2036(a)(2) cases. Almost every one of these cases that the taxpayer has won was based on the bona fide sale for full consideration exception to §2036. The three exceptions are *Kelly, Mirowski,* and *Kimbell* (at least as to some assets). See Item 9.f of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

Also, advisors should make sure that other planning is consistent with the purposes of the partnership. Consider documenting the nontax reasons. Contemporaneous evidence really helps satisfy the court. The estate planning attorney's files can significantly help (or hurt) at trial.

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

(2) **Section 2036(a)(1).** The IRS typically argues that assets should be included under §2036(a)(1) as a transfer to the FLP/LLC with an implied agreement of retained enjoyment. The latest of those reported cases is *Estate of Moore v. Commissioner*, briefly summarized in Item 1010 below. The government wins about 2/3 of those cases. (In some of those cases, the FLP/LLC assets have been included in the estate under §2036 even though the decedent had transferred the partnership interests during life (*Harper, Korby*).)

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

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

§2036(a)(2) when the decedent held merely a limited partnership interest (*Powell*, as discussed in Item 8.c(1) below).

(a) **Possible Defenses Even as General Partner.** The Tax Court in *Estate of Cohen v. Commissioner,* 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 a co-general partner or manager, but, as a practical matter, the IRS does not view co-manager situations as critically as if the decedent was the sole manager. Having co-managers also typically helps support the nontax reasons for the partnership or LLC.

(b) ***Powell, Cahill,* and *Morrissette.*** The *Powell*, *Cahill*, and *Morrissette* cases applied §2036(a)(2), as discussed in Item 8.c below. *Levine* refused to apply §2036(a)(2) because the decedent could not participate at all in the decision to cause the cash surrender value of intergenerational split-dollar life insurance policies to be paid early. See Item 15.b below.

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

Planners report anecdotally that the IRS is continuing to raise the §2036(a)(2)/*Powell* arguments in audits.

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

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

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

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

For a brief overview summary of *Powell,* see Item 26.c(1) of Estate Planning Current Developments (December 2021) found **here** and for a more detailed discussion of the facts and court analysis in and planning implications of *Powell*, see Item 15.g. of the Current Developments

and Hot Topics Summary (December 2017) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(2) **Synopsis of *Estate of Cahill* and Settlement.** In *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (Judge Thornton), the decedent's revocable trust had advanced $10 million to an irrevocable trust under a split-dollar agreement for the trust to purchase life insurance policies on the lives of the decedent's son and his wife; the estate valued its reimbursement at only $183,700, because of the long period of time before the policies would mature at the insureds' deaths. The IRS argued, among other things, that the reimbursement right should have a value equal to the full cash surrender value of the policies (about $9.6 million) in part because of §§2036, 2038, and 2703. The court rejected the estate's motion for a partial summary judgment that §§2036(a)(2), 2038(a)(1), and 2703(a) did not apply and that Reg. §1.61-22 applied in valuing the decedent's reimbursement rights. The estate tax audit was settled on August 16, 2018, with the estate conceding all the issues regarding the intergenerational split-dollar arrangement (agreeing that the value of the decedent's reimbursement right was the $9.6 million cash surrender value of the policies) and the imposition of a 20% accuracy-related penalty under §6662; the IRS conceded regarding the value of certain notes from family members unrelated to the split-dollar transaction. For a more detailed summary of the *Cahill* case (including ramifications of its §2703 analysis) see Item 13 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

The court ultimately held that the bona fide sale for full consideration exception to §2036 and §2038 and the §2703(b) safe harbor applied, and the court valued the estate's reimbursement right, T.C. Memo. 2021-60 (May 13, 2021), as discussed in Item 16.a below. For a much more detailed discussion of the *Morrissette* developments before the 2021 opinion, see Item 13 of Estate Planning Current Developments and Hot Topics (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(4) **Section 2036(a)(2) Not Applicable in *Levine*.** The Tax Court held that §2036(a)(2) and §2038 did not apply in *Estate of Levine v. Commissioner*, T.C. No 2 (February 28, 2022). A big distinction from *Morrissette* is that in *Levine* the life insurance trust that owned the policies had the sole right to decide whether to terminate the split-dollar agreement or surrender the polices prior to the deaths of the insureds. The court reasoned that the decedent did not have any right, whether by herself or in conjunction with anyone else, to terminate the policies and therefore to designate who could possess or enjoy the property or to alter, amend, revoke or terminate the transfer. Also, the court reasoned that the mere ability of all the parties to the split-dollar agreement to revise the agreement to terminate it early would not trigger the "in conjunction with" language of §2036(a)(2), relying on the *Helmholz* and *Tully* cases that placed limits on such a broad interpretation of the "in conjunction with" phrase. See Item 15.b below for a discussion of *Estate of Levine*.

d. **What to Do? Planning After *Powell*.**

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

- No revocable transfers;
- Avoid transfers under a power of attorney;
- Satisfy the bona fide sale for full consideration exception;

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

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

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

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

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

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

(b) **Investment and Management Decisions.** There are strong arguments that investment and administrative powers held by the donor as a general partner (or manager of an LLC) should not trigger estate inclusion under §2036 or §2038. Citations of various cases are in Item 9.d(2) of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

Because of these concerns, if the donor makes a gift of an interest in the entity, some respected planners structure the entity to avoid having the donor as a general partner or manager or limit the donor's authority as manager or other management position to participate in "tax-sensitive" activities. Diana Zeydel (Miami, Florida) has noted the possibility of limiting the donor's authority as manager with respect to decisions, approvals, or consents relating to various potentially tax sensitive activities such as distributions, allocations to

reserves, determining the fair market value of interests, making loans to or guarantees of loans of any entity owner, withdrawal or resignation of any owner, dissolution or liquidation of the entity, any incident of ownership in any life insurance policy on the life of any entity owner, voting the stock of any "controlled corporation" as described in §2036(b), or an amendment of the governing instruments with respect to any of those matters.

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

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

(4) **Drafting for §2036(a)(2).** The following drafting recommendations are from John Porter (Houston, Texas).

(a) **Distribution Provisions Consistent with *Cohen/Byrum* Analysis.** In analyzing whether §2036(a)(2) applied to a trust, *Estate of Cohen v. Commissioner*, 79 T.C. 1015 (1982), focused on whether distribution powers may be exercised "arbitrarily and capriciously" or are "circumscribed by cognizable limits on the exercise of discretion."

Operating Distributions

1.01 No Other Distributions Except as provided in this Article, the Partnership shall make no distributions of cash or other property to any Partner until its liquidation as provided in Section _____.

1.02 Distributable Cash Distributable Cash includes only that cash held by the Partnership at the end of a Fiscal Year after reasonable reserves of cash have been set aside by the Partnership Management, subject to the duties imposed by Section ____, for working capital and other cash requirements, including current and reasonably projected expenses, current and reasonably projected investment opportunities, and reasonably anticipated contingencies. For purposes of this Section, any of the Partnership Assets that are contributed to the Partnership by the Partners, any borrowed funds, and any cash generated upon the sale of any of the Partnership Assets, including Partnership Assets that are purchased with borrowed funds and including the cash attributable to appreciation in value, shall be considered as necessary for investment purposes.

1.03 Operating Distributions

(a) From time to time during each Fiscal Year, the Partnership Management may, in the exercise of reasonable discretion, cause the Partnership to distribute any part or all of the Distributable Cash proportionately to each of the Partners based on their Percentage Interests.

(b) During the course of a Fiscal Year, in lieu of making any determinations or distributions under Sections 1.02 and 1.03(a), the Partnership Management may, in the exercise of reasonable discretion, cause the Partnership to distribute cash or other Partnership Assets proportionately to the Partners based on their Percentage Interests; provided that the total amount of distributions under this Section 1.03(b) in any Fiscal Year may not exceed five percent (5%) of the fair market value of the Partnership Assets (net of liabilities) as of the beginning of that Fiscal Year.

(c) No distributions under Section 1.03(a) or 1.03(b) shall have the effect of changing any of the Percentage Interests.

1.04 Income Tax Distributions Regardless of the amount of Distributable Cash and in addition to any distributions under Section 1.03, the Partnership may distribute during the course of each Fiscal Year an amount of cash that would be sufficient for each Partner to pay the Partner's federal and state income taxes attributable to profit and loss allocations by the Partnership at the highest marginal income tax rate, including quarterly estimated tax payments. Any distributions under this Section 1.04 shall be made proportionately to the Partners based upon their Percentage Interests, by distributing the smallest total amount necessary for each Partner to pay such tax.

(b) **Liquidation/Amendment Provisions to Address *Powell*.** Senior family members should have no right to participate in liquidation/dissolution decisions. For example, a "standard" liquidation provision based on the death or withdrawal of a general partner unless any remaining general partners wish to continue the business or on the unanimous consent of general partners would be appropriate where the general partner is an LLC owned solely by parties other than senior family members.

e. **Prior Cases That Have Limited the Broad Application of the "in Conjunction with" Phrase in §§2036 and 2038.** Section 2036(a)(2) was enacted with almost identical "in conjunction with" statutory language as in §2038. Several cases have limited the application of the "in conjunction with" provision in determining whether §2038 applied. The *Helmholz*, *Tully*, and *Bowgren* cases are cited and briefly summarized in Item 19.e. of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. *Helmholz* and *Tully* were cited by the court in *Estate of Levine*.

f. **Summary of §2036 FLP/LLC Cases (14-23, with 2 Cases on Both Sides).** For a summary of the various FLP/LLC cases that the IRS has chosen to litigate under §2036, see Item 9.f of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

g. **Review of Court Cases Valuing Partnership/LLC Interests.** Despite the many cases that have addressed the applicability of §2036 to limited partnership or LLC interests, fewer cases have actually reached the point of valuing partnership interests. Observe that some cases have allowed discounts even for controlling interests in FLPs or LLCs. *E.g.*, *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (4% lack of control discount for controlling majority interests in LLCs); *Estate of Streightoff v. Commissioner*, T.C. Memo. 2018-178, *aff'd*, 954 F.3d 713 (5th Cir. 2020) (18% lack of marketability discounts for estate's de facto controlling interest in LLC holding cash and marketable securities). John Porter summarizes discounts that have been allowed by the courts in FLP/LLC cases as follows (the *Streightoff*, *Estate of Jones*, *Grieve*, *Nelson, Warne,* and *Smaldino* case results have been added to the table):

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

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

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

9. Tax Effects of Settlements and Modifications; Early Termination of Trust; Commutation of Spouse's Interest in QTIP Trust; Modification to Add General Power of Appointment

The tax effects of court modifications, other trust modifications, decanting, and settlements are summarized in Items 42-51 of the ACTEC 2015 Annual Meeting Musings (April 2015) summary found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. This Item includes several brief miscellaneous comments.

a. **Background; *Bosch* and *Ahmanson*.** In *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), the Supreme Court observed that legislative history regarding the marital deduction directed that "proper regard" be given to state court construction of wills. Because the Senate Finance Committee used "proper regard" rather than "final effect," the opinion concluded that state court decisions should

not be binding on the issue, and that federal courts in tax cases will be bound only by the state's highest court in the matter before it.

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

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

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

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

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

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

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

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

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

resulted in termination of the trust but was treated as a charitable gift rather than as a sale or exchange of a capital asset that would have resulted in taxable income to the taxpayer).

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

e. **Section 2519 Brief Overview.** Transfers to QTIP trusts qualify for the gift and estate tax marital deduction. The assets in the QTIP trust are subject to transfer taxes at the earlier of (1) the date on which the surviving spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest (under §2519), or (2) upon the surviving spouse's death (under §2044).

Section 2519(a) provides that for estate and gift tax purposes,

> any disposition of all or part of a qualifying income interest for life in any property to which this section applies [i.e., property for which a QTIP election was made and a marital deduction was allowed under §2056(b)(7) or §2523(f)] shall be treated as a transfer of all interests in such property other than the qualifying income interest.

Reg. §25.2519-1(c)(1) clarifies what is deemed transferred when §2519 is triggered:

> (c) *Amount treated as a transfer.*—(1) *In general.*—The amount treated as a transfer under the section upon a disposition of all or part of a qualifying income interest for life in qualified terminable interest property is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under section 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. The gift tax consequences of the disposition of the qualifying income interest are determined separately under §25.2511-2.

If the surviving spouse disposes of all or part of a qualifying income interest for life, §2519 treats the disposition as a transfer of all interests in the QTIP other than the qualifying income interest (i.e., as a transfer of the remainder interest).

The effect is that if the spouse disposes of any portion of the qualifying income interest in a QTIP trust, the spouse is treated as having *transferred* the remainder interest in the trust. Whether the amount of the *gift* resulting from the deemed transfer of the remainder interest is offset by any consideration received by the spouse-beneficiary in the transaction that resulted in triggering §2519 is unclear but is addressed in *Kite II* and in CCA 202118008 (discussed below).

The *Kite* case is summarized briefly in Item 8.f of Estate Planning Current Developments (March 16, 2022) found **here** and is discussed in more detail in Item 21.f of Estate Planning Current Developments (December 2021) found **here**; for a more detailed discussion of *Kite I* and *Kite II*, see Akers, *Kite v. Commissioner*, Rule 155 Order and Decisions (Cause No. 6772-08, unpublished opinion October 25, 2013) found **here**, all available at **www.bessemertrust.com/for-professional-partners/advisor-insights)**.

The transfer of the income interest itself can be a gift under §2511 if the spouse receives less than full value in return for the income interest.

The conversion of QTIP assets into other property in which the surviving spouse continues to have a qualifying income interest for life is not a disposition for purposes of §2519. Reg. §25.2519-1(f) (sale and reinvestment of assets of a QTIP trust is not a disposition under §2519 provided that the surviving spouse continues to have a qualifying income interest for life in the trust after the sale and reinvestment).

A spouse-beneficiary of a QTIP trust may purposefully dispose of a small part of the income interest as a way of making a substantial gift without relinquishing significant retained economic rights. See Item 21.i(4) of Estate Planning Current Developments (December 2021) found **here** and Item 3.j(8) of Estate Planning Current Developments (December 2018) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

f. **Commutation of Spouse's Interest in QTIP Trusts With Charitable Trust as Remainder Beneficiary, PLR 202016002.** Letter Ruling 202016002 addresses the tax effects of a settlement agreement terminating QTIP trusts by paying to the spouse-beneficiary the actuarial value of her

income interest and distributing the remaining assets to the charitable trust that is the remainder beneficiary of the QTIP trusts. The payment to the spouse of the actuarial value of the income interest in exchange for her lifetime income interest is a disposition of her income interest for purposes of §2519, resulting in a deemed transfer of all interests in the trust other than the qualifying income interest (i.e., the remainder interest), but because the remainder interest passed to a charitable trust, the spouse was entitled to a gift tax charitable deduction for that deemed transfer.

For a more detailed discussion of PLR 202016002, see Item 7.g of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

   The IRS ruled that this transaction had significant adverse tax consequences: (1) the Children were treated as making gifts to the Spouse of their remainder interest; (2) the Spouse was treated as making a deemed disposition under §2519 of the full value of the remainder interest; and (3) the gift/sale by the Spouse of the trust assets utilized her gift exclusion amount and the Spouse would have the value of notes included in her estate for estate tax purposes. For a detailed discussion of CCA 202118008, see Item 8.h of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

h. **Planning For Surviving Spouses' Interests in QTIP Trusts.** Planning for surviving spouses who are beneficiaries of substantial QTIP trusts is complicated. This CCA is an example of clients entering into complicated transactions in planning with QTIP trusts – with bad tax results in the eyes of the IRS.

   (1) **Moore, Kawashima & Miyasaki Paper.** For an outstanding detailed discussion of planning alternatives for a surviving spouse who is the beneficiary of a QTIP trust, see Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 1202.3 (2010).

   (2) **Distributions.** One of the primary planning options is for the QTIP trust to make a distribution of substantial assets to the spouse-beneficiary, who could then engage in traditional transfer planning alternatives. The biggest hurdle to this planning option is that the trust agreement may have a restrictive standard for principal distributions, and the trustee may not be able to justify a large principal distribution under that standard. Commentators have pointed to possible gift implications of unauthorized distributions (or the failure to object to unauthorized distributions) from trusts. *See id*. at ¶ 1201.5.

      (a) **Possible Collapsed Transactions Argument by IRS.** Note, however, that the IRS may claim that a distribution followed by a gift should be collapsed and deemed to be a prearranged and simultaneous transaction, resulting in a distribution from the nonexempt trust to the end recipient.

      (b) **Effect of Unauthorized Distributions.** To the extent distributions are made that are not authorized in the trust agreement, the IRS might argue that it should ignore the distributions. Several cases have refused to give effect to trust distributions that were not authorized. *E.g.*, *Estate of Lillian Halpern v. Commissioner*, T.C. Memo. 1995-352; *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278. The IRS has made the argument in other cases, in

which the court ultimately determined that the distributions were authorized under the trust agreement. *Estate of Hartzell v. Commissioner*, T.C. Memo. 1994-576; *Estate of Council v. Commissioner*, 65 T.C. 594 (1975). (IRS argued that trustee did not have the authority to distribute trust assets to spouse for gifting purposes; court stated that the issue was not whether a state court would have approved the distributions beforehand but whether a state court would rescind the distributions after made; conclusion that trustees acted within the bounds of reasonable judgment).

Several cases have concluded that the failure to follow restraints on distributions caused trusts to be treated as grantor trusts for non-tax purposes. *United Food & Commercial Workers Unions v. Magruder Holdings, Inc.*, Case No. GJH-16-2903 (S.D. Md. March 27, 2019); *SEC v. Wyly,* 2014 WL 4792229 (S.D.N.Y. September 25, 2014).

A possible planning alternative may be to obtain a court order authorizing the desired distribution (perhaps generally authorizing distributions for estate planning purposes) prior to the distribution and to rely on Rev. Rul. 73-142 for taking action based on a binding final court order (as discussed in Item 9.b above).

For further descriptions of these cited cases, see Item 8.i(2)(b) of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(3) **Other Planning Alternatives.** Other possible planning alternatives include a spousal power of withdrawal, triggering a §2519 deemed disposition, or transactions to freeze the value of the QTIP assets. These and other planning alternatives are discussed in Item 8.i(3)-(5) of Estate Planning Current Developments (March 16, 2022) found **here** and Item 8 of the Observations in Akers, *Kite v. Commissioner*, Rule 155 Order and Decisions (Cause No. 6772-08, unpublished opinion October 25, 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)**. Transfer planning utilizing a §2519 deemed transfer is discussed in Item 3.j(8) of the Estate Planning Current Developments (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** *See also* Richard S. Franklin, *Lifetime QTIPs—Why They Should Be Ubiquitous in Estate Planning*, 50th HECKERLING INST. ON EST. PL. ch. 16 (2016); Richard S. Franklin & George Karibjanian, *The Lifetime QTIP Trust – the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exemption*, 44 BLOOMBERG TAX MGMT. ESTATES, GIFTS & TR. J. 1 (March 14, 2019).

i. **Trust Modification to Add General Power of Appointment, PLR 202206008.**

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

The term "Defined Portion" was described as "the largest portion of Trust B that could be included in Child's federal estate without increasing the total amount of the "Transfer Taxes" actually payable at Child's death over and above the amount that would have been actually payable in the absence of his provision." The term "Transfer Taxes" was described as "all inheritance, estate, and other death taxes, plus all federal and state GST taxes, actually payable by reason of Child's death." In default of exercise of the general power of appointment, the remaining assets would be distributed to the child's descendants, per stirpes, or if none, to the

Settlor's wife's heirs. The taxpayer sought rulings that as a result of "the exercise by Trustee of its discretionary authority ... upon the terms of the Settlement Agreement"– (1) the trust would retain its GST "pre-effective date" exempt status, and (2) only trust property subject to the child's testamentary general power of appointment would be included in the child's gross estate under §2041(a)(2). Both rulings were granted. Also, not specifically discussed in the PLR, the ruling tacitly confirms that a trustee with discretionary authority to distribute principal for a beneficiary's welfare may exercise the authority to grant a general power of appointment.

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

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

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

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

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

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

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

(2) **Basis Adjustment Planning.** Apparently, the purpose of the modification was to trigger estate inclusion in the child's gross estate, to the extent that doing so would not generate transfer taxes for the child, so the assets would receive a basis adjustment at the child's death under §1014(b)(9). However, planners should not view the language in the PLR as a drafting roadmap.

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

(1) making distributions (assuming the distribution standards are broad enough to justify the distribution);

(2) having someone grant a general power of appointment to a beneficiary;

(3) using a formula general power of appointment (as was done in PLR 202206008); or

(4) triggering the "Delaware tax trap."

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

(b) **Drafting Considerations.**

- **Manipulation; *Kurz v. Commissioner*.** Consider whether the beneficiary could manipulate the child's taxable estate (for example, by leaving the child's estate to a spouse or charity) to increase the amount of the trust over which the beneficiary would have a general power of appointment. If so, the IRS might argue that the beneficiary has a general power of appointment to that maximum extent. *See Kurz v. Commissioner*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995). However, *Kurz* makes clear that contingencies that have independent significant non-tax consequences are to be ignored. Those contingencies prevent the decedent from having realistic unfettered control to access the trust assets. As to the possibility of a marital or charitable bequest increasing the amount of the general power of appointment under the formula, such bequests would seem to have independent significance. However, to avoid that argument, the formula could refer to an amount "determined for this purpose without regard to any available charitable or marital deduction." For a more detailed discussion of the *Kurz* case and the possible implications for formula general powers of appointment, see Item 7.e of the Current Developments and Hot Topics Summary (December 2014) found **here** and available at **www.bessemer.com/professionalpartners**.
- **Specifying Assets Subject to the General Power.** Consider describing particular assets over which the power of appointment applies (for example to include only appreciated assets, or to provide an ordering of assets so that particular assets with high appreciation that are likely to be sold early or assets with the highest percentage appreciation would be first in order). Without such a provision, the general power may apply to a pro rata portion of all trust assets. See Ed Morrow, *PLR 202206008: Judicial Settlement Modification & Formula Testamentary General Powers of Appointment*, LEIMBERG ESTATE PLANNING NEWSLETTER #2946, at n.2 (March 17, 2022).
- **Limiting "Inappropriate" Exercise.** To limit the possible "inappropriate" exercise of a power of appointment, (1) state that some independent person has the ability to remove the general power of appointment before the powerholder dies or to revise the power (for example, to adjust a formula general power of appointment), (2) specify that the power is exercisable only with the consent of some other non-adverse party (but not the grantor), *see* Reg. §20.2041-3(c)(2), Ex. 3, and (3) limit the permissible appointees of the power (such as to persons related by blood, marriage, or adoption or to creditors).
- **Flexibility.** For added flexibility, add that a non-adverse party could modify the general power. An added advantage is that the holder of the general power of appointment would not have a vested interest, so actions by the powerholder reducing the pool of assets subject to the power would not constitute a gift as a result of a release of a general power of appointment.
- **Using Beneficiary's GST Exemption.** If another purpose of granting the general power is to utilize the powerholder's GST exemption, structure the formula to be based on the lesser of the individual's remaining GST exemption or applicable exclusion amount.
- **Avoiding Need for Powerholder to File Estate Tax Return.** Consider limiting the formula to $10,000 less than the powerholder's applicable exclusion amount so that

the existence of the general power of appointment will not require the powerholder's estate to file an estate tax return.

- **Sample Forms.** For examples of formula powers, see *Ed Morrow & the Optimal Basis Increase Trust (OBIT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2080 (March 20, 2013). An updated version is downloadable for free from **the ssrn.com website**. An excellent comprehensive form is in Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications* , at II.H.2.k (January 2022) (an extremely comprehensive resource available from the author). Various forms and references to other resources with form examples are also included in Item 5 of the Estate Planning Current Developments Summary (December 2018) found **here**, and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.
- **Power to Appoint to Creditors.** A method of limiting the manner in which a general power could be exercised is to provide that the power may only be exercised in favor of creditors. For an excellent discussion of the effect of a general power to appoint to creditors, and whether the power could be exercised only up to the amount of debt to a particular creditor, and the impact of that decision on the amount included in the gross estate under §2041, see Robert J. Kolasa, *Creditor General Powers of Appointment*, TRUSTS & ESTATES 16 (Feb. 2020).
- **Creditor Effects.** Bear in mind that the existence of the general power may have creditor effects, but the actual exercise of a testamentary general power of appointment may be more likely to subject the assets to the decedent-beneficiary's creditors than if the general power is not exercised. Section 502 of the Uniform Power of Appointment Act provides that creditors of the holder of a general power may reach the assets subject to the power to the extent the powerholder's property (if the power is *presently exercisable*) or the powerholder's estate is insufficient. This is the biggest change from traditional law principles under the Uniform Power of Appointment Act, and this is the provision of the Uniform Act that states are most likely to consider changing.
- **Similar PLRs.** Other PLRs that have addressed formula general powers of appointment include PLRs 200604028 and 200403094.

10. FLP Assets Included Under §2036(a)(1); Application of §2043 Consideration Offset; Formula Transfer to Charitable Lead Trust Not Respected; Loans Not Respected; No Deduction for Attorney's Fee, *Estate of Howard V. Moore v. Commissioner*, T.C. Memo. 2020-40, *aff'd*, 128 AFTR 2d 2021-6604 (9th Cir. Nov. 8, 2021)

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

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

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

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

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

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

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

The court also determined that (1) the $2 million transfers to the children in return for notes were actually gifts (with a detailed review of factors considered in determining whether bona fide debt exists), (2) additional gift taxes resulting from those gifts must be included in the gross estate under §2035(b) because the gifts were made within three years of death, and (3) a flat fee of $475,000 for attorney's fees was not deductible because the evidence did not establish what services were performed for the fee and that it was necessarily incurred in the administration of the estate.

The estate appealed only the denial of the charitable deductions to the Court of Appeals for the Ninth Circuit. In a short unpublished opinion, the Ninth Circuit affirmed on the narrow ground that the specific wording in the formula, which the court found unambiguous, limits any transfer to charity, without addressing the Tax Court's additional more general rationale denying the charitable deduction because the formula charitable transfer depended on subsequent events (the tax litigation). *Estate of Howard V. Moore v. Commissioner,* T.C. Memo. 2020-40 (April 7, 2020, Judge Holmes), *aff'd*, 128 AFTR 2d 2021-6604, Docket No. 20-73013 (9th Cir. Nov. 8, 2021).

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

b. **Estate Inclusion Under §2036(a).** Not surprisingly based on the facts, the court determined (after a lengthy analysis) that the farm was included in the gross estate under §2036(a)(1).

c. **Section 2043 Consideration Offset Discussion.**

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

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

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

(2) **Section 2043 Background.** The §2043 analysis was not actually "discovered" in *Powell*. The plurality opinion's summary of how §2043 applies in the context of §2036 FLP cases is similar to

what Professor Jeffrey Pennell has been telling planners for decades. *See*, *e.g.,* Pennell, *Recent Wealth Transfer Developments*, ABA REAL PROP., PROB. & TR. LAW SECTION 14TH ANN. EST. PL. SYMPOSIUM, at 21-23 (2003).

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

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

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

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

Over the last 24 years preceding the *Moore* decision, 22 cases (see Item 9.f of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**) had held that the value of assets contributed to a family limited partnership or LLC were included in a decedent's estate under §2036, but *none* of those cases, other than *Powell*, included both the FLP assets and the FLP interest in the gross estate. Despite this long history of FLP/§2036 cases and other examples of avoiding double inclusion described above, the *Moore* opinion responds:

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

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

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

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

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

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

Tax litigators observe that IRS representatives are now making the §2043 argument in FLP cases where the assets have appreciated, and estates are similarly making that argument in situations in which the assets contributed to an FLP or LLC have declined in value after the date of the contribution to the entity.

(6) **ACTEC Comments to IRS Recommending Adoption of the Position of the *Powell* Concurring Opinion.** The American College of Trust and Estate Counsel (ACTEC) filed comments with the Internal Revenue Service on May 26, 2021, recommending issues for inclusion in the 2021-2022 Treasury Priority Guidance Plan. The comments include a recommendation that if assets contributed to a partnership (or LLC) are included in the contributor's gross estate under §2036, unless what was transferred into the entity has been re-transferred or unless some third party paid consideration for what is included in the estate under §2036, the entity interest itself should not also be included under §2033. For a more detailed discussion of the ACTEC position see Item 10.c(6) of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

d. **No Charitable Deduction for Formula Transfer Attributable to Additional Value in Gross Estate Resulting From Estate Tax Audit.**

(1) **Facts and Tax Court Analysis.** Formula transfers to charity (to the Charitable Trust) were included in two places. (1) The Living Trust transferred to the Charitable Trust a portion of assets in the Living Trust sufficient to "result in the least possible federal estate tax payable as a result of my death." (2) The Irrevocable Trust (which owned the 95% limited partnership interest in the FLP) instructed the trustee to "distribute an amount equal to the value of any asset of this trust which is includible in my gross estate for federal estate tax purposes" to the Living Trust to be distributed in accordance with its terms (which included the formula charitable transfer described immediately above).

The IRS did not contest at least some of the charitable deduction claimed on the Form 706 for the formula amount left to the Charitable Trust based on values reported on the Form 706. Thus, the initial funding of the formula charitable transfer in the Living Trust based on values of assets and deductions reported on the Form 706 was respected, at least in part.

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

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

Observation: In one respect, this is nit-picking over words (and suggests that different drafting might have avoided the court's analysis), but in a broader respect this raises the same issue that has been referred to in the marital deduction context (at the death of the first spouse) as the "marital deduction mismatch" issue. An "amount" is included in the gross estate equal to the full undiscounted value of the farm, but all the trust owns to leave to charity is a discounted partnership interest. Indeed, footnote 23 of the opinion indicates that the IRS made an alternative argument that even if the formula clause is respected, "the Irrevocable Trust lacks the assets to donate a sum large enough to eliminate the estate tax." This issue is discussed in Item 13.d(7) below.

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

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

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

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

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

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

(2) **Ninth Circuit Analysis**. The estate appealed only the denial of the charitable deductions to the Court of Appeals for the Ninth Circuit. In a short unpublished opinion, the Ninth Circuit affirmed on the narrow ground that the specific wording in the charitable formula from the Irrevocable Trust to the Living Trust (which had its own charitable formula transfer) was "an amount equal to the value **of any asset of this trust** which is includible in my gross estate for federal estate tax purposes." The proceeds from the sale of the farm were included in the gross estate under §2036, but the Irrevocable Trust owned 98% of the partnership that had owned the farm, not the farm itself or its sale proceeds, and the partnership agreement provided that no partner had any interest in any of the assets of the partnership. The estate argued that "assets of this trust" is ambiguous, and that clause should be construed to encompass the assets of the partnership to effectuate the settlor's intent. The court of appeals disagreed, finding that the language was unambiguous. "The Trustee of the Irrevocable Trust was therefore not required to transfer the Farm's proceeds to the Living Trust and eventually to the Charitable Trust," so the additional charitable deduction was denied.

The court of appeals did not address the second "much more general problem" posed by Judge Holmes denying the effectiveness of a formula charitable transfer on the grounds that the charitable deduction was not ascertainable at the decedent's date of death. That second rationale seems suspect (as discussed immediately below), and fortunately the Ninth Circuit did not express its approval of that analysis. Indeed, the Ninth Circuit had previously affirmed *Petter*, which had given effect to a defined value clause case involving a formula charitable transfer.

e. **Tax Court's Rationale Denying Formula Charitable Deduction Based on Subsequent Events Seems Incorrect.** The Tax Court's second rationale questioned the validity of charitable formula transfers generally, as least for formula transfers depending on any contingency other than valuation issues. The Tax Court opinion drew a distinction between estate tax examinations and court determinations of value versus other issues. A contingency based on ultimate determination of valuation issues is not a "transfer … contingent on the happening of some event." The opinion reasoned that in *Christiansen* and *Petter* (opinions also written by Judge Holmes that recognized a formula transfer), "we *knew* the charity clearly would receive assets, just not how much. Here we *don't know* if the charity would get any additional assets at all." (Emphasis in original.)

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

Classic testamentary marital deduction formula clauses traditionally take into account a wide variety of factors, not just valuation issues, to leave enough assets to a surviving spouse in order to avoid or minimize federal estate tax (analogous to the "least possible federal estate tax" formula charitable

clause in *Moore*). Adjustments in estate tax examinations or litigation are taken into consideration in applying the formula marital bequest. Irrevocable life insurance trusts frequently provide that any portion of the life insurance that is owned by the trust that is determined to be in settlor's gross estate will pass to a trust designed to qualify for the marital deduction. If the formula transfer in the *Moore* case had been to a surviving spouse or marital trust, perhaps the formula bequest would have been respected, assuming sufficient estate assets were available to satisfy the formula bequest. *E.g.*, *Estate of Turner v. Commissioner*, 138 T.C. 306 (2012) (sometimes referred to as "*Turner II*").

The appeal of *Estate of Moore* was heard by the Ninth Circuit Federal Court of Appeals, which approved the *Petter* defined value clause case involving a formula charitable transfer. Fortunately, the Ninth Circuit did not express its approval of the Tax Court's second rationale, which would bring into question formula transfers generally.

f. **Transfers in Return for Notes Not Respected as Loans but Are Treated as Gifts.** Mr. Moore directed the FLP to transfer $500,000 to each of his four children in return for a five-year note bearing interest at a rate of 3.6% from each of the children. The court treated these advances as gifts from Mr. Moore rather than legitimate debt transactions, as discussed in Item 27.h of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. The loan versus gift issue was also addressed by the court in *Estate of Bolles v. Commissioner*, T.C. Memo. 2020-71, discussed in Item 28 of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

11. Gift and Sale of Partnership Interests Expressed as Dollar Amounts Based on Subsequent Appraisals, Lack of Control and Lack of Marketability Discounts, Multi-Tiered Discounts, *Nelson v. Commissioner*, T.C. Memo. 2020-81, *aff'd*, 128 AFTR 2d 2021-6532 (5th Cir. November 3, 2021)

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

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

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

The court allows significant multi-tiered discounts. It ultimately determined that the 27% interest that the partnership owned in the holding company was valued using a 15% lack of control discount (slightly lower than the taxpayers' expert's position of a 20% discount but higher than the IRS's expert's 0% discount) and 30% for lack of marketability (agreed to by experts for both the taxpayers and the IRS). The holding company value was then used to determine the value of the limited partner interests, which the court determined using a 5% lack of control discount (compared to 15% by the taxpayer's expert and 3% by the IRS's expert) and a 28% lack of marketability discount (compared to 30% by the taxpayers' expert and 25% by the IRS's expert). The values determined by the court resulted in an additional gift value of about $4.5 million.

Despite the favorable valuation result, Mr. and Mrs. Nelson filed notices of appeal of the Tax Court's decision to the Court of Appeals for the Fifth Circuit on the sole ground that the Tax Court incorrectly found that the transfers consisted of percentage interests rather than fixed dollar amounts. The Fifth Circuit affirmed the Tax Court, finding that "[t]he transfer documents clearly and unambiguously state that Mary Pat was gifting and selling the percentage of limited partner interests that an appraiser determined to have a fair market value equal to a stated dollar amount." *Nelson v. Commissioner*, T.C. Memo. 2020-81 (Judge Pugh), *aff'd*, 128 AFTR 2d 2021-6532, Cause No. 20-61068 (5th Cir. November 3, 2021).

For a detailed discussion of the facts, court analysis, and planning implications of *Nelson* (including the issues relating to the sale of assets in return for a note using the AFR as the interest rate for the note and regarding split gift elections for SLATs, see Item 24 of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. For a further discussion of issues regarding the split gift election, see Item 21.a of Heckerling Musings and Estate Planning Current Developments (September 2021) found **here** available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Fifth Circuit Analysis.** The Fifth Circuit affirmed the Tax Court's finding that the "transfers consisted of percentage interests, rather than fixed dollar amounts." The Fifth Circuit agreed that the transfer documents "clearly and unambiguously" transferred a percentage of limited partner interests that an appraiser determined to have a fair market value equal to a stated dollar amount, as distinguished from formula transfer clauses defining interests transferred as the fair market value as determined for federal gift or estate tax purposes that were used in the *Petter*, *McCord*, *Hendrix*, and *Wandry* cases. Also, the transfer language did not discuss what should happen to any additional shares that were transferred should the valuation be successfully challenged. The Fifth Circuit viewed this as a simple analysis, referring to the government's folksy analogy to a farmer selling cows.

> [I]f a farmer agrees to sell the number of cows worth $1,000 as determined by an appraiser, and the appraiser determines that five cows equals that stated value, then the sale is for five cows. If a later appraisal determined that each cow was worth more, and that two extra cows had been included in the sale, nothing in the agreement would allow the farmer to take the cows back. The parties would be held to what they agreed—a transfer of the number of cows determined by the appraiser to equal $1,000. So too here. No language in the transfer agreements allows the Nelsons to reopen their previously closed transaction and reallocate the limited partner interests based on a change in valuation.

Simple as that. Furthermore, no objective facts outside the language in the documents suggest a different result. The estate merely points to the desire of the taxpayers to "protect their assets while also avoiding as much tax liability as possible." Also, the fact that the appraiser did not complete the appraisal within the allotted times specified in the agreement does not change the result.

c. **Observations.**

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

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

(2) **Importance of Using Grantor Trusts With Defined Value Transfers.** The facts of *Nelson* illustrate the importance of using grantor trusts with defined value transfers. If the amount transferred depends on values as finally determined for gift tax purposes, the amounts actually transferred may not be determined for years. In the meantime, income tax returns are filed, reflecting the anticipated amounts that were transferred. If the defined value transfer is made to

a grantor trust, even if the ownership percentages change as a result of a gift tax audit, all the income and deductions will have been reported on the grantor's income tax return in any event, and no corrective returns should be necessary (unless the parties wish to file corrected entity level returns to make clear the appropriate sharing of profits and losses of the entity's owners).

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

As a result of the settlement discussions with IRS Appeals, the taxpayers attempted to adjust the percentage interests transferred from 64.79% (for the gift and sale) to only 38.55%. If that had been the effect of the assignment clauses, the parties would have decreased the Trust's interest in the FLP (with underlying assets of over $60 million) by 26.24%, or a reduction of the Trust's value by about $15.9 million, without counting subsequent appreciation and income. In effect, the taxpayers will pay an additional $2 million of gift tax in order to keep in the Trust an additional $15.9 million, plus untold subsequent appreciation and income (unreduced by income tax because the grantor pays it) that has accumulated in the Trust during the intervening twelve years, which amount could now be multiples of $15.9 million. Even in the face of that seemingly outstanding valuation result compared with the taxpayers' apparent settlement position, however, Mr. and Mrs. Nelson filed notices of appeal of the Tax Court's decision to the Court of Appeals for the Fifth Circuit but wisely did not contest the Tax Court's determination of value, only that the transfer should have been of a fixed dollar amount.

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

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

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

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

A client of the Taylor Lohmeyer law firm was audited, and the client agreed to pay about $4 million in tax, interest, and penalties regarding the assignment of income to foreign accounts that the law firm had helped him structure. The IRS issued a "John Doe summons" to the law firm to disclose the names of all clients over a 23-year period that had used the law firm's services "to acquire, establish, maintain, operate, or control" any foreign account, any foreign legal entity, or any asset in the name of any such foreign entity.

Section 7609 addresses special procedures for third-party summonses, and lists requirements for a John Doe summons, "which does not identify the person with respect to whose liability the summons is issued." One of those requirements is that "there is a reasonable basis for believing that such person or

group or class of persons may fail or may have failed to comply with any provision of any internal revenue law." §7609(f)(2).

The law firm acknowledged the general rule that a client's identity is not protected from the attorney-client privilege and is subject to subpoena but argued that an exception applies when disclosure of the identity necessarily discloses the substance of the legal advice. The enforcement of the summons was upheld because the summons would not reach:

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

Taylor Lohmeyer Law Firm P.L.L.C. v. United States, 957 F.3d 505, 513 (5th Cir. April 24, 2020), *petition for en banc rehearing denied,* 126 AFTR 2d 2020-7208 (Dec. 14, 2020), *aff'g* 123 AFTR 2d 2019-1847 (W.D. Tex.), *cert. denied,* S. Ct. Dkt. No. 20-1596 (Oct. 4, 2021).

The Supreme Court denied certiorari in an October 4, 2021 order.

Advisors have indicated that the IRS "is actively challenging the assertion of attorney-client privileges in tax cases" and the Fifth Circuit's decision "could deter individuals from seeking legal advice." *See* Kristen Parillo, *SCOTUS Won't Review John Doe Summons Dispute*, TAX NOTES (Oct. 5, 2021). As an example, IRS officials have indicated that they will continue the increased use of John Doe Summonses as an enforcement tool against illicit cryptocurrency transactions. Mary Katherine Browne, *A Look Ahead: John Doe Summonses to Increase in Crypto Crackdowns*, TAX NOTES (Dec. 23, 2021).

For a summary by Ronald Aucutt of the analysis of the issues by the District Court and the Fifth Circuit Court of Appeals, see Item 33 of Estate Planning Current Developments (December 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

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

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

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

The estate argued that the 100% interest in the LLC that was left to two charities should be completely offset by the estate tax charitable deduction (because the 100% interest was donated entirely to charities), but the court concluded that a charitable deduction was allowed only for the

value passing to each charity. The parties had agreed that a 27.385% discount applied for the 25% passing to the church and a 4% discount applied for the 75% passing to the foundation. (Applying discounts to the charitable deduction reduced the charitable deduction by over $2.5 million.)

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

The case was appealable to the Ninth Circuit Court of Appeals, but it was not appealed following the entry of a stipulated decision on October 9, 2021. *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (Feb. 18, 2021) (Judge Buch).

b. **Basic Facts.** Mr. and Ms. Warne amassed various real estate properties beginning at least in the early 1970s. Over time, the real estate properties were owned in five separate LLCs. Mr. Warne died in 1999. Ms. Warne made gifts of various minority interests in the LLCs to her two sons in 2012, and Ms. Warne died in 2014. The 2012 gift tax return was filed (late) at the same time as Ms. Warne's estate tax return (which was timely filed), in May 2015.

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

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

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

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

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

c. **Analysis.**

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

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

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

The court emphasized that majority interests were being valued and that the LLCs all grant significant powers to the majority interest holder (including the power to dissolve and to remove and appoint managers). The court pointed to cases that have held that no lack of control discount applies in similar situations (*Estate of Jones v. Commissioner*, 116 T.C. 121, 135 (2001); *Estate of Streightoff v. Commissioner*, T.C. Memo. 2018-178) and hinted that it might have concluded that *no* lack of control discount was allowed, but "[b]ecause the parties agree to a discount for lack of control, we will find one; however, given the control retained by the Family Trust, the discount should be slight."

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

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

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

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

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

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

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

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

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

d. **Observations.**

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

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

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

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

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

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

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

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

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

reduction of the charitable deduction would have applied because the entire 100% interest would have been transferred from the estate to a single charity.

(5) **Policy Rationale for Discounts When Asset Passes Entirely to Multiple Charities.** The ability to avoid the reduction of the charitable deduction under the *Warne* analysis merely by leaving the asset first to a foundation or donor advised fund, which could then distribute the asset to multiple charities, raises the question of the policy rationale of denying a full charitable deduction when an asset is left in its entirety to multiple charities. The court rejected the estate's attempt to distinguish *Ahmanson* because it involved splitting an asset between an *individual* and a charity rather than between two charities. The estate argued that applying discounts when the asset passed entirely to charities "would subvert the public policy of motivating charitable donations" and that leaving 100% of the LLC to charities should entitle the estate to a deduction of 100% of the value of the LLC. The court disagreed, focusing on allowing a charitable deduction for the value received by each donee.

Commentators have questioned the public policy rationale of denying a full charitable deduction when an asset is left entirely to charity, whether that is one charity or multiple charities, and suggesting that the case should be appealed for that reason. *E.g.*, Richard L. Fox & Jonathan G. Blattmachr, Estate of Miriam M. Warne - *Decedent's Splitting of Charitable Bequest of 100% LLC Membership Interest Between Two Separate Charities Results in Mismatch of Value Included in Gross Estate and Amount Allowed As Estate Tax Charitable Deduction*, LEIMBERG CHARITABLE PL. NEWSLETTER #306 (March 1, 2021).

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

(7) **Somewhat Analogous "Marital Deduction Mismatch" Argument for §2036 FLP Situations.** The IRS has made the similar argument in cases involving family limited partnerships if the undiscounted value of the assets contributed to the partnership is included in the gross estate under §2036, arguing that a marital deduction is allowed only for the discounted limited partnership interest that actually passes to the surviving spouse. This situation arises when a spouse contributes assets to an FLP, retains most of the partnership interests until his death, and dies with a formula marital deduction clause that leaves assets to the surviving spouse to minimize estate taxes, and the value of the assets contributed to the partnership is included in the gross estate under §2036. In two reported cases (*Estate of Black v. Commissioner*, 133 T.C. 340 (2009), and *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21) the IRS has made the argument that while the value of the partnership *assets* is included in the gross estate (without a discount), the estate actually owns only a limited partnership or LLC interest and does not own the assets directly. While the IRS has made this argument in several cases, no court has yet faced the marital deduction mismatch issue in the context of §2036 FLP cases. For further discussion of and comments from briefs in cases where the IRS has raised this issue, see Item 13.d(7) of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

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

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

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

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

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

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

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

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

The federal district court held for the Fund, reasoning:

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

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

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

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

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

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

b. **Planning Pointers from *Fairbairn*.**

- Many DAF sponsors have similar written policies (perhaps not to sell $100 million worth of shares ALL the NEXT day and all within 2½ hours).
- This is a recent case that made headlines in the public media.
- The DAF sponsor is in control of when to liquidate assets contributed to the fund.
- A contributor should assume the DAF sponsor will sell all the next day.
- The contributor should spread out contributions to assure the sponsor will not sell $100 million the next day, all within 2½ hours (ostensibly causing a huge price decline within that short time frame). That's why the December 28 contribution date is significant in this case. The donor did not have time to spread out contributions and still get a charitable contribution for 2017.

c. **Synopsis of *Pinkert*.** A Magistrate Judge for the federal district court in the Northern District of California has similarly denied relief for a donor of a donor advised fund against the fund's sponsor, but the rejection of the donor's claim was based on a lack of standing rather than a substantive finding that the sponsor did not breach a fiduciary duty as in *Fairbairn*. The Schwab Charitable Fund (the "Fund") is legally independent of the Schwab Corporation, but the Fund used the brokerage services and investment products of Schwab Corporation, and "every person working for [the Fund] is actually an employee of the Schwab Corporation." The donor's assertions included that (i) cheaper alternative index funds and money-market funds could have been used, (ii) the Fund invested in retail products rather than lower-priced wholesale products available to institutional investors, (iii) the Fund could have used its marketing power to negotiate lower rates, and (iv) the Fund benefitted Schwab Corporation to the Fund's detriment. The order reasoned that the donor gave up exclusive legal

control and ownership of the assets contributed to the Fund. To have standing under Article III of the U.S. Constitution, the plaintiff must have (i) suffered an injury in fact (an invasion of a legally protected interest that is concrete and particularized and actual or imminent), (ii) that is fairly traceable to the defendant's alleged conduct, and (iii) that is likely to be redressed by a favorable judicial decision. The court stated that the donor's advisory privileges regarding distribution or investment decisions do not equate to a concrete protected interest considering the Fund's exclusive legal control over the donated assets. A plaintiff must assert injury to his own legal rights, not the legal rights of others, and the plaintiff is not a beneficiary of the Fund. The court distinguished *Fairbairn* because it was a misrepresentation and breach of contract case involving allegations that the sponsor broke specific promises rather than a general claim of mismanagement (but, in fact, the court in *Fairbairn* stated that the plaintiff contended, apart from alleged promises, that the sponsor "violated the duty of care" owed to the donor). The order also reasoned that the plaintiff lacked standing under California law. *Pinkert v. Schwab Charitable Fund*, No. 3:20-cv-07657 (N.D. Calif. Order dated June 17, 2021).

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

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

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

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

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

For an insightful discussion about the case, see Scott St. Amand, *Valuing a Complex Legacy: Lessons in Valuation From Estate of Jackson*, BLOOMBERG ESTATES, GIFTS & TRUSTS J. (Sept. 9, 2021).

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

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

c. **Valuation of Decedent's Image and Likeness; Publicity Rights.** The decedent's legal rights in property are determined under California law, where the decedent was domiciled at his death. After

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

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

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

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

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

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

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

f. **Credibility of IRS's Expert.** The court made a point of noting that the IRS's expert lied twice at trial. (1) When asked if he had ever represented the IRS before and whether he wrote a valuation report for the IRS in Whitney Houston's estate tax case, he said "No, Absolutely not." The court responded, "That was a lie." (After "recess and advice from the Commissioner's counsel," the expert admitted he had been retained by the IRS in that case.) (2) The expert also "testified that

neither he nor his firm ever advertised to promote business. This was also a lie." He had sent an email blast bragging that he "is the expert of the century and will be testifying on behalf of the IRS," and he referred to his involvement in this "Billion Dollar Case" in a lecture given before trial. The estate moved to strike his entire testimony, as tainted by perjury. The court found that remedy "too severe," but concluded that the court would "discount the credibility and weight we give to [the expert's] opinions."

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

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

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

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

The Tax Court refused to allow tax-affecting in valuing an S corporation on the income method in *Gross v. Commissioner*, T.C. Memo. 1999-254, and Tax Court cases after that time consistently refused to allow tax-affecting until the *Estate of Jones v. Commissioner* case in 2019, T.C. Memo. 2019-101 (Judge Pugh). In *Jones*, the court explained that prior cases such as *Gross*, *Gallagher*, and *Giustina* did not prohibit tax-affecting the earnings of a flowthrough entity *per se*. The court viewed those cases as concluding that (1) assuming a zero income tax rate on the earnings properly reflected the overall tax savings of operating as an S corporation (*Gross v. Commissioner*), (2) the taxpayer's expert did not justify tax-affecting the earnings in balancing the burden of the individual level tax with the benefit of the reduced total tax burden (*Estate of Gallagher v. Commissioner*), and (3) tax-affecting the earnings resulted in a post-tax cash flow but the expert applied a pre-tax discount rate (*Estate of Giustina v. Commissioner*). In *Jones*, on the contrary, Judge Pugh concluded that the taxpayer's appraiser considered both the advantages as well as the disadvantages of operating as an S corporation and that the taxpayer's expert's "tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate." Judge Pugh viewed the issue as fact-based and noted that the court in the prior cases had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases. For a more detailed discussion of *Estate*

of Jones (as well as another 2019 federal district court case that accepted an expert's report using tax-affecting, *Kress v. United States*, 123 AFTR 2d 2019-1224 (E.D. Wis. 2019)), see Items 33 and 34 of Estate Planning Hot Topics and Current Developments (December 2019) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)**.

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

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

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

John Porter suggests that if the IRS argument is that a hypothetical buyer would not be a C corporation that would be subject to a corporate level tax as well as a tax to shareholders on dividends, that assumes that the hypothetical buyer would be an S corporation, which reduces the pool of prospective purchasers and should increase the level of the lack of marketability discount.

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

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

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

developing as to whether an individual can incorporate the laws of another state's statute regarding post-death rights by transferring the publicity rights to an entity created and operated in that state prior to death.

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

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

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

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

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

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

> For example, one entity could be created to manage endorsement contracts, appearance contracts and related existing contracts. It could receive a percentage fee for this, or actually be the recipient of the contract income. Another entity could own and license the right of publicity (to the management entity). A third could own memorabilia and other tangible assets (a potentially significant category in its own right for athletes). Tom Abendroth, *Estate Planning With the Right of Publicity*, ACTEC Estate & Gift Tax Committee (June 2021).

(Judge Holmes in *Estate of Jackson* noted that the IRS's expert kept trying to aggregate all assets associated with his right of publicity, including copyrights in musical compositions and performances, but those had already been transferred to separate entities.)

(4) To the extent possible, give the structure the characteristics of an active business (which may not be possible if all management responsibilities are outsourced). A business structure may achieve income tax benefits (such as qualifying for business deductions and avoiding the 3.8% NII tax) and estate tax benefits (such as qualifying for the bona fide sale for full consideration exception to §2036 and §2038). *Id.*

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

a. *Estate of Morrissette v. Commissioner.*

(1) **Synopsis.** Mrs. Morrissette (actually her revocable trust) paid large lump sum premiums ($29.9 million) for Dynasty Trusts to purchase universal life insurance policies on the lives of her three sons to fund buy-sell agreements to assure that ownership of a long-term very successful business would remain in the family. The advances were made under split-dollar arrangements providing that Mrs. Morrissette would be repaid the amount of the advances or, if greater, the cash surrender values of the policies. The reimbursement amount would be repaid when the split-dollar agreements were terminated at the respective deaths of the sons, when the trusts cancelled the policies, or when the parties mutually agreed to terminate the agreements. The estate valued the rights to be repaid for the premium advances at about $7.5 million (primarily because of the delay of when the repayments would be made), and the IRS valued the reimbursement rights at the cash surrender value of the policies at the date of Mrs. Morrissette's death (about $32.6 million).

In an initial opinion, the court held that the split-dollar agreements complied with the economic benefit regime, the decedent did not make taxable gifts of the premiums when the $29.9 million advance was made, and the Dynasty Trusts did not have current access to the cash surrender values immediately. *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016). The court entered an Order on June 21, 2018 denying the taxpayer's motion for summary judgment that §2703(a) was inapplicable (based on the court's reasoning in *Cahill v. Commissioner*) concluding that "[t]he restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2)." The IRS and estate subsequently filed motions for partial summary judgment regarding §2036(a)(2), §2038(a)(1), and trying again regarding §2703(a). The court entered an Order dated February 19, 2019 denying the taxpayer's motions for summary judgment that §2036(a)(2), §2038(a)(1), and §2703(a) do not apply. The court merely reasoned that *Estate of Cahill* "is directly on point" as to §2036(a)(2) and §2038(a)(1) but denied the IRS's motion for summary judgment regarding those sections because a material factual dispute exists concerning the issue of full and adequate consideration as to §2036 and §2038 and concerning whether the transfer satisfied the safe harbor in §2703(b). (For a summary of the analysis in *Estate of Cahill* about §2036, §2038, and §2703, see Item 8.c(2) above.)

The court held that (a) the advanced premiums or cash surrender values are not included in the estate under §2036 or §2038 because the $29.9 million premium advance transfers were made in a bona fide sale for adequate and full consideration, (b) the special valuation rules of §2703 do not require inclusion of the cash surrender values of the policies in the estate because the safe harbor exception in §2703(b) was satisfied, (c) the value of the estate reimbursement rights was determined under a discounted cash flow analysis, using an assumption that the repayment would be made three years after the estate tax return was filed (which greatly increased the value as compared to assuming that the repayment would not be made until the sons' respective deaths), and (d) the 40% gross valuation misstatements penalty under §6662 was appropriate, and the estate's reliance on its appraiser's valuation of the rights was not reasonable. *Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60 (May 13, 2021) (Judge Goeke).

On December 13, 2021, the court entered a Decision, based on calculations implementing its opinion to which the parties had agreed, determining an estate tax deficiency of $12,575,459.24 and an accuracy-related penalty of $3,232,339.89, both subject to interest.

For an excellent summary of this second *Morrissette* opinion (sometimes referred to as "*Morrissette II*") and of general planning issues involving intergenerational split-dollar life insurance, see Mitchell Gans & Martin Shenkman, *Morrissette II: Why the Tax Court May Have Improperly Applied the Hypothetical Purchaser Framework*, LEIMBERG ESTATE PLANNING NEWSLETTER #2896 (July 19, 2021).

(2) **Facts and Court Analysis.** For a summary of the case facts and the court's analysis of issues, see Item 16.a(2)-(6) of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(3) **Value of Reimbursement Rights.** The estate valued the reimbursement rights on the estate tax return at about $7.5 million (representing about a 75% discount from the $29.9 million amount advanced). The estate conceded that a mechanical mistake in one of the taxpayer's expert's appraisals meant that the appraiser's value would have been about $10.4 million, but another appraiser for the estate valued the reimbursement rights at about $7.8 million. (The reimbursement payment rights at the date of the decedent's death would have been about $32.6 million, the cash surrender value of the policies, but the revocable trust had no way to force the immediate cancellation of the split-dollar agreements and immediate payment.) The IRS's notice of deficiency valued the reimbursement rights at about $32 million, the cash surrender value of the policies. The IRS's expert valued the reimbursement rights at about $17.5 million assuming the split-dollar agreements remained in effect until the sons' deaths and at about $27.9 million assuming they were terminated three years after the estate tax return was filed. (**Observe:** The assumed termination date has the biggest impact on the valuation of the reimbursement rights – in this case $17.5 million versus $27.9 million in the IRS's expert's opinion.)

In valuing the reimbursement rights of the revocable trust, the estate's and IRS's experts both applied a discounted cash flow analysis. The primary factors in the analysis were determining (a) the appropriate discount rates to determine the present value of the anticipated cash flows and (b) the repayment schedule.

For the discount rates, the court agreed with the IRS's expert's use of returns on corporate bonds and company specific debt (discount rates of 6.4% and 8.85% for the two insurance companies after applying a small illiquidity premium) and rejected the taxpayer's expert's use of life settlement data (which reflected discount rates of 15% and 18%) because of the lack of transparency in that data.

Much more important in the ultimate valuation determination was the court's agreement with the IRS position assuming that the split-dollar agreement would be ended following the decedent's death (three years after the estate tax return was filed) rather than much later at the sons' subsequent deaths. The taxpayer argued that no pre-arranged plan for early termination existed and that the policies would be retained until the sons' respective deaths. The court pointed to an inquiry by one of the sons 10 months after the decedent's death about cancelling the policies, but an attorney advised "that the IRS had three years to audit the estate tax return and insisted that the policies remain in effect until the IRS audit was settled." The court accepted the IRS's proposed termination date of three years after the estate tax return was filed. The court said that the "key factor in setting the December 31, 2013, maturity date [i.e., about three years after the estate tax return was filed] is the brothers' complete control over the split-dollar agreements.… [T]here are grounds for setting an earlier maturity date, but we will use respondent's date."

A significant factor in the court's reasoning is that the trusts that owned the policies could trigger the acceleration of the decedent's reimbursement rights by cancelling the policies, and one of the sons actually asked about cancelling the policies before the estate tax return was filed for the estate. Furthermore, the revocable trust left to each Dynasty Trust the decedent's interest in the reimbursement rights that were attributable to the policies owned by that trust. Changes in those facts might have led to a somewhat different outcome as to the termination date used for valuing the reimbursement rights considering that the assumed termination date was the biggest factor in the valuation of the reimbursement rights. But the judge's ultimate decision regarding the valuation issue appears colored by the court's "gut reaction" that the estate had grossly undervalued the rights. For example, the court rationalized that the decedent received adequate and full consideration for purposes of satisfying the bona fide sale for adequate and full consideration exception to §2036 and §2038 even though the immediate value of the reimbursement right was economically worth far less than the $29.9 million advance because of other nontax benefits the overall insurance and business succession plan achieved, but the court observed its agreement with the IRS "that a rational investor would not give up approximately $23 million in value to achieve the nontax purposes achieved through the split-dollar agreements." And in the discussion of penalties, the court made very clear its view of having the revocable trust "pay $30 million and [turn] it into $7.5 million for estate tax reporting purposes. They should have known that the claimed value was unreasonable and not supported by the facts."

(4) **Penalties.** The IRS revenue agent initially did not believe that an accuracy related penalty was appropriate, but his supervisor convinced him that the 40% gross valuation misstatement penalty under §6662(h) should be imposed. While reliance on professional advice may provide a reasonable cause defense if the reliance was reasonable and in good faith, the court reasoned that the estate's reliance on its professional appraisal was not reasonable (among other things, the court pointed out that the sons should have known that valuing a right to receive repayment of about $30 million (or more) at only $7.5 million "was unreasonable and not supported by the facts," and the appraiser lowered the value from his initial opinion following a review of the appraisal by the estate's attorney), and the estate did not rely on it in good faith. The court also observed that the "legal advice" defense was waived by asserting the attorney-client privilege and that the intergenerational split-dollar transaction was marketed as a strategy to undervalue transfers. The harsh 40% penalty may deter taxpayers and planners from using intergenerational

split-dollar life insurance arrangements and claiming extremely large valuation discounts. *See* Kristen A. Parillo, *Tax Court Decision Could Chill Split-Dollar Arrangement*, TAX NOTES (June 9, 2021).

The court did not criticize the professional appraiser's credentials or experience as a professional appraiser. Indeed, the estate produced a second professional appraiser from a highly respected appraisal firm who also valued the reimbursement right at the trial and similarly valued the reimbursement right at far less than the court's determination. This factual situation is unlike that in *Estate of Richmond v. Commissioner*, T.C. Memo. 2014-26, in which the court held that reliance on an appraisal did not meet the reasonable cause exception where the estate relied on an unsigned draft report by an accountant who had some experience preparing appraisals (having written 10-20 valuation reports) but did not have any appraiser certifications. This leaves taxpayers (and their planners) in the precarious position of having to determine the correctness of a professional appraisal that is based on technical analysis and is not just a summary estimate of value.

Morrissette II's approach as to penalties is contrasted with the approach in the recent *Estate of Michael Jackson* case (discussed in Item 15 above, in which the court held that reliance on a professional appraisal constituted reasonable cause even though the appraised value was miniscule compared to the court's determination of value ($2,105 vs. $4.15 million for the value of the decedent's image and likeness)).

(5) **Decision Determining Deficiency.** On December 13, 2021, the court entered a Decision, based on calculations implementing its opinion to which the parties had agreed, determining an estate tax deficiency of $12,575,459.24 and an accuracy-related penalty of $3,232,339.89, both subject to interest. While the determined deficiency reflects estate tax values of the reimbursement rights significantly higher than those asserted by the executors, the deficiency is significantly less than the approximately $39.4 million the IRS had asserted in its notice of deficiency.

b. ***Estate of Levine v. Commissioner.***

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

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

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

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

The court determined that §2036(a)(1) did not apply because the decedent did not retain anything and could not surrender the policies or terminate the split-dollar arrangement. Sections 2036(a)(2) and 2038 also did not apply. Under the documents, the decedent had no right to the cash surrender values or to join with someone else in getting current access to the cash surrender values. But under general contract principles, all of the parties to a contract could amend it at any time; however, that was not sufficient to cause the decedent to have a right "in conjunction with" another to designate who could enjoy the property under §2036(a)(2) or to alter, amend, or terminate the arrangement under §2038. The court relied on *Helvering v. Helmholz* (U.S. Sup.Ct. 1935) and *Estate of Tully v. United States* (Ct. Cl. 1976) to conclude that rights to modify

contracts under general default rules of contract are not rights held "either alone or in conjunction with any other person" under §2036(a)(2) or §2038.

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

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

(2) **Basic Facts.** The decedent's revocable trust advanced $6.5 million of premiums under an intergenerational split-dollar arrangement with an irrevocable life insurance trust that owned second-to-die policies on the lives of the decedent's daughter and her husband. The revocable trust was entitled to reimbursement of the advance upon the death of the last of the insureds or earlier upon the termination of the split-dollar arrangement or the surrender of the policies by the life insurance trust. The revocable trust would receive the greater of the advance ($6.5 million) and cash surrender value of the polices upon the death of the last to die of the insureds or upon the earlier termination of the agreement.

If the irrevocable life insurance trust terminated the arrangement early, the revocable trust would have received the entire cash surrender value of the policies and the life insurance trust would have received nothing.

The life insurance trust had an investment committee that directed the trust's investment decisions, and the sole member of the investment committee was an unrelated long-time business associate who had a fiduciary duty to direct the investments prudently. (The business associate also was, together with the decedent's two children, an agent for the decedent under a power of attorney and a co-trustee of the revocable trust.)

The decedent reported a gift of $2,644 (as determined under the split-dollar regulations) upon making the advance, and the decedent's estate reported that the reimbursement right was valued at a little more than $2 million. The estate and IRS later stipulated that the value of the reimbursement right at the decedent's death was $2,282,195.

The IRS asserted that the cash surrender value of the policies at the decedent's death (about $6.2 million) should be in the gross estate under §2036, 2038, or 2703 rather than just the stipulated value of the reimbursement right (about $2.28 million) and also asserted that the 40% gross undervaluation penalty applied.

The case is appealable to the Eighth Circuit Court of Appeals.

(3) **Analysis.**

(a) **Split-Dollar Regulation Does Not Determine Estate Tax Value.** Reg. §1.61-22 generally treats the amount transferred each year under a split-dollar plan governed by the economic benefit regime as the cost of current life insurance protection in that year. However, that regulation applies for income and gift tax purposes, not for estate tax purposes.

(b) **Section 2036(a)(1).** Section 2036 (a)(1) includes the value of transferred property, except for a bona fide sale for full consideration, in which the decedent retained, directly or indirectly, the possession or enjoyment of, or the right to the income from the transferred property. The decedent had no right to force the early termination of the split-dollar arrangement. Although the unrelated business associate who was the sole member of the investment committee (with the power to terminate the arrangement) was also a co-agent under the decedent's power of attorney, he could not surrender the polices as attorney-in-fact because the decedent could not do that directly. Therefore, the decedent did "not retain any right to possession or enjoyment of the property transferred."

(c) **Sections 2036(a)(2) and 2038.** The gross estate includes the value of transferred property, except for a bona fide sale for full consideration, in which the decedent, alone or in conjunction with any other person, retained the right to designate who would possess or enjoy the property or income from the property (§2036(a)(2)) or at death held the power to alter, amend, revoke, or terminate the enjoyment of the property (§2038).

An important factual difference from *Estate of Morrissette* and *Estate of Cahill* is that in those cases the donor would have to act together with the owner of the polices to terminate the split-dollar agreement (and thereby receive the cash surrender value of the policy immediately), but in *Estate of Levine*, the insurance trust had the sole right to terminate the arrangement.

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

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

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

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

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

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

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

The specific facts of the case do not raise an "in conjunction with" §2036(a)(2) or §2038 power either. The court addressed whether the powers of others in effect gave the decedent rights or powers over the cash surrender values under the specific facts involved. In particular, the unrelated business associate owed duties to the decedent under the power of attorney and also had fiduciary duties to beneficiaries of the insurance trust that owned the policies. In *Estate of Strangi* and *Estate of Powell* the court held that §2036(a)(2) triggered the inclusion of assets transferred to a limited partnership where the decedent could act with others. In *Strangi*, the decedent could act with others to dissolve a partnership and, through his son-in-law who was his agent under a power of attorney and general partner, could determine the amount and timing of distributions. Similarly, in *Powell*, the partners could act unanimously to dissolve the partnership.

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

The IRS also argued that the decedent, through her agents, "stood on both sides of these transactions and therefore could unwind the split-dollar transactions at will." But the court noted that the unrelated business associate who held the power as the sole member of the investment committee of the insurance trust to terminate the agreement held fiduciary duties to beneficiaries (grandchildren) other than the beneficiaries of the revocable trust and those grandchildren would have received nothing if the business associate had terminated the arrangement early.

The court concluded with this analysis:

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

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

(d) **Section 2703.** The §2703(a) issue is whether restrictions on repayment rights under the split-dollar agreement are 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.

Section 2703(a) provides that the value of property is determined without regard to "any restriction on the right to sell or use such property." The court noted that the "property" referred to in §2703(a) is "property of an estate, not some other entity's property."

Therefore, it could not refer to the life insurance policies that were owned by the life insurance trust and that were never owned by the decedent. The court concluded, very simply, that there were no restrictions on the receivable owned by the estate.

> The Estate argues that section 2703 applies only to property owned by Levine at the time of her death, not to property she'd disposed of before, or property like the insurance policies that she never owned at all. If the inability to surrender the life-insurance policies is considered a "restriction", it is not a restriction on any property rights held by Levine since she never owned the policies.
>
> ...
>
> The property we have to value here is the property in Levine's estate, which is the split-dollar receivable she held at the time of her death. There were no restrictions on *that* property. She could do with the receivable what she wanted. She was free to sell it or transfer it as she wished. One needs to remember that what the Estate valued on its return was the receivable owned by Levine in her Revocable Trust. Section 2703 is not relevant to the valuation of the receivable because Levine had unrestricted control of it. Section 2703 therefore does not apply.

(e) **Conclusion.** The court observed, in conclusion, that the overall effect is that the decedent made an extremely low gift and included in her estate only a fraction of the amount advanced to pay premiums. The weakness, the court concludes, "lies in the calculation of the value of the gift between Levine and the Insurance Trust—the difference between the value that her Revocable Trust gave to the Insurance Trust and what it got in return. But the gift-tax case is not this estate-tax case." The court observed that the problem is with the gift valuation rule in the regulations and "the solution lies with the regulation writers and not the courts."

(4) **Observations.**

(a) **Typical Witty Judge Holmes Opinion.** Opinions by Judge Holmes invariably are very well written, clear, and easy to understand and are also very witty. This opinion is no different. Take this paragraph as an example.

> But we do think he's correct that we also must avoid being so blinded by any formal gleam from the Estate's armor that we overlook some practical chinks that deals like this may have: Can the Commissioner dismount from purely legal or theoretical arguments and start wielding shorter, sharper weapons forged from the particular facts of particular cases?

(b) **Description of Facts.** The court described the transaction as part of the decedent's normal estate planning taking into consideration the client's unique family situation and not as an abusive transaction designed to save estate taxes. The results in an opinion can often be gleaned from the way a court describes the facts.

(c) **Stipulated Value of Receivable; No Enormous Discount.** Unlike in some prior cases, the value of the reimbursement right was not reported at pennies on the dollar. In *Cahill*, the decedent advanced $10 million toward the payment of premiums but reported the reimbursement right as having a value of only $183,700 (representing about a 98% discount). The estate in *Levine* reported the reimbursement right at a discount (about $2 million versus the $6.5 million advanced) but nothing like the 98% discount that was reported in *Cahill*. Would the court's general approach have been different if the estate had claimed a huge discount as in *Cahill*? Also, unlike the prior *Cahill* and *Morrissette* cases, the estate and IRS stipulated the value of the reimbursement right. In *Morrissette*, the court determined that §2036 and §2703 did not apply (because of the full consideration exceptions) but then valued the reimbursement right at a much higher value than proposed by the estate.

(d) **Significant Limitation of "In Conjunction With" Analysis**. The *Strangi, Powell,* and *Cahill* cases have applied a broad reach to the "in conjunction with" clause in §2036(a)(2) and §2038. Planners have noted that prior cases have placed some outer limits on how far the "in conjunction with" clause should be applied, and this court picks up on those cases. The court concludes from *Helmholz* and *Tully* that the ever-present right of parties to a contract to amend the contract will not by itself trigger estate inclusion.

(e) **Fiduciary Duties to Others Is Critical; Different Beneficiaries of Insurance Trust and Revocable Trust.** *Strangi* and *Powell* distinguished the Supreme Court's fiduciary duty

analysis in *Byrum* to find that the fiduciary duty of a party who acts in conjunction with the decedent does not shelter the estate from estate inclusion. In determining whether *Byrum* can be distinguished in a particular situation, *Levine* focuses on whether the fiduciary duty is illusory and in reality is just owed to the decedent and not to other parties. If so, the fiduciary duty is really no limitation at all on the fiduciary's ability to act in a way that would benefit the decedent.

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

(f) **Very Different Section 2703 Analysis Than in *Estate of Cahill*.** The *Levine* opinion did not point out that its analysis of the §2703 issue was markedly different than the analysis in *Estate of Cahill*. The court in *Cahill* concluded that §2703(a) applies, to disregard the irrevocable trust's ability to prevent an early termination of the agreement in valuing the reimbursement right, because the provision preventing the decedent from immediately withdrawing his advance was an agreement allowing the third party to acquire or use property at a price less than fair market value (§2703(a)(1)), and because the agreement significantly restricted the decedent's right to use his "termination rights" under the agreement (§2703(a)(2)).

The court in *Morrissette* adopted the *Cahill* reasoning. Three days after the entry of the *Cahill* decision, the Tax Court entered an Order in *Morrissette* on June 21, 2018 denying the taxpayer's motion for summary judgment that §2703(a) was inapplicable, observing that "the termination restriction prevented the decedent from terminating the split-dollar arrangements unilaterally and receiving repayment of the premium or, if greater, the policy's cash surrender value," and concluding that "[t]he restriction on the decedent's termination rights is a restriction for purposes of section 2703(a)(2)." Order in Docket No. 4415-14 (June 21, 2018 (Judge Goeke).

The *Cahill* case analyzes §2703(a) in a broad manner in which many, if not most, multi-party arrangements may be subject to the general rule of §2703(a), and the determining issue will then be whether the §2703(b) exception applies.

The §2703(a) issue for split-dollar arrangements generally is whether restrictions on repayment rights are 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 being valued and the terms of the contract are not merely a restriction on the property transferred.

The key issue that arises in determining whether §2703(a) applies to any particular "property" is whether the property being tested under §2703(a) is an asset with inherent characteristics that impact its value or whether the property is an asset subject to some agreement or restriction that allows someone to acquire or use the asset at less than its fair market value or that restricts the right to use or sell the asset, which restriction must be ignored under §2703(a) in valuing the "property."

For example, is an automobile that has a governor limiting its maximum speed to 30 miles per hour valued as an under-30 MPH vehicle (with a minimal value), or is it valued as an automobile subject to a restriction on the right to its use because the governor restricts it

from exceeding 30 MPH, which restriction must be ignored in valuing the automobile under §2703(a)?

A step removed from ignoring contractual restrictions in entity agreements, and perhaps a small step removed from the *Cahill* §2703(a) analysis, is a notion that any restriction on a person's ability to acquire the maximum possible value under a contract would be viewed as a §2703(a) restriction. The §2703(a) analysis in *Cahill* could lead to a general treatment of any contractual limitation on achieving maximum value as a §2703(a) agreement or restriction, with the key issue being whether the §2703(b) exception requirements are satisfied.

Fortunately, the *Levine* analysis approaches the §2703 issue in a much more straight-forward manner and just reasons that there is no restriction on the estate's ability to sell or transfer its reimbursement right and that §2703 does not apply.

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

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

c. **Loan Regime Case.** The existing reported cases (*Morrisette*, *Cahill*, and *Levine*) have all involved economic benefit regime split-dollar transactions. Some planners believe that economic benefit regime split-dollar transactions may carry serious gift tax risk and that loan regime transactions should be safer (but may have more risk if interest rates rise in the future). John Porter is defending a loan regime case in the Tax Court now. The IRS denied the taxpayer the right to go to appeals, stating that it views the loan regime transaction as an abusive tax avoidance transaction, that no precedent exists for loan regime situations, and that establishing a precedent would avoid proliferation of this tax avoidance transaction. John Porter believes that we will see more split-dollar cases being litigated.

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

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

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

b. **Validity of the "Protected-in-Perpetuity" Conservation Easement Regulation (At Least Regarding Improvements).** The IRS has been most successful in its attacks on conservation easements by challenging whether easements violated the requirement in regulations that the easement last in perpetuity, because upon termination or extinguishment of the easement the grantee would receive from the proceeds an amount reduced by the increase in value attributable to improvements made after the grant of the easement, which is inconsistent with the regulations. *E.g.*, *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014). For a discussion of some of these many cases, see Item 37 of Estate Planning Current Developments and Hot Topics (December 2019) found **here**, Item 39.b. of Heckerling Musings 2020 and Estate Planning Current Developments (August 2020) found **here**, and Item 38 of Estate Planning Current Developments (December 2021) found **here**, all available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. For a review of the status of the extensive case law developments regarding the "proceeds regulation," see Nancy A. McLaughlin, *Conservation Easements and The Proceeds Regulation*, 56 REAL PROP., TRUST & EST. LAW J. (Summer 2021) and Ronald D. Aucutt, The Top Ten Estate Planning and Estate Tax Developments of 2020 (January 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**).

The latest development in the conservation easement "protected-in-perpetuity" requirement under the judicial extinguishment proceeds regulation (Treas. Reg. §1.170A-14(g)(6)(ii)), which is intended to assure that easement donations comply with the "protected-in-perpetuity" requirement in §170(h)(5)), is whether the regulation is valid (at least as to improvements). The Sixth and Eleventh Circuits have recently reached opposite results as to that issue.

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

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

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

The analysis of whether the regulation (and the IRS's interpretation of the regulation to bar subtracting improvements from the reimbursement calculation) satisfies the requirements of the APA to be a valid regulation is very interesting. Whether a Treasury regulation satisfies the

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

The Tax Court held that the regulation was procedurally valid, relying on its decision in *Oakbrook Land Holdings, LLC v. Comm'r*, 154 T.C. 180 (2020). *Oakbrook* is discussed in Item 17.b(2) below.

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

> Judge Toro explained that the "Treasury received more than 700 pages of comments" during the comment period and that, in the final regulations, Treasury responded to those comments and other administrative matters in just two of the twelve pages—"six columns in the Federal Register"—consisting of the final regulations. *Id.* at 221. In his view, it was likely that Treasury "was simply following its historical position that the APA's procedural requirements did not apply to these types of regulations," noting that the final regulations referenced Treasury's belief that they did not require notice and comment and that this belief was mistaken. *Id.* at 222.
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> Judge Toro then found that the "Treasury failed to 'respond to "significant points" and consider "all relevant factors" raised by the public comments.'" *Id.* at 223 ... The proposed regulations' preamble explained that they reflected Congress's "major policy decisions," and NYLC "in effect countered that the proposed rule on future donor improvements was contrary to those policy decisions, would lead to inequitable results that were inconsistent with the statute, and would deter future contributions." *Id.* at 225 (quoting 48 Fed. Reg. at 22,940). In other words, Judge Toro found that NYLC "offered comments that, 'if adopted, would require a change in an agency's proposed rule,'" and that "were both 'relevant and significant,' [as to] require[e] a response." *Id.* ...
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> ... Judge Toro also explained that the *Oakbrook* majority's reasoning as to the issue was flawed for several reasons. He explained that courts were "not required to 'take the agency's word that it considered all relevant matters,'" as the majority asserted. *Id.* at 226–27 (quoting *PPG Indus., Inc. v. Costle*, 630 F.2d 462, 466 (6th Cir. 1980)). He further noted that "[a] 'relevant and significant comment' requires a response, regardless of whether the point is made by many, a few, or even a single commenter," and "a comment does not lose its significance because it is presented succinctly." *Id.* at 227 (quoting *Carlson*, 938 F.3d at 347). And, if the scope of the project "was too large to permit an appropriate response to all 'relevant and significant comments,' then Treasury could have broken the project down into smaller parts." *Id.*

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

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

Commentators have emphasized the significance of this case as representing "one of the few successful challenges to a Treasury regulation on procedural grounds." Miller & Chevalier Tax Alert, *In Case You Missed It: Hewitt v. Commissioner Has Broken New Ground in Disputes Over Conservation Easements* (January 19, 2022), available at https://www.millerchevalier.com/publication/case-you-missed-it-hewitt-v-commissioner-has-broken-new-ground-disputes-over.

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

The U.S. solicitor general has decided not to appeal *Hewitt* to the Supreme Court, despite the circuit split in light of the Sixth Circuit's contrary holding in *Oakbrook Land Holdings, LLC*, discussed immediately below. That disclosure was made in a letter from a Justice Department attorney to the Eleventh Circuit in a pending Eleventh Circuit case involving the same issue. *Glade Creek Partners LLC v. Commissioner*, No. 21-11251 (11th Cir. 2022). (The taxpayer's time for appealing *Oakbrook Land Holdings* has not expired; the taxpayer has until June 13, 2022, to file a petition with the Sixth Circuit for rehearing en banc.) *See* Kristen Parillo, *U.S. Won't Seek Supreme Court Review of Easement Reg Decision*, TAX NOTES (May 2, 2022).

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

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

The Sixth Circuit Court of Appeals affirmed the Tax Court and upheld the validity of the "in perpetuity" regulation. 129 AFTR 2d 2022-1032 (6th Cir. March 14, 2022). A majority of the three-judge panel upheld the validity of the regulation, but the third judge in a concurring opinion reasoned that the regulation was invalid. The majority agreed with the Tax Court that the very concise statement of basis and purpose of the regulation was sufficient and that the comments, including the comment by the NYLC mentioning donor improvements, do not raise valid concerns about how the regulation served the policy of restricting the conservation easement deduction to where the easement's purpose can be protected forever and "do not qualify as significant;" therefore, the comments do not require a response under the APA. The NYLC's comment "left Treasury to guess at the connection, if any, between the organization's problems and the proceeds regulation's basis and purpose." The Sixth Circuit specifically found the Eleventh's Circuit's reasoning in *Hewitt* "to be unpersuasive."

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

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

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

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

(2) ***CIC Services, LLC v. IRS,* Eastern District Tennessee*.*** A couple of weeks after the Sixth Circuit decided *Mann Construction*, a Tennessee federal district court followed the same approach to invalidate Notice 2016-66, which designates certain micro-captive transactions as "transactions of interest" subject to reporting obligations. *CIC Services, LLC v. IRS*, 129 AFTR 2d 2022-1119 (E.D. TN March 21, 2022). The court followed *Mann Construction* (which is binding on this district court located in the Sixth Circuit) and held that the Notice did not follow the notice-and-comment procedures of the APA. The court further concluded that the Notice must be invalidated under the APA because the IRS acted arbitrarily and capriciously in issuing the Notice.

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

> The IRS and Treasury have long claimed that subregulatory published guidance is exempt from notice and comment requirements established by the Administrative Procedure Act. Two recent cases, *Mann Construction* in the Sixth Circuit and *CIC Services* on remand from the Supreme Court, however, rejected this claim in the context of two IRS notices, paving the way for taxpayers to wage similar successful attacks.
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> ...
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> As recent cases like *Mann Construction*, *CIC Services*, and *Liberty Global* show us, courts keep encouraging Treasury and the IRS to join the mainstream of administrative law principles. It is unclear how developments will evolve and to what extent other courts will follow suit. What is clear, however, is that momentum continues to build behind APA challenges, and the recent run of taxpayer wins suggests that the government's traditional defenses against these challenges are no longer tenable. We anticipate that more taxpayers will press APA claims, as is their right. The government has a lot of old guidance that may be vulnerable. The situation is not sustainable from a tax policy perspective. Gregory Armstrong et. al., *No Notice: Why Unilateral IRS Rulemaking Is Obsolete*, TAX NOTES (May 2, 2022) (footnotes omitted).

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

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

something that's contrary to the text, so how are you going to meet the *Chevron* standard of ambiguity?" *Id*. (quoting Caitlin Tharp).

18. Estate Tax Value of Shares Included Proceeds of Corporate-Owned Life Insurance to Fund Buy-Sell Agreement; Buy-Sell Agreement Did Not Meet §2703(b) Safe Harbor or Other Requirements to Fix Estate Tax Value, *Connelly v. U.S.*, 128 AFTR 2d 2021-5955 (E.D. Mo. September 2, 2021)

a. **Synopsis.** A buy-sell agreement required that a company purchase a decedent's shares of a corporation owned by two brothers. The pricing provision called for the parties to agree annually on the company value, and if an annual value had not been agreed on, the price would be determined by securing two or more appraisals (which would not consider control premiums or minority discounts). The company funded the agreement with life insurance policies on the two brothers' lives. The brothers never entered into any agreement about the company value and on the death of the brother owning about 77% of the company, the estate and the company did not comply with the appraisal requirement in the agreement but agreed to pay the estate $3 million (using part of the $3.5 million of life insurance proceeds paid to the company) (as well as providing other benefits for the deceased brother's son).

The estate reported the shares at about $3 million, but the IRS assessed an additional $1 million of estate tax, maintaining the $3.5 million of life insurance proceeds should have been taken into consideration in setting the value. The estate paid the additional estate tax and sued for a refund. The parties stipulated that the value of the decedent's shares was $3.1 million if the life insurance proceeds were not considered, and the only issue was whether the life insurance proceeds should be considered in determining the value of the shares for estate tax purposes.

The court determined that the buy-sell agreement did not fix the value of the shares. First, it did not satisfy the §2703(b) safe harbor; although the agreement met the bona fide business purpose test it failed to meet the device test (because the purchase price did not include the life insurance proceeds in determining the company's value, the *process* of selecting the redemption price indicates the agreement was a testamentary device, and the agreement prohibited considering control premiums or minority discounts) and the comparability test (the estate "failed to provide any evidence of similar arrangements negotiated at arms' length"). Second, the agreement did not satisfy requirements recognized by various courts for buy-sell agreements to fix estate tax values: the agreement did not provide a fixed and determinable price; it was not binding at death (evidenced by the fact that its procedures were not followed); and it was a substitute for a testamentary disposition for less than full consideration.

Having determined that the agreement did not fix the estate tax value of the decedent's shares, the court determined the value of the stock without regard to the agreement. The court concluded that the life insurance proceeds should be considered, disagreeing with the Eleventh Circuit's rationale in *Estate of Blount v. Commissioner* that the contractual obligation of a company to purchase a decedent's shares offsets the life insurance proceeds on the decedent's life paid to the company. A hypothetical willing buyer of a company would not factor the company redemption obligation into the value of the company because the buyer would merely be obligated to redeem the shares the buyer then held, and "the buyer would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The taxpayer's request for a refund was denied. *Connelly v. United States of America, Department of the Treasury, Internal Revenue Service*, 128 AFTR 2d 2021-5955 (E.D. Mo. September 2, 2021).

b. **Basic Facts.** Two brothers owned an operating business (Michael owned about 77% and Thomas owned about 23%). As is typical for family businesses, they entered into a buy-sell agreement regarding the purchase of shares at the death of a brother. The surviving brother had an option to purchase the shares, but if he chose not to do so, the company would be required to purchase the shares. The company purchased life insurance on each of the brothers' lives (including a $3.5 million policy on Michael's life) to fund the purchase agreement.

The purchase price would be determined under a two-step process. First, the brothers "shall, by mutual agreement, determine the agreed value per share by executing a new Certificate of Agreed

Value" at the end of every year. Second, if they failed to do so, the "Appraised Value Per Share" would be determined by securing two or more appraisals.

The brothers never signed a single Certificate of Agreed Value. One brother, Michael, died on October 1, 2013, owning about 77% of the shares. The surviving brother, Thomas, chose not to purchase the shares, so the company purchased the shares, using $3 million of life insurance proceeds on Michael's life to fund the purchase price. The parties did not obtain appraisals, as required by the agreement, but Thomas and Michael's estate agreed (1) the estate would receive $3 million cash (from the life insurance proceeds), (2) Michael's son had a three-year option to purchase the company for $4,166,666, and (3) if Thomas sold the company within 10 years, Thomas and Michael's son would split evenly any gains from the sale.

The estate reported the value of Michael's shares at $3 million, but the IRS asserted that the value of Michael's shares should also include the value of the $3 million of life insurance proceeds that were used to redeem the shares as a corporate asset and assessed "over $1 million in additional taxes." (The estate tax rate for decedents dying in 2013 was 40%, and $3 million times 40% is $1,200,000. Details about how the IRS calculated the additional estate tax is not made clear in the opinion.)

During the audit, the estate obtained an appraisal of the decedent's shares from an accounting firm. The appraisal reasoned that the buy-sell agreement created "an enforceable obligation to use the life-insurance proceeds to purchase" the decedent's stock and that, pursuant to the holding in *Estate of Blount v. Commissioner* (428 F.3d 1338 (11th Cir. 2005)), the life insurance proceeds should be excluded in determining the value of the company.

The estate paid the tax and sued for a refund of over $1 million. The estate and the IRS stipulated that if the life insurance proceeds should not be considered in determining the value of the shares, the value of the decedent's shares was $3.1 million. The only remaining issue was whether the life insurance proceeds received by the corporation as a result of the decedent's death should be considered in determining the value of the estate's shares.

c. **Court Analysis.**

(1) **Estate Tax Value of the Shares Is Not Fixed Pursuant to the Buy-Sell Agreement.**

(a) **Section 2703(b) Safe Harbor Does Not Apply.** Under §2703(a), the value of property is determined without regard to an agreement to acquire property at less than fair market value or any restriction on the right to sell the property. The court stated that a buy-sell agreement must meet the three statutory requirements of the §2703(b) safe harbor to control the value of a decedent's property for estate tax purposes –

a. "It is a bona fide business arrangement;"

b. It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth;" and

c. "Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction."

i. **Bona Fide Business Arrangement, §2703(b)(1).** The parties stipulated that the purpose of the buy-sell agreement was to ensure continued family ownership of the company, and the court held that was sufficient to satisfy the bona fide business arrangement requirement.

ii. **Device to Transfer Property to Family for Less than Full and Adequate Consideration, §2703(b)(2).** The court acknowledged that the brothers' good health when they executed the buy-sell agreement weighed in favor of the estate's position that the agreement satisfied the device test, but the court reasoned that the agreement did not satisfy the "device" test for three reasons. (a) The $3 million redemption price was not full and adequate consideration; that purchase price did not include the life insurance proceeds in determining the company's value. (b) The *process* of selecting the redemption price indicates the agreement was a testamentary device. The parties to the

purchase excluded a significant asset (the life insurance proceeds) in determining the valuation of the company, failed to obtain an outside appraisal or professional advice in setting the redemption price, and disregarded the appraisal requirement in the buy-sell agreement. (c) The agreement specified that appraisals would not take into consideration control premiums or minority discounts, which led to undervaluing substantially the estate's 77% of the company and overvaluing Thomas's 23% of the company.

iii. **Comparability Test, §2703(b)(3).** The report and testimony of the taxpayer's appraiser was not persuasive regarding the exclusion of life insurance proceeds in determining the company's value because it merely relied on *Estate of Blount*. Also, the failure of the parties to comply with the detailed valuation mechanism in the buy-sell agreement suggests that the agreement and its valuation mechanism were not comparable to similar arm's length agreements. The estate "failed to provide any evidence of similar arrangements negotiated at arms' length. That closely-held family corporations generally use life-insurance proceeds to fund redemption obligations does not establish that this particular Stock Agreement was comparable to an arm's- length bargain, particularly when the $3 million valuation was so far below fair market value." In addition, the prohibition in the agreement of considering control premiums or minority discounts raises question as to whether the agreement is comparable to similar arrangements negotiated at arm's length.

(b) **Additional Requirements Under Regulations and Case Law Not Satisfied.** Various cases have recognized several requirements for a buy-sell agreement to determine the price that will be recognized for estate tax purposes. These requirements are also embodied in Reg. §20.2031-2(h). The court summarized these requirements as follows.

> (1) the offering price must be fixed and determinable under the agreement; (2) the agreement must be legally binding on the parties both during life and after death; and (3) the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition for less than full-and-adequate consideration.

i. **Fixed and Determinable Offering Price.** The price was not determined under the agreement. The parties did not follow either of the two steps in the pricing mechanism in the agreement. "Instead they completely disregarded the Stock Agreement and negotiated their own value, which not surprisingly was less than the value of the life-insurance proceeds." The $3 million price "has no mooring in the Stock Agreement."

ii. **Binding During Life and Death.** The IRS argued that the agreement was not binding during life and at death because (1) the brothers ignored their obligations to value the company each year during their lives, (2) they ignored the pricing mechanism in the agreement, and (3) they agreed to allow the decedent's son to retain a profits interest in the company and to split evenly any gains from a future sale of the company, so the $3 million redemption price did not actually account for the decedent's entire interest in the company.

The court concluded that the failure to agree annually on the company's value was not dispositive in finding the agreement did not apply during life, but "[t]he parties own conduct demonstrates that the Stock Agreement was not binding after Michael's death." The estate argued that the pricing mechanism in the agreement "was only meant to determine the value of the shares if the parties disagreed over the value," but the court pointed out that the agreement repeatedly used the word "shall" in describing the pricing requirements under the agreement. The court also pointed to the windfall effect to a surviving shareholder if life insurance proceeds paid to a company are not considered in determining the value of the decedent's interest in the company.

iii. **Bona Fide Business Reason and Not Substitute for Testamentary Disposition for Less Than Full and Adequate Consideration.** As discussed previously in the §2703(b) analysis, the court reiterated that while the agreement was a bona business arrangement

it was a substitute for a testamentary disposition for less than full and adequate consideration.

(c) **Summary Regarding Agreement.** Accordingly, the buy-sell agreement did not require that the redemption price under the parties' agreement after the decedent's death fixed the estate tax value of the decedent's shares.

(2) **Determination of Fair Market Value.** Because the buy-sell agreement did not control the value of the decedent's shares, the court determined the fair market value of the shares. Under the stipulation of the IRS and the estate, the only issue was whether the life insurance proceeds paid to the company at the decedent's death should be considered in valuing the decedent's shares.

The estate's primary argument was based on the Eleventh Circuit's opinion in *Estate of Blount*. The court in that case held that the fair market value of a closely-held corporation did not include life insurance proceeds used to redeem the shares of a deceased shareholder under a stock purchase agreement. The court summarized the *Blount* holding and rationale:

> The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life insurance proceeds. [Citation omitted] The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate."

The court in *Connelly* disagreed with the Eleventh Circuit's analysis, preferring the reasoning of the Tax Court in *Blount* that a "redemption obligation should not be treated as a value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued."

The court pointed out that a hypothetical willing buyer purchasing a company subject to a redemption obligation would not reduce the value of the company by the redemption obligation "because with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation." The buyer would merely be obligated to redeem the shares the buyer then held, and "the buyer would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The court observed that "construing a redemption obligation as a corporate liability only values [the company] post redemption (i.e., excluding Michael's shares), not the value of [the company] on the date of death (i.e., including Michael's shares)."

The court reasoned that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." The court concluded that the IRS's assessment of "over $1 million" (apparently by applying the 35% estate tax rate to the $3.0 million of life insurance proceeds used to redeem the estate's shares) had not been established to be an incorrect determination, and the estate was not entitled to a refund.

> Because the insurance proceeds are not offset by [the corporation's] obligation to redeem Michael's shares, the fair market value of [the corporation] at the date of date of [*sic*] death and of Michael's shares includes all of the insurance proceeds. Therefore, based on the undisputed facts in the record, the Estate failed to prove that the IRS's tax determination is incorrect and that it is entitled to a tax refund.

d. **Observations.**

(1) **Result of Considering Corporate-Owned Life Insurance Is Not Surprising.** Taking into consideration the life insurance proceeds received by a company at the decedent's death in valuing the decedent's interest in the corporation for estate tax purposes is not at all surprising. At a minimum, outside the Eleventh Circuit and perhaps the Ninth Circuit *Connelly* highlights that corporate-owned life insurance used to fund buy-sell agreements may be considered in some manner in determining the value of a decedent's shares.

Some commentators maintain that corporate-owned life insurance that is used to fund a buy-sell agreement should not be included in determining the value of the company. Among the reasons given are (1) including life insurance as a corporate asset should be offset by the obligation to redeem stock because the value of the company actually decreases after the life insurance

proceeds are used to redeem stock (though the value per share of the remaining shareholders as a result of the stock purchase should not be diminished), (2) the bargained purchase price between unrelated or even related parties should be recognized (though the IRS has historically viewed with "heightened scrutiny" purchase agreements between related parties), (3) including life insurance in the value would increase the amount of life insurance coverage required to fully fund the purchase price, and (4) including life insurance proceeds received after the decedent's death is an unwarranted expansion of §2042 (though prior cases have consistently addressed whether corporate-owned life insurance received after the decedent's death should be included in some manner in determining the value of the corporation without any application of §2042). *See* Paul Hood & Ed Morrow, *Are Redemption Buy-Sell Agreements Using Life Insurance Still Effective After Connelly v. United States*, LEIMBERG BUSINESS ENTITIES NEWSLETTER (February 23, 2022).

(2) **Manner of Considering Corporate-Owned Life Insurance in Determining Value of Decedent's Shares.** The lack of detail in *Connelly* regarding how life insurance proceeds were considered in determining the value of the decedent's shares raises questions about whether the IRS's approach was appropriate. For a strong criticism of *Connelly's* analysis of the impact of the corporate-owned life insurance on the value of the decedent's shares, see Paul Hood & Ed Morrow, *Are Redemption Buy-Sell Agreements Using Life Insurance Still Effective After Connelly v. United States*, LEIMBERG BUSINESS ENTITIES NEWSLETTER (February 23, 2022); Steve Seel & Dan Griffith, *Connelly v. IRS: Casting Shadow Agreements*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #246 (January 18, 2022);

The corporation received $3.5 million of life insurance proceeds following Michael's death. The IRS apparently did not simply add $3.5 million to the value of the decedent's shares, because $3.5 million times 40% would have been $1,400,000, which presumably is more than what the court referenced as "over $1 million." Exactly what the IRS added to the value of the decedent's share is not made clear in the opinion.

(a) **Effect of Considering Life Insurance Proceeds in Determining Value.** If a buy-sell agreement does not effectively fix the estate tax value of the stock, the corporate insurance proceeds should be considered as a factor in determining the corporation's value, and the proceeds should **not merely be added to the value of the corporation** determined without regard to the proceeds. *See Estate of John L. Huntsman*, 66 T.C. 861, 872-76 (1976), *acq*. 77-1 C.B. 1 ("determine fair market value … by giving 'consideration' to the insurance proceeds"); *Newell v. Commissioner,* 66 F.2d 102, 103-04 (7th Cir. 1933) (key man shareholder's estate established that stock increase was offset by decrease in corporation's value caused by the loss of a key man). For example, if a corporation is valued primarily on the basis of its ability to produce income, having additional cash as an asset of the entity may not produce dollar-for-dollar additional value (or indeed may not add any additional significant value). Reg. §20.2031-2(f)(2) ("consideration should also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity").

(b) **Cash Surrender Value Versus Death Proceeds.** Before the moment of death, the corporation is entitled to the cash surrender value of the policy, but the moment after the death, the corporation is entitled to the death proceeds. Which amount should be considered in determining the value of a decedent's shares? Even cases relied on by the estate in *Connelly* had recognized that the life insurance death proceeds, and not just the cash surrender value, payable to a corporation at the decedent's death should be considered in valuing the decedent's interest in the corporation (although those cases ultimately determined that the life insurance proceeds were offset by liabilities). *Estate of Blount v. Commissioner* (428 F.3d 1338 (11th Cir. 2005); *Estate of Cartwright v. Commissioner*, 183 F.2d 1034 (9th Cir. 1999); see Reg. §20.2031-2(f)(2) ("consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company").

(c) **$3.5 Million vs. $3.0 Million.** The corporation actually received $3.5 million of death proceeds after the decedent's death, but the IRS apparently just took into consideration $3.0 million of the insurance proceeds that were used to redeem the estate's shares. If the decision is to consider the death proceeds rather than the cash surrender value, why was just $3.0 million of the death proceeds considered?

(d) **Impact of Life Insurance on Value of Decedent's Shares.** No individual shareholder would have rights to the life insurance value owned by the corporation. Perhaps a 77% shareholder with a clearly controlling interest would have a much greater ability to force a distribution of some or all of those death proceeds from the company than a 23% minority shareholder, but a determination should be made of the value of the additional corporate assets attributable to a particular shareholder's shares.

Presumably, at most 77% of that additional value should be considered for a 77% shareholder (even if there is no marketability discount, the most that a 77% shareholder could receive of that value is 77%). For example, even if the IRS considered the full $3.5 million paid to the corporation as adding to the value of the decedent's shares, that should have resulted in additional estate tax of $3.5 million x 77% x 40% or $980,000. But the opinion clearly says that the "fair market value of [the corporation] should have included the $3 million in life-insurance proceeds used to redeem the shares." If $3 million is considered as additional corporate value, that should have resulted in additional estate tax of no more than $3 million x 77% x 40%, or $840,000, not "over $1 million."

As indicated in subparagraph d(2)(a) above, life insurance payable to a corporation at an owner's death is merely treated as a factor that must be considered in valuing the decedent's shares in the entity. Life insurance is generally treated like other nonoperating assets "to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity." Reg. §20.2031-2(f)(2) (penultimate sentence).

The IRS's calculation of additional estate tax of "over $1 million" is perplexing.

(3) **Buy-Sell Agreement With Life Insurance Funding.** One of the factors in determining whether to use a corporate purchase or a cross-purchase arrangement in structuring a buy-sell agreement that will be funded with life insurance is that life insurance proceeds received by the company may be included in the estate tax value of the decedents' shares, resulting in escalating values of the shareholders' interests in the company. (If the purchase price is fully funded with life insurance, as each owner's interest is purchased at death using the life insurance proceeds the company value remains constant, but the remaining owners have increasing percentage interests in the entity as each owner dies, which increases the value of their interests and requires more life insurance funding.) A pricing formula that does not include the full amount of insurance proceeds is suspect as failing to satisfy the §2703(b) safe harbor under the reasoning of the *Connelly* opinion.

The economic impact of not including insurance proceeds in valuing a decedent's shares is to produce a huge windfall to the surviving shareholders. If the purchase price is fully funded with life insurance, the surviving shareholders end up owning the company free of the decedent's shares without having to pay anything following the decedent's death.

The windfall to the surviving shareholders may be greatly reduced by including the amount of the insurance proceeds on the decedent stockholder's life in the value of the corporation. However, this approach will be circular and thus will greatly increase the amount of insurance coverage needed in order to fund fully the buy-sell agreement. But including life insurance proceeds in determining the value of the company following a shareholder's death reflects the economic reality of the value of the company at that time. That the IRS maintains that the estate tax value of the decedent's shares following an insured shareholder's death should reflect that economic reality is not surprising.

(4) **Buy-Sell Agreement Structuring.** A very important issue in structuring a buy-sell agreement is whether an entity purchase or cross purchase arrangement will be used. For example, the *Connelly* agreement gave the surviving shareholders the first option to purchase a decedent's shares, but if that option was not exercised, the agreement required the corporation to buy the shares.

- Entity Purchase – the parties may feel more comfortable with the entity taking steps to fund the purchase agreement rather than relying on other owners to accumulate funds (or purchase life insurance) to fund a purchase obligation, but the funding in the entity (such as life insurance) may increase the value of the entity (as in *Connelly*); for a corporation, tax considerations include whether the redemption of stock by the corporation will be given sale or exchange versus dividend treatment.
- Cross purchase – the parties must rely on the remaining owners to purchase their interests at death, funding will be outside the entity, not increasing the entity's value at the death of an owner, and a basis step up for the units purchased will be permitted; these advantages are quite significant; a disadvantage if an entity has multiple owners is that a multiplicity of policies would be required for each owner to own a policy on every other owner's life, and a possible solution is to have the owners form a separate partnership to own a single life insurance policy on each owner's life. (However, one commentator suggests that a trusteed cross-purchase or life insurance LLC "may suffer from some of the same issues as *Connelly*." Paul Hood & Ed Morrow, *Are Redemption Buy-Sell Agreements Using Life Insurance Still Effective After Connelly v. United States*, LEIMBERG BUSINESS ENTITIES NEWSLETTER (February 23, 2022).)

(5) **Agreement Provision to Determine Value Without Regard to Discounts.** While a prohibition on considering control premiums or minority discounts may not be included in a majority of buy-sell agreements, it is not rare either. Business partners may, when planning the amount that would be paid to a deceased owner's family, make the decision that a full pro rata portion of the business's value should be paid to the estate without considering minority discounts. To conclude that such a prohibition in the agreement results in the purchase price under the agreement being necessarily disregarded for estate tax valuation purposes (because the §2703(b) safe harbor would not be satisfied) is a novel concept.

(6) **Section 2703(b) Analysis Consistent With Various Other Cases Regarding Comparability Analysis.** The *Connelly* opinion observed that the estate "failed to prove any evidence of similar arrangements negotiated at arms' length" [about determining the purchase price without including life insurance proceeds received by the company at the decedent's death]. Various other cases regarding §2703 have similarly been pretty strict in requiring examples or evidence of actual comparable arrangements negotiated at arm's length. *E.g.*, *Kress v. U.S.*, 123 AFTR 2d 2019-1224 (E.D. Wi. 2019) ("Though Plaintiffs contend *restrictions* like the Kress Family Restriction are common in the commercial world, they have not produced any evidence that unrelated parties at arms' length would agree to such an arrangement."); *Estate of Blount v. Commissioner*, T.C. Memo. 20014-116, *aff'd in part, rev'd in part*, 428 F.3d 1338 (11th Cir. 2005) ("He did not present evidence of other buy-sell agreements or similar arrangements, where a partner or shareholder is bought out by his coventurers, *actually entered into* by persons at arm's length…Because Mr. Grizzle has failed to provide any evidence of *similar arrangements actually entered into* by parties at arm's length, as required by section 2703(b)(3), and his opinion is based solely on his belief that the purchase price for decedent's BBC shares was set at fair market value, Mr. Grizzle's conclusion that the terms of the Modified 1981 Agreement are comparable to similar agreements entered into by parties at arm's length is unsupportable."); *Smith v. Commissioner*, 94 AFTR 2d 2004-5283 (W.D. Pa. 2004) ("In this case, both parties concede that it would be inherently difficult to find an agreement between unrelated parties dealing at arm's length that would be comparable to a family limited partnership, which, by its terms, is restricted to related parties.… Nevertheless, Plaintiffs have submitted the affidavits of two attorneys…who essentially state that restrictive provisions requiring installment payments and charging interest at the applicable federal rate are common in both family limited partnerships and transactions

involving unrelated parties…. Upon review, these affidavits merely state opinions that are conclusory in nature and do not constitute evidence sufficient to dispel any genuine issue of material fact as to whether of [*sic*] the restrictive provision in the Smith FLP agreement meet the test set forth in Section 2703(b)(3).")

The comparability test was satisfied in *Amlie v. Commissioner*, T.C. Memo. 2006-7, involving a rather complicated fact pattern. The court concluded that an agreement met the comparability test because it was based on price terms in an earlier agreement, which was based on a survey of comparables.

(7) **Contractual Obligation Versus Estate Tax Value Mismatch.** The *Connelly* opinion highlights the risk of contractual obligations to sell stock under a buy-sell agreement not being respected for estate tax purposes. The possibility exists that a contractual obligation to sell shares at a specified amount under a buy-sell agreement would be enforced even though the estate may eventually be determined to owe estate tax on a much higher value, with the estate tax liability possibly even exceeding the total value paid to the estate under the agreement. Buy-sell agreements often have mechanisms to increase the purchase price to the amount ultimately determined to be value of the decedent's interest in the entity for estate tax purposes.

(8) **Buy-Sell Agreements Structuring Takeaways**.

> While Connelly is something of a bad facts case, the court's broad pronouncements unfortunately do not turn on the existence of those facts. Going forward, as practitioners draft or review existing redemption agreements, they should consider the following:
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> 1. Rethink insurance funded redemption agreements (while rare, they are out there). *Connelly* will make planning for more than two owners challenging, given the complexities involved in a cross-purchase involving multiple owners.
>
> 2. Get an appraisal at death and follow it.
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> 3. To avoid the *Connelly* court's concern over creating a windfall in value, consider defining the term *value* in entity agreements as the value determined by a third-party appraiser, without requiring or prohibiting discounts. However, note that if discounts are considered, a decedent's interest will likely be undervalued; if ignored, an interest may be overvalued.
>
> 4. Prepare for the possibility that a shareholder agreement is both effective for state law purposes to set the actual amount payable to the decedent's estate for entity interests, and also ineffective to set value for federal estate tax purposes. The result could be a cash-poor estate and an unfunded federal estate tax liability.
>
> 5. Avoid using certificates of value, and certainly do not to make them mandatory.
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> 6. Respect the entity agreement in its entirety; courts in general abhor structures that are simultaneously ignored and hidden behind.
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> Steve Seel & Dan Griffith, *Connelly v. IRS: Casting Shadow Agreements*, LEIMBERG BUSINESS ENTITIES NEWSLETTER #246 (January 18, 2022).

19. Real Estate Undivided Interests Gifts to Separate Donees In Each of Four Years Valued Separately and Not Aggregated for Valuation Purposes, *Buck v. U.S.*, 128 AFTR 2d 2021-6043 (D. Ct. September 24, 2021)

a. **Synopsis**. Gifts of 48% undivided interests in timberland to each of the donor's two sons (the donor retained the remaining 4%), were valued with a 55% discount for gift tax purposes compared to the purchase price of the tracts. The IRS maintained that no fractional interest discounts should be allowed unless the donor owned only the fractional interest prior to the gift and that the donor could not value simultaneously gifted portions of the property separately. The court denied the government's motion for partial summary judgment requesting that "the value of each donee's interest is simply the value of the whole times the percent ownership." Valuing each gift separately at the time it passes from the donor to the donee is supported by the relevant statute, regulations, and case law. (The court did not mention Rev. Rul. 93-12, which is the IRS's published position that gifts of 20% of the stock in a closely-held corporation to each of the donor's five children should be

valued separately without assuming that all voting power held by family members would be aggregated.) *Buck v. U.S.*, 128 AFTR 2d 2021-6043 (D. Ct. September 24, 2021).

In a separate opinion delivered the same day, the court allowed the government to compel production of the donor's will and information about his estate planning. The court rejected the donor's arguments to reject discovery because of (1) attorney-client privilege (the donor did not provide basic information necessary to support the elements of attorney-client privilege, and the requested information had been shared with the donor's financial manager without any showing that his presence was necessary or highly useful for the attorney's advice) and (2) relevance (the information was relevant to the propriety and proper extent of any discounts as a factual matter). AFTR 2d 2021-6041 (D. Ct. September 24, 2021).

b. **Basic Facts**. The donor purchased about $82 million in tracts of timberland between 2009 and 2013. Over a period of four years (2010-2013), he gave a 48% undivided interest in each of these tracts to each of his two sons (with the donor retaining the remaining 4%). The donor reported the gifts with fractional interest discounts totaling about $37 million, reflecting a 55% discount from the purchase price.

The IRS challenged the valuations and alleged deficiencies. The donor paid the deficiencies and sued for refunds. The government moved for a partial summary judgment denying any fractional interest discounts on the gifts.

c. **Court Analysis.**

(1) **Government Position.** The court described the government's position as follows.

> It asks the court to "conclude as a matter of law that no discount should be available for a gift of a fractional interest unless the taxpayer held such interest in fractional form before the gift, rather than viewing several simultaneously gifted portions of the property as fractional interests in the hands of the donor for purpose of valuing the gift." ... The government maintains that gift tax law categorically prohibits such a discount because it is contrary to one of the primary purposes of the gift tax.... It contends ... that "it is not appropriate to apply fractional interest discounts in valuing a gift of land to more than one individual" ... and "that the value of each donee's interest is simply the value of the whole times the percent ownership."
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> ...
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> ... The government notes, correctly, that "[t]here is no question that ... there would be no discounts based on the separate values of the interests received by each son" if this were a case about the estate tax.... The government argues that, when valuing interests in property like the property interests here, discounts should be prohibited for gift tax purposes because "the gift tax is construed *in pari materia* with the estate tax" in order to prevent taxpayers from "avoiding the estate tax altogether" by "depleting their estates through *inter vivos* transfers."

(2) **Cases Interpreting Gift and Estate Tax In Pari Materia Do Not Support Aggregating Gifts for Valuation Purposes.** The court distinguished cases cited by the government holding that the gift and estate are *in pari materia* as being in different contexts (such as not reducing gifts by relinquished marital rights). Those cases support that words appearing in the gift and estate tax statutes should be understood to have the same meaning and that a donor should not have to pay gift tax with respect to property retained by that donor that will be included in the donor's gross estate, but they do not provide support for aggregating separate gifts for valuation purposes. To the contrary, the court cited various cases that have allowed fractional interest discounts for gifts of fractional interests to separate donees.

(3) **Each Gift Should be Valued Separately Rather Than Basing Gift Amount on Value to the Donor.** The government's position is that value of a gift for federal gift tax purposes is the value to the donor, not the donee. The government's position in the court's words: "[E]ven if the property is now worth less because of the creation of fractional interests, the property was worth more in the donor's hands before the fractional interests were created, and it is that value, not the new value, that should be the basis for calculation the gift tax."

The court disagreed, reasoning that "[t]he gift tax statute, the regulations and relevant case law require the court to look at the value of each gift at the time it passes from the donor to the

donee." Footnote 1 observes that the gift tax statute (§2512(a)) might reasonably be interpreted as applying to multiple gifts made from the same property, but the gift tax regulations (Reg. §25.2512-1 & §25.2512-2) are reasonably read as only applying to individual gifts.

Cases cited by the court as allowing fractional interest discounts for gifts made to multiple donees include *LeFrak v. Commissioner*, T.C. Memo. 1993-526, and *Shepherd v. Commissioner*, 115 T.C. 376 (2000).

(4) **Discovery Permitted of Donee's Will and Estate Plan Information.** In a separate opinion delivered the same day, the court compelled production of the donor's will and information about his estate planning.

The donor objected first on the ground of attorney-client privilege. The court noted three requirements for establishing attorney client privilege ((a) communication between client and attorney, (b) intended to be kept confidential, (c) made for the purpose of obtaining legal advice) but said the donor had just made conclusory assertions without providing the basic necessary information to support the privilege. In addition, the information had been shared with donor's financial manager without offering evidence that his presence was :necessary, or at least highly useful, for the effective consultation between the client and the lawyer" under the *Kovel* doctrine.

The donor also objected as to the information's relevance, but the court agreed with the government that the information reflects part of the objective circumstances under which the gift was made and "may lend support to the government's position with respect to the propriety and proper extent of any discounts as a factual matter."

d. **Observations.**

(1) **Inconsistent Positions.** This summary quotes and summarizes the government position at some length because it seems so directly contrary to the government's published position in Revenue Ruling 93-12 (discussed below). Furthermore, the government contends that the value of a gift is determined by the value to the donor and not to the donee. The government's view is that the value to the donor before gifts were made determines the value, not the new values of the gifts in the hands of the donees. It is not surprising that no regulations or cases were cited in the case to support that position. That is a fundamental distinction between valuations for gift tax versus estate tax purposes.

(2) **Rev. Rul. 93-12.** The government was in a 30-year time warp; the arguments may have made some sense 30 years ago. The government's published position in Revenue Ruling 93-12, 1993-1 C.B. 202, though, clearly makes the government's position in *Buck* inappropriate. That revenue ruling addressed a situation in which a donor who owned all the stock of a corporation gave 20% of the shares to each of the donor's five children at the same time. The IRS had previously nonacquiesced in *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978), *nonacq*., 1980-C.B. 2, which held that corporation shares owned by other family members could not be attributed to an individual family member for determining whether the individual family member's shares should be valued as a controlling interest, and Rev. Rul. 81-253 ruled that a minority discount generally is not allowed for transfers of stock between family members if majority voting control or de facto control through family relationships exists in the family unit.

The IRS changed its position in Rev. Rul. 93-12, in which the IRS substituted acquiescence for its nonacquiescence in *Estate of Lee*, ruling that for estate and gift tax valuation purposes the IRS would not assume that all voting power held by family members may be aggregated for purposes of determining if transferred shares should be valued as part of a controlling interest. More specifically in the gift context, the ruling concluded that "the minority interests transferred to A, B, C, D, and E should be valued for gift tax purposes without regard to the family relationship of the parties."

Furthermore, Rev. Rul. 93-12 cites *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982), which allowed a discount in valuing a decedent's one-half fractional interest in parcels of real estate that the decedent and his wife held as community property at the time of his death.

The IRS followed the reasoning of Rev. Rul. 93-12 in Tech Adv. Memo. 9449001, which allowed discounts for simultaneous gifts of 100% of a corporation's stock to the donor's 11 children. The TAM observes that various cases "have consistently recognized that simultaneous gifts were to be valued separately for gift tax purposes." The TAM cites *Mooneyham v. Commissioner*, T.C. Memo. 1991-78, which allowed a 15% discount for a gift of a 50 percent undivided fractional interest in real property.

Rev. Rul. 93-12, TAM 9449001 and the reliance of those rulings on *Propstra* and *Mooneyham*, both involving gifts of undivided fractional interests in real property, all suggest that the IRS was totally off base thirty years later in disallowing discounts for 48% undivided fractional interest gifts to each of the donor's two sons in *Buck*.

(3) ***Rauenhorst v. Commissioner.*** The Tax Court in *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002) lambasted the IRS for taking a position in litigation contrary to its position in a revenue ruling:

> Rev. Rul. 78-197, 1978-1 C.B. 83, is contrary to respondent's litigation position in this case. Instead of accepting the legal principles articulated in that ruling, respondent's counsel contends that the Commissioner is not bound by revenue rulings, and his reliance on Blake v. Commissioner, 697 F.2d at 480-481, demonstrates that he is taking the position in this case that the ruling is incorrect.
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> ...
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> Surely, given these statements [in section 601.601(d)(2) of the Department of the Treasury's Statement of Procedural Rules], taxpayers should be entitled to rely on revenue rulings in structuring their transactions, and they should not be faced with the daunting prospect of the Commissioner's disavowing his rulings in subsequent litigation.
>
> ... These stated goals [of using published guidance to achieve "increased taxpayer compliance" and resolve "frequently disputed tax issues"] will not be achieved if the Commissioner refuses to follow his own published guidance and argues in court proceedings that revenue rulings do not bind him or that his rulings are incorrect. Certainly, the Commissioner's failure to follow his own rulings would be unfair to those taxpayers, such as petitioners herein, who have relied on revenue rulings to structure their transactions. Moreover, it is highly inequitable to impose penalties, which respondent has done in this case. Accordingly, in this case, we shall not permit respondent to argue against his revenue ruling, and we shall treat his revenue ruling as a concession. 119 T.C. at 182-183.

It is interesting that the court in *Buck* did not even mention that the government was taking a position that is contrary to its published position in Revenue Ruling 93-12, in which contemporaneous gifts of 20% interests in a corporation to each of five siblings were not aggregated for gift tax valuation purposes based on the family relationship of the donees.

20. Indirect Gifts – Step Transaction, Reducing Value of LLC by Present Value of Guaranteed Payment Obligation to Manager, *Smaldino v. Commissioner,* T.C. Memo. 2021-127

a. **Synopsis.** Mr. Smaldino ("Donor") owned in his revocable trust all of the voting and nonvoting units of an LLC that owned 10 rental properties. He had an overall goal of leaving his business interests to his descendants (or trusts for them) and leaving many of his remaining assets to his wife. The following transactions occurred effective over a two-day period:

- Donor gave about 41% of the nonvoting units to his wife (the transfers effective during this two-day period were stated as *Wandry*-type assignments but the parties for tax purposes treated them as percentage interests in the LLC) effective April 14, 2013;
- Effective the following day, April 15, 2013, the wife gave her 41% interest in the LLC to an irrevocable trust (the "Dynasty Trust") that Donor had created earlier for his descendants by a prior marriage (the units were appraised to have a value about equal to the amount of the wife's gift exclusion amount);

- Effective that same day, Donor gave about 8% of the nonvoting units to the Dynasty Trust; and
- Effective that same day, April 15, 2013, Donor amended the LLC operating agreement, in an undated document identifying his revocable trust as the "SOLE MEMBER," to provide that Donor as the sole owner of voting units would receive $10,000 per month as guaranteed payments rather than his prior arrangement of receiving compensation as manager equal to 10% of the net cash flow.

The Dynasty Trust owned 49% of the LLC units (nonvoting units) as a result of these transfers effective over a two-day period. The court treated the Donor as making the entire 49% gift of units directly to the Dynasty Trust, treating the 41% "purportedly" given to his wife as an indirect gift from Donor to the Dynasty Trust.

In valuing the gifted units, the court agreed with the taxpayer's appraiser's approach of reducing the value of the nonvoting units by the present value of the guaranteed payments, treating them as a 40-year annuity. (Part of the court's analysis was an acknowledgement of the favorable treatment of guaranteed payments under §2701, even though chapter 14 was not directly applicable.) The court agreed with the IRS's expert's application of a 36% discount for lack of control and lack of marketability (rather than the taxpayer's expert's 38.43% discount). The court's valuation analysis increased the gift tax value of the 49% interest from $6,281,000 to $7,820,008. *Smaldino v. Commissioner*, T.C. Memo. 2021-127 (Senior Judge Thornton).

b. **Basic Facts.** Donor owned in his revocable trust all of the Class A voting and Class B nonvoting units and served as manager of an LLC that owned 10 rental properties. He had an overall goal of leaving his business interests to his descendants (or trusts for them) and leaving many of his remaining assets to his wife. The rental properties were contributed to the LLC in late 2012, and Donor also created the Dynasty Trust for his descendants (by a prior marriage) in December 2012 with a son of Donor as trustee. Donor "resolved to transfer up to 50% of the LLC interests, the maximum he could transfer without triggering reassessment of property taxes on the LLC's assets." The following transactions were documented to have occurred effective over a two-day period, resulting in a transfer of 49% of the LLC interests to the Dynasty Trust:

- Donor gave a "sufficient number" of Class B nonvoting units to Donor's wife "so that the fair market value of such nonvoting units as determined for federal gift tax purposes shall be" $5,249,118.42 (she had $5,250,000 of gift exclusion, see footnote 12). While this and other transfers during this two-day period were stated as *Wandry* transfers of units equal to a dollar amount, the parties merely reported the transfers as "INTEREST IN SMALDINO INVESTMENTS, LLC" and Donor conceded "that these defined value clauses do not define or limit the amount of his taxable gifts to be determined in this proceeding." (Footnote 8). Donor contended that this transfer to his wife was a 40.95% Class B nonvoting member interest. The undated assignment stated it was "Effective: April 14, 2013."
- The wife gave an identically described (i.e., purportedly as a *Wandry* defined value transfer) interest in the LLC to the Dynasty Trust. The undated assignment was "Effective: April 15, 2013" (the day after the effective date of the gift of the units to the wife). (The units were appraised to be about equal to the amount of the wife's $5,250,000 gift exclusion amount). The wife reported this gift on her 2013 gift tax return. The wife testified that before the transfer was made to her, she made "'a commitment, promise' to her husband and family that she would transfer the LLC units to the Dynasty Trust, and when asked if she could have changed her mind, she responded: 'No, because I believe in fairness.'"
- Effective that same day, Donor gave about an 8.05% nonvoting member interest (again, purportedly stated as a *Wandry* assignment of a $1,031,882 dollar value but treated as a transfer of a percentage interest) to the Dynasty Trust.
- Effective that same date, April 15, 2013, Donor amended the LLC operating agreement, in an undated document identifying his revocable trust as the "SOLE MEMBER," to provide that Donor as the sole owner of voting units would receive $10,000 per month as guaranteed

payments rather than his prior arrangement of receiving compensation as manager equal to 10% of the net cash flow. That undated amendment of the operating agreement also revised Exhibit A to show that the Dynasty Trust owned a 49% nonvoting interest (which consisted of the combination of 40.95% and 8.05% interests, but the Exhibit A did not reflect that the wife ever owned the 40.95% interest).

Donor obtained an appraisal dated August 22, 2013, of a 49% Class B nonvoting member interest valued as of April 15, 2013. The appraised value was $6,281,000, and the dollar amounts listed in the *Wandry* dollar-amount transfers in the assignments totaled that exact same amount. The court interpreted that as meaning that the assignments and the amendment to the operating agreement "were executed no earlier than August 22, 2013."

On December 31, 2013, the operating agreement was amended to delete the provision for guaranteed payments and to restore the previously deleted provision for manager compensation but increasing the compensation from 10% to 20% of annual net cash flow.

Donor's 2013 gift tax return reported a gift of "INTEREST IN SMALDINO INVESTMENTS, LLC" valued at $1,031,882 (i.e., the 8.05% nonvoting interest) to the Dynasty Trust. He did not report the gift to his wife. The wife's 2013 gift tax return reported a gift to the Dynasty Trust with that same description and with a reported value of $5,249,118 (i.e., the 40.95% interest).

The IRS treated both transfers to the Dynasty Trust as coming from Donor, including the 40.95% interest given indirectly through his wife, and valued the 49% interest at $8,180,000 (rather than the $6,281,000 value of a 49% interest as determined by Donor's appraiser). The primary difference in the appraisals was whether the present value of the guaranteed payment obligation should be subtracted in determining the value of the Class B nonvoting interests of the LLC.

c. **Court Analysis.**

(1) **Burden of Proof.** "For the most part" the case is decided based on the preponderance of evidence rather than by placement of the burden of proof.

(2) **Indirect Gift.** The court's statement of the facts foreshadowed its indirect gift result in the very *first* short paragraph of the opinion by noting that Donor "purportedly" transferred about 41% member interests to his wife and she "purportedly" transferred them to the Dynasty Trust the next day. The statement of facts also noted that Donor provided his wife with additional moneys and properties "[i]n exchange for the use of Mrs. Smaldino's available Federal estate and gift tax exemption."

The court noted that "Section 2511(a) implicitly embodies principles of substance over form by including 'indirect' transfers in the definition of a taxable gift," and that heightened scrutiny applies for transactions between relatives. Various cases have applied substance over form principles to recharacterize multistep property transfers among related parties as indirect gifts between the actual donors and donees. *E.g.*, *Heyen v. United States*, 945 F.2d 359 (10th Cir. 1991); *Estate of Bies v. Commissioner*, T.C. Memo. 2000-338; *Estate of Cidulka v. Commissioner*, T.C. Memo. 1996-149. The Donor tried to distinguish those cases because they did not involve an initial interspousal transfer, under the theory that the gift tax marital deduction "exempts interspousal transfers from gift tax." The court rejected that argument for the simple reason that the units were never effectively transferred to the wife.

Furthermore, Donor never expressly disputed that the transactions were part of a pre-arranged plan. Donor's express goal was to leave the business interests to his descendants and to leave other assets to his wife, and the wife acknowledged that she committed to re-transfer the LLC membership interests to the Dynasty Trust after she received them.

The formal transfer of units to the wife is not controlling because courts have "never regarded 'the simple expedient of drawing up papers,' … as controlling for tax purposes when the objective economic realities are to the contrary" (quoting *Kerr v. Commissioner*, 113 T.C. 449, 464 (1999), which in turn quoted *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1979)). The tax consequences of transactions involving a nominee or straw party must be determined with

regard to the true beneficial interests involved (citing *Snyder v. Commissioner*, 66 T.C. 785 (1976)).

The court pointed to various glitches in the documentation and failures to follow formalities. The formalities for admitting the wife as a member of the LLC were not followed, the Donor signed an amendment to the operating agreement stating he was the sole member but the effective date of the amendment was after the effective date of his transfer of units to his wife, Exhibit A to the operating agreement was never amended to show the wife as a member, the assignment document to the wife was undated and was actually signed long after the effective date of her subsequent transfer to the Dynasty Trust so that "as a practical matter there was never a time when" she could have exercised any ownership rights, and the LLC's income tax return did not reflect the wife as ever having owned a membership interest.

The court concluded:

> On the basis of all the evidence in the record, we conclude that petitioner never effectively transferred any membership interest in the LLC to Mrs. Smaldino and consequently that the Dynasty Trust received its entire 49% of the class B membership interests as a gift from petitioner.

(3) **Value of 49% Nonvoting Member Interest.**

(a) **Valuation Approach.** The taxpayer's and IRS's appraisers used about the same value for the LLC's net asset value (NAV). (The court used the IRS's slightly higher value because it included a few additional incidental assets and better explained how it identified the assets and liabilities.) The appraisers also used about the same discounts for lack of control and marketability (38.43% and 36%). The primary difference was whether the present value of the guaranteed payment should be subtracted in determining the value of the Class B nonvoting member interests, and the mathematical manner of applying that reduction.

(b) **Deducting Present Value of Guaranteed Payment.** Donor's appraiser treated the guaranteed payment as a contractual liability of the LLC that should be subtracted in determining its value under a net-asset-value approach. The appraiser treated the guaranteed payment as a 40-year annuity of $10,000 a month (which was not expressly disputed by the IRS and which the court viewed as a concession) and determined the present value using the AFR as the discount rate. That appraiser subtracted the present value in its entirety from the 49% interest (i.e., from 49% of the NAV) and the 38.43% discount was applied to the resulting number.

The IRS position was that the guaranteed payments were a substitute for future management fees, which ordinarily would not be subtracted in determining the value of an entity under the NAV method. The IRS's expert

> opined that the guaranteed payments are comparable to asset management fees paid by comparable real estate investment holding companies, the values of which would not ordinarily be affected by asset management fees within the range indicated by the amounts of the guaranteed payments.

Donor countered that the guaranteed payments must be made "whether or not entity level management fees are paid" and that the minority interest is less marketable because of the required future guaranteed payments.

(c) **Section 2701 Analogy.** Donor by analogy pointed to §2701. Even though no party maintained that §2701 applied in this situation, Donor pointed out that §2701 allows value to be assigned to a retained guaranteed payment owed by an entity when valuing the transfer of an interest in an entity rather than being valued at zero like some senior interests in the entity. The court observed in a footnote that one commentator concluded that "even if a guaranteed payment were governed by § 2701, it would constitute a qualified payment right and thus would be subject to the same fair market value principles as a guaranteed payment not subject to § 2701, with a couple of exceptions." Louis Harrison, *Special Valuation Rules Can Save Transfer Taxes*, 11 J. PARTNERSHIP TAX'N 239, 247 n.29 (1994).

Although §2701 did not apply to these transactions, the court looked by analogy to the calculation procedures under §2701. The value of transferred junior interests is determined by subtracting the value of senior interests (that are retained or held by applicable family members) from the aggregate value of all family-held equity interests, and then allocating the remaining value among the transferred interest and other interests of the same or junior classes, and then applying minority or similar discounts, as appropriate. Retained senior interests under §2701 would be analogous to the guaranteed payment held by Donor, so consistent with the calculation approach under §2701

> it is appropriate, in valuing the transferred class B units for gift tax purposes, to subtract from the LLC's NAV (before applying any discounts) the value of the class A units retained by petitioner, including the value of his priority claims, i.e., the guaranteed payments; to then allocate the remaining value among the transferred and retained class B units; and to then apply appropriate minority and marketability discounts to the transferred class B units.

(d) **Method for Subtracting Present Value of Guaranteed Payment.** The *McCord* case applied a similar method in valuing gifted class B limited partnership interests when the class A limited partner interests consisted of a guaranteed payment. The class A priority claims were subtracted from the partnership's NAV (before applying any discounts) in valuing the class B interests. *McCord v. Commissioner*, 120 T.C. 358, 376 (2003), *rev'd on other grounds*, *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006).

That same method is used by the court. The initial step in the valuation is to subtract from the NAV of the LLC the value of the class A voting interests, including the present value of the guaranteed payment rights (the guaranteed payments are made solely to the single owner of the class A voting interest – Donor). That difference is the value of all of the class B nonvoting member interests. That number is multiplied by 49% and is further reduced by the appropriate discount for lack of control and marketability.

(e) **Discount Rate.** To determine the present value of the assumed 40-year annuity represented by the guaranteed payments, the court agreed with the IRS appraiser to use a higher discount rate than the AFR, which is a risk-free rate. The court agreed with the appraiser to use a 6.75% rate, which is consistent with capitalization rates used to value the LLC's underlying assets (compared to the 2.67% AFR that was used by Donor's appraiser).

(f) **Subsequent Elimination of Guaranteed Payment.** The IRS argued that the subsequent elimination of the right to receive guaranteed payments about four months later (the time from August 22, 2013, the first date the court thinks the amendment applying the guaranteed payment was signed, until December 31, 2013) is a reason to disallow any reduction in value by reason of the guaranteed payments. However, the court observed that subsequent events that are not reasonably foreseeable are not considered in fixing fair market value. The court did note that the IRS did not raise as an issue whether the elimination of the guaranteed payment was a separate gift from Donor to other owners of the nonvoting member interests.

(g) **Result.** The court's valuation analysis increased the gift tax value of the 49% interest from $6,281,000 to $7,820,008 (but less than the $8,180,000 value asserted by the IRS).

(4) **Discount for Lack of Control and Lack of Marketability**. Both experts used very similar combined discounts for lack of control and lack of marketability (38.43% by Donor's expert and 36% by IRS's expert). Donor's expert said that his slightly higher combined discount rate "is explained by his taking into account the guaranteed payment." The court concluded that because it allows subtracting the present value of the guaranteed payment, it will not also allow including the additional LOC and LOM discounts because of the guaranteed payments. That would result in "inappropriate ... redundant adjustments."

(5) **Summary and Calculation of Gift**. The opinion concludes with a helpful summary chart of the calculation of the value of the gifted 49% class B nonvoting member interest.

LLC's NAV as of 4/15/13	$26,852,186

Less: Value of retained class A member interests, including guaranteed payment rights -Present value of guaranteed payments ($1,647,412) + 1% of NAV ($268,522) = $1,915,934)	(1,915,934)
Value allocated to aggregate class B member interests	24,936,252
Value allocated to 49% class B member interest before discounts ($24,936,252 x 0.49)	12,218,763
Less: 36% combined discount	(4,398,755)
Value of transferred 49% class B member interest	$ 7,820,008

d. **Observations.**

(1) **Indirect Gift Result Not Surprising.** Imagining a clearer case for applying an indirect gift/substance over form analysis is difficult. Donor's stated goal was to leave the business interests entirely to his descendants. So Donor's gift of the LLC interests to his wife effective Day 1 followed by a gift from her to the Dynasty Trust for the descendants effective Day 2 strongly suggests that the wife was just a straw party for Donor to give the interests to the Dynasty Trust. Furthermore, the wife testified that she indeed made a "commitment, promise" to re-transfer the interest to the Dynasty Trust. The crystal-clear goal was simply to use the wife's available gift exclusion to shield some of the transfer from gift tax.

The three cases cited in the opinion about recharacterizing multistep property transfers among related parties as indirect gifts (*Heyen*, *Bies*, and *Cidulka*) all involved attempts to make use of increased numbers of annual exclusions. *See also Schuler v. Commissioner*, 282 F.3d 575 (8th Cir. 2002), *aff'g* T.C. Memo. 2000-392; *Sather v. Commissioner*, 251 F.3d 1168 (8th Cir. 2001).

Section 2511 applies the gift tax to "direct or indirect" gifts, and Treasury regulations also explicitly incorporate the indirect gift concept. Treas. Reg. 25.2511-1(h)(2)-(3) (examples of indirect transfers for gift purposes).

Although the result in *Smaldino* is not surprising, the reasoning is interesting. Because of the documentation issues and failure to follow formalities, the court's rationale is that Donor never effectively transferred the nonvoting member interests to his wife, so the transfer of the 41% interest to the Dynasty Trust must have come from Donor and not his wife. Under the various cases cited, even if a transfer is effectively completed to an intermediate straw party, the indirect gift principle is applied if the clear intent is that the straw party will reconvey the assets to the intended donee. Even if the transfer had effectively been made to the wife, the clear pre-arrangement was that she would reconvey the assets to the Dynasty Trust, and that should be sufficient to apply the indirect gift/substance over form principle.

(2) **Other Implications of Indirect Gift Principle; SLAT Danger; Planning Considerations.** Often, the goal with indirect gifts is to do what was done in *Smaldino* – make use of the intermediate person's gift exclusion amount. Alternatively, the goal may be to have annual exclusion gifts both by the donor and also purportedly by the intermediate person. The downside in that situation if the IRS successfully makes the indirect gift argument is simply to disallow use of the additional gift exclusion amount or annual exclusions. A possible further downside would be if the IRS were to allege that the returns reporting the gifts are fraudulent (and indeed, sometimes gift tax returns might not be filed at all to report the gifts if they are all within the annual exclusion amounts of the multiple parties involved).

Alternatively, the indirect grantor may be identified for purposes of applying §2035 to gift tax paid on a transfer within three years of that "real" grantor's death. *See Brown v. U.S.*, 329 F.3d 664 (9th Cir. 2003) (husband made gift to wife; wife made gift to trust; husband died within three years; applied step transaction doctrine to determine that husband was the "real donor" so that §2035 applied to gift tax on transfer within three years of death).

A more devastating result can occur, though, if the "actual donor" is also a beneficiary of or has tax-sensitive powers over the recipient trust. For example, if A transfers cash to B, with the

understanding that B will transfer property to a trust for A's benefit, A is treated as the grantor of the trust even though he never owned the property that was transferred to the trust. *Estate of Shafer v. Commissioner*, 749 F.2d 1216 (6th Cir. 1984) (§2036 applied where decedent had purchased property and directed seller to convey life estates to decedent and his wife and remainder to his sons rather than receiving the property outright and conveying the property to his sons with a retained life estate). As another example, if a husband owes funds to his wife from a prior loan but pays the funds into a trust for the wife instead of repaying her, the wife will be treated as the grantor of the trust for purposes of applying §2036. *Estate of Marshall v. Commissioner*, 51 T.C. 696 (1969), *nonacq.* 1969-2 C.B. xxvi.

The §2036 situation can readily arise in creating a spousal lifetime access trust (SLAT). For example, both spouses may wish to create SLATs with the other spouse as a permissible beneficiary (building in a variety of differences to overcome the "reciprocal trust" doctrine under the *Grace* case, 395 U.S. 316 (1969)), but one spouse may not own substantial assets. The wealthy spouse may make a gift to the less-wealthy spouse that he or she could use to make a gift to a trust having the wealthy spouse as a permissible beneficiary. If the indirect gift principle is applied, the wealthy spouse would be treated as a grantor to such trust for estate tax purposes and §2036 may cause inclusion in the gross estate, or if the wealthy spouse is a trustee of the trust or otherwise holds tax-sensitive powers, estate inclusion may result under §2036(a)(2) or §2038. This is a frequently recurring situation for spouses having substantially unequal wealth.

Planning considerations, for those who want to be as conservative as possible to avoid a possible "indirect gift" attack, include:

- Very purposefully avoid any express agreements (or even legally binding commitments) for the initial donee to make a subsequent gift;
- The facts should support that the initial donee is making an independent decision to make the subsequent transfer (the initial donee may be aware at the time of the initial gift of possible advantages of making a subsequent gift, but the decision to do so should be that of the initial donee);
- Allow some appropriate passage of time (don't make the re-transfer at the same closing or even the next day as in *Smaldino*); analogy to the indirect gift/step transaction analysis of the *Holman* line of cases regarding contributions to partnerships supports the passage of time approach, *Holman v. Commissioner*, 130 T.C. 170 (2008) (transfer of Dell stock to partnership and gift of limited partnership interests six days later did not result in an indirect gift of the Dell stock itself because there was a "real economic risk of a change in value" between the time of funding and the time of the subsequent gift), *aff'd on other grounds*, 601 F.3d 763 (8th Cir. 2010);
- Consider not making the re-transfer of exactly the same assets received in the initial gift;
- Report the transfers correctly on gift and income tax returns;
- Consider having the initial donee retain the assets long enough to receive some distributions from the gifted asset; and
- Consider having subsequent transfers made in a subsequent calendar year.

(3) **Transfer Documents With Prior Effective Date.** Backdating documents is obviously a big no-no, with potential fraud implications. The parties in *Smaldino* did not do that and made clear they were merely signing documents with an effective date. As pointed out by the court, they selected an effective date more than four months (!!) prior to when the documents were signed. The opinion gave no indication that other documents signed contemporaneously with the stated effective date existed to reflect the intent of the parties to make these transfers once they knew the values. The parties must have had some intention to make the gifts, or they would not have obtained the appraisal, but if the appraisal had reflected a much higher value than anticipated, Donor might have decided in August not to make the April 15, 2013 gift.

Still, that apparently the IRS raised no questions about assignment documents made with an effective date at least four months prior to when the documents were signed seems interesting. But maybe the IRS did raise questions. Maybe that is why Donor agreed to drop any argument that these were *Wandry* transfers of a defined dollar amount. After all, they could have signed documents making *Wandry* transfers on April 14 and April 15. They did not need an appraisal to transfer a specific dollar value worth of units. On the other hand, if they were making transfers of specified percentages of units, they did need the appraised value to know how many units to transfer to the wife to equal her gift exclusion amount.

(4) ***Nelson* Transfers.** This case points to the practical chicken-and-egg problem with making gifts of a particular dollar amount. The appraisal needs to list the date of the transfers and the date the property was appraised to satisfy the "appraisal safe harbor" under the adequate disclosure regulations. Reg. §301.6501(c)-1(f)(3)(ii)(A). But on the date of the transfer, the appraised value will not yet be known to know how many units to transfer within a desired dollar amount of gift. The solution is to use the procedure employed in the *Nelson* case (see Item 11 above), making a transfer of a stated dollar amount based on an appraisal to be obtained within 90 (or 180) days. For example, in *Smaldino*, Donor could have signed an assignment to his wife on April 14, 2013 of a sufficient number of Class B nonvoting units in the LLC so that the fair market value of such nonvoting units shall be $5,249,000 as determined by XYZ appraisal firm within 180 days of the assignment. His wife could have signed an assignment the following day to the Dynasty Trust using the same description. Donor could have also made an assignment to the Dynasty Trust of Class B nonvoting units representing 49% of the ownership units of the LLC (Class B nonvoting units) less the number of nonvoting units having a fair market value of $5,249,000 as determined by XYZ appraisal firm within 180 days of the assignment.

The IRS did not find that approach abusive in *Nelson*, and indeed took steps to enforce the assignments for tax purposes as written.

Another alternative is to make *Wandry* transfers and be consistent in treating and reporting them as *Wandry* transfers. A downside of this approach is that the IRS has never formally conceded the effectiveness of *Wandry* transfers and maintains that it is still looking for an appropriate case to test the *Wandry* result in another court opinion. But *Wandry* transfers have become relatively common.

Another alternatives for dealing with the practical problem of obtaining an updated appraisal as of the transfer date are that the appraiser may update the appraisal based on facts as of the close-in-time transfer date for relatively little additional expense or obtaining an updated appraisal may be negotiated in the initial engagement with the appraiser.

(5) **Subtracting Present Value of Guaranteed Payments in Determining Value.** The court allowed reducing the value of the class B nonvoting interests by the approximately $1.9 million present value of the guaranteed payments. That the IRS did not raise objections to an assumption that the guaranteed payments would be made for 40 years Is interesting, especially when they knew in hindsight that the payments lasted only for a matter of months! But more important is the issue of whether the guaranteed payments, to provide for the manager's compensation, should have been allowed as a reduction at all in determining the value. Saying that ongoing management fees are not subtracted in determining the value of an entity on the NAV approach but that payments to the manager expressed as a guaranteed payment instead of a management fee would be subtracted seems arbitrary. The payments can be structured to be the same anticipated approximate amount. An obvious difference is that the entity is liable for the guaranteed payment notwithstanding the actual cash flow or profit of the entity. But in large part, whether the fee paid to the manager is structured as a guaranteed payment or as a management fee is typically based on the differences in the income tax treatment of the two approaches.

If this approach is followed in future cases and if management fees will be substantial for an entity that will be the subject of a gift or transfer at death, the parties may purposefully structure them as guaranteed payments in order to achieve a substantial reduction in the value of transferred interests. At the time of the transfer, the parties could not have a prearranged plan or

perhaps even an intention to change that, but they could still always make adjustments in future years and switch back to a management-fee approach if that became more appropriate.

The opinion raised the issue of whether Donor made a gift by switching from guaranteed payments to a management-fee approach for compensation later in the year. That would not necessarily result in a gift – the anticipated amount of the management fees (especially with the increase from 10% to 20% of annual net cashflow) may have been worth even more than the value of the guaranteed payments. Switching to guaranteed payments and then back to a management fee, with the result that a big reduction in value for gift purposes may result on the date of the transfer, could certainly have the appearance of abusive manipulation. (If such a change becomes desirable, it would seem far preferable to wait until at least the following tax year to make the adjustment.)

(6) **Potential §2036(a)(1) Issue with Guaranteed Payments.** Paying reasonable compensation to a donor as manager of a transferred entity should not result in estate inclusion as a retention of income from the transferred property under §2036(a)(1). But egregious management fees, with the result that a donor as a practical matter receives all of the income (or more) from an entity, in excess of the value of services provided, could arguably result in transfers of entity interests being brought back into the donor's gross estate under §2036(a)(1).

(7) **First Case to Discuss §2701.** This appears to be the first reported case with any substantive discussion of §2701. More than thirty years have elapsed since the passage of §2701, with all its complexity. At last, an opinion has a discussion about §2701, but in a case in which §2701 was not even applicable. The opinion had a discussion about guaranteed payments not being treated as the type of "senior interest" that would be valued at zero under §2701, and the opinion summarized the calculation method under §2701 and applied that same general method in accounting for guaranteed payments (which it analogized to a senior interest under §2701) when valuing transfers of interests in the entity that were analogous to junior interests under §2701. In addition, "for the sake of completeness" the opinion in footnote 20 summarizes the lookback rule in §2701(d).

(8) **Gift Splitting.** The result of the case was that Mr. Smaldino was treated as making the entire gift of the 49% interest, using none of Mrs. Smaldino's gift exemption amount. If Mr. Smaldino had simply reported the entire gift himself and they elected gift-splitting, he would have avoided gift tax on half of the court-determined value of $7,820,008. Of course, that would not have been as favorable as sheltering $5.25 million of the gift with Mrs. Smaldino's gift exemption if that had been possible.

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

a. **Basic Facts**. Donor, who was the founder of a "very successful company, Company," transferred shares of the Company to a two-year grantor retained annuity trust (GRAT) that appeared to satisfy the requirements for a qualified interest under §2702. The required annuity payments were a fixed percentage of the initial fair market value of the trust (whether that was the fair market value as finally determined for federal tax purposes, as described in the GRAT regulations, is not specifically stated). The value of the transferred shares was determined based on an appraisal as of a date about seven months earlier that had been obtained to report the value of a nonqualified deferred compensation plan under §409A.

Prior to the transfer to the GRAT, however, Donor had been negotiating with several corporations about a possible merger and had received offers from five different corporations within two and a half weeks before the transfer to the GRAT. Within three months after the initial offers, four of the corporations had submitted higher offers, and, three months after that, Donor accepted one of the offers, an initial cash tender offer for some of the outstanding shares at an amount that was nearly three times greater than the value used for the GRAT, with an option to purchase the remaining shares under a formula valuation.

Several weeks prior to closing the tender-offer purchase, Donor had gifted shares to a charitable remainder trust and valued the shares pursuant to a qualified appraisal at an amount equal to the tender-offer value. The charitable remainder trust also took advantage of the tender offer.

About six months after the end of the GRAT's two-year term, the purchasing corporation purchased the balance of the Company's shares at a price per share almost four times the value used for the GRAT valuation.

b. **Analysis.**

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

> Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of [the date the GRAT was created], would be reasonably informed during the course of negotiations over the purchase and sale of the shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger undermines the basic tenets of fair market value and yields a baseless valuation...

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

This is a big further step that treats the GRAT annuity as not being a qualified interest because of the undervalued appraisal used to determine the annuity amounts that were paid by the GRAT over its two-year term. Accordingly, Donor was treated as making a gift equal to the full finally determined value of the shares transferred to the GRAT, without any offset for the value of Donor's retained annuity payments.

The CCA reasons by analogy to *Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002). In *Atkinson*, no annuity payments were actually made from a charitable remainder annuity trust during the two years from the creation of the CRAT until the donor's death. Although the trust met the statutory requirements for five percent annual distributions, the trust did not operate in accordance with those terms, and the court denied an income tax charitable deduction. On appeal, the taxpayer argued that the deduction was denied because of a "foot fault," or a minor mistake, but the appellate court concluded that the trust failed to comply with the rules governing CRATs throughout its existence and denied the deduction. The deduction was denied because of the manner in which the trust was operated, even though the agreement itself met the technical requirements for CRATs.

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

> In addition, although the governing instrument of Trust appears to meet the requirements in § 2702 and the corresponding regulations, intentionally basing the fixed amount required by § 2702(b)(1) and § 25.2702-3(b)(1)(i) on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust. The trustee's failure to satisfy the "fixed amount" requirement under § 2702 and § 25.2702-3(b)(1)(ii)(B) is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust; instead, the amount was based on an outdated and misleading appraisal of Company, at a time when Company had received offers in the multi-billion dollar range. When asked about the use of the outdated appraisal, the company that conducted the appraisal stated only that business operations had not materially changed during the 6-month period. In contrast, in valuing the transfer to the charitable trust, the company that conducted the appraisal focused only on the tender offer, and accordingly gave little weight to the business operations for valuation purposes.
>
> The operational effect of deliberately using an undervalued appraisal is to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading

effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under § 2702. See Atkinson.

c. **Observations.**

(1) **IRS Reaction Understandable But....** A feature of GRATs that is especially attractive is the "savings clause" feature that is authorized in the GRAT regulations, which allows basing the annuity payments on a specified percentage of the initial fair market value of assets contributed to the GRAT, as finally determined for federal tax purposes. Reg. §25.2702-3(b)(1)(ii)(B). If the contributed assets are initially undervalued, the annuity amounts automatically readjust based on the finally determined fair market value of the assets so that the gift value of the remainder interest in the GRAT is still nominal.

The IRS's main concern with defined value clauses generally and the GRAT valuation "savings clause" may be that unscrupulous taxpayers will use very unreasonably low valuations and if "caught," will simply make adjustments based on a proper valuation with no risk of being penalized for trying to get by with the initial unreasonably low valuation.

Indeed, that seems to be what happened factually in the facts of this CCA. The donor used a seven-month-old appraisal that was prepared before negotiations had commenced with merger prospects and used a value that apparently was substantially lower than an actual outstanding offer at the time shares were transferred to the GRAT. Shares were actually sold six months later for nearly three times the value that was used for determining the GRAT annuity payments.

Rather than merely adjusting the amount of the annuity payments, so that the donor received back annuity payments equal to (actually, on a non-discounted basis, somewhat greater than) the full value that was contributed to the GRAT, the IRS took the **unprecedented** position that the retained annuity payments should be valued at zero, resulting in a very large, unexpected gift. That result is not described in the regulation. The only authority for that Draconian result is a broad extension of the reasoning of the *Atkinson* case. But the *Atkinson* case is a very different situation; the CRAT regulations require five percent annual distributions for CRATs, and the trust made **no** payment whatsoever, so the regulatory requirements were not satisfied. That is not the case with the GRAT. There are no mandated payments that were unpaid, and as soon as a higher value of the contributed shares is finally determined, the annuity payment amounts will be adjusted, as specifically permitted by the regulation addressing "incorrect valuations of trust property." Reg. §25.2702-3(b)(2). At a bare minimum, the present value of the payments that were made should be subtracted in determining the amount of gift made upon the GRAT's creation.

(2) **Potentially Horrendous Effect.** The result of the CCA may be to treat the entire contribution to the GRAT as a gift even though the donor may have expected that the taxable gift would be a nominal value (the value of the remainder interest). The CCA makes reference to the company having received offers "in the multi-**billion** dollar range." The value of shares transferred to the GRAT might have been many millions of dollars. Furthermore, the IRS may allege that the 40% undervaluation penalty would apply.

(3) **Are All GRATs Involving Hard-To-Value Assets at Risk?** The logical extension of CCA 202152018 is that if the value of assets contributed to any GRAT is ultimately "finally determined" to be larger than the initially anticipated amount on which annuity payments are based, the "operational failure" to pay the required annuity amounts on the annuity payment dates will cause the donor to be treated as having made a taxable gift equal to the full amount contributed to the GRAT, notwithstanding the fact that the donor will actually receive annuity payments having a present value equal to almost the full value contributed to the GRAT. The regulations that planners have viewed as a very helpful savings feature of GRATs will instead be turned into a huge trap – resulting in treating retained annuity payments as having zero value for purposes of determining the gift upon the GRAT's creation. The result would be especially egregious in light of the regulation's specific provision for making adjustments in the case of "any incorrect determination of the fair market value of the property in the trust." Reg. §25.2702-3(b)(2).

(4) **How Much Undervaluation Is Required Before Applying the *Atkinson* Result?** The IRS may respond that the *Atkinson* result would be applied only in extreme situations. The conclusion in CCA 202152018 refers to "deliberately using an undervalued appraisal ... to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars." One might ask how low must the initial valuation be before the IRS will apply the Draconian result? Any GRAT with hard-to-value assets would inherently be subject to the possibility of facing the risk of having the full amount contributed to the GRAT being treated as a taxable gift.

The IRS's reaction in this case, however, may have been because of the lack of any good faith effort at all to determine the initial value. The nature of a Chief Counsel Advice is that it arises from a specific audit of a specific case, and therefore possibly with a specific back-story, not revealed in the CCA itself, may explain the IRS's apparent sensitivity and aggressive reaction.

Perhaps the IRS concern in this CCA was not so much with the appraised *amount* but with the *process.* The donor appeared to have used a valuation that the donor knew was seven months out of date, prepared for another purpose, and which substantially undervalued the shares because of intervening events (obviously unknown to the appraiser).

In any event, the result seems totally inconsistent with the authority in the regulations for basing the annuity amount on the finally determined fair market value of contributed assets and allowing adjustments for "incorrect valuations of trust property."

(5) **Planners Can Use CCA As a Warning to Overly Aggressive Clients.** Clients who push planners to take aggressive valuation positions (such as relying on old appraisals or using low estimated values without appraisals) or other aggressive positions regarding GRATs may be reminded of the potential horrendous gift tax result under the reasoning of the CCA if the IRS should view the planning as abusive. Not only might the IRS take the position that the transfer to the GRAT resulted in a huge gift (of the entire amount transferred to the GRAT), but the IRS might allege that 40% undervaluation penalties would apply as well.

The CCA is a warning to clients who might be tempted to "cheat" by using unreasonably low valuations, thinking that no downside exists if they get caught because they could just adjust the annuity amounts without risking having to pay gift taxes. Furthermore, Stephanie Loomis-Price, a transfer tax litigator, reports that she has seen the IRS take this same overly-aggressive approach in several cases involving GRATs, though they were all resolved out of court. *See* Jonathan Curry, *Estate Planners Ponder IRS's 'Overaggressive' GRAT Slapdown*, TAX NOTES (February 15, 2022).

d. ***Baty v. Commissioner*.** In a pending Tax Court case, the IRS is maintaining that because the taxpayer intentionally undervalued stock contributed to a GRAT (by not taking into account pending merger discussions), the taxpayer is not able to take advantage of the GRAT provisions. *Baty v. Commissioner* is discussed in Item 22 immediately below.

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

In this pending Tax Court case (the case addressed in CCA 201939002), the IRS is maintaining that because the taxpayer intentionally undervalued stock contributed to a GRAT (by not taking into account pending merger discussions), the taxpayer is not able to take advantage of the GRAT provisions. *Baty v. Commissioner*, Tax Court Docket No. 12216-21 (Petition filed June 23, 2021).

a. **Prelude – CCA 201939002.** IRS Chief Counsel Advice (CCA) 201939002, dated May 28, 2019, and released September 27, 2019, was advice from the IRS Chief Counsel regarding the litigating position of the IRS in this case involving a gift of stock at a time that the company was undergoing merger discussions. The CCA concluded that a stock on a listed exchange had to be valued for gift tax purposes by taking into consideration an anticipated merger of the underlying company that was expected to increase the value of the stock. CCA 201939002. It relied on several cases, including an

"anticipatory assignment of income" case, to conclude that the New York Stock Exchange (NYSE) market price did not control the gift tax valuation of the stock and that ignoring "the facts and circumstances of the pending merger undermines the basic tenets of fair market value and yields a baseless valuation."

b. **Basic Facts.** Pleadings in *Baty v. Commissioner* reveal much more important details about the facts of the case than were described in the succinct and redacted CCA. The donor was a co-founder of Emeritus Senior Care, which eventually became one of the nation's largest assisted living and memory care providers that was traded on the NYSE. He served as Chairman of the Board of Directors of Emeritus. Many believed Emeritus might be the target of an acquisition, and in mid-2013 the company received a formal offer to acquire its real estate assets. Over the next six months, four different companies explored acquisition discussions. A bidding war emerged, and the company requested interested parties to submit their final offers in December 2013. Emeritus authorized exclusive merger discussions with Brookdale Senior Living through late January 2014 (later extended). The donor was not involved in the daily merger negotiations but was aware of the discussions and was precluded under securities laws from trading during the ongoing discussions or disclosing the information with third parties.

On January 14, 2014, the donor contributed 1,657,504 shares to a two-year, zeroed-out GRAT. The contributed shares were worth $36,564,538 based on the mean between the high and low NYSE price on that date.

The price of Emeritus shares increased significantly following the announcement of the merger, and the merger with Brookline eventually was completed on August 1, 2014. The Brookline price remained high for months but eventually collapsed to the point that the GRAT would have failed to be able to make the final second annuity payment had the GRAT not engaged in a substitution transaction with the donor to substitute other assets for many of the trust's Brookline shares and collared the remaining stock held by the GRAT.

The gift tax return was selected for audit. Following advice from the IRS national office in CCA 201939002 that the valuation should have considered the merger discussions, even though they had not been publicly announced at the time of the contribution to the GRAT, the IRS issued a Notice of Deficiency using the trading price of the combined entity on the date of the merger (six months after the date of the gift) for valuing the contributed shares, and refusing to adjust the annuity payments even though the instrument described that the annuity amount as a percentage of the fair market value of the contributed assets as finally determined for gift tax purposes. The difference between the value of the contributed stock as determined by the IRS ($55,012,557) less the present value of the annuity payments, as calculated on the gift tax return ($36,564,538), was assessed as an additional gift of $18,448,019. The IRS maintains, in the alternative, that the intentional undervaluation of the contributed stock caused the grantor's retained annuity interest in the GRAT to fail the qualified annuity requirements in Reg. §25.2702-3, which would cause the entire amount contributed to the GRAT to be a taxable gift. The IRS also assessed penalties under §6662.

The donor filed a Petition in the Tax Court on June 23, 2021, maintaining that no tax deficiency existed, that the publicly-traded price should control, indeed, that the stock was valued without considering transfer restrictions imposed by securities laws, that the GRAT actually overpaid the donor pursuant to the valuation adjustment clause in the GRAT, and that penalties should not be imposed.

c. **CCA Analysis of Requirement to Consider Merger Negotiations.** The issue considered by the Chief Counsel's office was whether the shares should be valued under Reg. §25.2512-2(b)(1) at the mean between the highest and lowest quoted selling prices on the date of the gift, or by taking into consideration the anticipated merger. Reg. §25.2512-2(e) states that if the value determined from the mean between the high and the low selling prices does not represent the fair market value of the shares, then some reasonable modification of the value shall be considered in determining fair market value.

Fair market value for transfer tax purposes is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Reg. §25.2512-1. The CCA reasoned that the presumption of having "reasonable knowledge of relevant facts" applies even if the relevant facts were unknown to the actual owner of the property (citing *Estate of Kollsman v. Commissioner*, T.C. Memo. 2017-40, *aff'd*, 123 AFTR 2d 2019-2296 (9th Cir. June 21, 2019)). Both parties are presumed to have made a reasonable investigation of the relevant facts, *id.*, and reasonable knowledge includes facts that a reasonable buyer or seller would uncover during the course of negotiations, even though not publicly available (the hypothetical willing buyer is presumed "to have asked the hypothetical willing seller for information that is not publicly available"). *Id.*

The CCA repeats the oft-stated general rule that post-transfer events may be considered only to the extent they are relevant to the value on the transfer date. *E.g. Estate of Noble v. Commissioner*, T.C. Memo. 2005-2.

The CCA cites two cases involving corporate mergers or reorganizations for authority that the value should be determined after taking into consideration the anticipated merger. *Silverman v. Commission*er, T.C. Memo. 1974-285, *aff'd*, 538 F.2d 927 (2d Cir. 1976), *cert denied*, 431 U.S. 938 (1977) (gift of shares of preferred stock while in the process of reorganizing with the intent to go public; court rejected expert testimony that failed to consider the circumstances of the anticipated future public sale); *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), *aff'g,* 108 T.C. 244 (1997) (taxpayer was an officer and director of a corporation of which the board of directors had approved a merger agreement; after the merger was "practically certain to go through" but before the actual merger occurred, the taxpayer gave shares to charities; when the charities sold the shares, the taxpayer realized the gain under the assignment of income doctrine). While *Ferguson* was an anticipatory assignment of income case rather than a gift tax valuation case, the CCA pointed to the many factual similarities with *Ferguson* (a target search to find merger candidates, exclusive negotiations before the final agreement, generous terms of the merger, and an agreement that was "practically certain" to go through) in relying on it for the proposition that "the facts and circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through." The CCA concluded:

> Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger would undermine the basic tenets of fair market value and yield a baseless valuation.

For a more detailed discussion of CCA 201939002 and planning considerations, see Item 25.b(2) of Heckerling Musings 2020 and Estate Planning Current Developments found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

d. **Taxpayer's Brief Regarding Valuation Issue.** The donor filed a motion for summary judgment on March 24, 2022, seeking a determination by the court that the stock should be valued as of the date of the contribution to the GRAT by the value from the public market. The shares were actively traded on the NYSE (almost 5.7 million shares traded during the month of January 2014). Observers of the senior housing industry were aware that the market was relatively fragmented and that significant consolidation in the industry was likely to happen in the future, and the donor maintains that the public market prices reflected that realization.

   The taxpayer's arguments in its Memorandum in Support of Petitioner's Motion for Summary Judgment (the "Memorandum") are briefly summarized.

   (1) **Price Determined by Public Market.** The price determined by an active public market is the proper measure of value under the case law and the regulations. The Memorandum points out that *Estate of Prentice v. Commissioner*, T.C. Memo. 1956-3, involved similar facts. In *Prentice* a company traded on the OTC market (smaller and less liquid than the NYSE) was under merger negotiations when the decedent died. No "meeting of the minds" occurred until more than a month after the date of death, and there was no public knowledge about the potential merger at

the date of death. The *Prentice* court concluded that "the fact that there was no public knowledge of the negotiations does not detract from the evidentiary value of the sale occurring about the time of the valuation date." Furthermore, rumors of bank mergers were prevalent, and "there is no reason to believe that the prices at which the stock sold on or about the valuation date did not adequately reflect the possibility of merger." The Memorandum also cites a number of other cases in which courts refused to adjust the value of publicly traded stock on the basis of non-public information. *Estate of Wright v. Commissioner*, 43 B.T.A. 551 (1941); *Harrison v. United States*, 475 F. Supp. 408, 415 (E.D. Pa. 1979); *Carter v. United States*, 2019 U.S. Dist. LEXIS 134035 (N.D. Ala. 2019); *Gourley v. United States*, 2009 WL 2700206 (Fed. Cl. 2009); *Polack v. Commissioner*, 366 F.3d 608, 612 (8th Cir. 2004); *First Nat'l Bank of Kenosha v. United States*, 763 F.2d 891, 894 (7th Cir. 1985); *Johnson v. Commissioner*, 74 T.C. 89, at 95-96*, aff'd*, 673 F.2d 262 (9th Cir. 1982); *Gudmundsson v. United States*, 665 F. Supp. 2d 227, 238 (W.D.N.Y. 2009, *aff'd*, 634 F.3d 212 (2d Cir. 2011).

(2) **Subsequent Events.** Determining the value of the stock contributed to the GRAT based on subsequent events violates the rule against employing hindsight.

(3) **Hypothetical Willing Buyer and Seller.** The hypothetical buyer and seller could never learn about the merger negotiations and thus would not have adjusted their valuation to take that information into account. Reasonable knowledge of a hypothetical buyer and seller include facts a reasonable buyer would uncover, and the CCA took the position that a hypothetical willing buyer "would be reasonably informed ... and would have knowledge of all relevant facts, including the pending merger." The taxpayer responded that the IRS "provides no mechanism to explain how the hypothetical buyer might learn of the closely-guarded merger negotiations, nor did Respondent address the fact that to trade on non-public information received from insiders would be illegal." Memorandum, at 27.

Several cases cited by the Chief Counsel involved information whose dissemination is not prohibited by securities laws. *Kollsman v. Commissioner*, T.C. Memo. 2017-40, *aff'd*, 123 AFTR 2d 2019-2296 (9th Cir. 2019) (non-public facts were whether Old Master paintings were amenable to cleaning); *Silverman v. Commissioner*, T.C. Memo. 1974-285, *aff'd*, 538 F.2d 927 (2d Cir. 1976), *cert denied*, 431 U.S. 938 (1977) (donor was in the process of recapitalizing his closely held company for an IPO).

(4) **Regulations.** The CCA cited an exception to the "mean between the high and low" method of valuing publicly traded stock in Reg. §25.2512-2(e). The regulation begins with the following sentence:

> In cases in which it is established that the value per bond or share of any security determined on the basis of the selling or bid and asked prices ... does not represent the fair market value thereof, then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in determining fair market value.

The CCA cited this regulation in concluding that a reasonably informed hypothetical buyer would have knowledge of the pending merger, and to ignore the circumstances of the pending merger "would undermine the basic tenets of fair market value and yield a baseless valuation." The regulation, however, mentions several situations in which the exception might be applied, including few or sporadic sales, a very large block of stock being valued that could not be liquidated in a reasonable time without depressing the market, or a block representing a controlling interest. None of those situations described in the regulation apply to the *Baty* facts.

(5) **Merger Not "Practically Certain" to Occur.** The merger of Emeritus and Brookdale was not "practically certain" to occur on the date of the contribution to the GRAT. The CCA cited an anticipatory assignment of income case, which held that the assignment of income doctrine applied to a gift of shares to charity that were the subject of merger discussions. *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), *aff'g* 108 T.C. 244 (1997). The court held the doctrine would apply if "the surrounding circumstances were sufficient to indicate that the tender offer and the merger were **practically certain** to proceed by the time of their actual deadlines – several days in the future." 174 F.3d at 1004 (emphasis added). The taxpayer points out, though,

that no cases suggest "that a future corporate transaction was 'practically certain' to occur, based solely on the existence of negotiations and in the absence of any agreement." Memorandum, at 42-43. The *Ferguson* case merely adopts a practical approach in determining **when** an agreement is reached; in the *Baty* facts, clearly no agreement to merge the companies had been reached at the time of the contribution to the GRAT.

(6) **Practicalities of Administration.** The government's position that non-public information should be considered in valuing regularly traded stock "would create an administrative nightmare of epic proportions for both taxpayers and the IRS." Memorandum, at 44. The approach is unworkable for a gift by an insider under the securities laws. "How can an insider comply with the tax laws in situations where he or she possesses material non-public information about his or her company? ... [It would] require providing an appraiser with embargoed information– i.e., a violation of securities laws." *Id.*, at 46. To modify the market price

> where non-public information would have an impact on the stock price if disclosed--is to exchange clarity (a rule that is broadly applicable, precise, and relied upon readily-available information) for confusion (a rule that is ad hoc, imprecise, and can only be applied with the aid of hindsight and after substantial and costly expert analysis).
>
> To ignore the market's valuation of a publicly traded stock is something that, to Petitioner's knowledge, **<u>no</u>** court has ever suggested, and Respondent has repeatedly advocated against. To do so would be akin to opening Pandora's Box. *Id.* at 46-47.

e. **GRAT Issues.** In *Baty*, the IRS's primary position is not the Draconian position announced in CCA 202152018 (that the GRAT would not be a qualified GRAT so the entire contribution to the trust would be a taxable gift). Instead, the Notice of Deficiency takes the position that the annuity payments would not be adjusted, so the difference between the IRS's determined value of the contributed stock and the value of the contribution reported on the gift tax return was a gift. The IRS argued, **in the alternative**, that the annuity interest would not constitute a qualified interest (meaning that the retained annuity payments would be valued at zero).

23. Malpractice Action Regarding Advice Involving Creation of FLP and Sale of LP Interests, *Wellin v. Farace*, (4th Cir. November 22, 2021)

a. **Synopsis**. Mr. Wellin ("Wellin"), on the advice of his estate planning attorney, in 2003 transferred about $90 million of Berkshire Hathaway Class A stock to a limited partnership, apparently to reduce estate taxes with valuation discounts. He owned a 98.9% partnership interest and an LLC controlled by his three children (from a prior marriage) owned the remaining 1.1%. In 2006, the attorney advised Wellin that the valuation discounting plan "was now considered questionable" and recommended that Wellin sell his limited partnership units to a grantor trust with his three children as trustees. Wellin did not proceed at that time, but, after being diagnosed with cancer in 2008, he implemented the sale strategy in 2009 by creating a grantor trust and selling his units to the trust in exchange for a note with a face amount of about $50 million. The attorney predicted future estate tax savings of $14 - $18 million resulting from the 2009 sale transaction.

After Wellin expressed confusion about the 2009 sale transaction, the attorney sent several letters in January 2010 and November 2011 explaining that the sale was "a very efficient strategy for reducing estate tax" by "freezing" the estate, and that "more wealth" would pass to the children.

On February 8, 2012, Wellin's wife sent an email to the attorney expressing concern over the attorney's loyalty to Wellin and suggesting he was giving priority to the interests of the children regarding advice about Wellin's tangible personal property. Wellin changed attorneys in mid-2013, and the new attorney filed suit in July 2013 to set aside the sale because Wellin did not understand that he had relinquished control of the partnership interests and would be liable for income taxes if the children sold the stock owned by the partnership before Wellin's death. That litigation was eventually dismissed without prejudice upon settlement of the case.

In late 2013, the children sold the Berkshire Hathaway shares for $157 million. Wellin died in 2014.

The Estate sued the attorney in February 2016 (within three years of when the new attorney was engaged), alleging that the original attorney "failed to inform Mr. Wellin about the risks and consequences of the 2009 transaction, including Mr. Wellin's potentially substantial tax exposure." Expert witnesses filed reports regarding alleged breaches of the standard of care, including:

- the attorney "misrepresent[ed] the actual risks [and] benefits" of the 2009 sale;
- the statement that the sale would result in "more wealth" for the children was "grossly misleading;"
- the attorney failed to advise of "potential gift tax liability of $17.5 million, plus interest and penalties, in exchange for only a *potential* savings in estate tax;"
- the attorney failed to inform Wellin that "he risked 'extreme' income tax liability if the Wellin children liquidated their assets in [the FLP] during Mr. Wellin's lifetime;" and
- Wellin "may not have [had] sufficient assets and liquidity to pay income taxes" that could have resulted, and that the potential income tax exposure exceeded $40 million, plus interest, from the sale of the partnership's assets while Wellin was still alive.

The lawsuit also alleged claims (i) relating to the 2003 creation of the FLP, (ii) regarding a conflict of interest in representing both the Estate and one or more of the Wellin children, and (iii) regarding aiding and abetting two of the children in breaching their fiduciary duties in connection with the 2009 sale transaction, but those claims were later abandoned.

The defendant-attorney moved for summary judgment on grounds that the claim was barred by the three-year statute of limitations because Wellin's wife's 2012 email reflected that the Estate was on notice of its potential claims against the attorney by that time. The district court granted defendant's motion for summary judgement. The Fourth Circuit reversed, reasoning that the purported conflict of interest in handling the disposition of the personal property referred to in the 2012 email and alleged failure to advise of tax risks were "different types of injuries." Knowledge of the attorney's interaction with the children concerning the personal property "did not place Mr. Wellin on notice that he should investigate the defendants' work performed three years earlier regarding a complicated tax strategy." "[A] person of common knowledge could not readily have discovered the alleged breach of duty involving the tax implications of the 2009 transaction ... [and] nothing in the documents relating to the 2009 transaction revealed any information about the transaction's tax consequences." Disputed issues of material fact exist regarding whether the purported malpractice was discoverable before the defendant hired the new attorney in mid-2013, and the summary judgment barring the claims under the statute of limitations was vacated. *Wellin v. Farace*, 2021 WL 5445968 (4th Cir. Nov. 22, 2021).

b. **Observations.**

(1) **Illustrative of Potential Claims Regarding Tax Advice and Representation of Multiple Family Members.** The case is an example of malpractice claims that potentially could arise regarding advice in connection with the creation of an FLP and the sale of units to a grantor trust controlled by the trust beneficiaries. The experts pointed out potential breaches related to the failure to advise about potential gift tax claims, the overstatement of estate tax advantages, and the failure to warn of potential income tax risks associated with the sale of assets prior to Wellin's death.

In addition, the case is an example of conflict of interest claims that could arise involving multi-family member representation without clear disclosure and waivers in engagement letters. (Planners should be especially sensitive to later possible allegations of conflicts of interest that may arise between a spouse and children by a prior marriage.)

(2) **Litigation Pending.** The litigation is still pending. The defendant-attorney no doubt will present evidence in defense against the malpractice allegations and will attempt to limit the scope of potential damages. (For example, footnote 4 of the opinion states: "The Estate did not pay any

tax on the Wellin children's sale of the stock shares, and any attempt to collect such a tax by the IRS appears now to be barred by the statute of limitations.")

Resource. For an excellent discussion of planning implications for estate planning attorneys arising from fact scenarios similar to the *Wellin* situation, see Sandra Glazier, Martin Shenkman, Jonathan Blattmachr & Joseph Garin, Wellin v. Nixon, Peabody, LLP – *Case Lessons on Defensive Practice,* LEIMBERG ESTATE PLANNING NEWSLETTER 934 (January 20, 2022).

24. Treatment of Amounts Passing to Children as Deductible Claim Against Estate, *Estate of Fulton v. Commissioner* (Pending Case)

A case pending in the Tax Court addresses a very interesting scenario. A divorcing wife insisted in the marital property settlement agreement that two-thirds of the spouses' respective estates pass to their six children. The husband died with an $858 million gross estate 41 years later without leaving two-thirds of his estate to the six children as required under the settlement agreement. The children sued and received $473 million, which the estate deducted as a creditor claim under §2053 for estate tax purposes. The IRS disagreed, and the total deficiency is $215 million (including other issues as well). *Estate of Fulton v. Commissioner*, Tax Ct. Dkt. No. 7200-22 (Petition filed April 4, 2022).

The case is intriguing. The estate argues that no estate tax should be payable with respect to assets passing to the children as required under the marital property settlement agreement. If the transfer to the children had not been bargained for in the settlement agreement, but the decedent merely left two-thirds of his estate to his children, no deduction would have been allowed. However, §2043(b)(2) in conjunction with §2516 may allow a claim deduction under §2053.

- Section 2053(c)(1)(A) prohibits a debt deduction based on a promise or agreement that is not based on adequate and full consideration in money or money's worth.
- Section 2043(b)(1) states that the relinquishment of marital rights does not constitute consideration in money or money's worth, but §2043(b)(2) (adopted later in the Tax Reform Act of 1984) provides that "[f]or purposes of §2053 (relating to expenses, indebtedness, and taxes), a transfer of property which satisfies the requirements of paragraph (1) of section 2516 (relating to certain property settlements) shall be considered to be made for an adequate and full consideration in money or money's worth."
- Section 2516(1), in turn, refers to transfers of property under a property settlement agreement within a certain period related to a divorce that are "in settlement of his or her marital or property rights."
- A relinquishment of support rights is treated as consideration in money or money's worth for gift tax (Rev. Rul. 68-379) and estate tax (Rev. Rul. 71-67) purposes. *Leopold v. United States*, 510 F.2d 617 (9th Cir. 1974), allowed an estate tax claim deduction under §2053(a) where a spouse released a portion of her support rights in exchange for the decedent spouse's promise to bequeath a certain sum to their daughter.

The estate argues in its petition that the wife "gave up substantial, valuable rights and claims to a greater share of Decedent's property and ... support sufficient to sustain the standard of living she had enjoyed during marriage in order to obtain the agreement" that the husband leave two-thirds of his estate to the children. The wife "would have received significantly more property and financial support" under Nevada law had she not negotiated for the bequest to the children. *See* Erin McManus, *Video Poker Pioneer's Estate Says Children's Claim is Deductible*, TAX NOTES (April 25, 2022). (If those purported facts are true, perhaps the IRS's primary argument should be that the *wife* made a gift when the agreement was made with husband.)

The prospect of receiving a huge deduction for leaving one's estate to his or her children is most intriguing but raises interesting questions of possible taxpayer abuse.

> Langdon T. Owen Jr. of Cohne Kinghorn told *Tax Notes* that the IRS "apparently is looking at this situation as a will contest (not deductible) rather than a true debt since the sharing agreement seems to have some donative intent behind it. On the other hand, the obligation to divide the estate does appear to be a bona fide agreement with

consideration, and particularly when made so long ago, the agreement does not have the earmarks of a sham or of lacking good faith."

"The good faith of the defaulting party in cutting off the kids' rights to a share of the defaulter's estate might be a different story. Was the default actually a tax planning strategy? Could there have been a plan to default, creating a claim under state law, and then deduct the share of the estate that measures the value of the claim for a very large tax savings? This will be an interesting case to watch," Owen said. *Id.*

25. New Norms in Trust Law – Right to Information; Decanting; Nonjudicial Settlement Agreements; Directed Gifts

The discussion about new trust norms is based on comments by M. Read Moore (San Francisco, California). Rapid changes in trust law over the last two decades have resulted in new norms for trust planning. States have diverged greatly in the implementation of these concepts and laws, resulting in a need for all estate planning professionals to be aware of the changing landscape and how the rules differ from state to state. In particular, the following four key changes have created new helpful norms but raise fundamental questions regarding the essence of trust law: (1) rules about providing information to trust beneficiaries, (2) decanting, (3) nonjudicial settlement agreements, and (4) directed trusts.

a. **Beneficiaries' Rights to Trust Information.** A trustee is tasked with administering the trust for the benefit of the beneficiaries. Accountability to the beneficiaries is paramount—beneficiaries need to know the terms of the trust and what actions the trustee has taken in order to be able to enforce their rights. In addition, trustees need finality—to be able to inform the beneficiaries of the actions taken by the trustee and allow them the chance to review and either contest or approve of the actions.

(1) **Uniform Trust Code**. Before the Uniform Trust Code ("U.T.C."), the laws surrounding the provision of information to trust beneficiaries varied greatly. The Uniform Law Commission ("ULC") thought the concept of entitling trust beneficiaries to certain information was important enough to specify the rules and then state that a settlor cannot modify these rules in the terms of the trust instrument. The ULC crafted a three-pronged approach, entitling qualified beneficiaries to the following key pieces of information: (1) notification that a trust exists, the identity of the settlor, and that the beneficiary has rights to certain information, (2) a copy of the trust instrument upon request, and (3) an annual report of the "trust property, liabilities, receipts, and disbursements, including the source and amount of the trustee's compensation, a listing of the trust assets and, if feasible, their respective market values." U.T.C. § 813. The U.T.C. also included a one-year statute of limitations, providing a beneficiary one year to bring a claim for breach of a fiduciary duty from the date that the beneficiary received the report. U.T.C. § 1005(a).

(2) **State Enactment**. As of May 1, 2022, thirty-six states have enacted the U.T.C. However, most states modified the provisions addressing notification to beneficiaries upon enactment, which Read argues largely defeated the purpose of uniform legislation. Therefore, it is important to closely review each state's version of the U.T.C. to understand the trustee's duty to inform and report to beneficiaries. Some states kept intact the provisions covering the trustee's duty to inform and report but removed them from the list of provisions that could not be modified in the trust instrument. Other states modified the specifics of the trustee's duty to inform and report but kept them on the list of nonwaivable provisions. Non-U.T.C. states vary greatly, from some having rules similar to those in the U.T.C., to others on the opposite end of the spectrum facilitating the use of "silent trusts."

(3) **Court Action**. Given that these provisions were so controversial, how have the courts interpreted them? There have been a few appellate court decisions that allow us to see how these statutes will be interpreted, many of which have been related to the mundane issues, such as what exactly is required in the annual "report." Other cases have analyzed the extent to which settlors and trustees can limit the information received by the beneficiaries without violating public policy, the most notable of which was a North Carolina case from 2010. In that case, the trust instrument provided that the trustee was not required to provide reports to the beneficiaries or any court. The court held that this language could not prevent the court from ordering the trustee to provide information to the beneficiaries that would enable them to enforce their rights.

The court noted that this strips the beneficiaries of their right to enforce the trust as well as the court's right to enforce the trust, which was against public policy. *Wilson v. Wilson*, 690 S.E.2d 710 (N.C. App. 2010).

(4) **Where Do We Go from Here?** In general, the new statutes are an improvement to the common law, providing trustees with guidance on what they should provide and beneficiaries with guidance on what they should expect to receive. However, the goal of uniformity among the states has not been met, states continue to tinker with their provisions, and there are often overlapping or inconsistent provisions and concepts with these new laws. The new legislation has resulted in additional complexity, not the simplicity originally sought. Therefore, it is important for attorneys to carefully analyze these provisions in trust instruments and discuss them with clients, as opposed to treating them as boilerplate language that warrants limited discussion.

Lastly, a healthy level of caution is warranted when taking advantage of the "silent trust" statutes available in some states. It is easy to understand the appeal of withholding information in particular beneficiary situations, such as not wanting to ruin a beneficiary's work ethic or create a problem for the beneficiary's lifestyle. However, as the so-far limited sample of court decisions reveal, when courts have analyzed situations in which a trust instrument or trustee attempts to limit information delivered to a beneficiary, the courts have been inclined to favor beneficiaries' rights to information over the settlor's right to limit information.

b. **Trust Decanting.** Trust decanting in general is not new. Decanting has been around for a while in England as well as several states in the U.S. under common law principles, and we have always been able to draft a power to decant into trust agreements as well. In recent years, more interest has grown in decanting due to the realization that it can be a very helpful way to modify trusts without court involvement, resulting in the enactment of various statutes throughout the states.

(1) **State Legislation.** Legislative activity in this area began with New York in 1992 and from then through 2014, about a dozen states enacted some form of legislation allowing for decanting. The ULC released the Uniform Trust Decanting Act ("U.T.D.A.") in 2015 after seeing all the activity at the state level and the vastly differing statutes. The U.T.D.A. has since been enacted by thirteen states. Given the timeline and evolution of the states' statutes, there is not great uniformity amongst the state laws. It is apparent that there are some key features and considerations that each state grappled with when enacting these statutes, including choice of law issues, how much discretion a trustee must be granted related to the scope of the trustee's authority to decant, whether this is a fiduciary power, whether a trustee now has a duty to decant, and when the trustee is required to give notice to beneficiaries.

(2) **Court Action**. There have been several appellate cases considering the question of whether the trustee has a decanting power over a particular trust, either pursuant to a decanting statute or other principles. The most notable decanting case thus far dealt with the more thought-provoking issue of whether a trustee breached its fiduciary duties when exercising a decanting power that was in theory authorized under state statute. *See Hodges v. Johnson*, 177 A.3d 86 (N.H. 2017). In *Hodges*, the Supreme Court of New Hampshire determined that a series of decantings that had the effect of removing certain contingent remainder beneficiaries violated the trustee's duty of impartiality. In quoting an article on the topic, the court implied that even if state law would allow a trustee to decant in a manner that has the effect of removing beneficiaries, the court was skeptical that a trustee could ever take such action without violating its fiduciary duty of impartiality owed to the eliminated beneficiary.

(3) **Tax Considerations**. The IRS released Notice 2011-101 inviting the public to provide commentary on the income, gift, estate, and GST tax ramifications of decanting, as it was considering publishing guidance on these topics. The notice provided that until the IRS issued this forthcoming public guidance, it would not privately rule on these issues. The decanting project was added to the 2011-2012 Priority Guidance Plan, and the "no-rule" list was updated to include decanting-related issues. The IRS still has not released this public guidance. The topic was removed from the 2012-2013 Priority Guidance Plan and has not reappeared, but it remains

on the no-rule list. Many practitioners are comfortable with some of the tax aspects of decanting, but many others remain uncertain.

(4) **Where Do We Go from Here?** The developing decanting laws have undoubtedly been helpful in situations where trustees need to modify certain trust terms to fulfill the settlor's intent or modify administrative terms and would prefer to do so without court involvement or consent of beneficiaries. But they also add greater complexity to trust planning. To what extent should practitioners discuss decanting laws and powers with clients while preparing supposedly irrevocable and unamendable trust instruments? The fact that there are also tax uncertainties further complicates providing advice to trustees and beneficiaries considering decanting to effect desired modifications.

c. **Nonjudicial Settlement Agreements.** For mundane issues, such as needing to modify trustee succession provisions, getting the court involved seems to be a waste of judicial resources and time for attorneys and all trust parties involved. The decanting legislation helped with this some, but decanting puts the burden on the trustee to make that decision. Oftentimes a trustee would prefer that the beneficiaries be involved in the modification or there is some other reason that decanting will not work in the context at hand. Starting in the 1980s and early 1990s, some states developed statutes to resolve trust disputes outside of court and to provide measures for representing minor and unborn beneficiaries. While these statutes originated in the litigation context, trustees soon realized that agreements of this nature could be used outside of the dispute resolution context for other trust-related issues.

(1) **State Legislation**. Washington was the first state to enact a statute allowing beneficiaries to resolve trust related matters without court involvement in 1984. Oregon and Illinois followed. Statutes became much more prevalent with the U.T.C. (originally released in 2000) permitting nonjudicial settlements and containing comprehensive coverage of virtual representation to facilitate such settlement agreements. U.T.C. § 111 includes a long, nonexclusive list of matters that may be resolved through a nonjudicial agreement. Such agreements are valid only to the extent they could be properly approved by the court and do not violate a material purpose of the trust.

U.T.C. § 411 gives the states an option regarding agreements to which the settlor and all beneficiaries are parties. Under those circumstances, a modification can be made even if it is inconsistent with a material purpose of the trust, and the states may choose whether or not to require court approval. If the settlor's consent is not obtained, an agreement among only beneficiaries is valid only if a court determines that the modification does not impair a material purpose of the trust.

Among the states that adopted the U.T.C., these sections were tinkered with regularly. Some states modified the list of matters that may be resolved, some states included more guidance on the parties required to be involved, and some states modified the virtual representation provisions. Most states retained the requirement that an agreement among only beneficiaries (without the settlor) is permissible only if they obtain court approval and it does not impair a material purpose of the trust.

(2) **Court Action**. There have been a few appellate cases addressing nonjudicial settlement agreements under the U.T.C. as well as under non-U.T.C. statutes. The most notable recent case, *In re McGregor*, 954 N.W.2d 612 (Neb. 2021), highlights potential hazards involved with nonjudicial settlements. In that case, three beneficiaries entered into a nonjudicial settlement agreement to terminate a trust, sending assets outright to two of the beneficiaries. Six years later, one of the beneficiaries claimed to revoke the agreement, causing another beneficiary to ask the court to approve the agreement under Nebraska's version of U.T.C. § 111. The trial court issued an order invalidating the settlement agreement on three grounds: (1) there was no representation in the agreement of unknown and unascertained beneficiaries, who were necessary parties, (2) the agreed changes were not permissible under the Nebraska statute, and (3) the agreement violated a material purpose of keeping assets in trust by sending the assets outright to the beneficiaries. The Supreme Court of Nebraska affirmed the decision, stating that

since the trust agreement included a spendthrift clause, the agreement to terminate the trust violated a material purpose.

(3) **Where Do We Go from Here**? Through the U.T.C. and other legislation, settling trust-related controversies has become much easier and saved courts' valuable time. While simplifying the modification of trusts was not the original goal of this legislation, it has undoubtedly facilitated countless trust modifications. Many of the trust law uncertainties of decanting can be avoided through the use of a nonjudicial settlement agreement, but the tax uncertainties still exist. Clients should be aware of these statutes and the fact that irrevocable and unamendable trust instruments are now in fact revocable and amendable, sometimes despite their best efforts. Some clients may embrace the flexibility, but not all will. Some clients may wish to address directly the idea of nonjudicial settlement agreements within the trust instrument, whether it is to attempt to prohibit them entirely or to place guidelines under which the trust may or may not be modified. In addition, detailed statements of intent or statements of material purposes could help address these issues in a less direct fashion.

d. **Directed Trusts.** Another trend that has been around a while, especially in the offshore context, is dividing fiduciary duties among various officeholders. Trust instruments have long incorporated roles such as advisers, trust protectors, power holders, and co-trustees with exclusive authority over certain decisions. However, until recently, what was missing in the United States was legislative and court guidance regarding these arrangements, specifically relating to how these officeholders interact with the trustee and which ones have fiduciary duties.

(1) **State Legislation.** The original 2000 version of the U.T.C. included § 808, which dealt with directed trusts in summary fashion without great detail. In 2017, the ULC released the Uniform Directed Trust Act ("U.D.T.A."), which provided the states with model legislation that was much more extensive and went into detail regarding the division of powers and duties, as well as which roles are deemed to be fiduciary roles. Thirty-two states adopted the U.T.C. before the U.D.T.A. was released. Some of these states have not since adopted the U.D.T.A., some have adopted it without fundamental changes, some have taken pieces from the U.D.T.A. and incorporated them into their equivalent of the original § 808 of the U.T.C., and still others have adopted their own directed trust legislation prior to the release of the U.D.T.A. The U.T.C. was revised in 2018, dropping § 808 because it is now superseded by the U.D.T.A.

The U.D.T.A. has been a popular uniform act. Eighteen states have enacted or introduced it, largely unamended. One area in which there has not been uniformity is the standard to which directed trustees are held when following the directions of an adviser. Some states' legislation provides that the directed trustee has no liability at all in following the directions of an adviser, while others provide that a directed trustee will have no liability so long as the directed trustee does not engage in willful misconduct. The comments to § 9 of the U.D.T.A. explain that the ULC chose the "willful misconduct" standard "after extensive deliberation and debate" and provide a very helpful explanation of the history and the ULC's thought process on this topic.

(2) **Court Action**. Due to the popularity of the directed trust structure, there is a decent collection of cases from the last twenty-five years. Some of the cases consider legal issues related to the division of powers granted in specific trust instruments and therefore provide limited precedential value on interpreting legislation. Others have considered the duties and powers of the different officeholders in a more general sense.

Two Delaware cases are particularly noteworthy as situations in which the Court of Chancery did not allow the conversion of traditional trusts to directed trusts. *See In re Peierls Family Inter Vivos Trusts*, 59 A.3d 471 (Del. Ch. 2012), and *Trust for Benefit of Shadek*, 118 A.3d 182 (Del. Ch. 2015). Converting a traditional trust to a directed trust is one of the most common changes families desire to make in older trust instruments, so these two cases provide valuable insight as to how a court may not agree with such a change.

(3) **Where Do We Go from Here?** The legislation is very helpful when it comes to providing comfort to trustees who must take action based on the direction from an adviser or other officeholder.

However, the legislation cannot address all issues in the directed trust context because there are infinite ways trust instruments can divide the roles, powers, and duties of fiduciary officeholders as well as non-fiduciary officeholders. This is one area where despite the existence of good legislation, the trust instrument still controls. As the cases have demonstrated thus far, courts will continue to analyze trust instruments on a case-by-case basis to determine the relationships between officeholders, the officeholders' duties to beneficiaries, the scope of powers held by officeholders, and the procedures through which officeholders can exercise their powers. All of this results in a premium on good drafting when the trust instrument is created.

26. Common Errors in Estate Planning Practices

The following discussion is based on comments at the 2022 Heckerling Institute on Estate Planning by Lauren Wolven of Chicago, Illinois.

a. **Apologizing for Mistakes.**

(1) **Helpful Effects of Apology.** A good apology requires (1) accepting responsibility for the error, (2) being unqualified, and (3) making amends. Clients will be more inclined to bring a lawsuit for malpractice when they are angry with their attorney or physician. An honest expression of regret and attempt to make amends may assuage the anger.

(2) **Risks of Apology.** Apology laws have been adopted in many states since the 1980s – providing that apologies cannot be used against the apologizing person in court. But that is not universal. In any event, an apology may be a mitigating factor and the absence of an apology may be an aggravating factor in a malpractice case.

(3) **Malpractice Insurance Carriers Advice.** Advising malpractice insurance carriers of potential claims is a necessity, and advice from the carrier's attorneys can be very helpful. For example, the attorney may advise about how to apologize in a particular situation without admitting fault or liability for the error.

b. **Ethical Rules Regarding Mistakes.** Ethical rules do not require an attorney who makes an error to apologize, but they do require the attorney to disclose mistakes that may harm the client's interest. The failure to disclose a mistake may be sanctionable. Model Rules of Professional Conduct §1.4.

c. **Common Goofs.**

(1) **General Power of Appointment Marital Trusts.** The QTIP trust is the most commonly used type of trust qualifying for the marital deduction since its creation in 1981. The marital deduction trust most commonly used before 1981 is one that includes the spouse as the only beneficiary during her life and gives the spouse a mandatory income interest and a general power of appointment. §2056(b)(5). For this purpose, the spouse must have a power to appoint to the spouse or to her estate. Merely giving the power to appoint to her creditors is *not* sufficient. There can be no restrictions (such as a time limit or requiring the consent of another person) on the spouse's ability to exercise the power.

(2) **Per Stirpes.** In trust instruments, define what is meant by "per stirpes," because the term can have different meanings in different states. Classic (strict) per stirpes divides the estate into equal shares for the generation nearest the decedent, even if no person in the nearest generation survives the decedent. RESTATEMENT (THIRD) OF PROPERTY §2.3(d) (1999). Modern (modified) per stirpes divides the estate into equal shares for the nearest generation surviving the decedent that has any living members. For example, if no children of the decedent are surviving, the estate is divided into equal shares for each grandchild who is surviving or deceased but survived by descendants.

A per stirpes distribution is a class gift among descendants of a specific person. For example, the following are incorrect: "my brother and sister, per stirpes;" 'Bob, per stirpes;" or "Bob and Judy, per stirpes."

"In equal shares, per stirpes" is ambiguous. (A per stirpes distribution among various people is often *not* in equal shares.) Do not use "in equal shares" and "per stirpes" in the same sentence.

(3) **Tax Apportionment Clauses.** A tax apportionment clause may be one of the most important dispositive provisions in a will or trust. Consider precisely what clients want in order to make sure taxes are apportioned as desired. For example, Charles Kuralt left a ranch to a longtime companion and the rest of his estate to his wife and daughters. The will provided that estate taxes were to be paid from the residuary estate. Therefore, his wife and daughter had to pay estate taxes attributable to the ranch property.

Federal estate tax apportionment statutes apply for life insurance (§2206), general power of appointment property (§2207), QTIP property (§2207A), and §2036 transfers (§2207B).

(4) **GST Issues.** Commonplace errors involving GST issues (which can be quite complicated) include (i) changes that cause the pre-enactment trust to lose its exempt status, (ii) improper allocation of GST exemption (including inadvertent automatic allocation, improper overriding of automatic allocation, failing to realize that automatic allocation does not apply to a gift with a hanging withdrawal power, §2632(c)(3)(B)(iv)), or (iii) failure to allocate exemption to annual exclusion gifts to trusts (an annual exclusion gift to a trust is exempt only if it is a single-beneficiary "vested" trust that will be included in the beneficiary's gross estate, §2642(c)).

(5) **Crummey Withdrawal Powers.** Withdrawal powers that lapse in excess of the greater of $5,000 or 5% of the trust result in a taxable release, which can treat the lapse of the excess amount (1) as a taxable gift (unless the gift is incomplete for other reasons) and (2) as a contribution to the trust by the beneficiary, thus causing the grantor "string statutes" to trigger gross estate inclusion for the beneficiary.

27. Private Foundation Self-Dealing Rules

The following discussion is based on comments at the 2022 Heckerling Institute on Estate Planning by Brad Bedingfield of Boston, Massachusetts.

a. **Historical Overview.** Since 1913, §501(c)(3) provides that charities cannot serve private purposes and net earnings cannot inure to the benefit of private individuals. From 1950 to1969, §503 addressed "prohibited transactions" with "related persons." Those provisions were modified in 1969 because the arm's-length standards were hard to enforce.

The current approach (1) prohibits private inurement or serving private purposes for all charities, (2) applies intermediate sanctions for public charities (§4958), and (3) applies self-dealing rules for private foundations (§4941).

b. **Self-Dealing General Principles.** The self-dealing rules apply fixed standards that are not dependent on subjective arm's-length determinations. As a general rule, assume all direct or indirect financial transactions between a disqualified person (DP) and a private foundation (generally referred to below as a foundation) are taxed and subject to correction. Most of the self-dealing rules do not focus on a detriment to the private foundation or potential benefit to the DP.

Section 4941 includes six categories of self-dealing, broadly construed: (1) sale or exchange or leasing of property; (2) lending of money or other extensions of credit; (3) furnishing of goods, services, or facilities; (4) payment of compensation or payment or reimbursement of expenses; (5) transfers to, or use by or for the benefit of, a DP; and (6) payments to government officials.

There are various exceptions, but they are narrowly construed. Generally, DPs can provide things to the foundation for free if in furtherance of the foundation's charitable purposes. Private foundations generally can provide things to DPs if on the same terms as to the general public and in furtherance of the foundation's charitable purposes.

c. **Disqualified Persons – Individuals Who Need to Worry About Self-Dealing.** Four categories of DPs under §4946 are:

(1) substantial contributors (including the creator, even if not a contributor, and including anyone owning 20% of contributing entities);

(2) foundation managers (including certain senior employees);

(3) family members of the above (ancestors, descendants down through great-grandchildren, and spouses of all of them [tip: DPs go up and down but not sideways to siblings, aunts, uncles, cousins, etc.; but if a foundation was created by a person's parents, brothers of that person would be descendants of the parent and all siblings would be DPs]); and

(4) 35% entities (if DPs have 35% voting power of corporations, 35% profits interest of partnerships, or 35% beneficial interest in trusts or estates – an estate is not automatically a DP just because the decedent was).

d. **Entities Subject to Self-Dealing Rules.** Entities that are subject to the self-dealing rules are private foundations, including §4947(a)(1) trusts, §4947(a)(2) split-interest trusts (CRTs and CLTs), and estates and certain trusts to the extent of private foundation expectancies. In addition, entities controlled by private foundations are subject to the rules. "Control" for that purpose means more than just 50% voting control but the ability to require the entity to engage in self-dealing or to veto such a decision.

e. **Consequences of Self-Dealing.**

(1) **Penalties.** First-tier penalties apply on the amount involved, and much larger second tier penalties apply on the amount involved if the self-dealing is not corrected within the "taxable period" (by the earlier of the mailing of a deficiency notice or the when the first-tier tax is assessed). Penalties on a DP (with no "reasonable cause" abatement) for each act of self-dealing are: First tier-10%, Second-tier-200%. Penalties for foundation managers (if there is a "knowing" violation) are: First tier-5%, Second tier (if the manager refuses to correct the self-dealing)-50%.

The penalties apply to each separate act of self-dealing, and a new act of self-dealing occurs at the beginning of each year until it is corrected.

(2) **Correcting Actions.** Correcting the self-dealing is necessary to avoid the Draconian second-tier penalties. Correction means "undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards." Treas. Reg. §53.4941(e)-1(c). For example, if a sale of stock to the foundation was self-dealing, the DP must re-purchase the stock, but leaving the foundation with any growth in value. The foundation gets any upside but does not have to bear any downside from the self-dealing transaction.

Any correction under that regulation is not a new act of self-dealing, but other forms of correction may constitute new acts of self-dealing. For example, correcting an act of self-dealing by transferring real estate to the foundation in lieu of a cash correction is a second act of self-dealing. Rev. Rul. 81-40.

f. **Categories of Self-Dealing.**

(1) **Sale or Exchange, or Leasing, of Property.** Any sort of exchange is included, whether or not it is detrimental to the foundation or beneficial to the DP.

(a) **Encumbered Property.** Transfers of encumbered property are treated as sales, even if nonrecourse. An exception applies for old and cold debt (at least 10 years old). A "first-bite" exception applies if one's DP status arises as a result of the transaction (such as giving encumbered property to a foundation); planning tip—when giving encumbered property to a foundation, give it to a new foundation or on death, empower the executor to give to a new foundation created by the executor.

(b) **Indirect Sales.** Beware of indirect sales through controlled organizations or through intermediaries (such as a grant of real estate from the foundation to a public charity, which the charity later sells to a DP). Ensure that no earmarking or pre-arrangement exists.

(c) **Estate Administration Exception.** The estate administration exception requires (1) a power of sale (or the power to reallocate property or a requirement to sell pursuant to an option), (2) court approval, (3) the sale is completed before the estate is terminated, (4) the consideration must be for fair market value (taking into account pre-existing options), and (5) the consideration received by the estate must be at least as liquid as what was sold (or the foundation must receive assets related to its charitable purposes or receive assets required under a pre-existing option). Pre-planning to qualify for the estate administration exception can be facilitated by having an option to purchase in place prior to the DP's death. The IRS will not rule on whether the estate administration exception applies if the DP issues a promissory note in exchange for property of an estate or trust. Rev. Proc. 2022-3, §3.01(126).

(d) **Leases.** Any lease other than an interest-free lease is self-dealing. The foundation can be required to pay certain maintenance expenses, such as janitorial services, utilities, and other maintenance costs paid directly to service providers.

(2) **Lending of Money or Other Extensions of Credit.** Any loan from a DP to the foundation other than an interest-free loan is forbidden. Even then, the funds loaned to the foundation must be used by the foundation exclusively for an exempt purpose. The foundation can never lend to a DP. Indirect lending is also self-dealing. For example, an estate may own a promissory note owed to the decedent by family trusts that are DPs. The receipt of those notes by the foundation would be a self-dealing transaction. The IRS recently announced that it will no longer issue rulings on whether the receipt of a non-voting interest in an LLC that owns a promissory note issued by a DP is self-dealing. Rev. Proc. 2022-3, §3.01(127), *superseding* Rev. Proc. 2021-40.

(3) **Furnishing of Goods, Services, or Facilities.** Anything from a DP to a foundation other than free goods, services, or facilities is self-dealing; even then they must be used for exempt purposes. A foundation may provide goods, services, or facilities to a DP on the same terms as for everyone else AND they must be functionally related to the foundation's charitable activities. For example, a DP can be given access to a private road to access the DP's facilities where the general public is allowed to use the road to reach the museum. Rev. Rul. 76-459.

(4) **Compensation; Reimbursement of Expenses.** The general rule precludes paying compensation to or reimbursing expenses of a DP, but exceptions override the general rule. An exception applies for compensation for personal services that are reasonable and necessary to carrying out the exempt purposes as long as the payments are not excessive. What constitutes "personal services" is unclear, but it generally includes brokerage, legal investment counseling, general administration, and general banking services and services in defense of the foundation. A Tax Court memo case further muddies the water by saying that only services that are professional and managerial in nature qualify for the personal services exception. *Madden v. Commissioner*, T.C Memo. 1997-395 (exception did not apply to a contract with DP's company for general maintenance, janitorial, and custodial services, because they are not "professional" services). The speaker thinks that *Madden* is wrong, and it is inconsistent with prior PLRs that applied the exception for maintenance services.

The test for whether compensation is excessive is whether payments exceed what would ordinarily be paid for like services by like enterprises under like circumstances. Treas. Reg. §1.162-7. All cash and non-cash benefits must be considered, whether or not treated as compensation for income tax purposes. Compensation for past services may be permissible if it is in the nature of end-of-employment compensation (such as a pension awarded for past services) as long as all compensation payments are reasonable in the aggregate. Rev. Rul. 74-591.

Reimbursement of expenses would seem not to present potential for abuse, but reimbursement payments are self-dealing. A possible counter argument is that the reimbursement is the repayment of an interest-free loan (but that may be inconsistent with the provisions in the regulations that maintenance payments for rent-free leases must be paid directly to service providers and not to the DP). Another possible argument is that the reimbursement is in the nature of compensation for personal services furthering the foundation's exempt purposes.

Compensation advances are allowed within the exception if reasonable in relation to the duties (but generally should not exceed $500).

(5) **Transfer To, Use By or For the Benefit of a DP.** This is a catch-all provision, not limited to examples in the regulations. Examples include access to capital if co-investing with the foundation (for example, to meet minimum investment requirements or to qualify for reduced fees), displaying art in the DP's personal residence, satisfying binding pledges of the DP, payment by the foundation of Chapter 42 excise taxes imposed on the DP (unless compensatory), or the purchase or sale of stock to manipulate the stock price. An exception applies for incidental and tenuous benefit, such as reputation benefits or benefits flowing principally to the general public.

(6) **Special Situations – Family Office Sharing of Resources.**

- Office space can be provided to the foundation for free or the foundation can pay a third-party owner directly (but cannot reimburse the DP for a portion of the office space rent).
- Equipment can be provided for free, and of course, the foundation could provide its own supplies.
- Employees can be provided for free or the foundation may reimburse for employees providing personal services where reasonable, necessary, and not excessive. In light of the *Madden* case, this exception may apply only for personal services that are "professional and managerial in nature." Beware of reimbursement arrangements even if they are fair to the foundation; they can be self-dealing unless they fall within one of the exceptions.

28. Domestic Private Placement Life Insurance

The following observations are from a panel discussion at the 2022 Heckerling Institute on Estate Planning by Mary Ann Mancini, Lawrence Brody, Richard Weber, and Mike Cohn.

a. **Advantages of Private Placement Life Insurance (PPL).** PPL (which, more specifically, is private placement variable universal life insurance), offers significant advantages:

- Tax-deferred investment opportunities (this is a **key characteristic)**;
- Access to customized investment portfolios;
- The ability to withdraw earnings on a tax-free basis;
- Investment strategies not found in other retail-based insurance products;
- Income tax-free death benefits;
- Lower costs than traditional life insurance products;
- PPL products typically have no surrender charges, unlike many traditional life insurance products; and
- Life insurance is exempt from the insured's creditor claims in some states, and cash values of variable life products are typically held in accounts that are segregated from the insurer's general assets and insulated from insurer's general liabilities.

Investing in bond funds or money market funds in a variable policy does not make sense because of the added expenses of the life insurance policy chassis. Consider investing in a PPL policy only when equity investments meet the risk profile of the policy owner.

Variable universal life products can offer guaranteed death benefits, but that results in increased mortality costs for life, reducing the equity returns. The typical PPL policy will not provide guaranteed death benefits.

b. **Modified Endowment Contracts.** Some PPL policies are created as modified endowment contracts (MECs). A MEC qualifies under §101 for income tax-free death benefits, but distributions during life

carry out income first and basis second, like annuities. (Distributions from non-MEC policies carry out basis first and income second.)

Section 7702A describes MECs as policies into which more premiums are paid in the first seven years than are required to keep the policy in effect for the insured's life expectancy. New rules issued in December 2020 reduced the "corridors" for testing non-MECs, which allow funding policies more heavily in early years while still qualifying for non-MEC treatment. The test can only be run by the carrier, and insurance companies will not accept premium payments that would convert a policy into a MEC without first notifying the policy owner of that fact. Once a policy is treated as a MEC, it is always thereafter a MEC.

Even if a non-MEC policy is acquired, the policy owner can reduce the death benefit after the seventh year without affecting the non-MEC status, which would allow lower annual cost of insurance charges and would result in better investment performance of the policy.

If distributions from (or loans from or pledges of) a policy are not contemplated, there is no particular disadvantage of being a MEC (and faster investments into the policy would be permitted). For example, if a policy will be owned by a GST exempt trust that will very likely make no distributions for a number of years, structuring the policy as a MEC may present no significant disadvantages.

c. **Key Distinguishing Factors for PPL Policies.** PPL products are distinguished by (1) many investment options and the ability to add managers for customized investments, (2) a requirement that the owner meet the qualified purchaser (QP) and accredited investor (AI) standards, (3) lower pricing than traditional life insurance products, (4) much lower commissions than traditional policies (only 1-2% of premiums paid, or even lower), (5) mortality and expense risk charges that are negotiated or are 40-50 bps annually, (6) substantial flexibility to design the product to meet the owner's particular goals and make the product as efficient as possible, and (7) no surrender charges. The costs of insurance are comparable to the costs of retail products.

Most PPL products have various mutual funds or "insurance dedicated funds" (IDFs). If an investor wants to add an outside manager to the platform, a separate cloned fund (or new entity) would hold the portfolio assets managed by that manager, but an insurer would not add a manager except for very large investments in the PPL product. (As discussed below, the minimum investment for a PPL policy is about $1 million, and an outside manager would not be added at that level of investment.)

Assets in a PPL policy may be moved around without cost among managers who are managing funds for that product, subject to lockup periods within particular funds. Investors must understand the lockup periods of particular managers in case the manager is not performing as expected. There is no income tax cost to moving assets among available funds or managers because the transactions are all taking place within a life insurance policy.

An owner of a traditional policy may be able to make a §1035 exchange into a PPL policy.

Planners typically think of PPL policies as opportunities for ultra-high net worth investors, but officers in a family office may be able to participate through a supplemental executive retirement plan (SERP) for executives in the office. That is a way for family office executives to participate in these products that would not otherwise be available to them.

d. **Investor Control**. Investor control rules are applied strictly by the IRS. These rules were developed by published rulings, PLRs and early cases. *E.g.*, Rev. Ruls. 77-85 , 80-274, 81-225, and 82-54. The panelists provide this summary:

   a. There can be no arrangement, plan or agreement between the policy owner and investment adviser regarding availability of specific assets to be held. The policy owner can choose among available strategies but cannot influence execution;

   b. Other than the policy owner's right to allocate premiums and transfer funds among available investment options, all investment decisions are made by the investment adviser (hired by the insurance company) in their sole and absolute discretion. Specifically, the policy owner cannot select or recommend particular investments or investment tactics;

c. The policy owner cannot communicate directly or indirectly with any investment adviser regarding selection, quantity, or rate of return of any investment or group of investments held in the policy;

d. The policy owner has no legal, equitable, direct or indirect, interest in any of the assets and all assets are owned by the insurance carrier. A custodian acceptable to the insurance carrier and the investment adviser will be named;

e. All decisions concerning the choice of an investment adviser are made by the insurance company in its sole and absolute discretion.

e. **Process for Advising a Client Interested in Investing in a PPL Policy.**

(1) **Goals.** First, ascertain the client's goals. Is there a particular manager the client wants to use? What insurance carriers have that manager on their PPL platform? Who is the insured? Does the insured have medical issues? Confirm that the owner of the policy is a QP and AI. Confirm that the risk profile of the client is someone willing to make all equity investments within the policy. Confirm that the client does not want death benefit guarantees by the life insurance company. Confirm that the client can live with the investor control rules. Key to policy structure and negotiations--How much is the client wanting to invest in the PPL policy?

(2) **MEC Versus non-MEC.** The starting point is that the policy should be structured as a non-MEC. The client may eventually get comfortable using a MEC (if the client wants no distributions or loans during life from the product, or perhaps because the policy will be owned by a GST exempt long-term trust).

(3) **Carrier Selection.** Look at possible carriers who have the ability to cover the desired amount of insurance, have the desired managers, etc.

(4) **Investment Amount.** The minimum investment in a PPL policy is $250,000 per year for four years, or $1 million overall. But at that low level of investment, the investor cannot negotiate to add a manger to the platform. Investments at that minimum amount will not be able to negotiate lower costs as much as investors making much larger premium amounts. Structuring a PPL policy takes a lot of time by the insurance agent. The commissions are not as large for the agent, but this is satisfying work and agents often like planning with PPL products.

(5) **Active Management.** A PPL policy is not a "put it in the drawer and ignore it" investment. It requires ongoing active management.

29. Elective Share Planning

This summary is based on presentations and panel discussions at the 2022 Heckerling Institute on Estate Planning by Terry L. Turnipseed, Jonathan Lasley, Suzanne Tucker Plybon, and Alex S. Tanouye.

a. **Limits on Testamentary Freedom.** The two main limitations on testamentary freedom in the United States are the elective share laws and community property regimes. All states except Georgia have either elective share or community property systems. (Georgia allows the surviving spouse one year of support, which can be more than the elective share in some cases.)

Other limits on testamentary freedom include provisions for support for the surviving spouse and sometimes minor children (in several jurisdictions), homestead and family exemptions (in several states), qualified retirement plans (which limit the ability to leave benefits to anyone other than the surviving spouse without the spouse's consent), and dower and courtesy (in a handful of jurisdictions).

b. **Community Property.** The ten community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, Wisconsin, and Alaska (opt-in state; default is common law property system).

A concern for a non-propertied spouse is if the couple moves from a common law state (which provides elective share rights) to a community property state (which may provide no protective rights to the spouse who has no separate property). Half of the community property states have "quasi-

community property" systems to provide protection in that situation (California, Idaho, Louisiana, Texas [but only for divorce, not at death], and Wisconsin).

Community property concepts are not discussed further in this summary. For a discussion of community property and planning issues with community property (including issues for migratory couples), see Items 8-11 of ACTEC 2020 Fall Meeting Musings (October 2020) found **here** and Items 1-4 of ACTEC 2013 Fall Meeting Musings (November 2013) found **here**, both available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

c. **Elective Share General Description.** Forty states and the District of Columbia have elective share statutes, providing that a surviving spouse can elect to receive a portion of the deceased spouse's estate (the traditional approach is one-third, but the percentage can vary, going up to 50%) instead of what the spouse would receive under provisions in the decedent's will (and in some cases in other documents) or by intestacy. Elective share laws generally just provide benefits for the surviving spouse and not for children.

d. **Overview of State Elective Share Statutory Systems.** The elective share statutes vary widely across the United States. Variables include the percentage applied, the extent to which non-probate assets are considered, the impact (if any) of the surviving spouse's assets, funding/valuation restrictions, and the length of the marriage (but most systems kick in fully immediately upon marriage).

(1) **Types of Elective Share Laws.** The elective share laws can be grouped into three general types of systems.

(a) **Probate-Only Elective Share**. In 18 states plus the District of Columbia, the elective share percentage is multiplied by the value of only property in the decedent's probate estate (except that Iowa, Massachusetts, and South Carolina also consider some or all assets in revocable trusts). Those 19 jurisdictions are Alabama, Arkansas, Connecticut, District of Columbia, Illinois, Indiana, Iowa, Kentucky, Massachusetts, Michigan, Mississippi, New Hampshire, Ohio, Oklahoma, Rhode Island, South Carolina, Tennessee, Vermont, and Wyoming.

(b) **Augmented Estate Elective Share (UPC Model)**. Thirteen states follow the Uniform Probate Code augmented estate model, applying the elective share to the value of virtually all property passing at the death of the decedent-spouse plus the surviving spouse's separate property, but crediting the elective share with the spouse's assets. Those states are Alaska (opt-in system), Colorado, Hawaii, Kansas, Maine, Minnesota, Montana, Nebraska, North Dakota, South Dakota, Utah, Virginia, and West Virginia.

(c) **Semi-Augmented Estate Elective Share.** Nine states expand the elective share base beyond the probate estate, but in a limited manner that includes less property than the augmented estate regimes. These nine states are Delaware, Florida, Maryland (applicable for decedents dying after October 1, 2020), Missouri, New Jersey, New York, North Carolina, Oregon, and Pennsylvania.

(2) **Other Factors**.

(a) **Length of Marriage.** A few states vary the elective share depending on the length of the marriage. For example, in North Carolina, the elective share ranges from 15% to 50% depending on the length of the marriage; in Tennessee from 10% to 40%; in West Virginia from 6% to 50%.

(b) **Consideration of Trusts.** In a few states (Alabama, Delaware, Florida, Maryland, North Carolina, and South Carolina) certain trusts for the surviving spouse's benefit count toward satisfaction of the elective share (partially or entirely), depending on the nature of the spouse's beneficial interest in the trust. For example, assets in a QTIP trust may count toward the elective share (sometimes only partially, for example 75% in Maryland).

(c) **Other Variables.** Other variables include (1) the extent to which other exemptions (such as a year's support or a family allowance) are permitted and whether such exemptions are in addition to or partially in lieu of the elective share, (2) the extent to which lifetime gifts are included as part of the augmented estate (for augmented estate jurisdictions), and (3) the time limit for filing a notice of election by the surviving spouse.

(d) **Multijurisdictional Estates.** If a couple owns property in multiple states, the states vary as to how the property is treated in the domiciliary state and in ancillary states where property is located and whether an election is required in both states (when in doubt, file an election wherever property may be). The most difficult issue is what effect an election in the domiciliary state will have on distribution of property in the ancillary state.

(e) **Case Law.** Planners cannot review just the elective share statute for a state; the elective share rules for the state may be colored by case law.

e. **Planning Alternatives For Avoiding the Elective Share.**

(1) **Title Assets in Non-Probate Form for "Probate-Only" Jurisdictions.** For states with a probate-only elective share approach, simply retitle assets in non-probate form to avoid the elective share. This could include using POD designations, changing the beneficiary designations away from the surviving spouse for life insurance or retirement accounts (IRAs can be left to persons other than the spouse, but qualified plans require spousal consent to leave benefits to persons other than the spouse). Simply transferring assets to a revocable trust could avoid the elective share in most probate-only jurisdictions (other than Iowa, Massachusetts, and South Carolina).

For augmented estate jurisdictions, other planning alternatives would be needed to avoid the elective share.

(2) **Marital Agreement.** All states allow spouses to waive elective share rights. (That is easier in a pre-marital agreement; some "sweetener" will probably be necessary in post-marital agreements.)

(3) **Completed Lifetime Gifts.** Completed lifetime gifts generally will avoid the elective share, but some states have lookback periods (typically 1-3 years), and gifts made during that time come back into the augmented estate. In most states, even deathbed transfers will avoid the elective share.

(4) **Change Domicile.** Changing domicile to a state that does not recognize the elective share or that is a probate-only jurisdiction may allow avoidance of the elective share.

(5) **Treasury Obligations.** New York law recognizes that federal law pre-empts state elective share statutes. The U.S. has guidelines on the beneficiaries of federal bonds.

(6) **ILIT.** In most jurisdictions, acquiring a life insurance policy in an irrevocable life insurance trust avoids the elective share. In most UPC jurisdictions, the spouse must survive by two years in order for the life insurance not to be considered.

(7) **Freezing.** Estate freezing techniques may limit the property subject to the elective share.

(8) **Incentives.** Offer the spouse a carrot to discourage the spouse from making the elective share election after the client's death.

(9) **Funding.** Satisfy the elective share in the most advantageous manner. For example, fund it with retirement account balances because they will be diminished by income taxes, but make sure the state will count non-probate assets passing to a spouse toward satisfying the elective share.

(10) **Property Location.** Move assets to or acquire assets in jurisdictions with more favorable elective share laws.

(11) **Divorce.** Elective share rules do not apply in divorce, only at death. If a majority of the couple's property is the client's separate property, the spouse may receive less in divorce than under the elective share at death.

30. International Charitable Giving

Brief musings from a presentation at the 2022 Heckerling Institute on Estate Planning by Martin Hall (of Boston, Massachusetts) are highlighted.

a. **No Income Tax Charitable Contribution Deduction for Direct Gifts by Individuals to Foreign Charities.** Individuals are not entitled to an income tax charitable deduction for gifts to organizations that are not created or organized in the United States, in a U.S. possession, or under the laws of the United States or any state or possession. §170(a) and (c)(2). However, contributions to domestic organizations are deductible for income tax purposes "even though all, or some portion, of the funds of the organization may be used in foreign countries for charitable or educational purposes." Treas. Reg. §1.170A-8(a)(1).

The "no deduction" rule applies even for U.S. citizens who are overseas residents, if the foreign charity receives recognition as an exempt organization under §501(c)(3), or if the foreign charity is an affiliate of or closely related to a domestic charity.

b. **Earmarking and Conduit Restrictions.** The donor may not exert control over how donated funds are deployed (no earmarking), and the domestic charity cannot merely serve as a conduit for passing donations to a foreign charity. Rev. Rul. 63-252.

c. **Options for Making Deductible International Donations.**

(1) **Public Domestic Charities With Overseas Operations.** A charitable deduction is allowed for gifts to a U.S. charity that has overseas operations, even if most of the operations are overseas. Examples are the American Red Cross and the Salvation Army.

(2) **American "Friends of" Organizations (AFOOs).** Revenue Ruling 66-79 provides a blueprint for structuring domestic organizations that can receive deductible contributions yet still facilitate support for foreign charitable organizations. Requirements include that a functional working board of directors of the domestic charity must review all requests from foreign organizations and determine that the foreign charity's use of funds will support the domestic charity's charitable purposes. Also, the board must receive periodic accountings by the foreign charity showing how the funds were used for the approved charitable purposes.

- A majority of the board of directors of the domestic organization should be U.S. citizens or residents who are not appointed by or act on behalf of the foreign charity.
- The donation to the foreign charity cannot be used for general operational support but must be used for specific activities described in the request from the foreign charity.
- Documentation should not permit or give the appearance of permitting the donor to require that the donor's donations be distributed to the foreign charity.

(3) **Gifts from Private Foundations to Foreign Charities.** While private foundations are not prohibited from making grants to foreign charities, various complexities arise regarding the minimum distribution requirement (§4942) and restrictions on taxable expenditures (§4945).

(a) **Minimum Distribution Requirement.** Grants to foreign charities can count toward the 5% per year distribution requirement for private foundations if any of the following are satisfied: (i) the foreign recipient has received a favorable determination letter as a U.S. public charity (this would be rare) (§4945(d)(4)(A)); (ii) the foreign grant recipient is a governmental unit and the grant is for specified charitable purposes (§4942(g)(1)(A)); (iii) the private foundation has made a good faith determination that the foreign charity is the equivalent of a publicly supported U.S. charity (the "equivalency determination"), supported by an opinion from a qualified tax practitioner; or (iv) the grant recipient is a foreign organization with respect to which the private foundation exercises "expenditure responsibility."

The **equivalency determination** procedures, described in regulations and in Rev. Proc. 2017-53, are very burdensome. Various organizations (examples are NGOSource and Charities Aid Foundation America) can provide outsource services to make and document that determination.

The **expenditure responsibility** elements are described in Treas. Reg. §53.4945-5(b).

If the foreign charity is the equivalent of a domestic private foundation, the grant must meet the "**out of corpus**" requirement to count toward the minimum distribution requirement of the domestic private foundation. Treas. Reg. §53.4942(a)-3(c). Requirements include that (i) the grant must be spent by the foreign foundation within 12 months of the end of the taxable year in which it received the funds, and (ii) the foreign charity must provide records to show that the foreign foundation also met a 5% distribution requirement before it received the grant and for the year in which the grant was received. Many foreign charities will be unfamiliar with minimum distribution rules and will not be able to satisfy this requirement.

(b) **Taxable Expenditures.** Private foundations are prohibited from making "taxable expenditures," and excise taxes are imposed if the expenditure is not corrected. §4945. A grant to a foreign charity that has not received a §501(c)(3) exempt organization letter will be a taxable expenditure unless the private foundation exercises expenditure responsibility or makes an equivalency determination as described above.

(4) **Donor Advised Funds.** DAFs may make grants to (i) domestic charities that perform work overseas (including foreign organizations that have received a favorable determination letter as a U.S. public charity), (ii) U.S. qualified AFOOs, and (iii) foreign charities that have not received a favorable determination letter (but if the DAF makes a direct grant to a foreign charity it must exercise expenditure responsibility to avoid an excise tax on the grant or the sponsoring organization must make a determination that the foreign grantee would meet the definition of a U.S. public charity).

(5) **Supporting Organizations.** There is no prohibition on using an SO to support a foreign charity, but requirements are complex to be able to satisfy the SO rules and avoid conduit and lack of control requirements. Using an SO to make donations for a foreign charity is rare.

(6) **Gifts Made Through Trusts.** Charitable remainder trusts (CRTs) cannot have foreign charities as beneficiaries, so do not use a CRT to support a foreign charity.

"Regular" trusts may receive an income tax deduction under §642(c) even if the beneficiary is a foreign charity. **Caution:** Trust instruments that allow distributions to charities often refer to §170(c) in describing permissible recipients. If the donor's goal is to permit distributions to foreign charities, make sure that "170(c)" is not in the definition of permissible charitable recipients.

d. **Transfer Tax Effects for Gifts or Bequests to Foreign Charities by U.S. Persons.** Estate and gift tax charitable deductions are allowed under §2055(a) and §2522(a) for gifts and bequests to foreign charities. As a practical matter, though, if the foreign charity has not received a favorable determination letter and qualified as a U.S. public charity, consider making the transfer to an AFOO that operates with the foreign charity. Otherwise, the status of the foreign charity must be confirmed, and that may entail a review process similar to the equivalency determination to confirm that the foreign entity is organized and operated exclusively for charitable purposes.

Regulations make clear that no estate or gift tax charitable deduction is allowed for gifts to a CRT if a foreign charity is a beneficiary of the trust.